Indian Private Equity:
Is It Different This Time?

Over the past several years, institutional investors have shown renewed interest in the Indian private equity (PE) market. Supported by a pro-business government, positive momentum in the public markets, and an increasingly robust exit environment, fundraising and exit activity have been resurgent. India-focused funds grew by 30% in 2018 to an aggregate of over US$7 billion raised (versus US$5.5 billion in 2017), while exits also increased consistently to reach nearly US$33 billion in 2018.[1] The world's second most populous country and the fastest growing economy has become harder for investors to ignore.

Despite our general optimism, we have some lingering concerns. A decade ago, investor sentiment and capital flows swung from optimistic to allergic. This history begs the question: Is this market on the brink of another downturn? If not, is the current narrative different enough to give global investors the confidence to lean in?

[1] Bain. 2019. "India Private Equity Report."

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The Previous Cycle

Although several factors have contributed to India's PE growth, the broad economic liberalization that began in 1991 is generally regarded as the catalyst for India's global expansion. Four years and an IMF bailout later, foreign investments had grown by over 40 times.

PE firms began to appear during this reformation. The first crop of general partners (GPs) had a hard time procuring and deploying capital given the narrow pool of limited partners (LPs) and entrepreneurs. Because PE was relatively unknown in India, founders and executives were also reluctant to cede some of their control in exchange for external capital.[2] Nonetheless, these pioneers persevered and enjoyed relative success amidst limited competition.

At the turn of the millennium, both controlling political parties in India enacted policies to spur economic development through infrastructure projects, anti-corruption bills, and other reforms.[3] Nominal GDP grew nearly threefold from US$462 billion in 2000 to US$1.2 trillion in 2007, and India found itself at the forefront of emerging markets.[4]

Investor interest proliferated throughout this golden era. Fundraising volumes tripled between 2000 and 2005.[5] With capital in hand, Indian GPs did not disappoint: From 1998 to 2005, realized gross returns averaged 25% (on an annualized basis), outpacing the 18% returns public equities delivered over the same period.[6] At the same time, India's PE penetration rate[7] stood at an average of 1.8%—much lower than that of the United States (4.4%) or Britain (4.2%).[8]

After this early success, between 2006 and 2009, more than 100 new PE firms launched funds targeting India. Yet the supply of investable companies did not keep pace with the surge of dry power. In 2013, for example, India only had 270 private companies with revenues over US$125 million. Brazil and China, on the other hand, had 1,295 and 7,680, respectively. This classic shortage case caused the valuations of private companies to skyrocket.

In 2008, the Indian economy grew 11%, seemingly unaffected by the global financial crisis.[9] However, investment opportunities for PE firms remained scarce. While valuations remained high, PE firms began to push into broader, competitive auctions, driving valuations even higher. The median purchase price multiple for sponsor-backed M&A transactions surged from 10.2x in 2010 to 12.8x in 2017.[10] Dry powder continued to grow, and many PE GPs began to show style drift, pursuing deals in the infrastructure sector.[11] Tighter bank lending and rising inflation weighed down on the returns of deals in this space.

After 2010, the number of IPOs in India fell significantly. With an unreliable IPO window, growing capital needs, and shrinking margins, India PE was challenged to realize deals at a profit.

Finally, a languishing Indian rupee (INR) affected realized returns. From July 2008 to July 2016, the INR depreciated roughly 38% against the US dollar.[12] Hampered by a small number of exits, funds that invested between 2006 and 2009 only yielded returns of 7%—well below public market averages during the same period.[13]

[2] EMPEA. 2015. "Special Report: Private Equity in India."
[3] Bahadur, Dr. Lavanya Rekha. 2014. "Trends of India's Political Economy." *Middle East Conference on Global Business, Economics, Finance and Banking*. Dubai.
[4] Trading Economics. 2018. *India GDP 2000-2007.*
[5] Preqin. 2018. *Private equity fundraising.*
[6] McKinsey. 2015. "Private equity in India: Once overestimated, now underserved."
[7] The ratio of PE investment volume to GDP.
[8] Supra note 6.
[9] Supra note 4.
[10] Bain. 2018. "India Private Equity Report 2018."
[11] Supra note 6.
[12] MarketWatch. 2018. *USDINR Currency Overview.*
[13] Supra note 6.

Is This Time Different?

THE GOOD

Despite the lackluster performance of PE over the past decade, India has benefited from a host of positive trends:

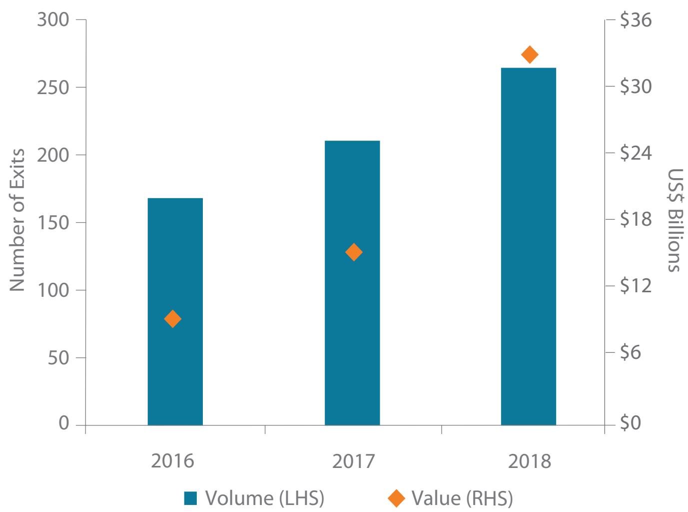
1. India continues to boast an attractive macroeconomic backdrop;
2. The Modi Administration is widely considered to be pro-business and pro-reform;
3. The IPO market in India has recovered and has been more active in recent years;
4. After several economic cycles, the PE landscape is less crowded, leaving only the hardiest GPs; and
5. These GPs have also matured, taking more of an active ownership strategy.

On a secular level, India continues to enjoy some of the most attractive macroeconomic trends in the world. GDP growth, although slower than the early 2000s, has been consistent at an average of 7% from 2012 to 2018.[14] Inflation, which was a challenge during the previous downturn, has been less volatile—falling from 10% to 3.6% between 2012 and 2017.[15]

Prime Minister Narendra Modi of the pro-business Bharatiya Janata Party (BJP) leads India's government. Since taking office in May of 2014, his administration has made sweeping legal reforms.

One such example is the Goods and Services Tax, which replaced a fragmented collection of 17 state and federal tax regimes with a nationwide tax system. These changes are expected to accelerate interstate commerce and improve the tax base. They are expected to help India maintain its status as the world's fastest-growing major economy; the IMF projects that India's economy will grow at 7.3% in 2019 and 7.5% in 2020—a full point higher than China in either year.[16]

FIGURE 1 | EXIT MOMENTUM



Source: Bain, 2019.

India has also improved its rank in the World Bank's Ease of Doing Business rankings by over 20 positions in consecutive years, edging higher in the top 100.

India's general election in May 2019 declared that Mr. Modi and the BJP will govern for a second term. Indian equity markets reacted positively, with the financial and industrial sectors recording the strongest gains.[17] Mr. Modi's victory validates the series of economic reforms that he put in place during his first term. Analysts believe he will work to actualize these policies during his second term.[18]

India PE exit momentum has seen robust growth since 2016, with the number of exits growing at a CAGR of 25%, and total exit value growing at a CAGR of 85% (**Figure 1**). The US$16 billion sale of Flipkart to Walmart in 2018 may have punctuated this trend, but exit values in 2018 were still the strongest in the last decade, even without that deal.[19] That IPOs have been the primary mode of exit since 2016 signals investor confidence in India's economy. The rejuvenation of the Indian IPO

[14] Statista. 2019. *GDP growth rate in India 2024.*
[15] "Statista. 2019. *Inflation rate in India 2024.*
[16] "Dhasmana, Indivjal, and Anup Roy. 2019. "IMF scales down India's growth projection for current fiscal year to 7.3%." *Business Standard*, April.
[17] "India stocks rally as Modi sets course for election victory", *Financial Times*, May 2019.
[18] Deutsche Bank Research. 2019. "What to expect from the new government and RBI post elections."
[19] Supra note 1.

market was most pronounced in 2017, which saw exit values grow by approximately 60% over the previous year to nearly US$16 billion. In particular, exits in 2017 were dominated by large company IPOs; the 10 largest public market sales alone accounted for roughly 40% of total exit value.[20] Although Indian startups have historically strayed from listing on domestic stock exchanges due to unfavorable regulations, which treated startups like established businesses, the market regulator has been working to attract more early-stage companies to the National and Bombay stock exchanges. Overall, the total number of public market sales increased from 45% in 2016 to 50% in 2017,[21] providing a long-awaited source of relief to PE investors.

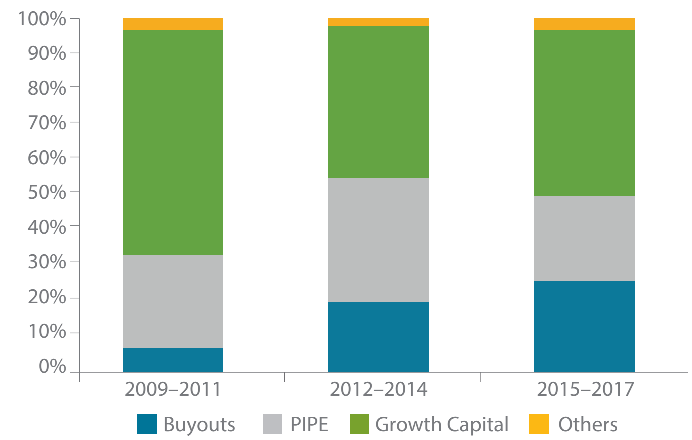
The PE landscape has also become less crowded; its participants more experienced. After weathering multiple economic cycles, the GPs that remain have come out stronger. For example, although 80% of venture capital (VC) and PE investments were minority deals in 2017,[22] GPs are becoming more focused on transactions that offer greater control over the strategic direction of a company. For example, between 2009 and 2017, the value of buyout deals rose seven times **(Figure 2)**. As a result, the most active funds in India have also begun to build out internal operating teams; they regularly hire industry veterans as advisors to help add value to their portfolio companies post-investment.[23]

Collectively, distributions have grown steadily over the last several years, increasing by a factor of four from US$2.3 billion in 2011 to US$10.8 billion in 2017.[24]

LINGERING CONCERNS

Notwithstanding secular macroeconomic tailwinds, as well as lessons learned from the past two decades, India's PE market continues to face a set of both familiar and new challenges. First, the Indian market remains expensive compared to its peers. In 2017, the median deal multiple for sponsor-backed M&A transactions was 12.8x, compared to 11.5x for the broader Asia-Pacific region (**Figure 3**). This statistic marks a seven-year high for the Indian market and a median multiple increase of over 40% since 2014.

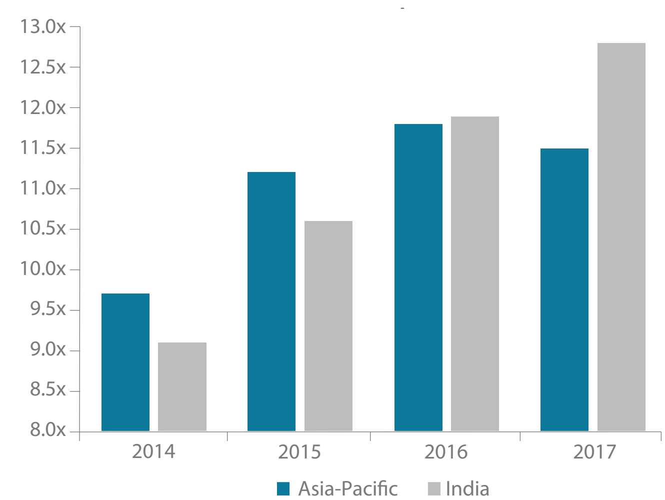
FIGURE 2 | SHARE OF INVESTMENT BY STRATEGY



Source: McKinsey, 2018.

Note: Excludes VC and real estate; "Others" includes mezzanine and pre-IPO investments.

FIGURE 3 | MEDIAN DEAL MULTIPLE FOR SPONSOR-BACKED M&A DEALS



Source: Bain, 2018.

[20] Supra note 10.
[21] Ibid.
[22] Ibid.

[23] McKinsey. 2018. "Indian private equity: Coming of Age."
[24] Ibid.

Second, the number of investable companies remains limited. In the wake of lofty valuations, GPs are once again chasing fewer but more expensive deals. Total PE investment value rose 55% between 2016 and 2018, while deal volume fell by 20%.[25] A series of big-ticket deals in the consumer technology, financial services, and insurance sectors drove this trend, while sectors such as manufacturing and IT saw a decline in deal making.

PE dry powder reached the highest point of the last decade in 2017 at US$11.7 billion[26], raising questions about supply-demand imbalance. Additionally, Indian PE firms have once again begun to deploy funds into capital-intensive projects. For example, from 2016 to 2017, investments in telecommunications ballooned by 8,400% in terms of deal value, with similar rates in engineering and construction (300% YOY) and real estate (182% YOY).[27]

Despite broad economic growth underpinned by pro-business policies, India's economy still faces macro-level risks. It imports four-fifths of its energy,[28] and rising oil prices in 2018 put pressure on India's current account balance. India's thirst for fossil fuel will not subside anytime soon. Until it does, the INR and GDP will continue to suffer: Oxford Economics estimates that for every 10% increase in oil prices, India's GDP will shrink by 0.2%.[29] India has seen large capital outflows as hot money has chased rising rates elsewhere. This has contributed to the depreciation of the INR,[30] which slid approximately 10% versus the US dollar in 2018 (**Figure 4**).

In addition, Indian GPs are facing a new tax regime under the amended Indo-Mauritius Tax Treaty. Historically, Mauritian companies that invested in India did not pay any capital gains or dividend taxes. However, the amended agreement, which took effect on April 1, 2019, requires PE investors to pay a long-term capital gains tax of 10% on investments made in India. Investments made before April 2017 will remain tax exempt.[31] At this stage, it is unclear if the new tax code will cause investors to domicile their funds in other jurisdictions.

FIGURE 4 | HISTORICAL INR/USD EXCHANGE RATE

Source: S&P Capital IQ.

India has also confronted challenges with its economic and social reforms.

To fight corruption and the black market, in November 2016, the government took 86% of cash out of circulation.[32] Since India remains a predominantly cash-oriented economy, this policy led to significant liquidity shortfalls, particularly in sectors with high levels of cash transactions (e.g., consumer and real estate). The country is still facing steep currency replacement costs as well as obstacles in creating a cashless society where over half of its population is ill-equipped to handle card-based transactions.[33]

Before that, the government launched the Aadhaar initiative in 2009 to establish a robust identification system. By providing Indians with a unique 12-digit identity number, Aadhaar has led to more digital transactions and improved transaction tracking. However, data leaks and hacks have plagued the initiative. Hackers stole personal data, including Aadhaar numbers, on more than 120 million users from Reliance Jio,

[25] Supra note 1.
[26] Ibid.
[27] Supra note 10.
[28] Nayak, Debiprasad. 2018. "Indian Rupee Hits Record Low Against Dollar." *The Wall Street Journal*, June.
[29] Tan, Weizhen. 2018. "Rising oil prices could take a bite out of India's economy." *CNBC*, August.
[30] ET Bureau. 2018. "CII suggests 12 ways to control current account deficit, rupee fall." *The Economic Times*, October.
[31] EY. 2016. "India-Mauritius tax treaty: An end and a new beginning." *Forbes India*, June.
[32] Rowlatt, Justin. 2016. "Why India wiped out 86% of its cash overnight." *BBC*, November.
[33] Vijay, Pavan Kumar. 2016. "Impact analysis of demonetization in India." *moneycontrol*, December.

one of the nation's flagship cellular providers.[34] In 2017, the Center for Internet and Society in India estimated that 130 million Aadhaar numbers were leaked through multiple government portals.[35] Until further security measures can be tried and tested, cybersecurity risks will linger in the minds of investors.

StepStone Assessment

StepStone believes that India is still years away from becoming the centerpiece of a diversified PE portfolio. However, because India is expected to become the world's principal growth engine, we believe that LPs should start thinking about how to make the region part of their broader private markets investment strategy.

LPs should approach India with cautious optimism—employing a rigorous and selective decision-making framework, while combining local expertise with experience gleaned from investing in developed markets.

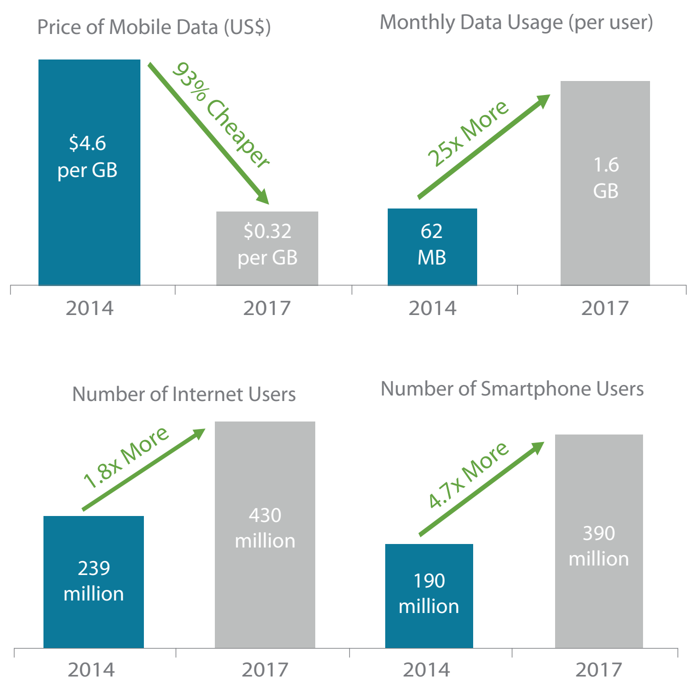
Although investors new to Asia can certainly access India through a pan-regional strategy, those who understand the merits and risks of the country can better track the strategies and managers that stand to benefit from India's thematic evolution. Those who want to partner with the managers who know the market best, would do well to consider gaining some direct exposure. To maximize the risk-adjusted value proposition of Indian PE, we believe investors who meet these criteria ought to consider venture capital, growth equity, and hybrid strategies.

VENTURE CAPITAL

In 2017, VC deals accounted for 76% of PE transactions in India.[36]

By deal volume, VC investments in India in 2015 were at the same level as China's in 2007, suggesting a long runway for growth. India has historically lagged behind China in terms of the development of its consumer internet market; however, growth in this space is being catalyzed by smartphone adoption and cheap mobile data. Chinese companies have increased their presence and investment in India, as highlighted by Alibaba's investment in Indian e-commerce platform Paytm and Didi's investment in its Indian analogue, Ola.

FIGURE 5 | THE JIO EFFECT



Source: Telecom.com, March 2018.

Cheap smartphones and cheap data are driving the mobile revolution in India. Consumers are skipping PCs and jumping straight to mobile. In 2016, Reliance Jio essentially gave millions of consumers free access to its data network.[37] This sparked a race to the bottom for cheap data rates, which led to an average increase of 25X in data usage per subscriber between 2014 and 2017 (**Figure 5**).

[34] Barbaschow, Asha. 2017. "India's Reliance Jio suffers data breach: Report." *ZDNet*, July.
[35] India Today Tech. 2017. "Aadhaar data of 130 millions, bank account details leaked from govt websites: Report." *India Today*, May.
[36] UBS Private Funds Group. 2018. "Asia Private Equity Overview."
[37] Mundy, Simon. 2018. "Reliance Industries' Jio reshapes India's telecoms market." *Financial Times*, March.

GROWTH EQUITY AND RISE OF BUYOUTS

McKinsey research suggests that sponsor-backed companies in India have improved revenues and earnings faster than their public counterparts—regardless of sector or vintage. Additionally, they tend to be better governed, more compliant with regulations, and more likely to engage in M&A activity.[38]

GPs have increased their focus on transactions where they have greater control over the strategic direction of a company. The transactional value of buyout deals between 2015 and 2017 grew more than seven times over the period between 2009 and 2011. As a reflection of this strategy shift, the most active GPs have built out internal operating teams and regularly engage industry experts to help add value post-investment.

HYBRID STRATEGIES

Stressed assets in India account for close to 13% of total assets, and the central bank projects that capital adequacy will continue to deteriorate.[39]

Indian GPs that are capable of using hybrid strategies (i.e., structured credit solutions) may capture value as the government seeks to resolve the country's growing nonperforming loans problem. Since many large Indian businesses and SMEs are family owned, the promoters prefer to maintain control, opting for debt instead of equity financing.

Further, bankruptcy and insolvency reforms made in 2018 have accelerated what were formerly perceived to be more company-friendly bankruptcy proceedings. To catalyze implementation, the government has forced some creditors to take action against certain companies, imposed strict timelines, and barred the owners of defaulting companies from the bidding process.

Conclusion

Indian PE may not yet be ready to be the centerpiece of an investor's private markets portfolio, but after two decades of growing pains, the sector is showing signs of promise. Any investor keen on tapping into the country's strong secular tailwinds and adding geographic diversification to their portfolios should begin building relationships with the many GPs who survived the tumult and emerged smarter and more resilient as a result.

Continuity, in the form of a second term for Prime Minister Modi, should also create an environment that allows business conditions to improve. Partnering with local managers who understand India's idiosyncrasies can help investors descend into the particular, to better understand attractive opportunities in VC, growth equity, and structured credit strategies.

[38] Supra note 23.
[39] Reserve Bank of India. 2017. "Financial Stability Report."

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