INTERVIEW OF THE MONTH

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INTERVIEW WITH:

Mr. Padmanabh Sinha

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- By Dhruv Chadha

EXECUTIVE ACCESS
INDIA'S LEADING GLOBAL SEARCH FIRM

Paddy Sinha is a private equity veteran and also has entrepreneurial and investment banking experience previously. He is currently the Chief Investment Officer & Senior Partner of Tata Opportunities Fund, which is already the largest first time private equity fund from India. Prior to this, Paddy was Managing Director – India at Temasek Holdings and was part of Temasek's founding India team in 2004, prior to which he was with ICICI Ventures.

Paddy also had an entrepreneurial stint as founding team member & President of eGurucool.com, an e-learning business funded by ChrysCapital, Star TV and International Finance Corporation, which he eventually sold to a listed Indian corporation. Paddy has served on boards of many Indian companies including Bharti Infratel, Tata Sky, Ginger Hotels, Fame Cinemas, Punj Lloyd, etc.

He is an MBA from the Indian Institute of Management, Calcutta and a Computer Science engineer from the Birla Institute of Technology and Science (Pilani), India.

You have been in the PE investing space for more than a decade now and have witnessed its progress in India since its nascent stages. How would you say the PE market in India has evolved over this period?

I think we have seen a distinct up-cycle as well as a down-cycle in the industry. Prior to 2006, returns were higher given that there were fewer Private Equity players around and public market valuations were relatively attractive. During 2006-07, a couple of things happened - an increasing number of global private equity funds started entering India and more local private equity funds were being raised, which led to a lot of competition for deals as both groups were keen to build out investment positions in India. Simultaneously, public market valuations (often used as a benchmark for private equity valuations) were approaching peak levels. Against this backdrop, pricing discipline wavered and I think this is now reflecting in terms of the performance of some deals done during this period.

Today the environment remains challenging, in the sense that the low hanging fruit are gone, but opportunities do exist to make returns. Previously a lot of the deals that were done were 'vanilla' growth capital investments, but I think going forward we will see funds with more differentiated investing styles and also more innovative deal structures to the extent that the regulations permit.

With the number of PE funds increasing drastically in the market, what according to you is the most important differentiating factor among the players?

One factor is in having a differentiated position in terms of deal sourcing / origination capabilities. In most cases these would arise out of focused strategies (sector, stage or theme) which can provide deeper access to specific networks or ecosystems. The differentiated position could be in the form of synergies across a large portfolio company network or access to a large corporate group, etc. These networks can play an important role in deal making and enable a fund to differentiate itself.

Another differentiating factor would be the ability to identify and invest early in sectors where there is likely to be some disruptive or extraordinary growth. Historically, these are the sectors that have provided superior returns. I think the EPC (engineering, procurement & construction) sector is a good example: early investments in the sector did very well riding the services play to the infrastructure build-out theme, but eventually price to earnings multiples rose from single-digits to over 20 times for these companies. These valuations then priced in near perfect valuations at a time when their order books and balance sheets got impacted by a variety of issues including rising interest rates and high debt, and so investments made later on didn't fare well.

Another factor could be innovating in terms of deal structuring and exits - for instance, when there is a valuation disconnect, exploring earn-out structures, etc to bridge those gaps. A key factor in this business is discipline in terms of entry valuations as well as the willingness to modulate the pace of investments, because there will be some points in time when there are attractive deals available and others when there are none. A fund that is able to accelerate or decelerate its investments in a meaningful manner and not be carried away by the market momentum (or lack of it) will be able to differentiate itself.

What has been your observation on the talent available in this sector?

PE funds have now been around for quite a few years and at the senior level there are people who have experienced the full PE investment cycle in India. Around 7-8 years ago, PE funds needed to recruit senior talent from Investment banks or consulting firms or bring in expats with overseas PE experience. Today, there is an adequate pool of talent available at senior levels, people with experience in fund deployment and exits, as well as fundraising.

At the middle and junior levels, the pool is still limited, but we have talent available from investment banks and consulting firms that can be groomed by senior professionals with the relevant experience.

An interesting trend in this sector has been that there has been a significant amount of churn which is atypical for a sector like PE given that the compensation is linked to 'carried interest' which is of a long term nature. However, this could also be attributed to the fact that this industry is relatively new in India and there have been new funds entering as well as experienced people leaving institutions to raise capital in more entrepreneurial formats, but having said that, we can expect to see some stability now as the industry matures.

India was the fastest growing PE market in Asia in 2011. Why do you feel are Indian entrepreneurs looking at PE as their primary source of funds?

In the past, many Indian companies listed prematurely in public markets, which is clear from the fact that we have a lot more publicly listed companies in India compared to many developed nations. Public listing was a preference given the lack of alternate sources of funding and promoters' preference for passive public market money over 'smart capital' from Private Equity, which came with strings attached, like board seats, involvement in corporate strategy and sign-offs for large investment decisions.

Now, the IPO market has become very difficult because of various macro issues and the relatively poor performance of the IPOs in the last few years. Almost 75% of the companies that went to IPO in the last few years are trading below their IPO prices, so now there is a very selective interest in IPOs and investors are looking for IPO pricing that gives them a margin of safety. An offshoot of this is that due to the poor performance, many of these smaller listed companies have also been unable to raise follow on capital to fund growth.

Against this backdrop, entrepreneurs have begun to realize the dangers of listing prematurely and the value of having PE investments in their companies. Even if they were to subsequently go and list in the market, having an Institutional or PE player as a shareholder helps their case. Also with rising interest rates, the willingness to turn to Private Equity (as opposed to borrowing further) is increasing.

Over USD 50 billion has been invested in India over the last decade in terms of PE and VC capital however the current scenario seems to be different. A governance deficit, a slowing economy and a ballooning fiscal deficit have dampened the investment climate. Where do you see this space heading in the next 12-24 months?

PE is a long term game, so ideally one should look at a horizon of longer than 12-24 months. However, as I mentioned, relative to pre 2006, the easy pickings are gone. Funds can no longer go by buying the macro India story, which is also not very good at the moment. Investors today need to identify sectors with some element of disruptive growth or competitive advantage for the companies, and then given the weak macro conditions globally and in India, must necessarily build in conservative macro assumptions when valuing these companies.
From a medium to long term perspective, the India story is still attractive given that hopefully we should have some pickup in policy action and long term growth will likely remain in the 7-8% range. India's favourable demographics mean that productivity per capita should improve, which in turn will lead to growing incomes and discretionary spends etc. Then the low base of infrastructure and the crying need for high infrastructure investments is likely to sustain for a few years. It's important to note that the companies which outperform within this context should grow faster (than 7% plus inflation), and this means that there should be no shortage of investment opportunities going forward. It is really more a case of finding the right management teams and mitigating some of the regulatory risks, and finally ensuring valuations provide some margins of safety.

Keeping this in mind, and given the lower benchmark set by public market valuations relative to recent years, I think the coming years could be good vintages for PE investing in India, for the PE teams that execute well.

Against this backdrop of volatile markets, the LPs are becoming increasingly selective and are keeping a tight grip on their investments. How difficult is it becoming to raise funds in an environment like this and how are you dealing with this problem?

Globally the mood is quite cautious for the pockets of money that invest into funds. Europe particularly is having serious problems so some of the traditional investors are quite cautious and the situation is similar with the US. In addition to this, there has been serious underperformance by some Indian PE funds investing post 2006. So LPs, particularly those with exposure to Indian funds of recent vintage are cautious, and many of them will not increase their India exposure until they see some returns. This is counterbalanced to an extent by the fact that the centre of gravity has now shifted from the West to the Emerging markets, so a lot of LPs who previously had no exposure to countries like India need to build positions.

Overall, the fundraising environment is difficult and many India funds have been reported as not being able to raise successor funds or exiting due to lack of LP interest – and then some global or regional funds like 3i and Jardine Rothschild Exor are reportedly shutting shop or cutting down in India. Against this backdrop, you need a strong differentiated story to raise capital. For instance, at the Tata Opportunities fund, which is a new fund, we have been relatively fortunate given the differentiated story that we have by virtue of proprietary Tata group deal flow. We managed the largest fund-raise in India in 2011 and have already raised USD 600 Mn with a final close due later this year. Besides that I think a few players with strong track records will manage to raise follow-on funds largely from their existing LPs (for example Chrys Capital raised over USD 500 Mn recently), but for a new or relatively new fund, fund raising is becoming increasingly challenging.

The number of exits by PE firms has been going down in India. Where do you feel are the PE funds going wrong in managing their exits from their portfolios?

My opinion on exits is that PE firms have been overly reliant on IPOs for exits and need to look at more avenues of exiting investments, like secondary sales. For instance, newer funds such as ours would be open to providing an exit to existing PE funds if the companies and the valuations are attractive. There are a number of PE investments made 6-7 years ago that would need to be exited as the fund life draws to an end, which implies quite a lot of supply. I personally don't think that the IPO market is currently conducive to providing exits for these PE investments.

The other thing I've seen based on experience is that it is a good idea to stagger exits and maintain some discipline in this regard, because it's very difficult to time an exit perfectly. By staggering exits, one can liquidate a part and keep a part for higher returns, and this helps average out returns in volatile markets.

Ultimately it boils down to the fact that though exits may be possible in a number of ways, it's also a question of price expectations, because a lot of PE firms are seeking to exit at artificially high prices linked to their high entry prices and their need to show a return. The problem according to me is not that exits aren't feasible, even in the current environment; it is that unrealistic price expectations can make them difficult.

There has been a heightened interest in e-commerce by PE & VC funds. What has prompted this interest, and under the present circumstances, is E-Commerce a safer bet than any other sector?

It's usually the case that a certain sector is the 'flavour of the month/year'. If you are one of the earlier investors, it could work well for you in a theme, but when everybody wants to play this theme, valuations become frothy. Investors need to be careful because they need to build some margin of safety. If you assume perfect execution at all times, you are bound to trip up at some point.

As for E- commerce specifically, I think some of these internet players are pretty nascent at the moment and are still stabilising their business models - the intricacies for example in the cash on delivery model in India with a large number of sales returns, and there is still no clarity on the steady state profitability of such a business model. The internet story is certainly going to grow though with increasing broadband penetration and the youth in India being very comfortable with online transactions.

How has the government impacted the growth of the PE space over the years? What kinds of reforms are required for the immediate growth of this space?

There have been some positives and some negatives by the government when it comes to the Private Equity space. SEBI recently announced AIF (Alternative Investment Fund) regulations and those have been welcomed by PE players as it has given clarity on domestic funds. As widely reported the Tax related GAAR provisions have increased uncertainty for all international investors, including dollar denominated private equity funds. Also, presently FVCI status (Foreign venture capital institutional investor) is only provided for foreign PE investments in a narrow set of sectors like biotechnology, infrastructure, nanotechnology etc. If the benefits of investing through FVCI could be extended beyond these narrowly defined sectors, it would be a push for the industry. Given India needs to attract foreign investment on the capital account and private equity is a very important long term and stable source of global funds, a stable and favourable regulatory regime for offshore PE funds would be welcome.

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