

# Indian outside, phoren inside

India's PE industry is booming. But domestic policies, including tax laws, ensure most funds have to be raised abroad

First, the good news: private equity (PE) in India is on a rebound. Deal volumes in 2010, at \$9.5bn, are more than twice the volume in 2009 at \$4.5bn. Going forward, deal volumes in the current year and 2012 are expected to stay strong and perhaps improve. Next, the bad news: less than 20% of the capital provided in this asset class will come from domestic sources. What is worse, but not surprising, is that this percentage is expected to drop in the future\*.

Contrast this with what is happening in China: there is a clear and strong trend of domestication of the PE industry. The regulatory environment in China has continued to evolve to support a domestic PE industry. In 2010, of the \$18bn of fresh capital raised by the PE industry, nearly half was RMB-denominated capital\*\*. Both indigenous and global firms are setting up RMB-denominated funds organised locally. Domestic PE in any country refers to those PE funds that are domiciled locally as opposed to being organised in offshore domiciles (offshore PE funds). The trends in China are driven through conscious efforts by regulators to promote the systematic development of private capital markets aligned with national interests. In fact, regulators globally are increasingly aware of the need to balance the source and character of capital inflows into their economies.

In India, we should draw our own lessons from experiences post the 2008 Lehman crisis. An extreme and unbalanced reliance on foreign capital flows ended up coupling our economy to the global financial crisis, even though fundamentally we are a fairly insulated economy. Simply speaking, a capital market controlled by foreign investors placed the average Indian retail investor

in harm's way despite a largely domestic economy. In order to prevent a repeat of the same, we need to ensure a balanced development of our capital markets, both private and public. The focus should be on providing a level playing field to both domestic and offshore PE funds. Not by making life more difficult for offshore PE but by removing the systemic disadvantages for domestic PE.

In order to promote the domestication of Indian PE, we need to address four systemic issues. First, organisational—how does one organise a PE/VC fund in India? The enabling laws needed to help funds organise themselves do not exist in an optimal form in India. Indian funds are organised under the Indian Trusts Act, 1882, under a structure ill-suited to this form of capital. On the other hand, funds in other parts of the world are largely organised as limited liability partnerships (LLPs). Investors need a tax transparent structure under which they can organise themselves and hand over the management to a professional manager who, in return for certain economics, assumes fiduciary responsibility and liability. The Indian LLP Act was for many years the promised solution to the problem until it actually arrived. One of the biggest beneficiaries was supposed to be the fledgling domestic PE industry, but that hope was destroyed as soon as investing was denied as an acceptable purpose of LLPs. The final rites were conducted by the Finance Bill, 2011, which introduced MAT for LLPs.

The second issue is a hostile and volatile tax environment. Investors that

invest in domestic PE funds face multiple incremental risks. Investors risk higher taxes, being taxed twice, being denied tax credit in their home domiciles and frequent changes in taxation rules. As a result, global investors prefer to invest in offshore funds that are organised in offshore domiciles and which invest in India through the FDI route. An investment into a PE fund implies a long-term contract between the investor and the fund manager. No wonder, under the current environment, domestic PE funds are able to attract capital only from domestic investors and not global investors. Domestic investors do not have the choice of investing in offshore funds whereas global investors do.

The third issue is dysfunctional regulation. Domestic PE/VC funds in India are regulated by Sebi under the venture capital funds (VCF) guidelines. Current regulations place domestic funds at a disadvantage when compared to offshore funds. They do so by restricting the scope of their activities and the breadth of sectors where they invest. The underlying logic for the same is mysterious. Is there a single sector in the Indian economy that does not need capital or innovation? In India, these regulations again promote choices in favour of offshore funds that invest under the FDI regime, which is a far more liberal regime.

Finally, domestic PE in India suffers from the lack of a domestic investor base. Normally, the institutional investor base for PE funds comprises of institutional investors such as pension funds, banks, insurance companies, ed-

ucational endowments and charitable institutions. Investors also include private sources such as family offices and HNIs. While there is some evidence of an emerging HNI investor base, the institutional segment in India is unusually weak. Restrictive regulations are the primary reason behind this. For eg, pension funds cannot invest in PE funds.

A domestic investor base will provide an incentive for funds to organise themselves domestically and also help impart a local and more relevant character to their investing behaviour. Support from local institutions also has an important signalling effect on global investors. The presence of domestic investors is seen as a measure of validation and credibility. In the short term we can, of course, build a domestic PE industry based entirely on a global investor base but in the long term there is no substitute for a domestic investor base.

India needs substantial amounts of capital on a long-term basis. Not only do we need to promote the growth of our capital markets but also work to ensure that they retain a strong domestic character. We have ended up exporting our capital markets abroad. It seems that our craze for 'phoren' has not abated with time. A strong domestic character in our private and public capital markets will help our economy and entrepreneurs. Clearly, other countries such as China get it. When will we?

\* IVCA Bain India Private Equity report 2011

\*\* PwC Asia Pacific Tax Bulletin April 2011

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