

**T&I ASIA**

**INDIA**

**SPECIAL**

**REPORT**

**PART ONE: Private Equity**

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## PE, Growth and Expansion Capital Investing in India

**THIS IS THE FIRST OF THREE STORIES IN T&I'S SPECIAL REPORT ON ALTERNATIVE ASSET INVESTING IN INDIA:**

### THE PARTICIPANTS

**Nilesh Mehta, Aureos.** We raised a \$100 million fund for mid market investments in India last year. We've made about 4 investments and committed about 35% of that fund so far into the SME sector, which we define as appropriate for a local



**From the Left: Hetal Gandhi, Rajesh Segal, Nainesh Jaisingh, Nilesh Mehta, Gopal Jain**



economy and which in the Indian context translates into \$5 million to \$10 million per transaction. We invest in what is really expansion capital. We tend to be sector agnostic. Before joining Aureos I ran a fund called

Infinity Ventures, which was a cross border India-US technology fund in partnership with Advent International. There we focused on the IT, BPO and services sectors and helped US companies come to India to outsource and do business.

**Gopal Jain, Gaja Capital.** Gaja Capital is an India-focused, independent private

equity firm. We're currently investing out of our second fund. Our investors comprise both global LPs as well some of the largest Indian institutions and families. Our strategy is to find emerging sectors and to invest in emerging companies in those sectors. So far we've invested in education, retail and financial services. In terms of my personal background I've been investing in India since I was a teenager, but professionally I've invested for the last 17 years and in private equity since 1995 so I concede that I began investing in private companies before I knew what private equity was all about. A few years ago, we started out by describing ourselves as sector agnostic, but what I think we really meant, was multi-sector and while that might be seen as a play on words, we see ourselves, not purely as an opportunistic



investor, but as a top-down investor. Because we invest across sectors we seem to be opportunistic.

**Rajesh Sehgal, Templeton.** I work for the Templeton Emerging Markets Group. On the public side everyone is familiar with our emerging markets equities business that Dr Mark Mobius



runs. What is not well known is that within this emerging markets group is a private equity sub-group that essentially leverages off our emerging markets presence and the network that we have built since that

business started in 1987. The mandate is very similar to what we do on the public equities side, with the essential difference being that we focus on small to mid-size companies which we classify as companies smaller than \$500 million in market cap. Sector wise, we follow the same philosophy as the public side. We're completely the opposite of what Gopal just said, in that we're completely sector agnostic and we work completely bottom up, focusing on opportunities on the ground rather than allocating capital across sectors. And as we do on the public side, we follow a value investment philosophy, so over the last three years, as you can imagine, it's been tough for us to do deals in this market, simply because any deal that comes up from the ground is compared with businesses in other emerging markets. Fortunately or unfortunately, time will tell and although we haven't been able to do very many investments in this market, we do have three investments in India. I joined Dr Mobius in 1999 on the

public side and in 2000 when we started off in private equity, I volunteered to be a part of this business. And although it's a small component within the overall emerging markets assets that we have, there is a lot of focus and attention that the investment committee gives to this product. We are now in the process of raising our third fund for emerging markets. In terms of investing, we're a team of six, spread across different geographies and we work very closely; so our people in Vietnam or in Moscow, work alongside me in emerging markets in China, Russia and South Africa. We are not country focused but the three key economies where most of our money goes are China, Russia and India. There is no allocation saying that this much money has to go into India, Russia or China; it depends upon what comes up from the ground.

**Hetal Gandhi, Tano Capital.** I co-founded Tano Capital in India along with Chuck Johnson and Carlton Pereira in 2006. Prior to that I spent 17 years at IL&FS in India, where I set up and led the Private Equity Group of IL&FS for 7 years before becoming the CEO for its financial services business in 2002. Chuck



Johnson, Tano's founder, is the former Co-Ceo of Franklin Resources, a firm founded by his family and now listed on the NYSE. FRI manages the Franklin Templeton funds globally with assets of over \$600 billion. Johnson had guided Franklin's establishment of Indian funds early in the 1990's and on founding

Tano we teamed up with our firm's third partner, Carlton Pereira. Carlton is the former Managing Director for KPMG in South Asia including India. Prior to that Carlton was partner at Ambit Capital, which he co-founded. Tano India raised its first fund of \$100 million in India in 2006, with a focus on growth investments. Tano India Fund I is substantially invested, and we are now preparing for our second fund with a target raise of \$300 million.



**Nainesh Jaisingh,**  
**Standard**  
**Chartered**  
**Private Equity.**

SCPE invests in Asia from the Bank's proprietary funds, since 2002, in China, India, Southeast Asia and Korea. In 2003 SCPE formed a

joint venture fund for India with Temasek, the Merlion India Fund, which is fully invested and which has returned about 5 times its capital invested for its four investments. Since then SCPE has been investing in India from our proprietary book in deals across sectors in areas including, BPO, shipbuilding,

**HG: THE SUPPLY OF PROPRIETARY DEALS IN INDIA ... DOESN'T EXIST.**

software, engineering and pharmaceuticals. We've been agnostic for our sectors. We've got a five man team in India where we focus on growth capital and where we've been looking for buyouts. I started in corporate finance and advisory at ANZ Investment Bank, moved to Singapore in 2000, to set up a corporate venture fund for Standard Chartered to invest in technology.

**DEAL FLOW AND PROPRIETARY DEALS IN INDIA**

**Nilesh Mehta (NM):** A big differentiator for proprietary deals, is found in the size of the deal and in the sector; the ability to source proprietary deals, is substantially different in different sectors and for different sized deals. In the fund that we run, we focus on deals in the sub-ten million deal size. We have ample scope to originate deals in our segment. I have friends who are at larger funds who are investing from \$15 to \$20 million per deal and when I look at their deal flow and their inability to originate deals in their segment, I don't complain. In discussing proprietary deal flow we should begin by answering the question of what is a proprietary deal because this is a topic that we hear a great deal about. Then we can address how one generates deal flow, what is the quality of deal flow at present and how a GP can use deal flow to differentiate itself from other GPs.

**Hetal Gandhi (HG):** In today's environment, the supply of proprietary deals is significantly limited; unless you're talking about original ideas, it virtually doesn't exist. But there are opportunities, where one can use relationships and knowledge of business to be ahead of others. I think this is the only real advantage one can generally have in most situations. We recently made an investment in ABG Motors, which truly falls in the 'proprietary' category. My partner, Carlton Perera has extensive relationships in Europe due to his years of presence in M&A. Sometime back, we met with one of his former associates, and he showed us a company that made flame proof motors that was up for sale. Motors is a generic business with applications in every

engineering industry, but flame-proof motors require special processes and technology. This is to insure that the motors can withstand the high



temperatures that one finds in applications like in case of power, mining or refining industries. It was a really attractive deal and we were pretty excited because this company appeared to have identified a sweet spot in the motors space and

had a good brand in Europe. We looked into our prior relationships and identified the ABG Group, an investment of Nainesh, as a possible suitor. ABG is a shipbuilder with plans, that we were aware of, to build a presence in the engineering businesses. A new company, ABG Engineering, had just been formed to focus on manufacturing of turbines, diesel engines and motors. They were staffing up the engineering group, including with a former CEO from a

**NM: ...IF I WANT TO PUT \$50 MILLION TO WORK YOU CAN BE SURE THERE IS NOTHING PROPRIETARY ABOUT A DEAL.**

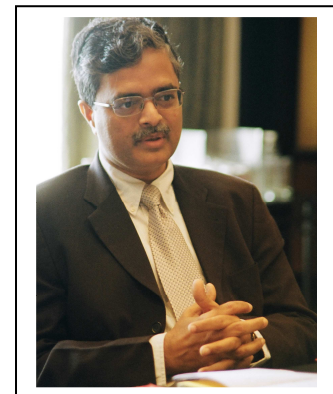
leading motor company. Thus, there was a clear synergy. We presented the acquisition opportunity to ABG and it turned out to be a perfect fit. The motors business was consolidated in ABG Motors which then acquired CEMP, the Italian company introduced by Tano. Carlton spent a fair bit of time in negotiating and structuring the acquisition, and in the end we own 40% of ABG Motors (which now includes CEMP) for a \$15 million investment.

**GJ:** I think you're talking more about privileged access than about the proprietary origination of deals.

**NJ:** Absolutely. It's rare to have exclusive access to deals.

**GJ:** There are ways to develop proprietary deals that depend on a few things. First, the size of deals you're looking at. If you're looking at smaller companies, the level of the financial sophistication of smaller companies is less than that of larger companies. Their ability to move on their own is less than that of larger companies. So naturally investors that do mostly smaller deals, talk in terms of doing proprietary deal flow. The second aspect of this discussion is whether you're approaching deals from a bottoms-up or a tops-down approach. Those funds that have a sector approach often think like entrepreneurs. And because they think like entrepreneurs they have to ability to move ahead of the curve, they have an extra moment make their deals.

**NM:** I agree, it depends upon size. When we began investing in 2001, \$10 million would get you a great deal with no competition at all and the



entrepreneur would sign your terms whatever you asked for. Today, if I want to do a \$10 million deal, it's still the same. You still get entrepreneurs who aren't very sophisticated, who aren't very savvy, they don't have access to the best investment banks. We still find those deals. But if I want to put \$50 million to work you can be sure that there is nothing proprietary about your deal; if you do have a proprietary deal at

\$50 million then either the promoter is naive or you're an insider. Look at the numbers for last year. Some 400 deals were executed. In larger deals, I can get maybe five or more of these guys to bid, who will kill each other and give me the best price. There were 120 to 150 deals which were less than \$20 million each. And I think that is where the intermediary role is limited, because while there are investment bankers, they have no time to do \$5 million or \$10 million dollar deals so you end up talking to your accountant, your lawyer



or your trusted advisor, whom ever he may be. And he does investment banking work, though he may not be qualified to do so. So the process takes time. And to make a counterpoint about deals within the larger segment, I think that people look at these

deals as a partnership. I think that they want to do deals with people with whom they feel comfortable and that makes a lot of difference in deals being done. Entrepreneurs understand that if they shop around they may get ten percent more valuation, but then they have to live with an investor for the next three years. So if they're comfortable with X, they'd rather get into that deal with him.

**NJ:** Because we're value investors and we're careful about what we pay, but my experience so far has been that if he is going to dilute ten percent or less to you, then he is not going to care about how stringent you are or whether it's a three year or a five year relationship; it's just an "okay, give me ten percent." I've seen deals walk out of my door for ten percent more. I think that there are

different kinds of entrepreneurs; there are guys who come to private equity investors for the right reasons and there are guys who come to us because maybe there is a big check on the table, because an IPO doesn't look that easy to do, or because its too painful a process to list the company, and they say look, here is a firm that can give me a big slug of cash, but I can get maybe five of these guys and get them to kill each other and

### **NJ: ...I CAN GET FIVE OF THESE GUYS AND GET THEM TO KILL EACH OTHER ... THEN GIVE ME THE BEST PRICE.**

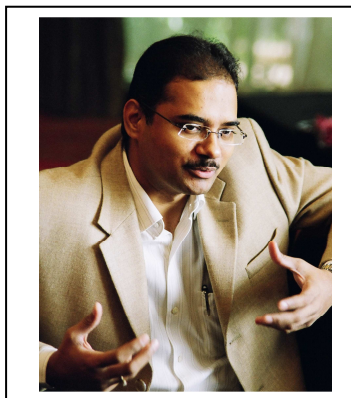
then give me the best price. What we do right up front, is to try and understand what kind of guy we're dealing with. Is this an auction kind of a guy, or is this a guy who wants private equity for the right reasons. Powerica, in which we invested \$50 million dollars six months ago, an unlisted company, could have gone public, but instead said, I'm not ready. I need somebody like a private equity firm, who has taken companies public, to sit us down, get us ready. It may take a year or two, but we're in no hurry. We want to IPO when we look solid to the market and not just because we're part of the momentum game. That strikes a chord with us.

### **INDIAN SPIN-OUTS VS INDIAN STARTUPS**

**Hetal Gandhi:** Our view is that the spinout phenomena is not due to any significant changes in government policy or business requirements or due to the economic environment or a new generation of entrepreneurs arriving; we think it is more due to perceived need to manage the market valuations. People ran out of ideas about how they could talk up the value of the share prices of

their companies; valuations had run ahead of themselves, sometimes well into the future for three, four even five years. I think that is when spinouts were born. We have as many investment bankers and private equity investors working for companies as CFOs as there are working outside of companies. If you look around, most of the spin offs have happened not due to business reasons but out of a desire to sustain and or increase market capitalization of companies.

**RS:** I think that the spinout phenomenon is partly a reflection of the team at any point in time. So that in some cases a spinout is based on an interest in diversification when people want to have a diversity of businesses within a company. But at some point, focus



becomes the mantra and companies say that they want to focus on something and then they want to spin out all of their non core businesses and that creates an opportunity. And I believe that today we're passing through the phase where people say that

focus is a virtue in business. If you are focused and have a specialization you will have a better market capitalization. Ten years back, everyone was on the theme of diversification; everyone wanted to do everything.

**GJ:** One of the changes that we're observing is the one that is happening in the larger corporate houses like Bharti, Reliance and Tata. In the 1980's Reliance was just an upstart company, not the 200,000 person company it is today. It was an SME going public in 1978. Bharti was an SME in the mid-90's. Some of us are now trying to find

the next Bharti and Reliance. Analyzing the Nifty 50 years over the years up to 1997, two-thirds of the companies that were not owned by multinationals or the government were family led. Today, while only one-third of the Nifty 50 companies are family led, some of those vibrant, large, traditional family houses are going from strength to strength.

### **RS: ... WE'RE PASSING THROUGH THE PHASE WHERE FOCUS IS A VIRTUE.**

**NJ:** I totally agree with that. In fact I would say that the bigger trend over the last five to seven years has been the unshackling of the mid-sized entrepreneur. What was happening over the last forty to fifty years of India's history since independence was that the large houses controlled access to opportunities they had privileged access to licenses in the license era, to capital and to India's capital markets which were quite shallow and access to institutional funding. If you look back at the ICICI, IFCI and IDBIs of the world, the large developmental institutions as they were called, they were substitutes for today's private equity. They were taking large positions on debt in companies. They were actually able to see them through that period of development. The mid-sized entrepreneur never had access to those institutions; he'd get killed anytime that he even got close to them. Today as capital markets have opened up, private equity and other asset classes are open to backing mid-sized entrepreneurs. A Bharti, for example, without a Warburg Pincus, would have struggled to come to terms with the Reliances of the world. Suzlon, the BPO industry in India, without venture capital and private equity might not have succeeded as they have. I think that what has happened in

India, in similar to what happened in China with Foreign Direct Investment (FDI) but in India it is happening with private equity and venture capital. The spin-offs from the Tatas and the

### **GJ: ...INVESTMENT BANKERS HAVE INCENTIVES ... ALMOST ANTITHETICAL TO THOSE OF THE INVESTOR.**

Reliances would have happened anyway, because they see a vibrant capital market, and they say “hey, here is some embedded value,” in investment banking terms, “let’s go and monetize it.”

### **ISSUES IN DEAL MAKING IN INDIA**

**NJ:** One problem is that you cannot get registered with the intermediary community in India unless you do a certain type of a transaction. And at the same time, the intermediaries have a short list of promoters who they think will fit the bill and they approach those people to say, look I think this is your kind of a deal. Because they’re looking at the probability of a deal getting done, so they go to three or four guys. They don’t go abroad anymore. They used to. When we were all based in Singapore, all of the private equity houses were based within one square kilometer. When promoters and investment bankers came to visit, every house saw every deal. There were few deals and few houses. But that is no longer the case.

**GJ:** I believe that investment bankers are very smart about making us all feel very special. But the issue I want to discuss, returns us to the question about the level of financial sophistication that an entrepreneur has. In India not all entrepreneurs want or manage to find intermediaries. I think that the number of intermediaries, finding entrepreneurs, waxes and wanes with the markets, but

finding intermediaries has gotten much more difficult than it was a few years ago, based upon demand and supply. And as a result, the lives of all of us have gotten tougher, because there are entrepreneurs who are not in the hands of intermediaries.

**T&I:** Maybe you could comment upon the quality of intermediaries and what goes into making up a good or a bad intermediary?

**GJ:** Are there any positive roles of intermediaries?

**RS:** Just four or five years ago, I was sure to have seen any deal as it would pass across my table. That is not the case now. I am seeing a lot of things happen, where I’m sure that an intermediary has taken deals to three or four, investors who they think have the highest probability of doing the deal.

**GJ:** I take all of this with a pinch of salt. We’ve all been in this market for such a long time. Many of the investment banks

in India are run by people that some of us consider our closest friends. But in fact there is a self-defeating argument about this because investment bankers have incentives on parameters which are almost antithetical to those of the investor. I’d be bothered if I were the first choice of an intermediary.

**NJ:** I don’t think that the concept of a first choice exists. I think it’s just a question of the investment banker’s convenience. He is not going to talk to twenty investors about a deal. He is going to talk to five.

**GJ:** The deal will be shopped around but not to everyone; a function of the



number of deals having gone up. Maybe in 2001 and 2002 there weren't many guys doing deals...

**NJ:** It's just too tiring to have twenty guys meeting management, so they're doing fewer meetings, they say okay, lets go with five, a half dozen, and we'll make them kill each other.

**GJ:** one other aspect of this is the value added proposition. The way the deal dynamics work, is that they are a function of the deal sophistication of the issuer and of the value proposition for the subscriber or the capital provider.

### VALUE-ADD AND SECTOR FOCUS

**RS:** There are two things that we manage to bring to the table and where we have a lead over the others here. First of all in pre-IPO investments. At Templeton, we love the Pre-IPO for the very simple reason that when you go to the market with the Templeton name, it definitely helps in the emerging markets. We've seen examples of that in China, recently where we exited one of our pre-IPO investments; a deal in the gear space, China Hi-Speed, which we exited at about 17X. I'm not going to comment on the appropriateness of the valuation given to the deal by the investment bankers, but clearly we were happy with the deal. The second advantage that we bring to our portfolio companies is our ability to leverage our deals globally. We have businesses we've invested in for India, that benefit from our background. In the PE space, we focus on small to mid-sized companies of less than \$500 million in market cap. In that space, opening doors means a lot, because entrepreneurs and companies of that size do not have access to companies or businesses around the world.

**NM:** The advantages that we offer, probably brings us to our next topic or next theme, that of sector-based

### NM: IF YOU ARE FOCUSED ON A PARTICULAR SECTOR ... YOUR ABILITY TO ADD VALUE IS BETTER...

investing. If you are focused on a particular sector or a particular theme, your ability to add value is substantially better, because you can help your investments build their network, which further enhances the value of your investment. Today, if you have a sector focus you have a network and relationships that can add value to your investments.

Today I do healthcare, I do education, financial services. What is my ability to add value to my investments - over and above the oversight role, corporate governance, preparing the company for a potential IPO, helping them with recruitment, MIS, the standard value-added functions that one can bring to the table. Those are all valuable functions and in most cases companies also come to us for assistance in the ultimate IPO or exit and they want someone to help them prepare for corporate governance, by having independent directors on their board; something easy for us, but not so easy for the entrepreneur who on his own would not know how to go about doing these things.

**NJ:** Our experience has been along three lines. Adding to the companies ability to deal with the capital markets. Many of our companies have grown very



fast due to the economic upturn, but they haven't got the sort of sophistication that allows them to handle a listed market. The second value add we offer is cross-border or even domestic acquisitions which may seem easy to the Tatas or the Reliances of the world, because they have access to the best investment

### **NJ:...IF YOU TALK ABOUT A MID-SIZED COMPANY... THEIR CFOS ARE NOT THE ROCK STARS OF THE INDUSTRY.**

advisors. But if you talk about a mid-sized company of \$400 to \$500 million in revenues, looking to make an acquisition, they're not sure; their CFOs are not the rock stars of the industry, they're looking at you as their in-house advisor to help them do these kind of deals. So in-organic growth advice is a huge issue. Out of our ten investments, we have helped three of them make successful acquisitions; that is one of the planks on which our value proposition is built, especially now that we have a track record. Another value add is in our handling of capital markets in terms of investor relations. If you look a company like iFlex Solutions which makes banking software and which was eventually sold to Oracle, it took a year of us going around to the market and saying, look this is where this company belongs. It was much the same when we invested in ABG Shipyards. When we invested in shipbuilding, I got calls from four people saying, are you nuts? Shipbuilding in India? You're kidding. Today you have Larsen & Tubro, Papayav Shipyards. You have Tata and Reliance talking about shipbuilding.

**GJ:** There are two aspects to this question; there is the business aspect and the financial aspect. Great companies have the ability to make financial markets work to their advantage. And

that is something that our portfolio companies look to us to support them on; they see us as more financially sophisticated and they expect us to help them play that game better. The divergence comes on the business side of the equation in that those investors who are sector specialized can add more value to their companies. It is possible to add value, but now we're talking about methodology. Bringing in consultants is one thing that we can do, but what we can do depends upon the combination of who is the company, what is their stage of development and who is the investor. In our case, we believe that we're in the business of investing in smart entrepreneurs and smart business people, who know how to run their own businesses. When our entrepreneurs come to us for help they



want clout, they want help in terms of closing deals, they want help in terms of building out their businesses and these are the areas where we think we can add value.

**Anubha Shrivastava (AS):** In the West, often times, when we're doing our due diligence, at the end of the day you see how fund managers source their deals and the approach most often taken is opportunistic.

**RS:** I can address that very simply by saying that we're sector agnostic, so we

don't have a sector focus. But at the same time, we do things that sector focused funds can do and we do run across and we do some deals where the other investors are sector focused.

**AS** But yet you say that your value-add is not vastly different from a sector focused fund.

### **AS: ...WHEN [WE] SEE HOW FUND MANAGERS SOURCE DEALS...IT'S MOST OFTEN OPPORTUNISTIC**

**RS:** If you're sector focused I presume that you will be able to add more value, if you get involved in operations. But if you're going to be like us, adopt our philosophy of not getting involved in the day to day operations of the company, then I fail to see the distinction, other than your portfolio composition. If you're sector focused investor I presume



that you have a more hands on approach, you get fully involved in the day to day operations, you get into minute decisions in the company, and therefore you can add more value.

**GJ:** I started investing in the current cycle in '05, and I started with my value added paradigm, because I needed some more time on the auction podium. There was no way that I could compete effectively in the auction market, given my return expectations. So my approach was partially borne out of necessity and partially borne out of my earlier experience of being comfortable with sector specificity.

**AS:** I think that sector focused investors offer a lot of operating experience because their founders came out of those

industries and so they have a comfort zone and that is why the LPs like them. They have a lot of experience and they can add a lot of experience to their companies. If you look at India, much of the private equity industry has come up through financial services or the investment banking so that first, there is much more comfort in being broader and second, that is where the opportunity has been.

**GJ:** I think that is certainly a feature of the current cycle. I've seen more and more professionals come out of the industrial sector into private equity firms. That is not just a feeling, it's backed by statistics, that there are now more people with operating backgrounds working at private equity firms. It also has to do with the fact that there are many more successful entrepreneurs looking at post career or early-retirement scenarios for whom investing is a second career of choice.

### **GROWTH CAPITAL IN INDIA**

**RS:** If we look at growth capital from the context of the value add that we have been discussing, I think that whenever you're adding capital to a business, there has to be a value add. In a buyout the situation is completely different. The value-add is completely up to the investor. You make all the changes that you want to; which is not the case in growth capital. A promoter in India, is definitely looking for more value add from the investor, than merely writing a check. Returning to the question about what is growth capital; there are various definitions for this but there is a big difference between what the VC funds are doing in India and what the private equity firms are doing. At present, private equity in India is not about

buyouts. Though all of us would love to go out and raise a billion dollars to go out and do buyouts in this market, the market is still not defined well enough to have meaningful buyouts. For me, the

### **RS: AT PRESENT, PRIVATE EQUITY IN INDIA IS NOT ABOUT BUYOUTS...**

difference between venture capital and private equity lies in the stage the business is in. We did a study and found that of the more than 6,000 listed companies in India, more than 4,000



don't deserve to be listed. Their public status has more to do with history. It was a fad, some time back to be publicly listed; it was very easy to be listed, there was no regulator, so most of the companies listed today were listed in that period. You could classify investments in these companies as private investments in public companies (PIPES), because these are listed companies, but for all practical purposes, they're private companies, which for one reason or another have some listed information and as we say about such firms they trade by appointment. If you want to trade in their stocks, you have to find someone to play the game with you. For these companies, when you say growth capital, what it means is that you are going to be a partner with them, a helpful partner to the company's owner, because you are putting in money that the owner wants to fulfill his business plans and you are going to help him fulfill that business plan. So most of the time what we end up doing is to sit down with a promoter who is re-drawing a

business plan, which is one of our value-adds for his business. You don't want go into such a business and tell the owner, okay, your plan is crap and we want to change it, but you do have to modify his business plan to suit your value-add.

**NJ:** It's not a question of the sector that differentiates VC from Growth investment. We don't do venture capital investing. How we define it internally, is by defining our sweet spot as a late stage company. So when we do growth capital, it will have to be late stage capital. We aren't going to invest in a company, go in and do hand holding for the next six years, top off the investment and then exit through an IPO, or an acquisition or a trade sale or something.

**T&I:** Given what you are all saying what is the difference between growth capital and late stage investing?

**RS:** In this market, there isn't much difference. Whether its six months or two years.

**GJ:** I think that it depends upon whether the terms are being applied to the company in the context of the financial markets or in terms of its business maturity; if it's the maturity of the business there are some firms that are late stage, that are not Pre-IPO. And there are companies that are not in the late stage of their business cycles and they are pre-IPO. But returning to the question of technology versus textiles, and defining an investment relative to its sector. We've never invested in textiles in our portfolio.

**NJ:** Lucky you. (laughter)

**GJ:** I want to defend textiles...

**NJ:** Stay away from it. (more laughter)

**GJ:** The example of investing in a travel portal versus investing in textiles, as being a point of differentiation between venture capital and private equity is that first, it's possible, that textiles could be

to India, what technology was to the US. Keep in mind that 20% of Indians go to sleep each night without meeting their very basic needs. We're talking about two very different countries. So in some ways, I shudder to use Western

### **GJ... YOUR QUESTION IS THIS: IS THERE VC INVESTING IN INDIA, OR IS ALL INVESTING GROWTH?**

analogies in India, but I think that your question is this: is there VC investing in India, or is all investing growth? In India I don't think it's an and, or an or, I don't think it's a versus. I think you see traditional VCs doing growth capital slash private equity here. And I think that a lot of people who do growth investments in India have VC elements to the investments model in India, so definitions start to lose their meaning in India, especially when those definitions are transported from an entirely different market. I think for certain firms, VC is a real opportunity in India and that there is an opportunity to back innovation in India. At the same time, growth provides the leverage here, and because we don't have a developed debt market there is an opportunity for private players to fund growth. Many of the growth opportunities, from a business cycle perspective, are from companies that are not fully mature so you actually have to work like a VC. Of course many VCs in India are doing what would normally qualify as growth investing.

**NM:** Overall, there is a lack of venture capital money in the system with the exception of the technology sector. There are specialist funds to invest in technology sector, but outside technology I'm not sure if there is funding available for early stage transactions. We all want to do late stage or mature businesses, you may call it

Pre-IPO, but the fact remains that there is a lack of capital for early stage transactions outside technology sector.

**GJ:** But that is the nature of venture capital. In early stage investing, usually you have to quantify innovation and in non-technology it's usually more difficult to quantify innovation, to productize innovation. Isn't that the reason, just by definition, that it's been more difficult to do VC in non-tech or bio-tech.

**RS:** Perhaps because you don't understand that sector, you are able to take a view?

**GJ:** I don't think it's a question of not understanding something. I think it's a question of the nature of innovation.

**RJ:** And mindset (a general conflagration of voices arises).



**SPEAKER:** Look at some of the biggest successes. Sun Pharmaceutical a pharmaceutical business. Nitin Mukesh at ICICI Venture invested in Sun when it was \$4 or \$5 million per year, so there have been bio tech investments too.

**RS:** Today there is an obvious temptation to put more money to work. People all want to scale up the deal size and put in more money and do larger and larger deals and we're not equipped to deal with that mindset. Our problems today are probably more to do with our mindset than our ability to do deals.

**GJ:** And a question of the maturity of the market. As the domestic market matures, as the distance between the entrepreneur and market collapses, we're all seeing an all time high surge in innovation, in all sectors. What I was saying, was that in certain sectors it's more difficult to quantify innovation.



**RS:** But why should VC be linked uniquely to innovation?

**GJ:** Because it's a new business model.

**NJ:** Not really. VC doesn't have to be about innovation. Ask Vishal about what they did (Vishal Retail is a Gaja investment). They did very well and that was

all about innovation.

**GJ:** All I'm saying is that innovation is of many kinds.

**T&I:** Innovation can take place in a new weaving process?

**GJ:** In fact I think that there is a call for somebody to develop technology that can bring down the cost of cotton clothing by, let's say, 50%. It hasn't been done, it's very theoretical, but there is a call to do this. Will this not be revolutionary to India. Isn't there going to be a revolution if somebody invents a way to do this.

**NJ:** Absolutely. The way that venture capital is defined especially in the West, has to do with new intellectual property that is patentable, that has to do with research and development, or has something more to do in some way with technology and the allied spaces than in the innovation of business models. In India, the concept of innovation, and I think for all of Asia this is true, a lot of innovation still doesn't happen here, it still happens where there is a lot more

capital to go into R&D in technology. Here innovation is more about business models and about solutions.

**Sudhir Sethi, IDG Ventures (SS):**

Look at IFlex. A banking product company, it was more about domain knowledge being put into a new product rather than creating a new technology, as in creation of a new search engine or something. So it was more about solutions and applications than about technology.

**Ash Lilani, Silicon Valley Bank (AL):**

I think that one of the reasons why there is a dearth of early stage venture capital in India is that there are not enough innovative startups of high quality. So what happens if you can't find enough startups of sufficient quality? You go to where you can find enough quality

## **AL: ...THERE ARE NOT ENOUGH STARTUPS OF HIGH QUALITY. SO WHAT HAPPENS?**

opportunities. And while there is a critical mass of companies in India, with revenues in India, that have never raised any institutional money, they need to grow so that they absorb VC money. But there is not enough seed money out there creating concepts to attract future venture capital funding either. And I don't see how this situation changes in the near term.

**Ellen Shuman, Carnegie (ES):** I think that we're seeing this same situation in the US where you're applying technology in a way that is considered early stage, for better or for worse.

**SS:** One of the trends I see is that foreign venture funds tend to invest more in technology deals; Indian funds tend to invest more in non technology deals. Funds like Sicom, SIDBI, Kitven are examples of home grown funds. Interestingly a number of non technology early stage

investments are done by not the global leading funds but the home grown funds. I think that the DNA of the GP is very important in terms of where they're

### **SS...ONE OF THE TRENDS I SEE IS THAT FOREIGN FUNDS TEND TO INVEST IN TECHNOLOGY...**

going to invest. Are there GPs who are working outside of technology doing deals where they can be assured that they're going to get the best price? I'm not so sure of that. But there are



certainly a lot of non-technology deals being done. And we can't all do that. And the guys who fund that the portfolio companies who are doing that...are not the leading funds from around the world.

**GJ:** Having said that innovation has not always been about product innovation. Innovation has always included how to take something to market, how to build something. Look at Dell, a big poster child for the tech sector, what was innovative about Dell? The way they marketed themselves and their products. All we're saying [here] is that many US parallels don't work here in India. I [also] disagree that we don't have many

### **HG: IT'S NOT AS THOUGH THESE ARE MANAGERS WHO ARE NEW TO PE...**

high quality startups here. There may not be many high quality startups in the sector that you're looking at [namely technology], but the quality of entrepreneurship in this country is phenomenal.

### **THE CURRENT STATE OF PE INVESTORS IN INDIA**

**HG:** Every day the number of GPs in India is increasing and there is a reason for that; the PE business has always been an attractive destination for professionals in financial services [of whom there are many in India.] From the perspective of what we saw from 1996 to 2000, the quality of currently active fund managers is generally good. People have gone through a couple of cycles, made investments and the GP community and today has a high degree of maturity.

**AS:** Hetal, when you say that, are you talking about yourselves and the handful of managers who have been here for the last decade? What about new managers?

**HG:** There are quite a few new managers that have spun out of the teams of the mid-90's. Looking back on that time, the three major players were IL&FS, ICICI and Unit Trust of India. A number of professionals who were part of my team at IL&FS are now occupying partner positions in new funds or have set up their own firm. As



examples, Muneesh Chawla co-founded Blue River, Deepa Sankaran is heading Darby, Srinivas is heading Lazard PE and so on. Similarly, ICICI has a half-dozen examples. Nitin Deshmukh was part of the core team at ICICI and is now managing partner at Kotak PE. So it's not as though these are new generation managers who are completely new to PE space in India.

**AS:** So there are a number of firms who have been around, but I'm talking about the 200 funds in the market actively

seeking to raise funds in India. And there are at least another 200 who come in and do deals in the country opportunistically. The names you've given us I recognize, and they take us to about 15 funds [which have experience]. What about the rest of the funds?

**HG:** The rest of the funds, you need to categorize into different buckets. There is the global group of firms such as Standard Chartered, Warburg, General Atlantic, APAX and then there are investors using their proprietary book such as Lehman and Goldman. The third group is comprised of hedge funds who also look at PE. Then there is the last group comprising investment bankers and first time fund managers. I guess this

**PT: ... I WOULD CONSIDER INVESTING WITH SOMEONE LIKE HIM DESPITE IT BEING A FIRST TIME FUND.**

is where LPs need to make their own assessments. If we look at the investment environment, there is blurring of investment styles across private equity, public equity and venture capital. We have arbitragers in the form of hedge funds, who have different investment horizons and return expectations. For most of us here, we would prefer a 30 to 35% IRR over a longer time period rather than a 50% IRR over 18 months. The hedge funds, for example, work on interest rate differentials by leveraging their investments. This allowed them to generate the same set of returns through constant churning – until of course, the music stopped! If we leave aside the international groups and the hedge funds, the number of active investors would drop down to less than 20. Leaving aside the numbers for a moment, the challenge comes as every new investor seeks to announce its presence through an aggressively priced

investment. When this happens on a constant basis, it distorts valuations to an extent that it becomes very difficult for incumbents to close investments at a rapid pace. In 2007 we made only two investments, one of which was proprietary.

**RS:** I want to ask [Paresh] as a Fund of Fund manager to comment on the quality of GPs that they see in India.

**Paresh Thakker, Evolvence:**

I agree with Hetal who mentioned Srinivas Baratham for example who was at IL&FS, then he was at UTI and now he is at Lazard. He is heading a fund for the first time but he has been around, he has seen the evolution of VC/PE in India, he's worked with people. As an LP I would consider investing with someone like him despite it being a first time fund. Are their issues, as an LP that I might raise with a Lazard? Sure. But investing experience wouldn't be in doubt.



**GJ:** I think quality is a bigger issue and quality is in the eyes of the beholder. Quality among GPs is not an issue of first generation or second generation. Today this industry in India is about 15 years old, so naturally there are managers who have more experience under their belt, but thinking about the industry from the qualitative point of view, I think that what is more interesting about industry is the relatively more novel phenomena of the emergence of local franchise owners: Chrys Capital. Baring Private Equity India. Gaja Capital.

## TEAM DYNAMICS IN INDIA

**NJ:** This is a relevant question for all of us, which I'll address from the perspective of one of the things that we mentioned earlier; the segregation our industry, into several different layers and the fact that you have to find your sweet spot not just in terms of deal sizes or deal types; the flavors of the deals are also important. For example, we have done deals with a certain type of promoter, in a certain type of business, at a certain stage where our input is required in a certain way. You can find a sufficient number of companies to meet the technical criteria that we seek in our



deals and that meets our comfort zone for deals. I think that what happens is that a team across a region, or within a region, starts developing a common way of thinking about deals to the effect

of, this is what works for us, this is what does not work for us. If I spend three or four years with a team, and one of our guys calls me up from a tier two city and says "Nainesh, I'm at a company that works for us, it has good management, they're a bit raw on the financials, but they can get there." That call comes in and it hits me where it should. That takes a long time to develop. That kind of rapport. What Kharam did very well, was to build that way of working into our team. As someone has said about the building of a team, I think that like that old saying holds true from the top to the bottom of the private equity industry that

"the sea tastes the same at every beach," so too the building of teams, the development of an understanding of how we all think, a common way of thinking about what works for us and what does not work for us, is vital to team building and making deals.

**GJ:** Not in Bombay (laughter).

**NJ:** Maybe that's why we have a different team here. If you can't get a team together to say this is what we like and this is what we will debate to death, and have a good understanding of how the debates will work, then it becomes difficult to define your identity as a fund.

**NM:** I have a question about that, especially given that you work from different locations. We're in the same position as we have offices in Mumbai, Bangalore and London. But when we

### **NJ: ...AS WE PUSHED PEOPLE OUT INTO THE REGIONS, THE DNA FOR THE FIRM WAS HARD-WIRED IN.**

look at our internal team dynamics, being in one office is a great advantage in terms of building team chemistry, but we all here around the table know the imperatives of working in multiple locations. For you (indicating Alok from Canaan), for you (indicating Nainesh at SCPE), how do you deal with the question of team dynamics?

**NJ:** It's a very good question. The way that we have dealt with it, and the way that people from Warburg have dealt with this, is that we have all started in one place. The key guys all started in Hong Kong in the case of Warburg and we took our start from that case. We started from one office in Singapore. I was in Singapore, we wrote the charter for Standard Chartered Private Equity in Singapore. Kharam Bhutalia, Allastair Morrison and myself and a couple of others. And as we developed and as we

pushed people out into the regions, the DNA for the firm was kind of hard-wired in how we think. I know how the four partners in Singapore think. So that is the good news when someone like Kharam leaves; there are others like Alastair and myself who are there, who have been around for long time and we are able to keep the momentum going.

**AL:** The other question is how much does economics play a factor in the



development of teams. As teams build a good track record, obviously they are faced with the question of how much of the carry do I keep for myself and how much do I distribute to others in the team, to insure the retention of the more junior members of the team. This might be a bigger problem for venture funds in the next cycle, than with private equity, because there are a lot more new funds in the VC side of the industry.

**GJ:** I'm not an expert on this, but I will observe nevertheless that India is an evolving environment. Ownership of

### **GJ: THERE HAVEN'T BEEN MANY FOUNDERS IN INDIA...MOST HAVE BEEN LOCAL AGENTS.**

carry, let alone the ownership of a franchise is a relatively recent phenomena in the Indian market. The entire 1998 to 2000 cycle of investment was done without the ownership of carry; just salary and bonuses.

**T&I:** Founders or the associates weren't receiving carry in that time frame?

**GJ:** You need to use that term "founders" with a certain amount of discretion here. There haven't been very many founders in India, in Indian private equity business. Most have been local agents.

**AS:** What do you mean?

**GJ:** Most of the firm managers in India have been country managers. I think that 1999 saw the emergence of some of the first PE businesses owned by the managers. In the current cycle what I see is that the concept of the distribution of the carry has become a standard, it has proliferated. Placement agents understand it. Head hunters understand it. And now I think that people are beginning to understand the concept of the ownership of management firms and are beginning to ask the question, "Do I own this business?" This is a small market as compared to what happens in the US, where we hear about the larger firms going public. But people at PE firms in India are often asked the same questions; how long are you going to stay? What is going to make you stay? And the answers are that retaining people is about ownership and that salary, bonuses and carry are not going to be enough to keep people on in the long term.

### **WHEN DOES INDIA LOSE ITS LABOR COST ADVANTAGE?**

**NJ:** I think outsourcing from India has been helped a lot by the arbitrage of labor cost. But I don't think that outsourcing in India has been all about price. We talked about textiles earlier, which I think is a good example, with mass manufacturing which is based on scale, efficiency and the size of

operations. We have never been able to compete purely on price. India's exports have always been based in skills. If you look at software, pharmaceuticals, if you look at auto components, in all these areas you find that India has been better at higher skills levels of outsourcing. If

### **NJ: ... WE'VE BEEN HEARING ABOUT INDIA BEING UNDERCUT IN SOFTWARE DEVELOPMENT SINCE 2000.**

you look at Europe, just before India became a big pharmaceuticals outsourcing destination, Europe had the maximum number of FDA approved pharmaceutical manufacturing plants in outsourcing. So it wasn't as though it was always the cheapest country that



was doing these things. What it does mean is that, and here I'll point to software, we've been hearing about India being out-priced or undercut in software development since 2000. People were saying even then, "Oh, China is

going to take you guys out," people said "Vietnam is coming up," this idea that India has out-priced itself has always been there. But India has always been able to maintain an advantage. Why? Because India has scalable resources. You can produce 1,500 English speaking software engineers in India and other countries cannot do that. Infosys, for example, built a robust process, which could keep replicating an offshore development center, over and over again without making a mistake. They can keep adding 5,000 guys quarter after quarter and manage it. Growing a

business in that fashion is a management issue. It's not just about saying, we can do something cheaper. There is a lot more to India's success in outsourcing than price alone. And I think that the industry in India is already re-inventing itself in terms of repositioning itself, which we have to do as our margins go from 25% net to 15% net. But in doing that will the growth of India's BPO industry [decline]? I don't think so. I think we're still chipping away at the edges of the size of the opportunity.

**RS:** I want to add to that from our captive perspective, not from a business perspective. Our organization has a campus in Hyderabad, where we have 200 people, who are working for the US and other markets and our COO has been asking herself this question a lot. What is the price point, at which India is not that attractive as a source of outsourced work? And we're comparing our numbers in India, to another off-shoring center that we have in Poland and then back against our guys in the US, where we have guys working. And while I haven't seen the numbers, her estimate is that India will have to increase costs, in terms of salaries, wages, overhead and land by more than 20% in order to lose its competitive edge. So even for price, where you are all correct, margins are going to decrease for outsourcing work in India, we are still not completely priced out. But I

### **RS: INDIA WILL HAVE TO INCREASE COSTS, BY MORE THAN 20% IN ORDER TO LOSE ITS COMPETITIVE EDGE.**

agree with everyone else, it's not just a price issue, it's more the kind of work that outsourcing companies are doing. Clearly, low end work you may not see coming to India for us to do that. People are talking about Thailand and now

we're hearing about Vietnam, so maybe India is not the destination for low end processes.

**Sudhir Sethii:** With one exception perhaps; I've seen Robert Bosch, the German tool manufacturer is hiring 7,000 people in Coimbatore, and other companies of that nature will be following them into smaller towns in India. So you need to keep in mind that India is not just one country. If Vietnam is today at X, in terms of wages and India is a X plus 20%, then Coimbatore is at X as well. And there is another set



of maybe 20 more cities, whose price is comparable to that of Coimbatore.

**NM:** There are two sets of people who you're talking about here. I completely agree with you when you're talking about people who are in India, or people who know India, that is one thing, but we're talking about people who are from the US or people coming from the US who are looking at India and for them, Coimbatore is not an option.

**Gopal Jain:** I think it's too early to write the obituary for the BPO industry in India but I think that pricing/ cost arbitrage is today insufficient to bring outsourcing to India. That is the big message from the last ten years. In '98 we used to say cost can bring you here,

but [even then] you need quality and process improvements to keep the customer. And in '98 we used to say that there is a 60% cost differential between the costs in the US and the costs here and today we hearing it's a 20% cost differential. Isn't this all

### **GJ: ...IT'S TOO EARLY TO WRITE THE OBITUARY FOR THE BPO INDUSTRY**

mathematics? If you have a 5% inflation differential factor in India then 20% of arbitrage will be lost if not within four years then within 7 years. So I don't think that is where the answer is. India is one of the few countries in the world that can offer both scale – not just in numbers but in also breadth in term of the skills offered, certain stability, certain maturity – but more importantly India is one of the few countries of the world that can deliver process improvement. Outsourcing India 2.0 and 3.0 is about process improvement and process re-engineering and if you take that into account the industry still has a future in India; notwithstanding the tax benefits going away, notwithstanding the cost arbitrage going away.

### **THE IMPACT OF THE US CREDIT CRISIS ON INVESTING IN INDIA: DE-COUPLING**

**NM:** I think the issue is a very portfolio specific question. I'm not too worried about the impact of the US credit crisis because of the portfolio that we have today and because of where we're looking at investing. Today there are more domestic opportunities than were available earlier. One thing that is more or less clear, is the direction of the Rupee Dollar exchange rate. If you have dollar revenues then you need to factor that possible negative impact on revenues when performing your due

diligence. My belief is, that compared to other countries, the impact is going to be limited here, as there may not be any significant impact on the business side. I think the impact is far more on the capital markets side; the publicly listed companies and flow of capital into the

### **NM: IF YOU HAVE DOLLAR REVENUES YOU NEED TO FACTOR THE POSSIBLE NEGATIVE IMPACT ON REVENUES...**

listed market. At the end of the day, that has the greatest impact on valuations. We have seen an impact on stock prices and in coming months we may see more impact. But it's a very generic impact; I believe that firms in the late stage or pre-IPO stage of investing may have some review to do, because they'll be the first to be affected. What we do at Aureos is typically with a three year view in mind, more like a traditional venture capital approach, so I'm not too worried. As I have mentioned in my portfolio, there are companies that have dollar revenues, but it's insignificant and they have reasonably differentiated service and therefore an ability to pass a reasonable portion of the currency loss on to their customers.

**RS:** I agree with you, in that the businesses that we have in our portfolio are not that much impacted by something happening in the US, though I must point out that no broker that supplies us with research has ever returned to the point of view of decoupling; earlier there was so much certainty that "Oh, we're not going to be affected." That point that there is going to be an impact on India has sunk in. Everyone is going to be affected by the situation in the US, the question is how much. But on the business side I don't think that we're going to be affected too much, but an impact will be seen. What I

am more worried about, and by nature I'm an optimistic person, is the flow of capital to emerging markets. For two reasons. First the US remains the largest source of capital for India. For Indian deals. For Indian private equity houses. Our LPs and large sums of investment come from the US, so the US remains important. In all of my interactions with LPs, in all of my interactions with LPs, placement agents, consultants, I've never heard that India is a safer place than the US. So in terms of the risk profile, we're still riskier than the US market. But more important, is the entire issue of asset allocation, what is happening with the public markets and hedge funds taking a hit, is that the component of emerging markets, private equity in the portfolio of the large LPs is suddenly going across a threshold. So when you talk with them about fresh capital, they're saying, we would love to re-up but through no fault of yours, my commitment to the asset sub-class into

### **RS: EVERYONE IS GOING TO BE AFFECTED BY THE SITUATION. THE QUESTION IS HOW MUCH?**

which you fall, is already more than my risk assurance allows. In the short run, this doesn't impact us, because in the short run you already have an LPs commitment, capital is coming for this year and perhaps next year, usually we have a three year primary investment period, so the next two years may not be an issue. But going forward, if this problem continues, then I see capital infusion into these markets, including India, being at risk. ■

**T&I**

**End of Part 1**

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