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V JAYASANKAR & S RAMESH/KOTAK MAHINDRA CAPITAL

Indian promoters will start to see PE investors as more strategic

By Sanat Vallikappen & Baiju Kalesh

MUMBAI

Private equity (PE) deals in India have slowed in the last two quarters, and are likely to be muted over the next two-three quarters, according to **S. Ramesh**, chief operating officer of **Kotak Mahindra Capital Co. Ltd**, the investment banking arm of **Kotak Mahindra Bank Ltd**, and **V. Jayasankar**, executive director and head of the unit that focuses on PE deals. PE investors are looking at sectors where the downside is clearly visible, they say, in order to exploit opportunities when the market stabilizes. Going forward, they say companies will look at PE firms more as partners and less for their ability to write a cheque. Edited excerpts from an interview:

Forging partnership: *V. Jayasankar (left) and S. Ramesh of Kotak Mahindra Capital Co. Ltd.*

mint INTERVIEW

What is your general sense about PE investments into India? Will the next wave of funding for Indian companies primarily come from this route?

Jayasankar: For one, PE investors have raised a lot of money in the last two years. If you look at the top 15 or 20 buyout and growth funds, they have raised in excess of $60 billion-$75 billion (Rs3.03 trillion-Rs3.79 trillion). If you start figuring out where they would invest today, adjusted for growth, even though the US may be in a recessionary phase, investors will see some of the assets there, especially distressed ones, (as) very attractive. On the growth front, you will still see them coming to India because if the GDP (gross domestic product) is growing at 6-7%, you will still see real earnings growth.

Of course, what you are going to see is a fair amount of pain on the margins and top line, but over the one-two years time frame, investors can still come in and aspire for a 20-25% growth. Indian promoters have started moving away from a state of denial into waking up to a state of reality. Wherever they are seeing the growth opportunity, they will raise capital from PE investors.

You'll find the pace of PE transactions slowing down in the next one year, but it will not be shut. And wherever there is a compulsion to invest for growth, you'll see that happening. The last two months were very trying because people were trying to make sense of what was going on. Not that they've made full sense of it now, but there are transactions in progress.

But considering that PE investors have been hit hard in the market meltdown, they'll be completely different animals when they meet promoters now. How differently will they structure deals now?

Ramesh: Even assuming that PE investors have the money, and they're willing to invest, the key question is why would somebody dilute at these valuations. So, convertible structures and other innovative structures is the way they will go about once they know entrepreneurs are ready to take the money.

One of the things I saw (that was) very good in the Sebi (Securities and Exchange Board of India) window (of allowing promoters to increase their stake up to 75%, as opposed to 55% earlier, without triggering an open offer) is that if promoters have the money to buy, it gives them that extra ability to dilute later.

At some level, every bit of shareholding will count. At some stage, in the future, you will see hostile takeovers in India. The second thing is the return expectations of investors have now gone up. That's a drastic change from earlier when capital was easily available.

Certain funds such as ChrysCapital and Nalanda Capital Pte Ltd are using the flexibility they enjoy with their limited partners to invest heavily in listed entities via secondary market transactions. Now that public market valuations look compelling, do you think others too will employ a similar strategy?

Jayasankar: Other funds have the flexibility of investing only 10-20% of their fund size in the secondary market, without having a board seat or direct rights. So, if they've raised a $15 billion fund, then there is a 10% flexibility (up to $1.5 billion) to invest in this particular fashion. But since it's only 10%, they'll be typically a little choosy.

The other issue is if you take the top 15-20 funds globally, all of them have the same limited partners (LPs) that invest money in the funds. The question the LPs are asking the funds today is why they should invest in listed companies and take a 2% commission from the LP year-on-year, and a 20% carry-on profit, when the LP can do the same through portfolio schemes where they don't pay that kind of carry. I hear investors talking about this pressure a lot more openly. So, whether they will use that 10-20% flexibility today or they will do it much later is a question.

Because, if you make an investment today, the question the LP will ask is why do they have to take a 30% mark-to-market hit. Whereas, if the investment was in an unlisted firm, then the investor can say this is part of the overall portfolio, and it's different.

So you won't see all that money coming into secondary market transactions straight away. The fund will not invest the entire $1.5 billion in public stocks, and say that for private companies, it's still waiting for opportunities. If they invested $5 billion from the $15 billion fund, they'd proportionately deploy around 10% of that $5 billion.

So, when they incrementally keep making more investments though the classical PE route, proportionately they'll perhaps exercise that option of investing in listed companies. So, you can't just look at the size of the $15 billion fund and say that $1.5 billion of that can come into the listed space today.

What about downside protection?

Jayasankar: Investors definitely want to protect themselves against the downside. So, they'll have a base case and a downside case. Earlier, this was not necessary because there was only an upside. Even now, we're seeing investors interested in construction, health care, education, consumption-led sectors, and some of the larger industrial houses if they are willing to unlock private companies within the group or bring in investors in the listed companies itself. These are areas where investors are actively working on. If you talk to investors today, they've all realized that deal flow has stopped. They find pockets of companies where valuations are attractive. But the promoter may not dilute for the same reason. They're now doing their work and being ready, so that six or nine months down the line, when markets have stabilized, they know what deals can be worked out. Even in media, I think investors are interested in print so long as there's a stake available. Also, in distribution such as cable and direct to home (television). But not so much in general entertainment category. In many other sectors, you may not be able to model what your downside case is. So, people are trying to figure out which are these sectors where they can look at opportunities for the next year, and where they have a better grip of what the downside is.

While that may be for future, how are they coping with excesses of the past?

Jayasankar: Everyone's going through a certain level of pain. What they are focusing on now is whether their portfolio companies are doing the right things from a business standpoint and executing as well as they can in this environment.

So hopefully, over three-four years, they'll make some decent returns. It may not be three times or five times the initial investment. But they also have balance money. They will try to extract a higher return from this remainder.

> Going forward, PE investors will also play a part in helping in the process of family settlements

When is the pace of deal closure likely to pick up?

Jayasankar: The pace of closure of transactions will continue to remain slow until you see a reduction in the volatility in the markets, and you see some level of stability in valuations. Today, if you talk to people outside, they're still wondering if the Sensex will touch 8,000-8,500. So, until that sort of feeling dissolves and they find the picture out there is not as bad, you'll see people more willing to look at the downside case a lot more positively. For instance, when you're talking about consumption-led investors, how much demand destruction can there be? If you look at construction, government spending will only increase. So, if you are investing in a Nagarjuna Construction (Co. Ltd) or an IVRCL, which has got 70-80% of their orders from the government sector, and in a scenario where the government will keep pumping in money towards infrastructure, these companies will benefit. Therefore, investors are doing their work around these sectors and trying to see where they can find opportunities.

But isn't there a lot of risk in the construction sector?

Jayasankar: On the top end, the risk is 30-40% exposure to private sector. It could be in the area of power, commercial construction or oil and gas. But when it comes to roads, ports, irrigation, where the government is spending money, there is a high visibility of both your top line and your order book. The biggest concern today is on working capital. And if you look at Ebitda (earnings before interest, tax, depreciation and amortization), it's around 10-12%. That can get compressed by another 1.5-2%, if interest costs remain very high. But interest costs are also coming down.

Do you see more PE investors investing in holding companies on the lines of TPG Capital's investment in Shriram Retail Holdings Pvt. Ltd, the holding company of Shriram City Union Finance Ltd?

Jayasankar: Wherever promoters are willing to treat buyout funds as almost equal partners, the holding company trend will continue. This is in cases where there is a clear understanding between the promoter and the investor on a mutually accepted exit.

Otherwise the issue is, the financial investor comes with a five-year perspective, the strategic investor has a 10-15-year perspective. When you have that misalignment, you can't be in agreement and so you cannot have a transaction in a holding company.

Some investors have committed money to companies via warrants that are convertible based on certain performance benchmarks. What happens if this performance is not met?

Jayasankar: A warrant is not an obligation, but a right. For the right, you have paid 10% of the money upfront. The investor will take a call. The conversion term says a price X. If the shares are trading at a discount to X, he will take a call on how much hit he can take on the mark-to-market. I think it will be an investment committee call.

Ramesh: There are also companies doing something else. Whether it's promoters or investors, whenever there is a warrant, they are also calculating whether they can procure shares from the market cheaper, despite forgoing the 10% paid upfront for the warrant.

Is there a case for investing in the larger companies, as opposed to just capturing the growth in mid-caps?

Jayasankar: You'd be surprised. All the large industrial houses have done a lot of acquisition. They need financing and it's a combination of debt and equity. With various sources of financing really drying up, you'll see some of them trying to unlock value in other group companies, maybe the unlisted ones, or they may even be open to inviting a PE investor.

Ramesh: What you'll also see, like what we saw till 2002 or 2003, when people picked up the top one or two software companies, in every sector, investors will now make a big differentiation between the top one or two and the others. It's time to become choosy.

So what happens to number three or four? They are probably the ones who need the financing?

Ramesh: Consolidation is the answer. It's wrong to say it universally, but that's the answer.

Jayasankar: Consolidation may be true for a sector such as IT, where differentiation is pretty high. But if you look at the construction sector, then there is growth for the top seven or eight players. The top five or six are listed today. The unlisted companies will have to make a choice. Valuations have come down, but they need to be pragmatic and dilute. So you'll see investments going into newer sectors such as construction. If you look at the next 5-10 years, there is still enough growth for infrastructure. So, in such industries, where there is still a huge growth opportunity, you'll see even the No. 5 or 6 attracting PE investments.

The capital that came in till now was for growth. Will future capital also look at distress?

Jayasankar: That's what buyout funds like. I don't think you'll have minority investments in distressed companies. But buyouts can rise now.

Ramesh: I think there are essentially two opportunities in the next one or two quarters. One opportunity is continuing to evaluate unlisted companies in the sectors mentioned earlier. The second is looking at secondary PIPEs (private investment in public equity). Not all PE investors will do that, but the valuations are really compelling and cheap. The model needs to be well thought-out. As an investor, you can get a block of 5-6% from the secondary market. And over time, the company also recognizes that you are a PE investor with a large shareholding, and when the next primary round comes, there may be an opportunity to build on that partnership and explore further investments on the primary side.

How do you see PE change in the next couple of years?

Jayasankar: I think over the next couple of years, you'll find Indian promoters looking at PE investors differently. Earlier, they didn't care about the colour of the money, but were only interested in their large chequebooks. But I think they'll start to see them as a little more strategic as compared to portfolio investors. Going forward, PE investors will also play a part in helping in the process of family settlements.

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