



PRIVATE EQUITY

# Reshaping for future success

What's next for Private Equity in India

KPMG IN INDIA

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# Introduction

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Although an emerging economy, India has key institutional similarities to Western countries, notably its developed capital markets and lack of state industrial activism – consequences of decades of democracy and independent entrepreneurship. As a result, India differs significantly from the other developing Private Equity (PE) giant - China in being well-placed to replicate the Western PE model and it is not surprising that the private equity industry should have expanded so rapidly in India as in the three years, prior to the credit crunch.

Today, the PE landscape is different: rapid expansion and high returns on exit have given way to declining deal volumes, lower average deal sizes, lower returns, reduced allocations by Limited Partners (LPs) and, in some cases, a rescheduling of existing commitments.

This report, based on research conducted in the second quarter of 2009, examines the impact of the global financial crisis on private equity in India and the prospects for the market in the near and long-term. The research, undertaken by KPMG in India in conjunction with Stanford University's Shorenstein Asia-Pacific Research Center included a detailed survey of 40 General Partners (GPs) and Limited Partners (LPs) active in the Indian market.

Given the prospects of high growth and the huge scale of the Indian economy, it is not surprising that the key message of this report is that India offers immense opportunities for private equity.

Simultaneously, the global financial crisis has given investors the opportunity to reflect on the challenges still to be overcome in creating a successful and sustainable "Indian model" for private equity investment. Not least of these is the challenge to general partners of managing a portfolio successfully through a slowdown in the business environment.

We would like to extend our thanks to all the respondents for their time and contribution to this research.

We hope you will find these insights useful and interesting.



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# About the survey

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In the second quarter of 2009, KPMG in India undertook research jointly with Stanford University's Shorenstein Asia-Pacific Research Center on the impact of the global financial crisis on private equity in India.

The principal source of information for the findings showcased in this report is the survey participants' responses. The guidelines followed for participation in this survey are as follows:

- Participants must have investment experience in India either as a General Partner or as a Limited Partner and could be based out of India or overseas.
- In order to help ensure a better quality response, we pre-informed interviews that they would not be identified in the report.

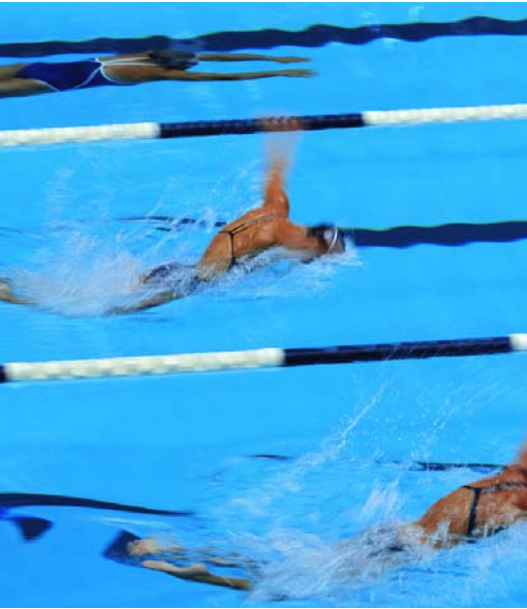
We extend our thanks to all the PE houses and Limited Partners who took time to participate in this survey. Thirty nine respondents, of which 26 are India-based, filled out two different questionnaires one each for Fund managers and Investors. We asked respondents to describe their expectations at the start of 2008, relate these to actual events in 2008 and, finally, describe their expectations for the second half of 2009.

The survey was conducted by KPMG in India and Stanford University in the form of in-depth face-to-face interviews or over the telephone.

To preserve the confidentiality and anonymity of the survey respondents and to have an independent unbiased report, the analysis of the survey findings was carried out by Stanford University and not by KPMG International or its member firms.



## Executive Summary



Despite its origins in the late 1990s as a predominantly western import, PE in India is evolving its own characteristics, our research reveals. One of the goals of the research was to discover the Indian model of PE. A second goal was to understand how the downturn might affect PE in India in ways perhaps different from developed countries and East Asia.

Table 1 below compares the Indian PE environment with its developed-country peers. Many factors make Indian PE similar to other developing countries rather than developed countries: an unstable tax environment, costly regulatory compliance, dependence on equity over debt, corporate governance problems and importance of family-run firms. The reliance on public markets for exits and the availability of a sophisticated professional services environment are factors India has in common with developed countries.

| Situation in =>                                        | Developed countries | India                            |
|--------------------------------------------------------|---------------------|----------------------------------|
| Tax                                                    | Stable              | Unstable                         |
| Regulation                                             | Low-cost            | High-cost                        |
| Cheap debt                                             | Available           | Not Available                    |
| Institutional equity                                   | Available           | Available                        |
| Equity markets                                         | Developed           | Developed                        |
| Management shareholder differences in public companies | Present             | Absent (due to family-run firms) |
| Corporate governance                                   | Not a concern       | Important                        |
| Economic growth                                        | Low                 | High                             |
| Public markets for exit                                | Developed           | Developed                        |
| Professional Services Quality                          | High                | High                             |

Source: KPMG India analysis, 2009

PE fund manager needs to possess operating skills along with financial and strategic skills to support unlisted funds that require “smart” capital

## Key Findings:

The survey showed the effects of both the unique Indian environment and global trends, such as:

- Unlike their Western counterparts, GPs invest largely in unlisted-firms that require ‘smart’ capital, i.e., capital that comes with support to grow and expand. This means that PE managers must possess operating skills along with financial and strategic skills. This is similar to venture capitalism, though applied to established firms. Investing in unlisted, often family-owned-and-run firms poses its own challenges of corporate governance, raises the operational risk and tenure of investment, and increases reliance on deal intermediation. On the other hand, the relatively sophisticated state of equity markets implies that exits via IPOs are the favored option.
- Respondents indicated frustration with some features of the Indian PE market, largely because they are viewed to be intrinsic – unlike regulation, which tends to improve with time. Respondents were particularly concerned about corporate governance, portfolio risk and the reliance on intermediaries.
- Though funding comes from similar sources as in the West – predominantly, funds of funds, foundations, endowments and high net worth individual (HNWI)/family funds, it was found that dedicated India funds (rather than global or Asia-Pacific funds) are the favored investment vehicle. According to our survey, preferred fund sizes average USD 350 million, about a third of the average US PE fund size, where average investments range from USD 25-30 million.
- Portfolio choices indicate that the euphoric attitude of the past led to taking too much operating risk; in response, portfolios are being rebalanced towards safer stances. However, by focusing more on portfolio management and assisted by reduced competition, fund managers and their investors feel confident that past rates of annual returns, which exceeded 25 percent on an average according to our survey, will continue.
- LPs are co-investing more with their GPs and even investing on their own and pursuing secondary transactions; they are more open to changing GPs and the terms of investment, in response to poor performance – although few have done so.

LP's are concerned about the lack of skilled GPs for the size of the Indian Market

GPs with operating skills are likely to be more successful over the next few years

- GP priorities have changed significantly from issues external to their portfolio firms, such as tax, regulations, deal closing costs or the worry about unrealistic valuations of deals, to operational issues: domain skills, innovation and corporate governance. However, GPs have yet to develop the competencies required to be effective post investment in nurturing portfolio companies and providing operational and strategic support.
- LP priorities are similarly related to performance issues with the added layer of concern about the lack of skilled GPs. The challenge in a developing country PE environment, according to many LPs is whether or not PE can act as a catalyst for change. To quote one LP respondent: "It is difficult to find a PE manager in India with all the five attributes that we consider essential: team depth, fundraising skills, deal access, operational skills and exit management." Another investor summed it up by stating that "the general PE market in India is very immature." The importance of GPs with operating skills rang louder and clearer as the downturn progressed into 2009, and as the falling tide exposed the internal problems of portfolio firms. As LPs will make clear through their choice of fund managers, it is this factor, more than any other that will likely separate the successful PE firm from its peers over the next few years.

Based on the above, India is well-placed for PE success if the above challenges are met and, in consequence, if the following conditions develop over time: a large funnel of diverse deals at different stages in different sectors; owner driven businesses that are ready to accept change; a PE organization structure that includes strategically, financially and operationally skilled GPs; long-term capital provided by a mixture of local and global LPs; an effective and stable, but not burdensome regulatory, corporate governance and tax environment; good macroeconomic parameters; sophisticated professional services; and adequate avenues for exit.

India offers immense opportunities for PE investments and India will likely be at the forefront of a global PE recovery. The next 12 months should be viewed as an opportunity to build value in portfolio firms, and show that PE is an integral part of India's future.

## The Indian PE Model



India cannot be compared with China. China has a different demography, business culture, infrastructure and governance

The western PE model leveraged three features of the capital markets that arose in the 1980s: cheap debt, a large supply of institutional equity and differences of opinion between the managers of public companies and shareholders over the disposition of spare capital.<sup>1</sup> This last feature was critical as it resulted in operations that consistently underperformed due to capital that was misallocated or often inadequate. The PE funds' strategy, therefore, was to discover and then to buy out such companies, recapitalize them with cheap debt and institutional equity, close or sell unprofitable operations, and resell the company directly or indirectly to the public via an IPO or trade sale (almost always to a public company). The skill-sets needed by PE firms were thus strategic and financial.<sup>2</sup>

PE markets emerged in developing economies in the late 1990s and have very different driving forces:

- They are financed by developed country investors
- Immature domestic capital markets and regulatory barriers prevent easy access to domestic and foreign debt in scale. This significantly reduces the returns from transplanting the western model, in which debt typically accounts for between 55 percent and 85 percent of the capital base of private equity buyouts
- They lack the large, mature capital markets that provide PE funds in developed countries with their natural targets, i.e. inefficiently run, but cash-flow positive, publicly-listed firms with a low debt ratio. GPs therefore focus on unlisted firms that need capital to grow.

However, India differs from many other developing nations (including China) in two significant respects, i.e. capital markets maturity and professional service provider sophistication. For example, the Shanghai Stock Exchange (China's main stock exchange) has 860 listed firms or about a sixth of the Bombay Stock Exchange's 4700 listed firms.<sup>3</sup>

<sup>1</sup> The Eclipse of the Public Corporation, (1989, revised 1997), Harvard Business Review, Sept-Oct.

<sup>2</sup> Since the global downturn that began in 2008, developed countries no longer fulfill the first two conditions. The third condition, though undoubtedly existent, is muted by the general downturn. Nevertheless, the apocalyptic predictions commonly heard at the end of 2008 about private equity's imminent demise have remained unfulfilled in developed countries as 2009 has progressed, even as the grand ambitions of private equity heard up until 2007 remain equally distant. The reason for PE's survival is that, with the collapse in public issue markets due to the downturn, private equity is more needed than ever before.

<sup>3</sup> China's main stock exchange, the Shanghai Stock Exchange, has 860 listed firms, or about a sixth of the Bombay Stock Exchange's 4700 listed firms. (Source: <http://www.bseindia.com/about/introbse.asp>, downloaded June 18, 2009, and [http://www.sse.com.cn/sseportal/en\\_us/ps/about/bi.shtml](http://www.sse.com.cn/sseportal/en_us/ps/about/bi.shtml), downloaded June 18, 2009)

## Investing in unlisted family run companies poses unique challenges to PE firms

So, why do Indian PE houses, then, invest primarily in unlisted companies? The answer is a long-standing disposition towards family control in most Indian companies, large or small, public or private. In addition, since the largest shareholders of public companies are also the managers, the disagreement (between managers and shareholders) over the utilization of free cash is absent.

Hence, in India, PE typically invests in unlisted firms that are both cash-poor and need 'smart' capital, i.e., capital that comes with support to grow and expand. This means that PE houses must possess operating skills along with financial and strategic skills – a lesson, which as our survey findings show, they are slowly learning.

But investing in unlisted firms does pose challenges:

- A public track record to validate corporate governance is, by definition, absent - as the Satyam scandal suggests. In addition, given the preponderance of family management of listed firms, that this problem may be more widespread than earlier realized even in listed firms
- Unlisted firms are often industry laggards, thus raising market risk<sup>4</sup> and lowering average investment per firm
- Operational excellence takes longer to achieve than recapitalization or strategic disposals, raising the holding period from the 3-5 year period that is common in developed economies
- Finding fund managers with operational experience is difficult given the immature, family-controlled operating environment. Such managers also don't have adequate experience of operating in an environment that has slowed down
- Discovering good investments is costly since information on such firms is relatively scarce. This increases the reliance on intermediaries.

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<sup>4</sup> In developed countries, industry leadership is prized by PE firms because it strengthens the stability of cash flow and allows PE managers to play a strategic rather than an operational role. For instance, a leading US PE firm, KKR, describes its approach as: "We acquire industry-leading companies and work with management to grow them into thriving, sustainable enterprises." [http://www.kkr.com/company/company\\_approach.cfm](http://www.kkr.com/company/company_approach.cfm), downloaded June 19, 2009

The differences in PE operating environments is summarized below:

| Situation in =>                       | Developed countries | Typical developing country                                                | India          |
|---------------------------------------|---------------------|---------------------------------------------------------------------------|----------------|
| Tax                                   | Stable              | Unstable                                                                  | Unstable       |
| Regulation                            | Low-cost            | High-cost                                                                 | High-cost      |
| Cheap debt                            | Available           | Not available (NA)                                                        | Not available  |
| Institutional equity                  | Available           | Depends on the Regulatory/ tax/ professional service (differs by country) | Available      |
| Equity markets                        | Developed           | Underdeveloped                                                            | Developed      |
| "Agency conflict" in public companies | Present             | Absent                                                                    | Absent         |
| Corporate governance                  | Not a concern       | Important                                                                 | Important      |
| Economic growth                       | Low                 | High                                                                      | High           |
| GPs with operating skills             | Available           | Not available                                                             | Not available  |
| Fund size                             | Large               | Small                                                                     | Small to large |
| Public markets for exit               | Developed           | Underdeveloped                                                            | Developed      |
| PE portfolio risk relative to market  | At market or lower  | Higher                                                                    | Higher         |
| Access to deals                       | Proprietary         | Intermediated                                                             | Intermediated  |
| Professional Services Quality         | High                | Low                                                                       | High           |
| Holding period of investment          | 3.5 years           | Higher                                                                    | Higher         |

Source: KPMG India analysis, 2009

During the current economic downturn, the supply of institutional capital has declined and exit opportunities are weaker across the board. However, India's short-term growth prospects remain solid. Interestingly, the longer holding period earlier built-in to the Indian PE model should help it to better ride out the global downturn.

The survey findings are presented in the following section.

## Key Survey Findings



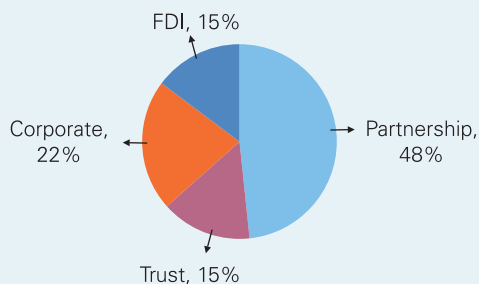
Overwhelmingly, and perhaps not surprisingly, respondents identified the global economic downturn as the key change; it affected events in 2008, especially during the latter half of the year. It also is expected to be the driving force of change looking ahead. Nevertheless, survey respondents expected several important aspects of Indian PE to be unchanged by the downturn - which may indicate a certain maturing of the industry as its perspective increasingly moves to the longer-term.

### Organization, Funding and Fund Size

The typical organization structure of PE firms in many countries globally is the Limited Liability Partnership (LLP). LLP structures are now allowed in India following the proposals in the July 2009 Indian Government Budget. Alternative investment structures such as the trust structure or the creation of domestic advisory services by an overseas LLP parent investing via the foreign direct investment route enable the key features of LLPs – tax pass-through, limited liability of limited partners (investors) and compensation by carried interest – to be replicated.

Of the respondents we surveyed, we found to funds operate either as overseas LLPs (48 percent), domestic trusts (15 percent) or FDI (15 percent), thus validating the relevance of LLP's for the Indian PE market.

#### PE funds organisation structure



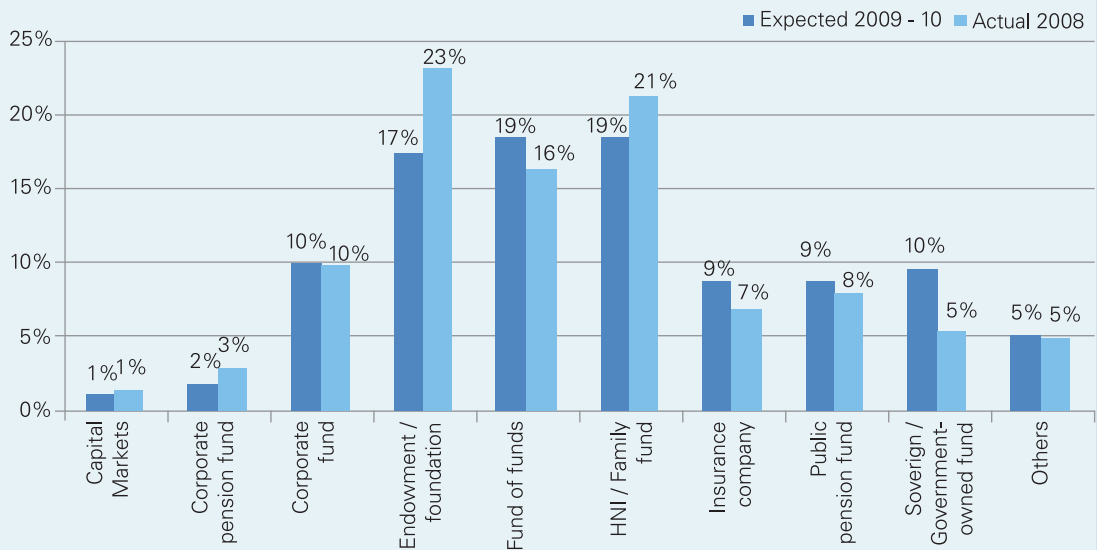
Source: KPMG India analysis, 2009

### Sources of Capital - General Partners

Sources of capital for general partners (GPs) are primarily foundations and endowments (23 percent), HNWIs and family funds (21 percent), and funds of funds (16 percent).<sup>5</sup>

The downturn is expected to cause a reduction in endowment and foundation contributions to 17 percent.

#### PE funds sources of capital



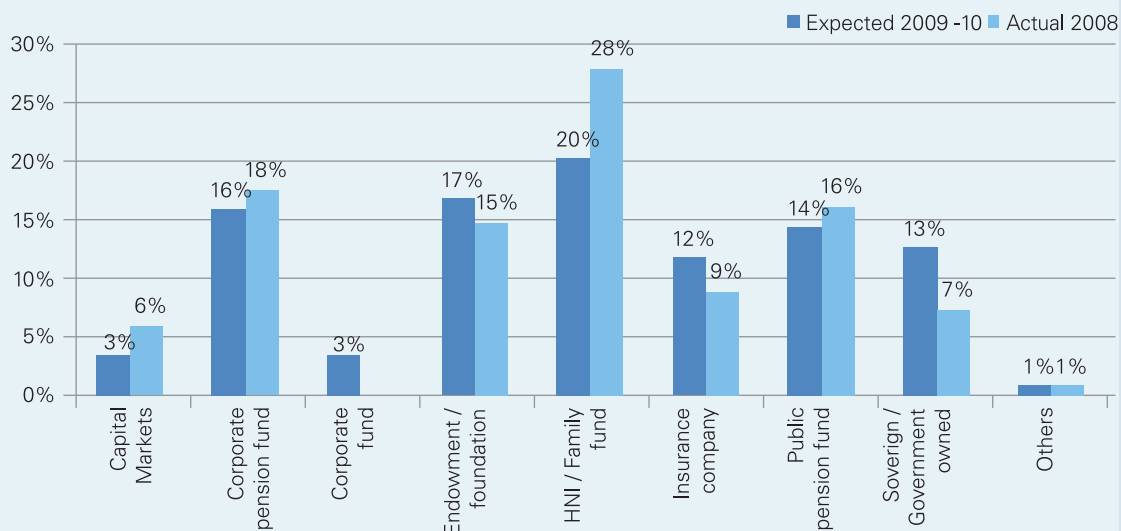
Source: KPMG India analysis, 2009

<sup>5</sup> Overseas LPs face high transactions costs in India relative to investing in domestic markets, given the high registration and monitoring costs. A fund of funds allows them to save these costs, albeit in return for higher fees. Hence, it is not surprising the funds of funds are a relatively prominent feature of India's PE landscape.

### Sources of Capital - Limited Partners

Behind the limited partners (LPs) are a diversified set of sources. Many have HNWI/family funds as their sole source of capital. The downturn does not appear to have significantly changed the sources of capital even though overall volumes may fall.

#### LP sources of capital

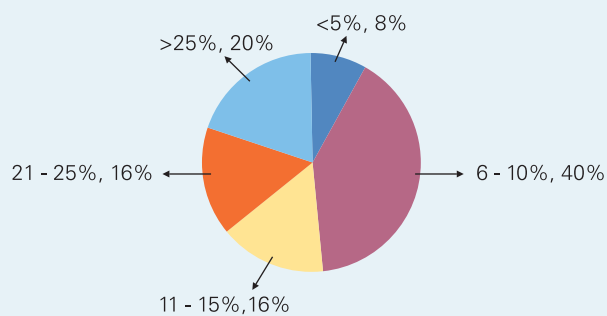


Source: KPMG India analysis, 2009

## Hurdle Rates

Hurdle rates, i.e. the rates of return above which the GP starts to earn the carried interest, average 8 percent. These rates are in line with developed country averages. This is unexpected; because Indian PE should earn higher returns for developing country risks than developed country PE, We would, therefore, expect hurdle rates to be higher than developed country rates.

### PE firms' hurdle rate - Expected 2009 - 10



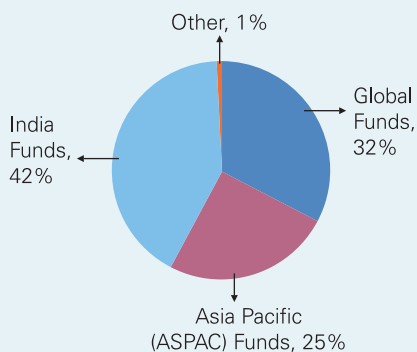
Source: KPMG India analysis, 2009



### General Partners by Region of Interest

GPs investing in India are either domestic, global or Asia-Pacific funds. Asia-Pacific funds are the smallest proportion, and are usually from East Asia. These favor a corporate rather than a partnership structure.

#### Main PE managers by types



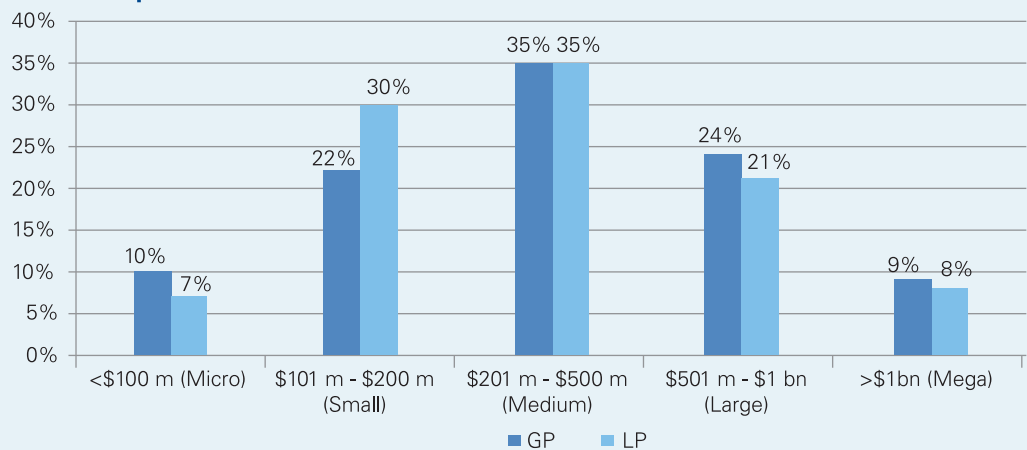
Source: KPMG India analysis, 2009

A large number of Asia-Pacific funds do not consider India to be part of their investment horizon. Many Asia-Pacific funds were initially established to invest in East Asia, not India. As one of our respondents noted: "Many Asia-Pacific funds exclude India because of substantial differences: the democratic culture is different, the role of government is higher in East Asia and the infrastructure challenges in India are greater. That is not offset by the similarities, which are the cost of labor, the knowledge of entrepreneurship and similar ways of coping with a downturn."

## Size of Fund

Both LPs and GPs think that a fund size of USD 201-500 million is appropriate for India, though this is smaller than the global average. According to a majority of respondents, the tenure of Indian investments is likely to be longer than in developed countries. Together, these imply that Indian PE will invest smaller amounts for longer periods.

### GPs & LPs preferred fund size



Source: KPMG India analysis, 2009

## Preferred fund size depends on the industry and stage of investment

However, one respondent who favored fund sizes at the upper end of the USD 200-500 million range, noted that “most promoters want about USD 20-25 million; if a fund is to manage 20 investments, that determines the optimal size. In my opinion, typical India PE funds are below critical mass.”

Another respondent noted that “several PE funds are raising money in the micro (sub-USD 100 million) size. Such a small fund makes diversification difficult.”

So what is the optimal fund size? The answer depends on the investor’s characteristics. As one smaller investor noted “being a small limited partner, we prefer smaller funds in order to get a greater voice. Also, fewer variables are involved than in a larger fund. For example, in larger funds, there might be a push for large deals and quicker returns. Another factor is that developing a long-term relationship with a fund manager, is important for us and this drives down desired fund size.”

By developed country standards, the fund size may appear small, since the US average is over USD 1 billion. However, Indian-focused funds do not need to be as large as those focused on developed economies due to the difference in opportunities. As one investor remarked about billion dollar-plus funds, “There is not sufficient depth or inefficiency in the Indian markets to justify that scale of investment.”

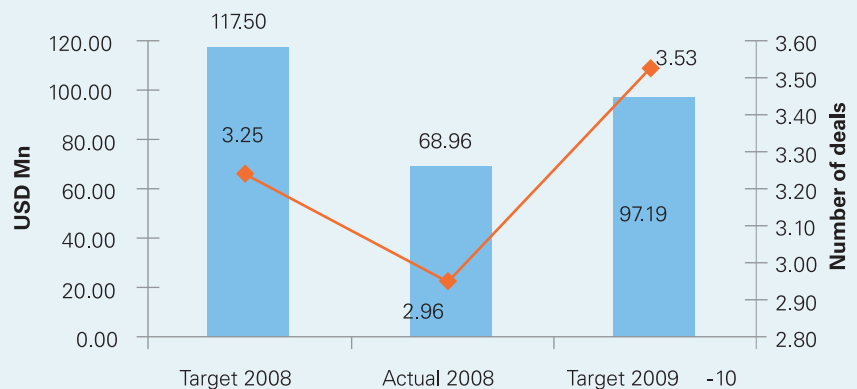
Yet another noted “the preferred fund size will depend on the industry and stage of investment”. For instance, smaller size funds and early stage investments are seen in the IT industry whereas an infrastructure fund is likely to attract larger funds and predominantly focus on growth to late stage investments.

## Investments and the Investment Environment

### Average investment and the number of deals by General Partners

The average fund invested about USD 69 million in an average of three deals in 2008, an amount that was 40 percent below expectations. Current trends indicate a recovery to USD 97 million invested in an average of 3.5 deals by 2010, albeit this is still 20 percent below the expectations of 2008. Respondents largely related this recovery to expectations of a global economic recovery in 2009-10.

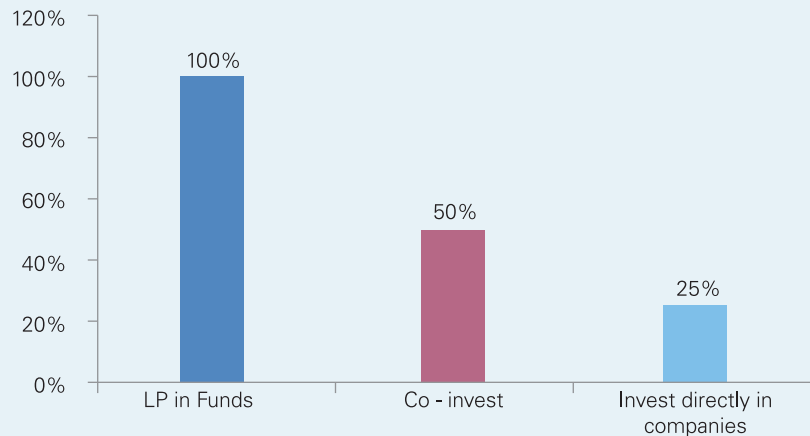
**Average PE firm's investment and no. of deals**



Source: KPMG India analysis, 2009

## Limited Partners Investment in India

**LPs investment in India**



Source: KPMG India analysis, 2009

LPs are now significantly co-investing with their GPs and are also making direct investments

One of the results of the global economic downturn has been a change in the way LPs invest, 50 percent of the LPs we surveyed co-invest along with their GPs and 25 percent make direct investments in other companies.

However, most LPs are still supporting capital calls, although that ratio, according to GPs, has fallen to 95 percent. In some cases, LPs are only committing to capital calls for management fees rather than for fresh investments.

Given the state of the global economy and the expected contraction in the number of GPs, 83 percent of LPs have not sought to change GPs, it is perhaps interesting that or exit prior to maturity - although 33 percent have sought a change in the earlier standardized "2/20" norms. Those LPs who have succeeded in doing so report that the new terms approximate 1.5/15.



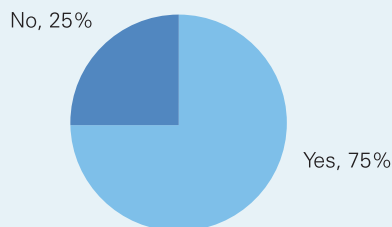
## The better performing GPs in India are now visible to LPs

### The Role of Limited Partners in the Investment Process

Fourteen percent of GPs and 42 percent of LPs surveyed, stated that LPs are taking a more hands-on role in investments. This represents a significant cost for LPs - and one that they probably did not plan for. While the LP response could indicate an unexpected level of dissatisfaction with the GP's performance, it could also be partly driven by the level of their co-investment. If driven by dissatisfaction with their GPs it will be interesting to see going forward whether LPs are still supportive of GP capital calls.

Moreover, a significant proportion of LPs (75 percent) are pursuing secondary transactions, primarily to invest in better-performing GPs. Interestingly, except for one LP who mentioned they were sellers, all other LPs mentioned that they were buying LP secondaries. Buying secondaries is attractive vis-à-vis primaries as these are available at a 35-40 percent discount.

#### Are LPs pursuing secondary transactions?



Source: KPMG India analysis, 2009

The current domestic LP base is small and inadequate.

About a third of LPs indicated that the Indian PE environment had matured sufficiently so that the better GPs were visible. The downturn had also helped improve the visibility of higher-quality GPs. In part, this is because LPs are collaborating and have begun to share information and due diligence notes on the performance of funds they have invested in. These findings suggest that GPs' market share may, in future, start to be skewed in favour of better performers.

Some of the other reasons mentioned by LPs on why they pursue secondary transactions included 'taking advantage of quality portfolios available at attractive valuations', 'discovering new managers' as well as 'pursuing secondaries being their main line of business'.

### The Importance of the Domestic Limited Partner Base

Seventy six percent of GPs and 83 percent of LPs believe that having a domestic equity base is important, although for different reasons.

First, overseas LPs acknowledge that it is difficult to be hands-on. They view Indian-based LPs as more knowledgeable than them on issues relating to the Indian business environment and thus perceive them as being able to help protect the interests of all investors. As one overseas LP observed, "in the event of any regulatory changes, it is always useful to have domestic participation as the sector becomes susceptible to concerns about foreign equity involvement." Another stated "overseas limited partners rarely act unitedly as distance tends to prevent coordinated action," whilst a third noted "it is important for this asset class to be understood by local industry. This is possible only with a domestic capital pool, so that industry understands what benefits it brings."

Some international LPs also saw value in building networks with domestic investors as a result of joint investments. However, another, located in the United States, noted “it is hard to get to know domestic LPs from such a distance; there is a community of US-based LPs that we can communicate with instead.” Some also saw competition ahead, a U.K. based investor noting that “India is not at the stage of development where the capacity to absorb PE is large enough. Overseas LPs do not want too much money going into the market in order to prevent excessive competition for deals.”

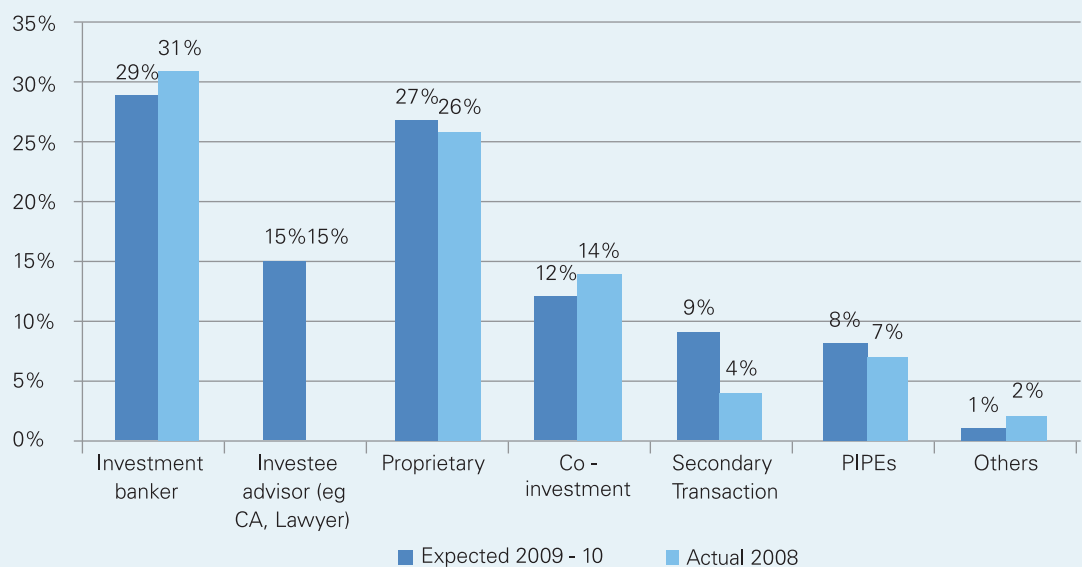
For managers, the reasons for wanting more domestic investors were for diversifying the sources of funds as well as from a sense that domestic funds might be a more stable source of capital, especially during the current global downturn. Investors understood this view, one overseas investor remarking that “especially in times like this, it is important to have a domestic LP base, as international capital has dried up.”

### Sources of Deals

The reliance on deal flow from intermediaries is not expected to change in the near future with 44 percent of all deals expected to come from intermediaries.

PIPEs are expected to marginally increase to 8 percent but still substantially down from previous years.

#### Sources of deals



Source: KPMG India analysis, 2009

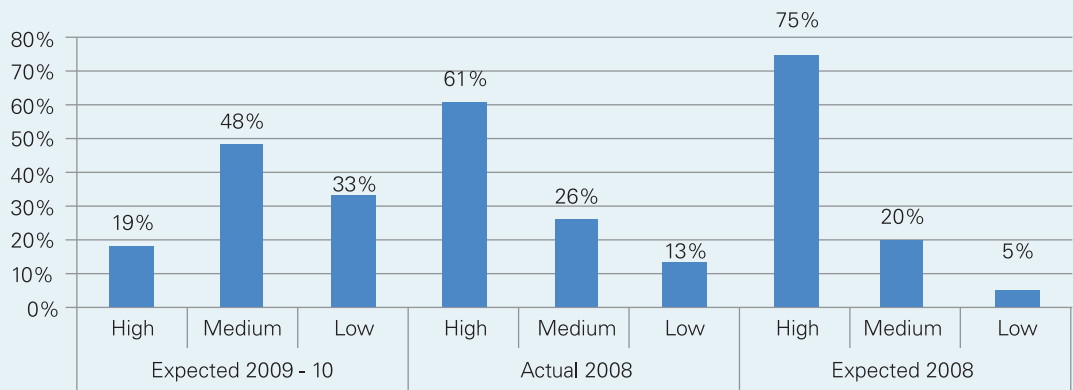


### Competitive Environment

At the investment funnel's other end, deal access has improved dramatically. As the figure below shows, there has been a significant improvement, although LPs expect that, looking ahead, the competition for deals will increase. This stems from their belief that although there are a large number of deals, there are very few high quality deals, thus making the environment competitive.

On the other hand, from the GPs' perspective, as one respondent notes "for funds that have demonstrated success either in terms of value-add in their portfolio companies or focus on few sectors where they have demonstrated expertise or have been able to build a rapport with the management of the portfolio company – for such funds the competition is lower".

**PE firms' assessment of competition for deals**



Source: KPMG India analysis, 2009

Although the competitive environment is expected to fall, competition for high quality deals is expected to be strong

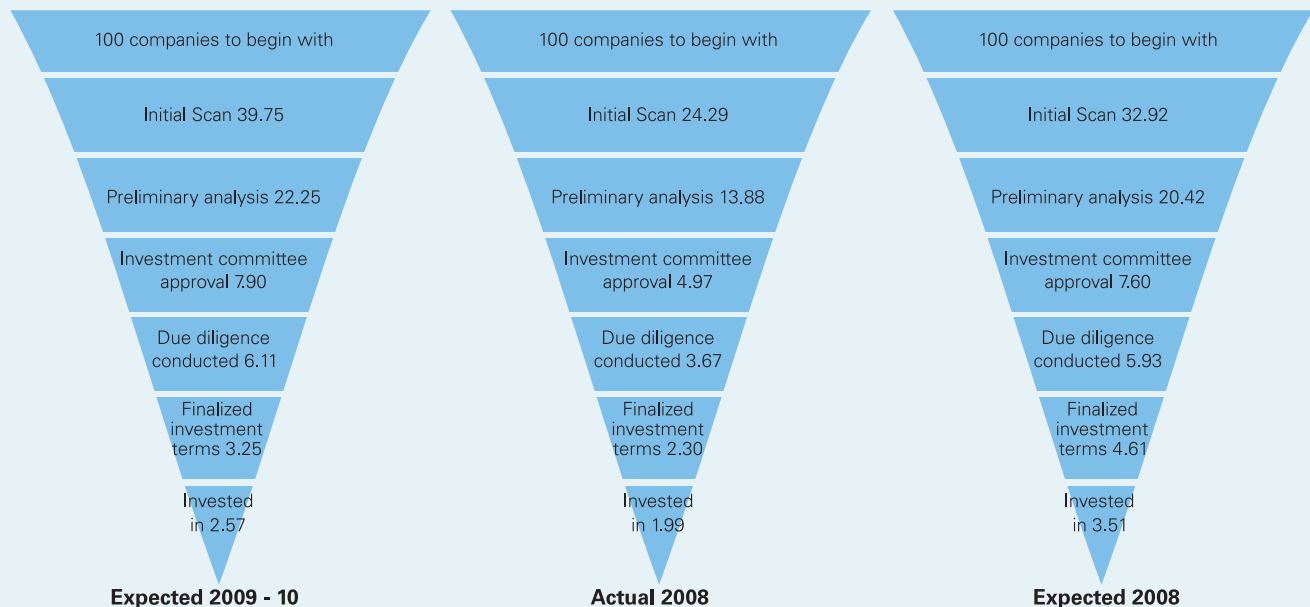
## The investment funnel is expected to improve as competition for deals decline

### Investment Funnel

The investment funnel has changed from the frenetic times that marked most of 2007 and the first 9 months of 2008.<sup>6</sup> Compared with expectations of 3.5 percent hit rates, fewer deals (less than 2 percent) passed fund managers' filters to closure in 2008. The likely reasons are several: poorer quality deals than expected or, more likely, the high prices of deals. The global downturn also impacted deal closure as investors became more cautious and conducted more stringent due diligence.

Current trends indicate, as noted above, reduced competition for deals. Hence, they show a return to the higher deal-quality expectations of 2008, with fund managers expecting, on average, to invest in 2.6 percent of offered deals.

#### Funnel of Investment



Source: KPMG India analysis, 2009

<sup>6</sup> [http://www.indiape.com/blog/\\_archives/2008/3/14/3579486.html](http://www.indiape.com/blog/_archives/2008/3/14/3579486.html)

## GPs believe that the risk within their portfolios exceed market risk

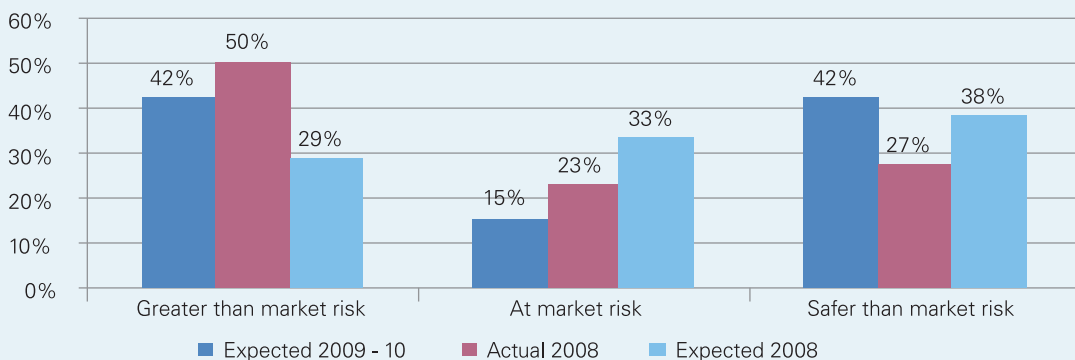
### Portfolio Management

GPs began 2008 anticipating that investments in the 'hot-market' that India had at the time carried sub-market risk. However, by year-end, they had come to the realization that the risk within their portfolios exceeded market risk. In response, risk positioning in 2009 appears to follow a divergent pattern: some funds have become more risk-averse, while others have chosen to take greater risk, leading to a decline in those willing to be at-market. Those choosing the latter stance argue that choosing investment instruments with downside protection such as investments with anti-dilution clauses and focusing on a few sectors in which they have expertise leads to a real risk-exposure that is relatively low.

#### Assessment of Portfolio Risk

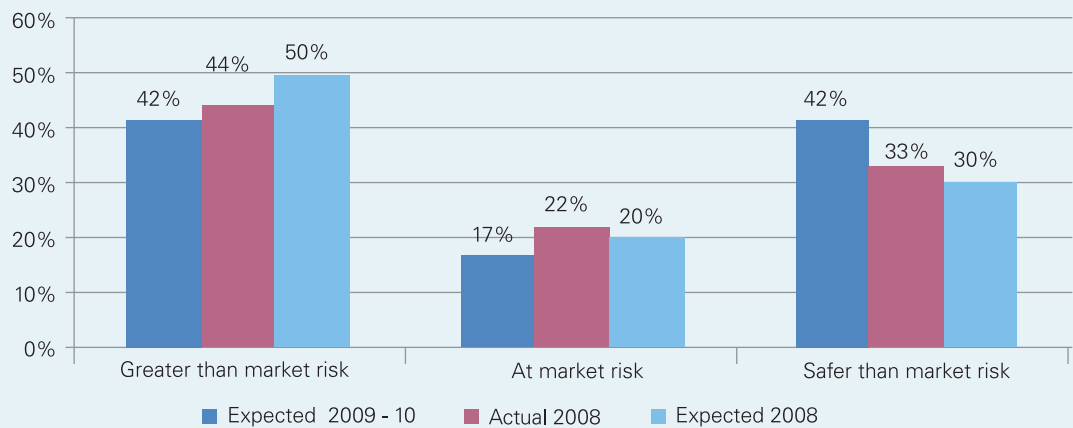
Interestingly, LPs appear more realistic about future market risks, always believing it to be greater than market risk for 2008; although there is agreement with GPs on the risk profile looking ahead.

PE managers' assessment of portfolio risk



Source: KPMG India analysis, 2009

### LPs' assessment of portfolio risk



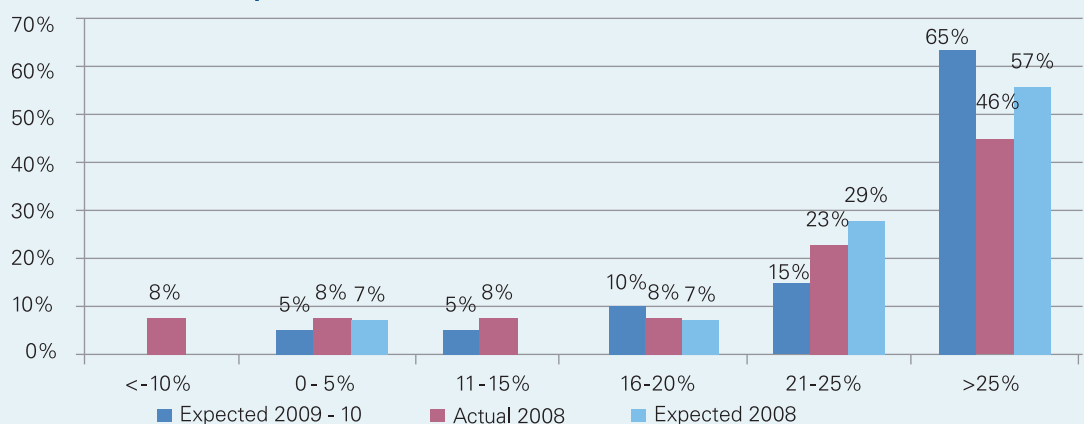
Source: KPMG India analysis, 2009

### Assessment of Return on Capital

GPs are twice as optimistic than their LPs on returns

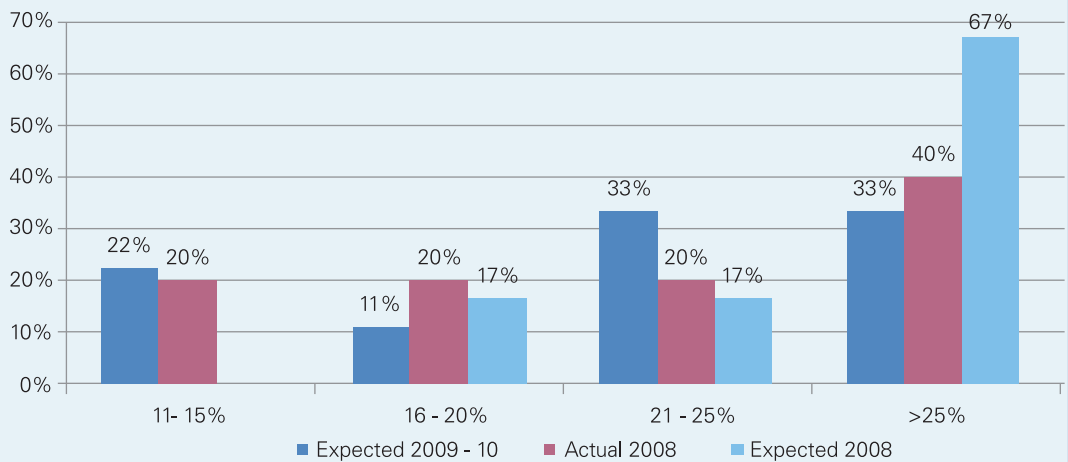
Sixty five percent of GPs expect the median expected return for 2009-10 will be over 25 percent - surprisingly this has not been affected by the above shifts in risk-tolerance. Further, although the return expectations exceed developed country PE returns, actual returns equal the average five-year performance of Indian equity markets and are about equal to past Indian PE returns. GPs, however, are twice as optimistic than their LPs about the future, with only 33 percent of LPs expecting returns for the same period to exceed 25 percent.

### PE firm's return on capital



Source: KPMG India analysis, 2009

### LPs' assessment of return on capital



Source: KPMG India analysis, 2009

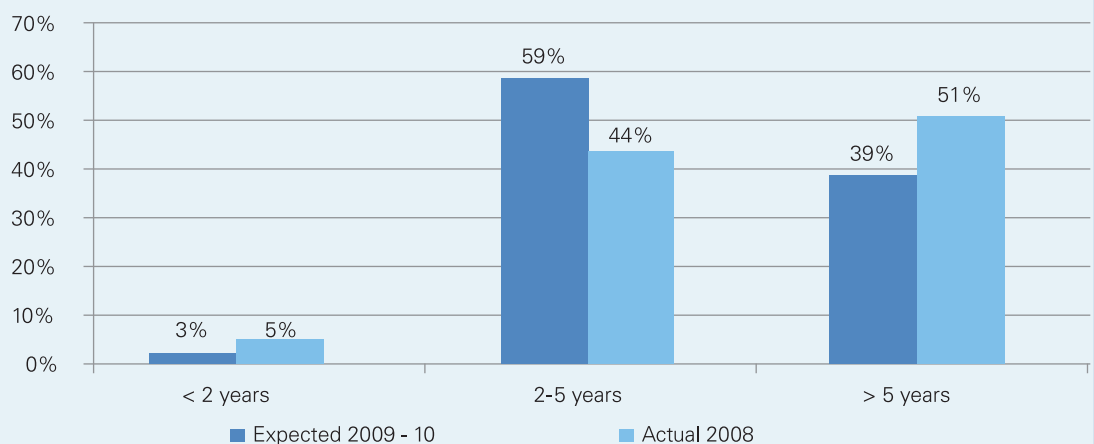
In our introductory analysis, we argue that a reliance on brokered deals was likely to be an intrinsic feature of the Indian PE model going forward. Could this affect returns across PE firms? One argument is that deals that are brokered tend to be finely priced which means that PE firms have to work harder post investment to achieve their desired returns. Since most GPs have similar costs of capital, they will have similar thresholds for investment. Hence, a deal that is attractive to one GP is likely to be attractive to others as well. Therefore, we could expect to see some commonality in expectations of returns. This is confirmed by the figures above.

## Holding Period

In the United States, the holding period of the typical investment is 3.5 years. In India, it averages over 4 years, with, as in developed markets, a blip towards 5 years due to the unexpected events of 2008.<sup>7</sup>

Both GPs and LPs believe that holding periods will reduce to between 2-5 years indicating their expectation of a positive change in the environment going forward.

### GPs assessment of holding period of typical portfolio firm



Source: KPMG India analysis, 2009

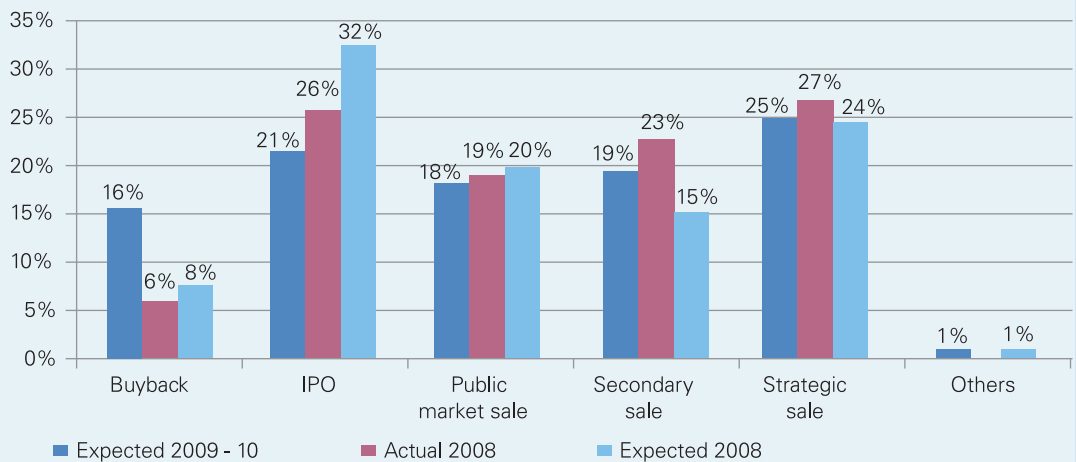
<sup>7</sup> [http://money.cnn.com/magazines/fortune/fortune\\_archive/2006/11/27/8394344/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm), downloaded June 19, 2009

## Exiting Investments

Exit via public markets, whether through an IPO, public market sale or strategic sale (usually to a public company), continues to be the dominant expectation. The decline in equity markets in 2008 has not affected this perception significantly, reflecting, perhaps, on confidence in long-term market depth.

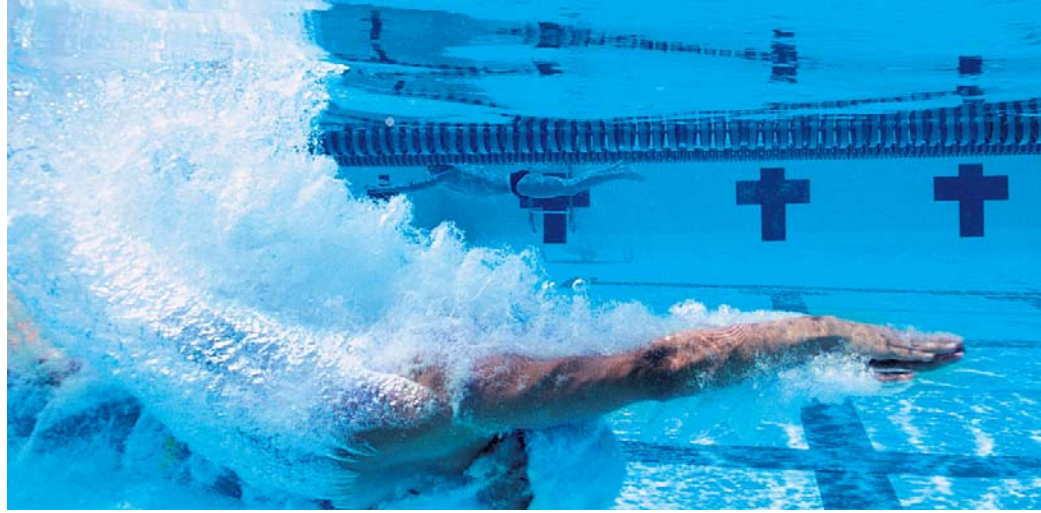
Since August 2009, the Indian public markets have already recovered significantly and initial signs indicate that there is a considerable amount of liquidity in the market from institutional investors for IPOs.

### Avenues of exit



Source: KPMG India analysis, 2009

Strategic sales is likely to be preferred source of exit as against IPOs



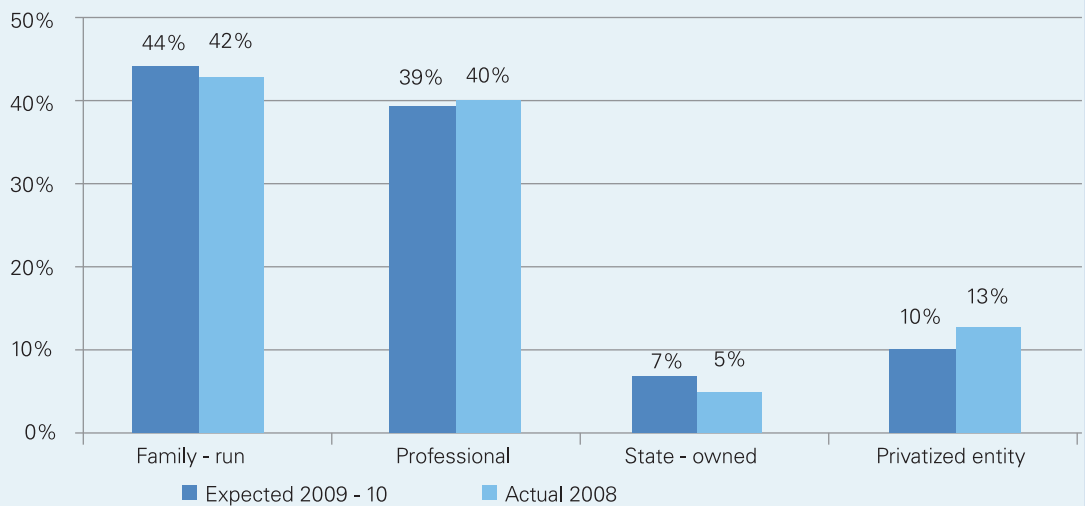
### Focus on Portfolio Companies

A portfolio dilemma that emerging country PE managers typically face is the professional versus family-run firm.

Given the entrepreneurial environment in India, investment opportunities in family-run firms is probably unavoidable. However, we found that our respondent GPs were of both types: managers who strongly declared that they would invest only in professionally run firms due to problems of control and corporate governance in family-run firms; and those who indicated a preference for family-run firms as these offered a wider field of opportunities. Overall, it is a near tie, with little change over the past year.

Our view is that this is unlikely to change in 2009-2010.

#### Management of portfolio firm



Source: KPMG India analysis, 2009

Operational changes post investments have not reduced. Are PE firms being effective in their portfolio companies?

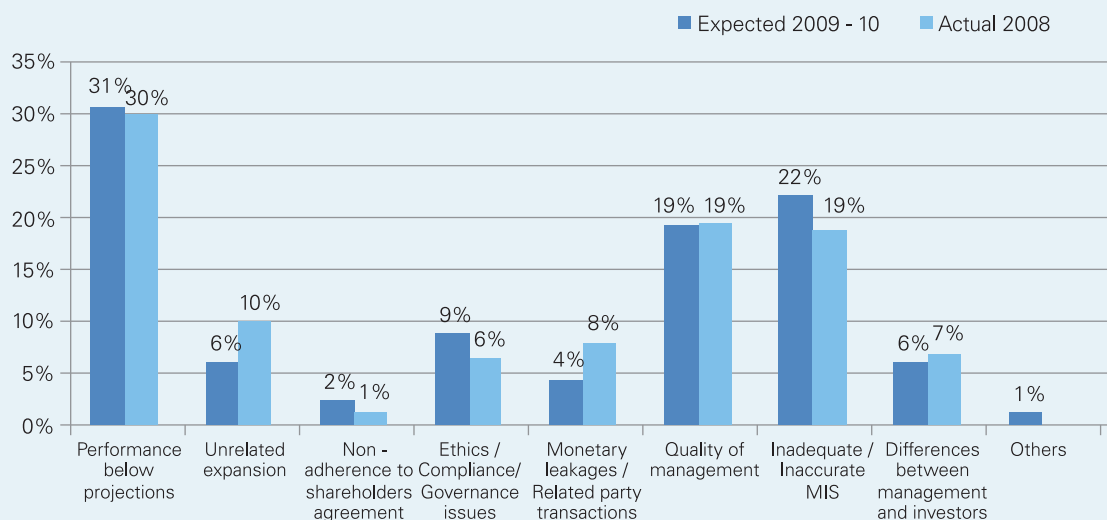
### Post Investment Challenges

The key post-investment issues and challenges consistently center on performance being below projections, inaccurate information systems and poor management quality. These appear to be fundamental issues as there is little change expected. It raises also the question as to whether the portfolio environment is maturing.

Improvement in the quality of due diligence could equip PE Houses with a better understanding of these issues. Due diligence of the target is typically around financial, market, and business issues and the management team. Expanding the due diligence scope to include MIS systems, the budgeting and planning process and other key business processes could highlight weaknesses which could be better addressed post investment.

These findings also provide some insight on how effective PE firms are with their portfolio companies post-investment. They throw up several key questions. Are PE firms acting as a catalyst for change? Are they adequately challenging their portfolio companies on performance? Are they making a meaningful contribution on operational and strategic matters? Are they compromising the overall quality of corporate governance if MIS systems continue to remain weak?

GPs post - investment key issues / challenges



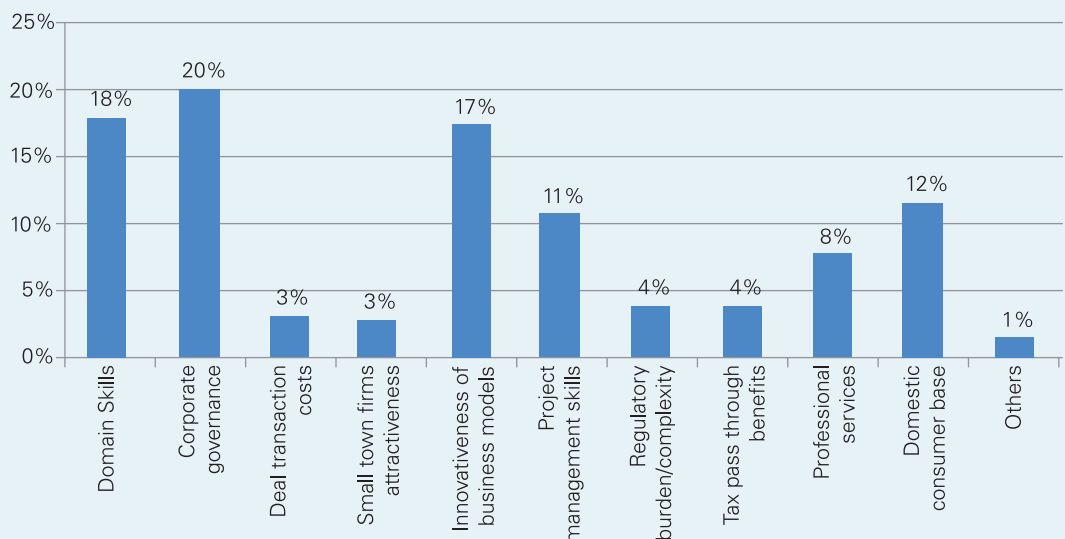
Source: KPMG India analysis, 2009

## PE Industry Expectations on Environmental Changes

These figures indicate some dissatisfaction with how investees have organized and projected themselves to investors. While some overconfidence is inevitable when presenting to investors, fund managers are generally experienced enough to discount this. That they continue to feel challenged by these issues is a sign of deep uncertainty.

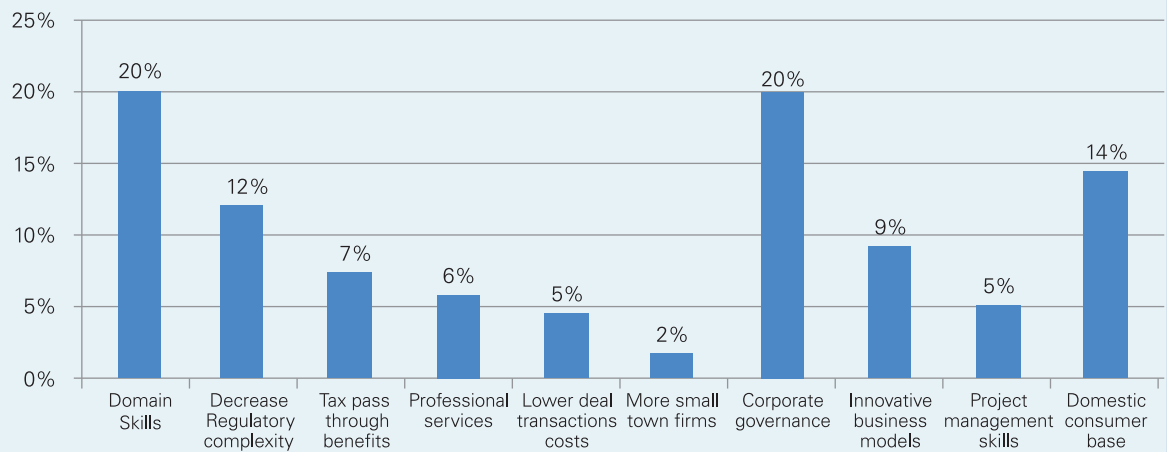
This is further evident by the expectations of fund managers about the environment – they are focused on operational issues rather than external changes, such as tax or regulations. Three of the top four concerns, accounting for two-thirds of total concerns, are operational: domain skills, innovativeness of business models and corporate governance (the fourth is the domestic consumer base). LPs echoed the concern about domain skills and even more strongly on corporate governance.

### PE industry expectation of environmental changes



Source: KPMG India analysis, 2009

### LPs expectation of environmental changes



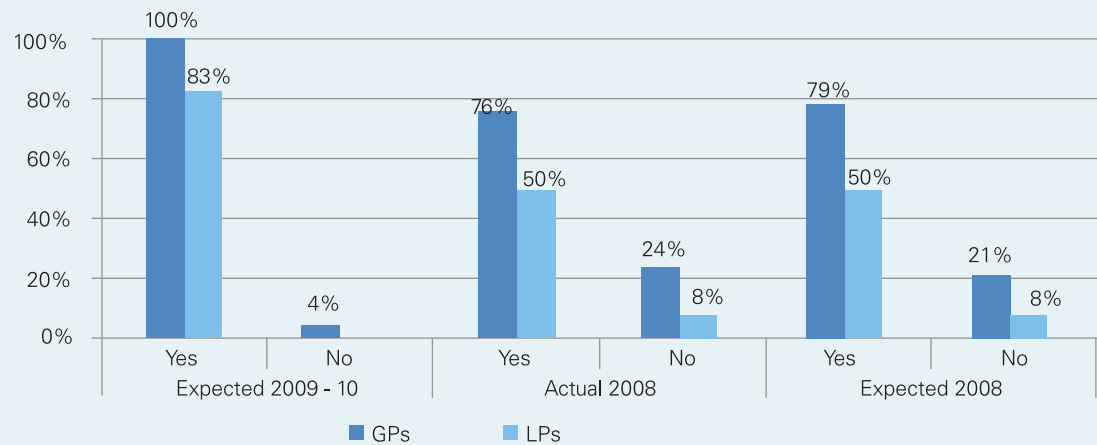
Source: KPMG India analysis, 2009

Although tax and regulatory burdens did not figure in the top three concerns, they nevertheless, remain as key issues. For example, one respondent stated: “there is too much change, leading to a feeling of vulnerability that the laws might go against the investor at short notice. Partnership agreements are, therefore, hard to write”. Another commented that “too many approvals are needed and regulations change frequently”.

### Preference for Independent Directors

A dramatic change is found in the importance of corporate governance. This may be, in part, due to the Satyam corporate scandal that broke in December 2008, or the result of experience. The percentage of fund managers who called for independent directors on the boards of their portfolio companies rose from 76 percent in 2008 to nearly 100 percent looking ahead; limited partners offered similar indications.

### PE managers' & investors preference for independent directors



Source: KPMG India analysis, 2009

Both GPs and LPs recommended that the percentage of independent directors should be between a third and half of all directors, with roles focusing on strategic, financial and regulatory oversight, and on risk assessment. In addition, LPs wanted independent directors to review operations.

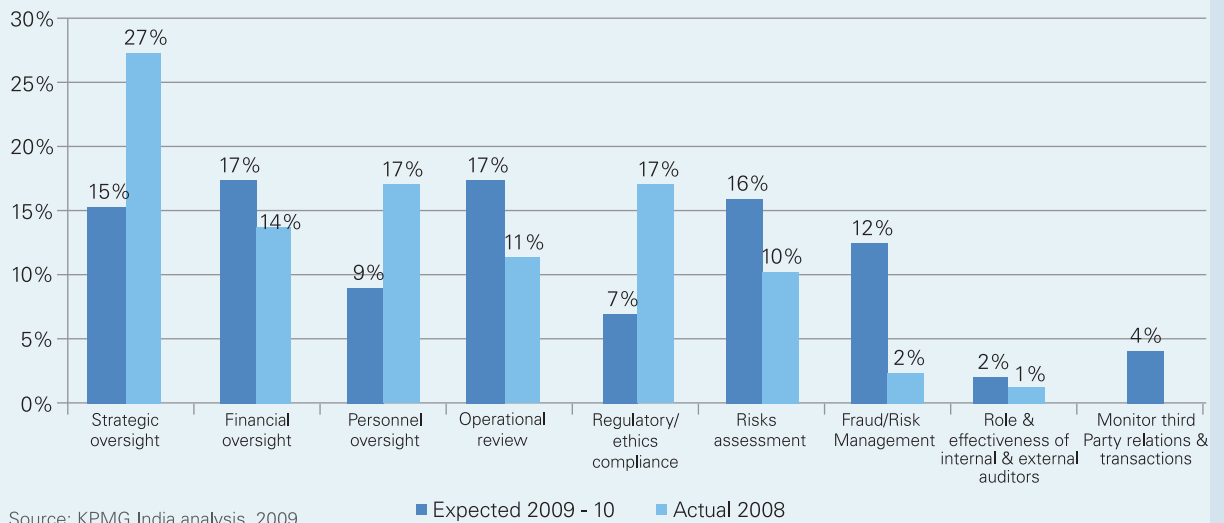
However, to improve corporate governance it is not enough to have more independent directors. This is only the start of the journey. PE firms need to act as the catalyst for change to bring about meaningful improvements in corporate governance.

### Preferred Role of Independent Directors

Whilst GPs desire that independent directors focus their roles more around strategic oversight, and less on risk assessment, fraud risk management and the effectiveness of the internal and external audit function, LPs clearly prefer that independent directors should focus their roles more around regulatory compliance, fraud risk management and risk assessment.

This analysis seems to suggest that GPs have not changed their views significantly on the risks of poor corporate governance but that LPs have become increasingly concerned in light of the Satyam scandal.

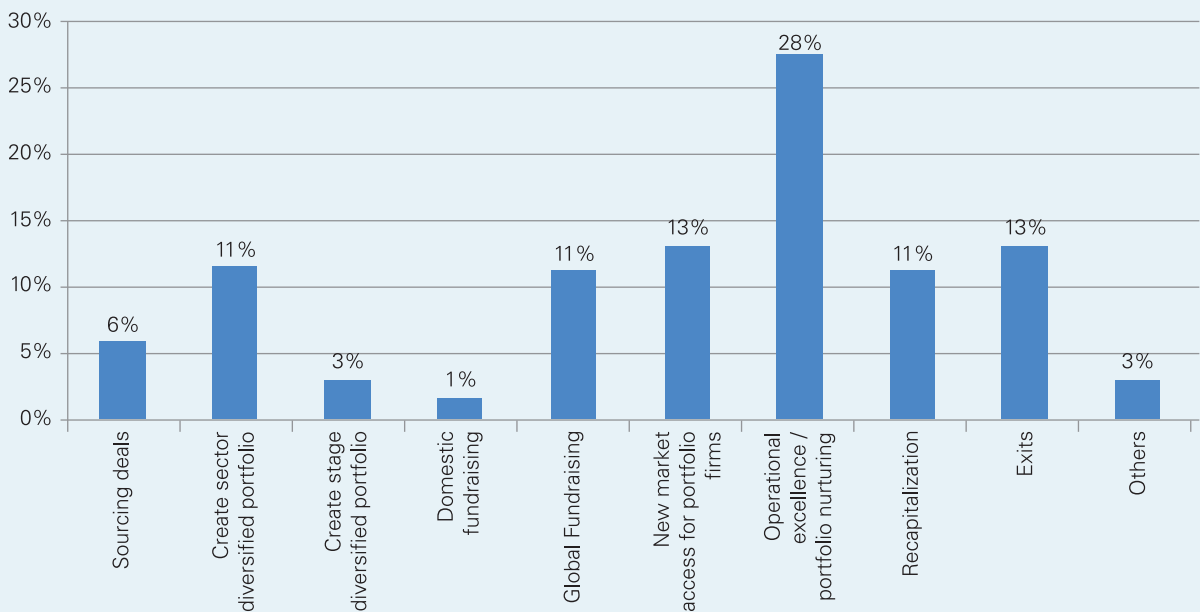
#### LPs preferred role of independent directors



## Priorities of Private Equity

So what does this mean for the future focus of PE? The data for GPs expectations for 2008 show that PE in India was still focused on strategic issues on the one hand – such as opening new markets for investee firms, but also tactical issues on the other – for example accessing ‘hot deals’. The downturn of 2008 has brought home to PE fund managers that, the real value of PE is currently similar to that of other global markets - i.e. improving operations. This is reflected in their future priorities.

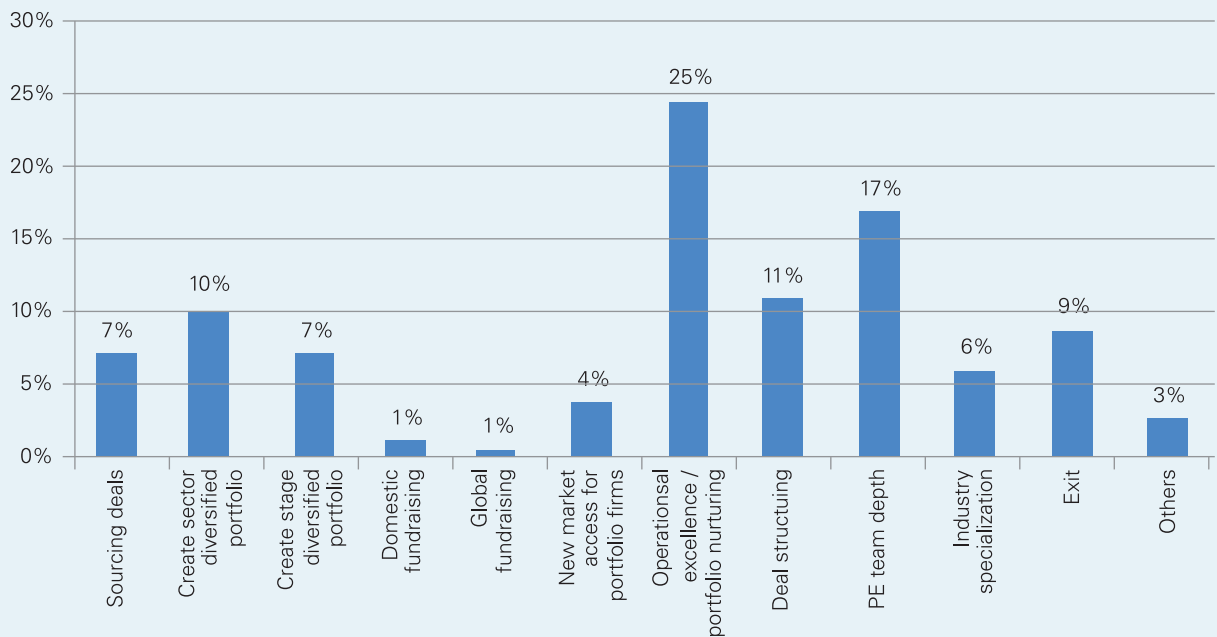
**GP priorities of private equity - Expected 2009 - 10**



Source: KPMG India analysis, 2009

Their limited partners agree. Focusing on operational excellence of the portfolio firm emerges as the clear preference of limited partners for their fund managers.

### LPs priorities for GPs - Expected 2009 - 10



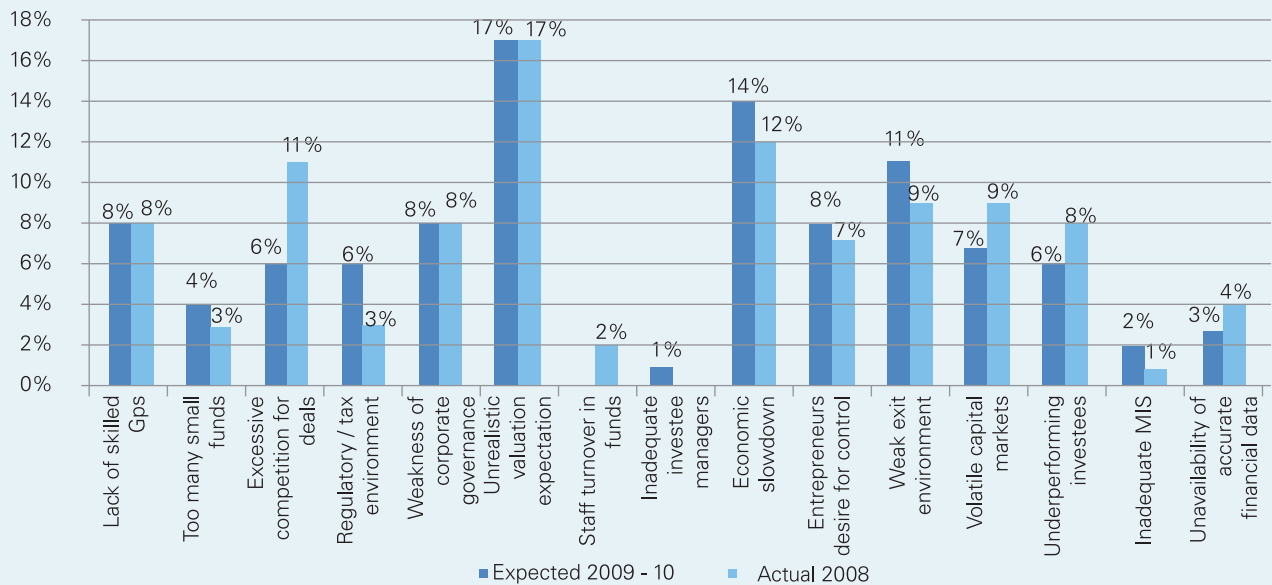
Source: KPMG India analysis, 2009

However as one GP observed - "the priority will be different depending on the lifecycle of the fund. For an existing fund which is two-thirds into its fund lifecycle, exits may be more important and they can defer fund raising by a short period, but for a new fund, deal sourcing and investing may be more important".

## Key issues facing Private Equity

Unrealistic valuations remain the key issue facing GPs according to our survey.

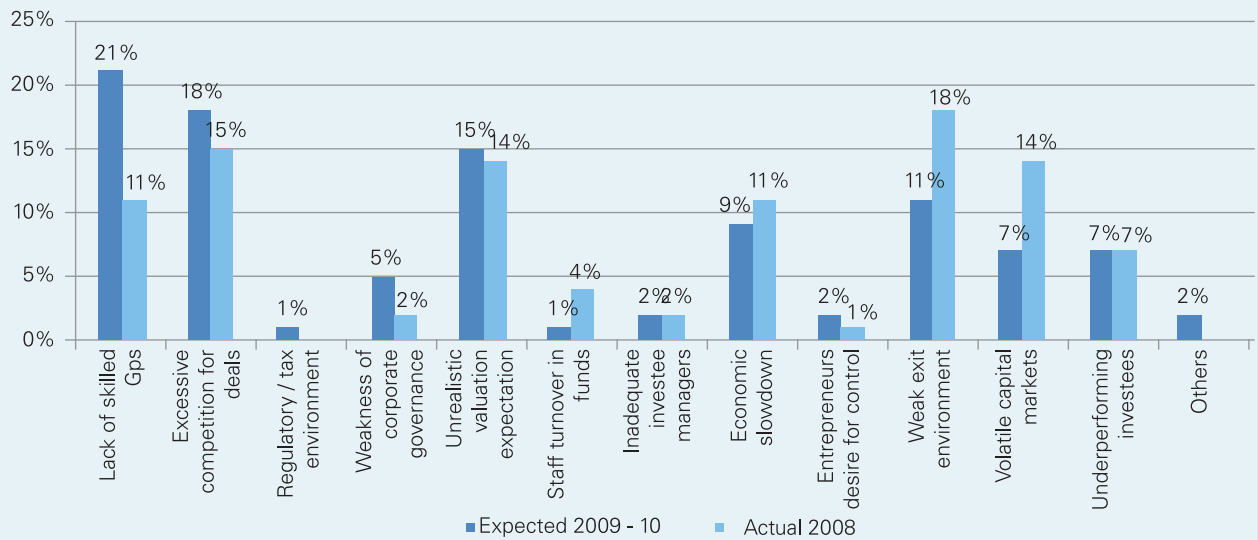
### GP perspective on key issues facing PE



Source: KPMG India analysis, 2009

LPs' ranking of the key issues facing the PE industry, however, indicates a different dilemma in that they do not think their GPs have the necessary skills to help the portfolio firm achieve operational excellence. This is shown by their top concern for 2009-10, the lack of skilled fund managers – note the change from 2008.

### LPs perspective on key issues



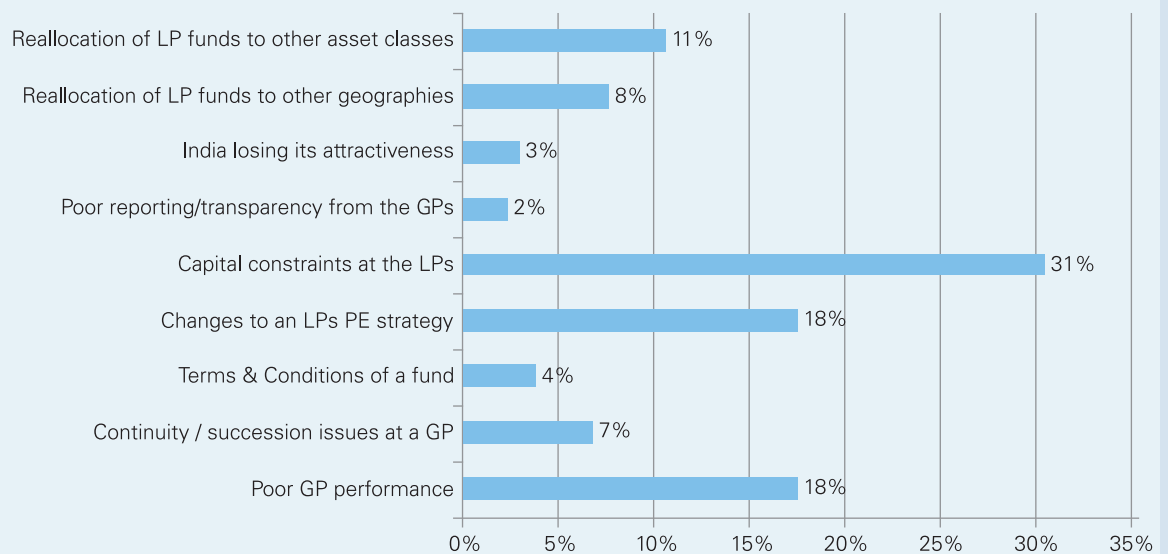
Source: KPMG India analysis, 2009

The different dimensions of this issue are apparent from the responses of LPs. One international LP bluntly stated that “GPs on the ground in India do not have the needed operational experience.” Another stated that “It is difficult to find a PE manager in India with all the five attributes that we consider essential: team depth, fundraising skills, deal access, operational skills and exit management.” One investor summed it up by stating that “The general PE market in India is very immature.”

### Factors affecting LP re-ups

Despite the above mentioned concerns on PE manager quality, LPs' reasons why they may not support their GPs in the future are external to the manager, such as capital constraints faced by the LP or a change in the LPs strategy with regard to asset class or focus on PE. The GPs' performance is a reason in just 18 percent of the responses.

#### Likely factors deterring LP re - ups or renege on capital calls in the next 12 months



Source: KPMG India analysis, 2009

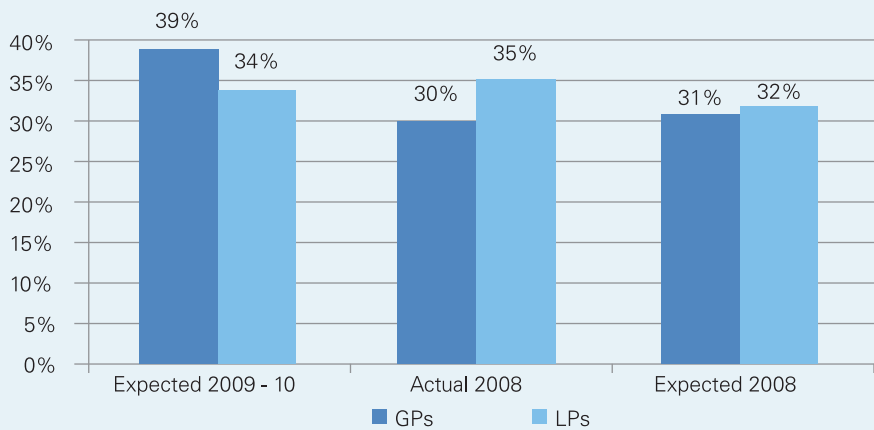
As one LP said "LPs don't typically renege on capital calls. They will lose their entire position in the fund so prefer to sell their LP position to another LP in a secondary transaction".



## Looking Ahead

Our survey findings indicate that both GPs and LPs rate PE as being important for India's economic development. Their logic is that although it is probably not the most important factor, PE is a significant factor for the development of small businesses, which are important to the overall health of the Indian economy. One investor, however, noted that the debt market needs to be vitalized first and this factor is probably more important than PE.

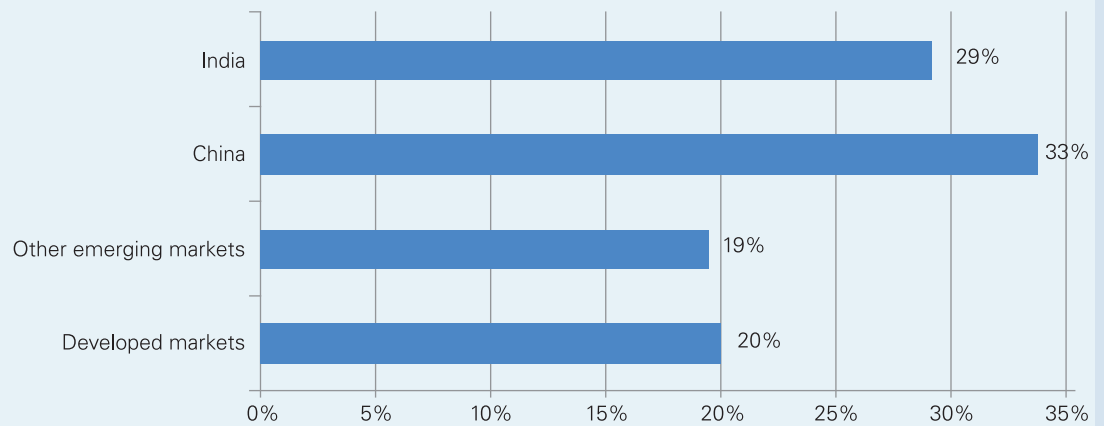
**GPs & LPs assessment of the importance of private equity for India's economic development**



Source: KPMG India analysis, 2009

Equally, both domestic and international investors rated India as an important emerging market destination for PE, second only to China. India is seen by the survey respondents to offer diversification from other emerging market investments because of its uniqueness.

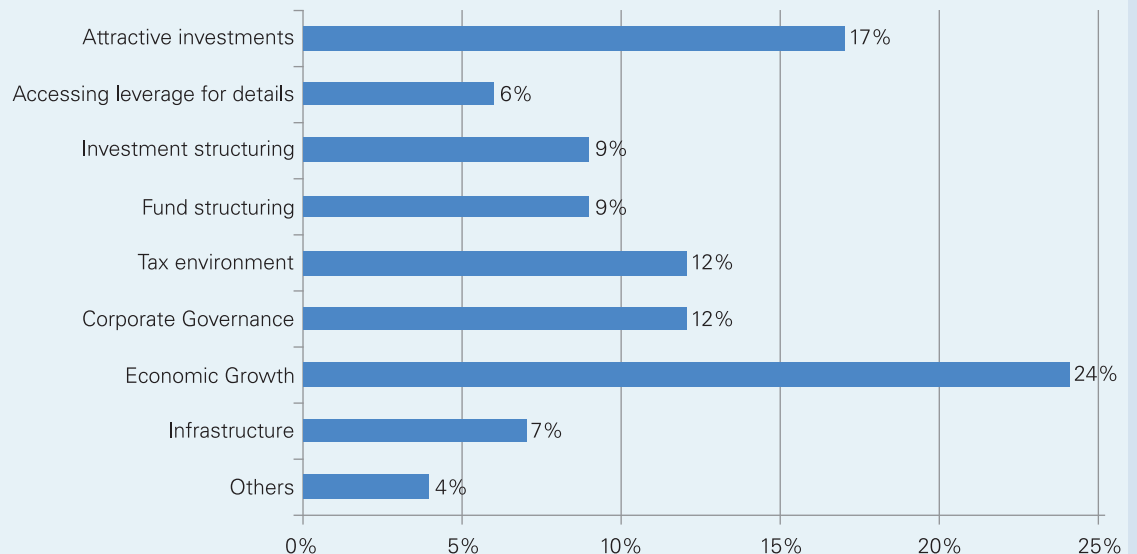
### Ranking India with competing geographies



Source: KPMG India analysis, 2009

The attraction of India for LP investors - most being from overseas – is India's economic growth. This was attractive to 24 percent of investors. Interestingly, as the following chart shows, deal quality (attractive investments) remains a tactical attraction. The downturn has not changed these parameters since 2008.

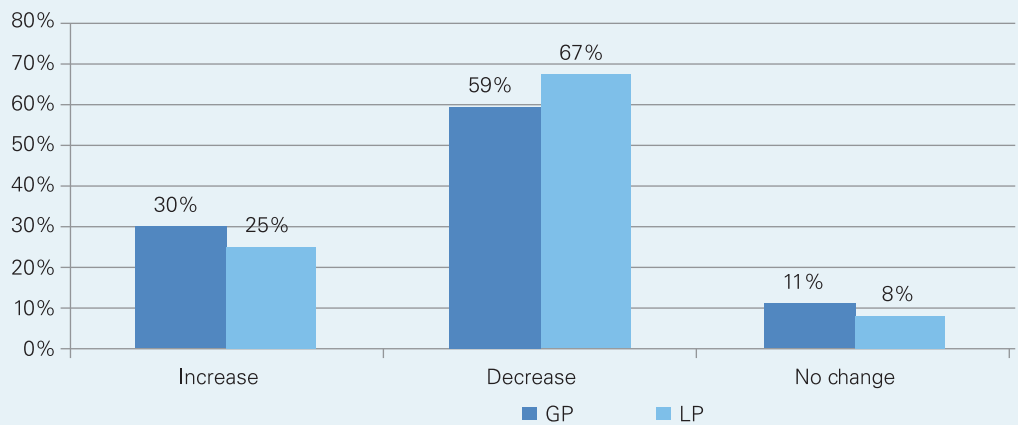
### India versus other emerging economies



Source: KPMG India analysis, 2009

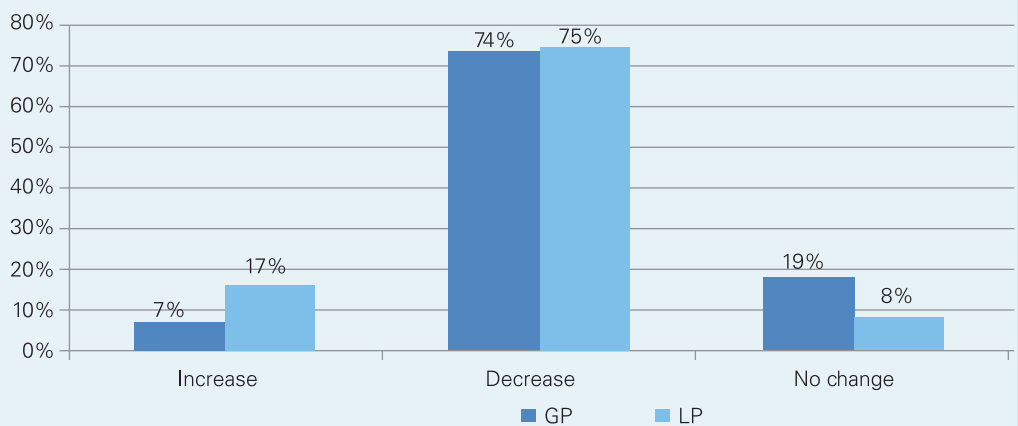
2010 is expected to be a year of consolidation: a focus on portfolio nurturing, fewer new deals or fund-raising, smaller investment sizes, fewer exits, and a smaller industry generally.

### GP & LP perspective on number of deals



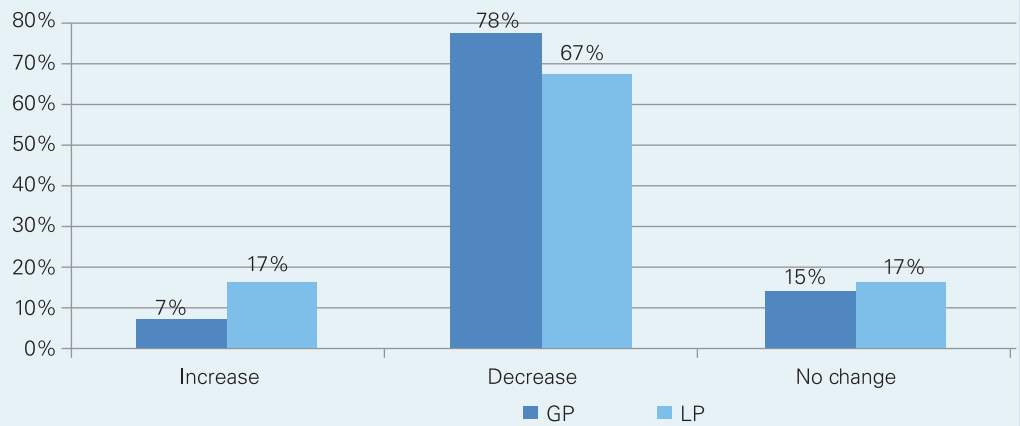
Source: KPMG India analysis, 2009

### GP & LP perspective on total PE investment



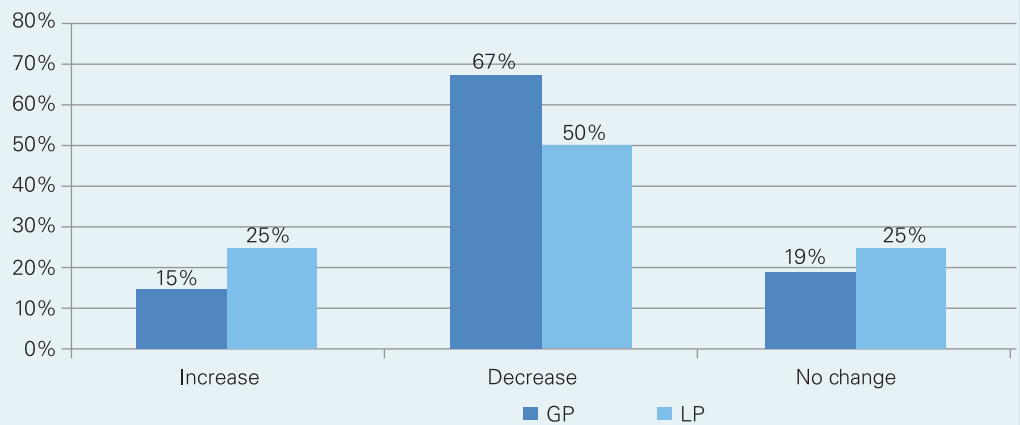
Source: KPMG India analysis, 2009

### GP & LP perspective on average deal size



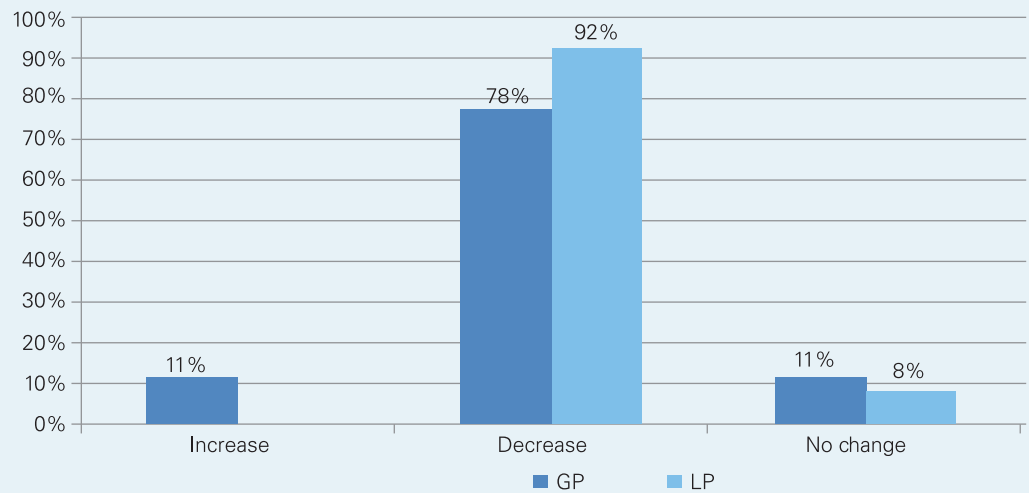
Source: KPMG India analysis, 2009

### GP & LP perspective on exits



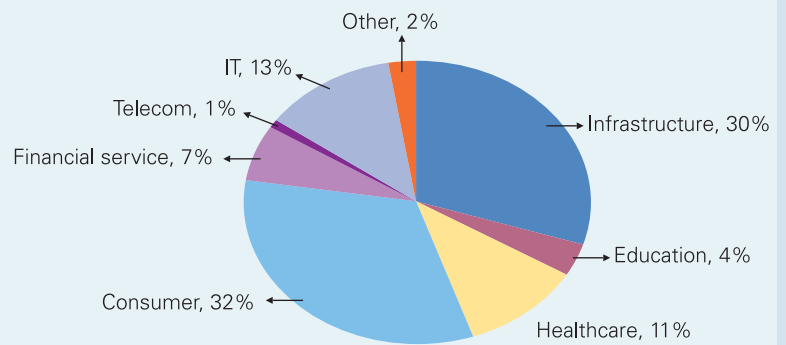
Source: KPMG India analysis, 2009

### GP & LP perspective on overall fund raising

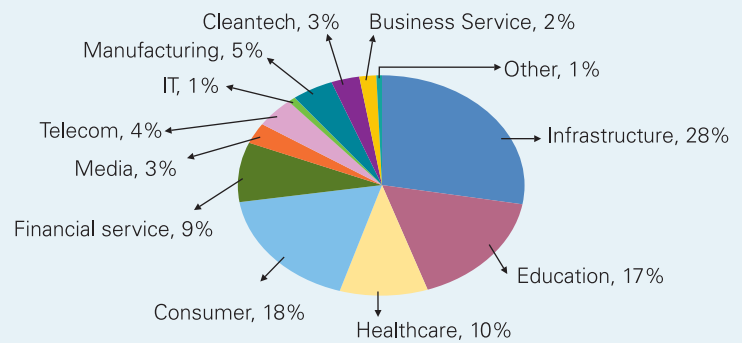


Source: KPMG India analysis, 2009

The expectation is that growth stage infrastructural investments will predominate and that exit avenues will be widespread. While growth stage investments pre-dominate the expectations of both GPs and LPs, LPs prefer, as a second choice, a focus on buyout, while GPs are interested in late stage investments. While LPs prefer domestic/consumer products, infrastructure and IT, GPs indicate a preference for infrastructure, education and domestic/consumer products. The difference appears to stem from being on the ground. LPs, most of whom are located overseas, view the attractive opportunities in developing country frameworks, with the addition of India's known prowess in IT. GPs – closer to the ground – identify a particularly active sector; education, as an opportunity. Of course, being closer to the ground can often mean a loss of perspective, as the fortunes of PE in 2009 showed.

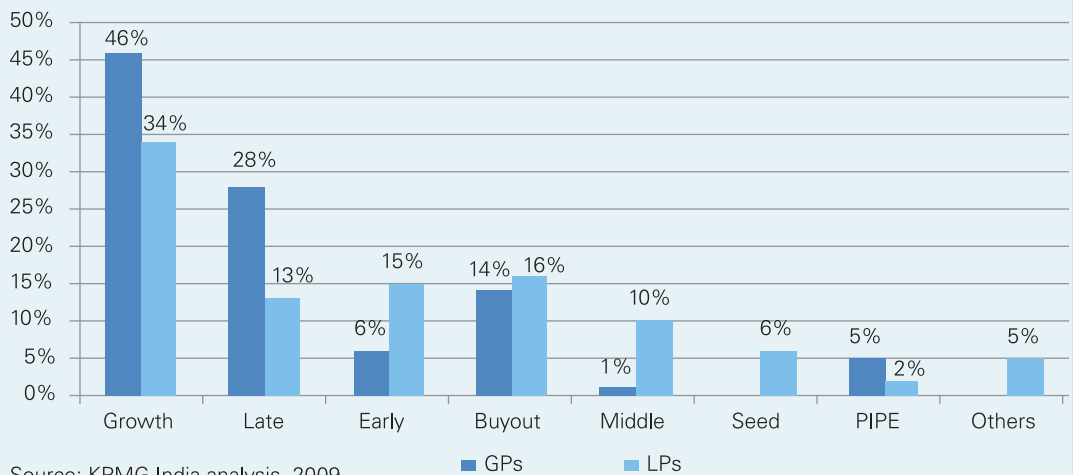
**LPs sectors for investments in 2009 - 10**

Source: KPMG India analysis, 2009

**GPs sectors for investment in 2009 - 10**

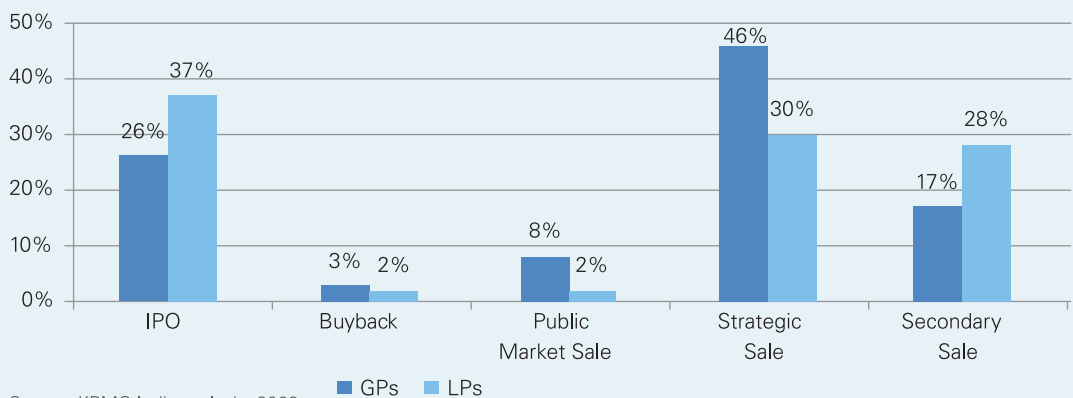
Source: KPMG India analysis, 2009

### Preferred deal stage in 2009 - 10



Source: KPMG India analysis, 2009

### Preferred exit routes in 2009 - 10



Source: KPMG India analysis, 2009



# Conclusion

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The PE environment in India has fundamentally changed post the credit crunch. Gone are the days of making money by investing in pre IPO and PIPE transactions and riding out on increasing valuations on the Indian stock market.

To achieve the desired returns of 25 percent or more, PE firms are going to need to work closely with their portfolio companies. This is a significant challenge as the survey reveals that PE firms have further to go to develop the operational skills needed to help improve the performance of their portfolio companies. GPs will be increasingly challenged on this aspect by their LPs and by the added fact that their portfolio companies are facing a slowdown in business, something which Indian businesses have not experienced since 2001.

GPs would need to become more focused about improving corporate governance in their portfolio companies and acting as a catalyst of change. This will be a challenge as they will need to balance this role with the fact that they are largely minority investors in their portfolio companies.

GPs who develop operational skills sets and who make meaningful contributions to improving performance and corporate governance standards at their portfolio companies are likely to be seen as a class apart by LPs. These GPs are likely to find it easier to raise future funds as these added skills sets will help in delivering superior returns to investors. However it is evident today that these skills sets are yet to be developed. GPs need to answer the following key question: Should GPs continue with their model of using the same investing team to nurture and develop the portfolio or should they create separate operational teams to bring greater operational excellence to portfolio companies?

Although GPs want more independent directors on the board of their portfolio companies, there is need for caution here. There are more than 4700 listed companies in India<sup>8</sup> and the demand for independent board directors is intense and there is a significant shortage in supply. PE firms would need to ensure that board members are carefully selected and that these board members possess the desired skill sets needed to execute their responsibilities.

GPs would be advised to require their independent directors to focus more on risk assessment, and fraud risk management. The Satyam scandal and more recently the Subhiksha situation highlights the need for greater focus on these areas of corporate governance.

India offers immense opportunities for PE investments and India will likely be at the forefront of a global PE recovery. The next 12 months should be viewed as an opportunity to build value in portfolio firms, and show that PE is an integral part of India's future.

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<sup>8</sup> Source: <http://www.bseindia.com/about/introbse.asp>, downloaded June 18, 2009

## KPMG in India

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Across the globe, KPMG International's member firms are dedicated to PE. With access to this global network of professionals, we at KPMG in India, provide progressive, technology-enabled services to meet our clients' PE requirements.

We believe that successful PE investments is based on a relationship built with you during the PE lifecycle - from deal sourcing, execution, portfolio management and through to successful realization.

KPMG in India Private Equity practice combines professionals from across our Audit, Tax and Advisory service lines, and across our industry sectors to bring you quality PE experience and delivery. KPMG in India has over 170 partners and directors and more than 3500 employees across eight locations.

KPMG in India is amongst the first in India to create a coordinated multi-disciplinary PE Advisory Group that works closely with leading PE investors and their portfolio companies. Our PE group is well positioned to support PE houses on their India transactions, offering extensive services which include deal origination and support, valuations, financial, tax, integrity, business and commercial due diligence and creating progressive and efficient transaction structures.

Reflecting the needs of the current times, our PE Group is experienced in providing a range of services to nurture portfolio companies to create value. The wide range of post deal services includes audit, risk and controls assessment and corporate governance, IT advisory, corporate and debt restructuring and cost optimization service offerings.

In 2008, KPMG in India served over 75 PE houses and was associated with more than 150 PE transactions.







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