The State of the Indian Private Capital Industry

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The Indian private equity industry has been the subject of intense interest in recent years. According to Bain & Company, Indian private equity and venture capital investments reached almost $70 billion in 2021, up from $17 billion five years before. Despite the global slowdown, the environment in India is well positioned for significant growth with a surge in investor confidence, a talented pool of entrepreneurs, favorable economic conditions, and an established infrastructure with consumer technology, fintech, and software industries leading the way. This discussion explored the extraordinary surge of Indian private capital activity and the challenges and prospects in the years ahead. The panelists included: Rajan Anandan, Managing Director, Sequoia Capital; Prakul Kaushiva, Managing Director Private Equity, CPP Investments; Renuka Ramnath, Founder, MD and CEO, Multiples Alternate Asset Management; and Karthik Reddy, Co-Founder, Managing Partner, Blume Venture Advisors. Professors Josh Lerner (Harvard Business School) and Thillai Rajan (IIT Madras) served as the moderators.

As one of the largest and fastest-growing economies globally, India is attracting global pools of sophisticated money. Figure 1 shows the tremendous growth of total private equity and venture capital investment dollars and the recent increase in the total number of transactions.

This growth had several sources. The Covid-19 pandemic accelerated the digitization of India and brought new business models and value creation. In addition, changes in the listing regulation led to multibillion-dollar companies going public. And returns have been attractive: for instance, the performance of recent Indian venture capital funds has been on par with U.S. VC funds in terms of total value to paid in (“TVPI”), 2.14 vs. 2.16, respectively.[1] The speed of the growth in Indian private markets was led by a handful of family offices that were able to move more quickly than large domestic financial institutions.

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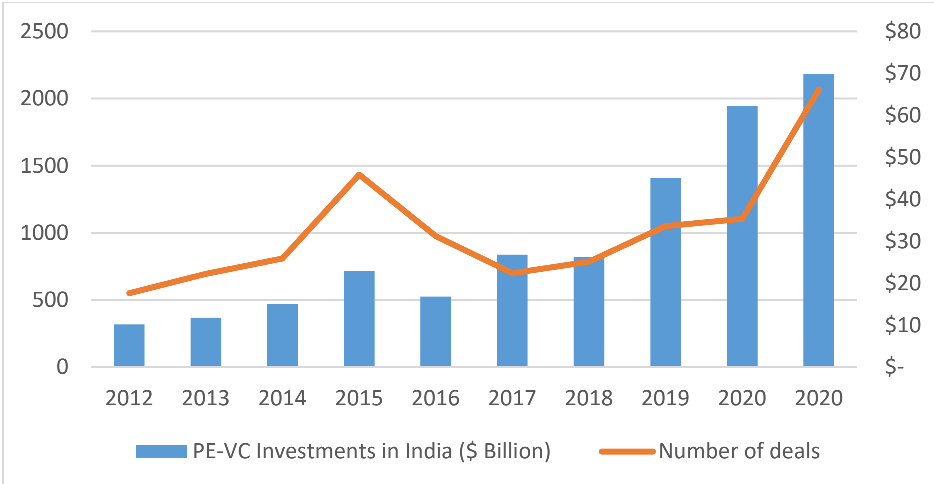
[1] Source: State Street Global Private Equity Database, as of December 13, 2022. Performance of venture capital funds, vintage years 2005-2022.

Figure 1
Annual PE-VC Investments in India*



*Adapted from Figure 6 in the Bain Capital India Private Equity Report 2022.
https://www.bain.com/insights/india-private-equity-report-2022/.
Note: Source: Bain PE deals database. Includes real estate and infrastructure, private investment in public equity (PIPE), and venture capital (VC) deals; deal volume includes deals where the deal value is unknown.

Opportunities in India

With the recent sharp correction in the U.S. private capital markets and many other markets like India, the panelists shared their perspectives on the current landscape of the Indian private market and the opportunities and obstacles ahead. The panelists highlighted several factors that provide a potential advantage for investing in India.

- **Strong Domestic Consumption**

One factor driving the robustness of the Indian markets is the upward revenue growth trajectory, fueled by strong domestic consumption. In India, industries such as new consumer brands, financial services companies, and FinTech companies are experiencing high revenue growth, unlike their global competitors who have slowed considerably. The seemingly permanent shift to digital activity following the Covid-19 pandemic is a main contributor to the strength of demand: the digitization of the economy is also driving investments at all stages of Indian private equity. Much like the Chinese economy, Indian startups and growth companies are increasingly building for the domestic market and do not rely on external demand.

- **Private Equity is a Growth Story in India**

Growth equity continues to be a booming market in India. Approximately 70% of later-stage private capital funds invested are allocated annually to growth equity versus 30% to buyouts.

Even in the buyout transactions, a growth aspect is embedded. Unlike U.S. buyouts, private equity in India is not a financial engineering play. Leverage levels are far below those in U.S. buyouts. Instead, superior returns are generated from companies that are well-positioned for growth and success. Many funds are investing in technology and digital infrastructure and driving new business models that address market solutions.

In addition, private equity in these markets seeks to fund companies focused on transforming themselves. For example, in the pharma industry, some pharmaceuticals are transitioning away from contract manufacturing for the rest of the world to putting out products of their own (known as integrated pharma companies). Lastly, with the recent productivity-linked incentive scheme of $35 billion announced by the Indian government, a much broader section of manufacturing companies (e.g., specialty chemicals, electronic products, consumer goods) could come into the fold, looking for private capital to scale up.

- **Pockets of Opportunity in Manufacturing and Infrastructure**

India is not competitive today in low-end manufacturing. However, there are pockets of opportunities in high-end manufacturing that take advantage of local talent, supply chain shifts to India, and some government initiatives. India's ability to succeed in global manufacturing also hinges on its ability to augment its infrastructure, which has yet to receive significant private capital investments. Even though infrastructure globally has been an area of interest for private investors and has attracted international dollars for decades, private capital expenditures on Indian infrastructure have lagged far behind government capital expenditures. Success in this area will rely on regulatory and policy initiatives to stimulate private investments in infrastructure and manufacturing.

- **Competitive Advantage: Low-Cost Labor and Talented Employees**

For years, India’s industries focused on using their low-cost labor advantage to deliver cost savings to customers and drive growth. Today, Indian business leaders are looking beyond their cost advantage to win contracts. Instead, they are utilizing their well-trained, talented pool of employees and new technologies to develop solutions to customer problems and bring sustainable benefits to those enterprises. In addition, firms are using their talent onshore and offshore to serve different markets worldwide. Thus, a young Indian company like Quantiphi, Inc.[2] is able to be among the several partners that Google uses to help build specific advantages for its products and clients.[3]

Challenges of Investing in India

- **Public and Private Market Valuation Correction**

Aggressive, late-stage investors fueled the exuberance in the VC markets globally through 2021. Of late, there has been a sharp correction in both the public and private markets. The handful of technology companies that went public last year on Indian exchanges had over a billion-dollar valuation. Those stocks' valuations have since been corrected and are down about 50%-70% from their peaks. They have fared slightly better than the U.S. average.

Similarly, in the private markets, there is a valuation correction at every stage, led by growth-stage investments. In the last three quarters of 2022, only a few growth investments occurred in India at all. Before 2022, pre-launch companies often were able to raise $5-$6 million in a seed round, with a post-money valuation of about $20 million. Currently, investment amounts and valuations are down to 2019 levels: pre-launch companies can only raise $1-$2 million with a $10 million valuation. Similarly, Series A valuations were between $50 and $80 million, but those numbers today are between $20 and $30 million. However, valuations at the seed round have dropped less dramatically because large later-stage investors are taking a step down one or two levels to take risks at a more comfortable entry point, such as at the seed level. So, instead of writing one $100 million check, these investors are more comfortable writing smaller checks, hoping to pick up assets relatively cheaply.

Despite the valuation adjustments, India has yet to experience the large numbers of down rounds seen in the U.S., where subsequent funding rounds are occurring at a fraction of previous rounds' size and valuation. India has avoided these down rounds to date, because most Indian companies raised large amounts of capital in 2021, which could last them three or four years. Moreover, Indian companies simply take longer to run through their funds, reflecting the lower costs of starting and scaling entrepreneurial businesses there.

- **Liquidity Issues**

Another challenge in investing in Indian private capital is the ability to exit, which has resulted in India having some of the most expensive unicorns in the world. There is a large gap between the

[2] Quantiphi, Inc. is an award-winning AI-first digital engineering company driven by the desire to reimagine and realize transformational opportunities at the heart of business. We are passionate about our customers and obsessed with problem-solving to make products smarter, customer experiences frictionless, processes autonomous and businesses safer.

[3] "Quantiphi and Google Cloud: Rethinking Partnerships to Drive Innovation," https://quantiphi.com/quantiphi-and-google-cloud-rethinking-partnerships-to-drive-innovation/. October 18, 2022.

nominal unrealized value of portfolio companies and the amount distributed to investors. Even though the TVPI for both the U.S. and India are roughly equivalent, the Distributed Paid-in Capital ("DPI") is almost three times lower for India than the U.S.[4] However, these issues were felt by the panelists to be more severe in the venture space than elsewhere. Using corresponding State Street data for later-stage funds, the differential is significantly smaller.[5]

Acquisitions, the most common exit route in the U.S. and Europe, can also be difficult in India, as many private capital-backed companies are too large to buy, except by a handful of domestic acquirers. Unlike in the U.S., foreign acquirers require a certain scale before a company can become a meaningful acquisition. Even if there is an acquisition, the deal may not result in the investors getting cash. Investors often get stuck with an acquirer's stock if merged in a consolidation play. Meanwhile, only a handful of large companies have been capable of an IPO each year, reflecting the shallow IPO market in India. As a result, investors tend to hold on to assets for a long time or extend fund life.

Regulatory and Policy Environment

The panelists discussed areas for government involvement that could improve the investment appetite for India. We highlight a few areas below.

- **Enhance the Public Markets**

The depth of the domestic IPO market in India is critical to the evolution of the venture sector, as investors care for the ability to exit. As such, regulators of the Indian public market are taking measures to boost the IPO market.[6] The fact that half a dozen companies were listed in India last year is an improvement and demonstrated that profitability is not a requirement for going public.

But in a developing country like India, retail investor participation is high, with a lot of small investors investing directly and not necessarily through mutual funds. Thus, Indian regulators have the responsibility of protecting investors, so regulations will unlikely make it easier for more companies to list. There will likely be more scrutiny on matters like valuation to ensure that an

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[4] Source: State Street Global Private Equity Database, as of December 13, 2022. The DPI for the U.S. funds is 0.94 vs. 0.36 for India, for venture capital funds in vintage years 2005-2022.

[5] Source: State Street Global Private Equity Database, as of January 19, 2023. For later-stage funds, the TVPI was quite similar (1.59x for India and 1.64x for U.S. in the same years where Indian data was available), while the DPI was again lower for Indian funds, but with less of a differential (0.86x for India vs. 1.09 for the matched U.S. funds).

[6] Small and medium enterprise ("SME") exchanges that have emerged to enable smaller companies go public. Both the main exchanges, the Bombay Stock Exchange and the National Stock Exchange have SME platforms: https://www1.nseindia.com/getting_listed/content/sml_med_enterprise.htm; https://www.bsesme.com/
The scrapping of IPO grading was also seen as a major reform measure: https://www.thehindu.com/business/markets/sebi-scraps-ipo-grading-safety-net/article24241711.ece.

IPO is not a bailout of VCs by unsuspecting investors. In the meantime, there will likely be some later-stage players buying the assets of venture capitalists in secondary transactions as private equity players become more comfortable with such deals.

- **Tax Policy Changes**

There are unlikely to be any changes to the Indian tax policy that would be considered uniquely favorable to private equity investors. Based on evidence from other countries, it will be important for regulators to push to make it easier for private equity investments in India.[7] There should be consistent policies to maintain a level playing field between all investors, foreign and domestic. Structures with regulatory flexibility, such as the Gift City[8] or the Alternative Investment Fund[9] initiatives, were applauded by the panelists.

There was also agreement as to what not to do. Because private equity is a long-term investment, there cannot be surprise changes in tax policies every few years. Meanwhile, direct fiscal incentives often lead to misuse.

Conclusion

Regardless of geography, investors find India to be an attractive venue for private capital investment on a risk-adjusted basis. Investing in India is driven by its growth, with its recent digitization initiatives and strongly growing domestic consumption. In addition, a host of regulatory and policy initiatives have been implemented to improve the appetite for investing in India.

However, the nation is still subject to high inflationary risks (albeit less problematic on a relative basis), foreign exchange risk (many investors are dollar-based), and global macroeconomic dynamics. For long-term investors, patience is required.

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[7] Poterba, James M. (1989) *Venture Capital and Capital Gains Taxation, Tax Policy, and the Economy*, Cambridge: MIT Press. Gompers, Paul and Josh Lerner (1998), *What Drives Venture Capital Fundraising?,* Brookings Papers on Economic Activity, Microeconomics, pp. 149-204.

[8] GIFT City is an emerging global financial and IT services hub, a first of its kind in India, designed to be at or above par with globally benchmarked business districts. It is supported by state-of-the-art infrastructure encompassing all basic urban infrastructure elements along with an excellent external connectivity. Companies from Financial Services, Technology and all other services sector will be targeted as potential occupants within the city.

[9] An Alternative Investment Fund, or AIF, is a confidentially pooled investment vehicle developed or incorporated in India that collects assets from expert investors, whether Indian or global, for investing in line with a defined investment policy for the welfare of its investors. AIFs can be formed or incorporated as a corporation, trust, or other legal entity (including limited liability partnerships). The SEBI (Mutual Funds) Laws of 1996, the SEBI (Collective Investment Schemes) Laws of 1999, or any other Board regulations governing fund management do not apply to AIF.