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Capital Comes Calling on India

L. Brooks Entwistle

One of the toughest tickets to come by today is a seat, any seat, on a flight from the world's financial centers to India. If you are lucky enough to get a seat, you will find yourself surrounded by private equity professionals, venture capitalists, and investment bankers. You cannot miss the type: just look around at the people working throughout the flight devouring analysts' reports, business plans, and other background research as they begin their quest for the next big investment opportunity on the subcontinent. Some of the world's leading private equity firms, venture capital players, and hedge funds (collectively referred to as "financial sponsors" in this essay) already are firmly established in India, including Warburg Pincus, the Carlyle Group, General Atlantic Partners, and Newbridge Capital. The race has begun, with a second wave of international private capital players now looking to plant the flag on the subcontinent. In the spring of 2005 alone, over 25 new India-focused private equity, venture capital, or hedge funds were raising new investment capital. Add to that the firepower of financial sponsors who are looking to invest in the country through an already existing fund and you have a huge wave of capital heading toward India.

This heightened interest among financial sponsors in India has been driven by several factors. First, the overall economic picture for India is one of explosive and sustained growth. According to some predictions, India's economy will be the third largest in the world by 2035. This economic engine will drive demand for capital. Second, investors have developed an "investment thesis" with respect to India based on five key factors, including an abundance of skilled labor and a significant time-zone advantage. Third, the success of several sectors of the Indian economy in the global marketplace has given financial sponsors case studies to show to their investment committees. Infosys and Wipro in the information technology (IT) services sector and Dr. Reddy's Laboratories and Ranbaxy Pharmaceuticals in the healthcare sector are excellent examples of Indian companies achieving world-class status. Fourth, India's own public equity markets have matured and performed well in the last year, attracting significant foreign institutional investor (FII) interest in the country. Net inflows of FII funds to India have increased dramatically from $6.7 billion in 2003 to $8.5 billion in 2004 to $4 billion already in early 2005. The existence of a deep public equity market provides financial sponsors with both increased investment opportunities and a means through which to "exit" or realize profits on these investments. Fifth, the emergence of a robust mergers and acquisitions market has given financial sponsors another mechanism through which to exit their investments. General Atlantic Partner's sale of Daksh, a business process outsourcing company, to IBM is a good example of this phenomenon. Finally, the first wave of private equity players have realized significant success in the last several years. Warburg Pincus, the largest foreign investor in India, has been able to return a significant amount of the over $1 billion in equity it has invested while still holding several substantial stakes in leading Indian companies, including Bharti Telecom.

At the same time, several important factors could divert the wave of capital heading toward India. First, India has failed to invest in infrastructure to keep pace with the growth of the economy. For example, only five years ago the drive from one's hotel in Bangalore to Electronics City, the home of India's IT services miracle, took 30 minutes. Now that same drive is a pollution-choked experience that takes an hour and a half through heavy traffic. Second, capital needs ideas. While no one would suggest that India is lacking in entrepreneurial spirit, the country must work toward promoting investment across all sectors. Financial sponsor activity has been concentrated in the information technology, telecommunications, and healthcare sectors. The automobile components and chemical sectors show signs of coming to life, but others need to follow. The retail sector, for instance, is still heavily regulated, restricting foreign investment. Lastly, China looms. Potential financial sponsors are also looking at China, and just as China and India will compete for natural resources in the years to come, they will also square off against each other to attract capital.

The Macro Economic Machine

The change in India since the market liberalizations of 1991 has been extraordinary. The abolition of the government-controlled "Raj" industrial licensing scheme, the reduction of import tariffs, and the initial opening of the country to foreign direct investment set the stage for India's emergence from its economic shell. As positive as these changes were, however, it is future possibilities that have potential investors in the country breathless with anticipation.

As noted, India's economy is projected by some sources to be the third largest in the world by 2035, trailing only China and the United States. Along the way, India will pass Japan and the combined economies of Britain, France, Germany, and Italy. India is also projected to sustain its spectacular annual rate of growth of 5 percent or better through 2050. No other country, China included, will show this sustained growth rate over the same period. With its overall population expected to surpass China's in 2035, India's workforce will continue to expand into the middle part of the century, long after China's workforce begins to age and thus decline.[1]

What does this all mean for potential investors? Consider the following examples from the oil, automotive, and mobile phone industries. India's contribution to the rise in global demand for crude oil is likely to surpass that of China in 15 years. India will represent potentially 15 percent of overall global demand for crude by the year 2050. The geopolitical implications of India's increasing demand for crude are evident in its recent negotiations with Russia, Iran, and Myanmar.

Related to this steep growth in oil consumption is the dramatic rise in the number of automobiles in India. Over the next ten years, the number of cars in the country will likely triple. By 2050, India is projected to have the second largest car market in the world after China. As India's manufacturing prowess grows, the proliferation of industries related to the automotive sector, including an already burgeoning auto parts market, will provide ripe opportunities for financial sponsors looking for businesses in which to invest.[2]

Many experts believe that the "sweet spot" for mobile phone penetration is GDP per capita of roughly $3,000 per year. India, whose mobile phone market has already taken off, will not hit that level of GDP per capita for another 15 years. Even so, the telecom sector has proven to be fertile ground for investment.[3]

Beyond this rosy macroeconomic picture, it is important to point out the critical tenets of the investment thesis for financial sponsors looking at India. First, India has an abundance of skilled resources. The country's large pool of engineers and postgraduates, all of whom speak English, have a proven track record of providing high-end solutions to problems and world-class research and development. Second, the cost benefits of doing business in India, while eroding in IT engineering and other sectors, are still significant. Importantly, this cost-benefit structure has coexisted with recognized high-quality work. Third, India has established a reputation for quality delivery. Over the years, the importance of refined process methodology, stringent quality controls, and the general adoption of global "best practices" have enabled Indian companies to deliver competitive services and products globally. Fourth, the country's time-zone advantage, which makes it possible for Indian companies to program software, staff call centers, produce documents, and provide myriad other services while the United States sleeps, has continued to be a critical dimension of the value-added thesis for India. Fifth, the dramatic rise in domestic consumption has provided a key corresponding impetus, along with the global interest in Indian services and products, driving the demand side of the equation.

While these five forces clearly do not apply to all sectors of the Indian economy, the sectors that have enjoyed success—IT services, telecom services, healthcare, and, increasingly, financial services and automotive components—have exploited these factors to develop globally competitive businesses.

The first world-class companies to emerge on the global stage were the leading IT services firms. Infosys and Wipro, with their gleaming campuses in Bangalore, blue-chip customer base in the United States, and successful listings on the U.S. stock markets were early indicators of what the investment thesis highlighted above could yield. For many potential investors in India, their "I get it!" moment occurs when they tour the sprawling Infosys headquarters in Bangalore. From just one building less than a decade ago, the campus now comprises 20 buildings and features a swimming pool and health club for employees, restaurants serving both local Indian cuisine and Dominoes pizza, and a coffee shop with the best latte on the subcontinent. This impressive complex, with its enormous training facilities and futuristic board room, is an epiphany for people who once questioned India's potential.

Infosys is by no means alone. Wipro and other IT services firms have created similar world-class facilities around the country. Healthcare companies have followed suit, with Dr. Reddy's and Ranbaxy achieving a level of international recognition. The success of these companies has spawned a plethora of smaller start-up companies that are striving to follow in the footsteps of these early pioneers. The opportunity to invest in the next Wipro, Dr. Reddy's, or their equivalent in other emerging industries is driving the financial sponsor community to scour the country for investment possibilities.

Important Factors for Investors

An important part of any market entry strategy for financial sponsors is to understand the possibilities for "exit," or divestment in order to reap the profits generated by their investment through either the public equity markets or a strategic sale of the company. The impressive performance of India's equity markets over the last two years has helped financial sponsors answer the question of how they can unload their investments for cash. The benchmark Bombay Stock Exchange SENSEX index gained 13 percent in 2004. More importantly, the market recovered immediately after a wild dip in May of that year when national elections provided a surprise (at least to the markets) outcome.

In addition to overall market performance, the financial sponsor community also watches the level of investment by foreign institutional investors, their brethren who invest directly in the Indian stock market. As a result of India's strong overall performance and the influx of FII funds, there has been a solid flow of initial public offerings over the last three years. In addition, the market has been able to provide successful exits for financial sponsors who have invested in companies. Warburg Pincus recently completed two very successful, and sizable, transactions that enabled it to monetize a large portion of its stake in Bharti Telecom. In February of this year, Warburg sold $306 million of its stock in Bharti; it sold another $560 million in March. These deals, impressive and sizable in any market, were a watershed moment for the financial sponsor community in India as they showed that the Indian capital markets are now deep and robust enough to support significant, and profitable, exits for quality companies and their backers.

Equally important to financial sponsors are developed mergers and acquisitions markets. While India is by most measures still early in this game, there have been several very encouraging signs over the course of the last few years. While the overall dollar volume of transactions is down from its peak in 2000, the total number of deals and the number of cross-border deals have increased dramatically.

In 2004, General Atlantic Partners sold one of its earliest Indian investments, Daksh, to IBM for $170 million. This deal was significant for several reasons, including the fact the business was sold in a cross-border transaction, showing the interest of foreign strategic players like IBM in the Indian market. Furthermore, the sale came only two years after General Atlantic made its investment in the company. The Daksh transaction, similar to Warburg's successful sale of its Bharti stake on the public markets, showed financial sponsors thinking about investing in India that real and lucrative exit opportunities now exist.

This has heightened the interest of other financial sponsors looking at India. In 2004, financial sponsors invested $1.7 billion in the country. However, when compared with the $100 billion in financial sponsor funds dedicated to all of Asia at the end of 2004, the percentage allocated to India is still quite small. The second wave of financial sponsors, those individuals filling up the airplane seats to India, are on their way. Their predecessors, the early adopters, have been flexible in their investment approach, often changing their investing model from strategies employed in home markets. The challenge of looking at new industries, focusing on smaller deals, and using different vehicles through which to invest awaits the new entrants to the market.

Critical Issues Must Be Addressed

While the next wave of financial sponsors who are looking at India need to adjust their model for future investments, India itself needs to address some critical issues. At the top of any list is the state of India's infrastructure. The comparisons with China have been well documented and do not shed the most flattering light on India. Travelers to China and India notice the difference immediately. The new state-of-the-art airports across China stand in stark contrast to the decaying terminals in India's main cities. The difference is even more striking outside the airport. The trip on the tree-lined superhighway leading to downtown Beijing is a much more pleasant experience than the painfully slow crawl along Marina Drive to the heart of Mumbai.

There are encouraging signs of improvement in India: over 25 new airports are either under construction or planned, and new roads, including the Mumbai to Pune expressway, are finally emerging. However, the government must continue to focus on meeting the challenge of building infrastructure because no matter how strong the investment thesis for India is for prospective financial sponsors, the infrastructure bottleneck will slow this flow of capital. Not surprisingly, several dedicated infrastructure funds have emerged on the scene in anticipation of new investment.

New Delhi must also keep its foot on the pedal of reform. The impact of the 1991 market liberalization measures and subsequent reforms has been dramatic. Certain sectors, including telecom and financial services, have had their foreign direct investment limit increased. Other sectors, such as media and retail, are still far more difficult or impossible to invest in under the current regime due to restrictive laws. Lastly, primary education, rural poverty, and other classic emerging market issues must be addressed by the government.

The Challenges Ahead

India is one of the hottest topics in the financial sponsor community today. The country's enormous potential for economic development, its solid underlying fundamentals, and the impressive early returns to the first wave of investors have made this a market that investors sitting in New York, London, or Hong Kong cannot ignore. Even if such individuals have no intention of investing in the country directly, chances are that one of their existing portfolio companies, or more likely all of them, are feeling the impact of the Indian economic machine. As further proof of this trend, as this essay was going to press, Blackstone, one of the largest private equity firms in the world, announced the opening of a Mumbai office and the launch of a $1 billion fund.

The challenge for India will be how to deal with its remaining obstacles to development, including its transportation infrastructure issues and its need for a reliable supply of energy. If India can address these problems, it will be able to capitalize on its skilled human resources, low costs, reputation for producing quality products, time-zone advantage, and rising domestic consumption and international demand for its products. Meanwhile, growing capital markets and increasing mergers and acquisitions activity will provide more opportunities for investors to get a toehold in the new generation of India's world-class companies and to realize returns as their investments mature. India's time for financial sponsors is the present. Buy your tickets now, seats are filling up fast. ●

Notes

1. Goldman Sachs Research, "Dreaming with BRICs," October 2003. The acronym "BRIC" stands for Brazil, Russia, India, and China.

2. Goldman Sachs Research, "The BRICs and Global Markets: Crude, Cars and Capital," October 2004.

3. Goldman Sachs Research, "BRICs Layers," April 2005.