Trends in Private Equity and Venture Capital Investments with Special Focus on the Booming India Growth Story

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Abstract. Private Equity investments have restructured the trend of acquisitions and aided in value creation as against strategic buyers. Private equity's growing involvement in many sectors is even more striking. The nature of investments of private equity firms and funds, the strategies employed, value creating practices, profitable exits are significantly different from that of other strategic and corporate buyers. The paper deals with the above aspects. The paper is divided into two parts. Part I deals with the basics of private equity investment structures and exits. Part II of the paper deals with the private equity growth story in India. Private equity investments, proposed changes to regulations, sectoral growth, venture capital regulations as well as impact of the latest Union budget a the credit crunch have been dealt with.

1. Basics of Private Equity Investments – structures, funds and exits

1.1 Introduction

Private Equity is the provision of equity capital by financial investors – over the medium or long term – to non-quoted companies with high growth potential.[1] Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, earl development, or expansion of a business. Private equity covers not only the financing required to create a business, but also includes financing in the subsequent development stages of its life-cycle. When financing is required by a management team to buy an existing company from its current stakeholders, such a transaction is called a buy-out. [2]

Private Equity and Venture Capital may refer to various stages of the investment but the essential investment remains the same: it is the provision of capital, after a process of negotiation between the investment fund manager and the entrepreneur, with the aim of developing the business and creating value. For the sake of simplicity, from this point onwards, the term private quity will be used to cover both venture capital and buyout. (Refer Annex 1)

Private equity firms have a main goal: seek out companies e potential for growth and with the aim to put in place the capital, talent and strategy needed to permanently strengthen the company and raise its value. Private equity is often categorized under the umbrella of "alternative investments", complementary to the stock and bond portfolios traditionally held by investors.

Private Equity and venture capital is an increasingly source of finance for high-growth potential companies. The goal of private equity and venture capital is to help more businesses achieve their ambitions for growth by providing them with finance, strategic advice and information at critical stages of their development.[3] Most entrepreneurs who approach private equity and venture capital investors welcome the improvement in their business activities and in their budgetary and financial monitoring. In a similar vein, the investor's experience and network of contacts were also engaged as very positive elements. [4]Furthermore, private equity and venture capital investors provide the companies with more credibility their clients, suppliers, banks and competitors. This is particularly true for start-ups, which have intangible assets and which have to provide numerous guarantees.

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[1] For a definition of a high-potential company refer the EVCA (European Venture Capital Association) Barometer of May 2005: Identifying a high-potential company.

[2] When the investment management comes from the target company, the investment is referred to as a agement buyout (MBO). If the new management team comes in from outside the target company, the investment may be referred to as a management buy-in (MBI)..Todd D. Peter(2008) Guide to executing a Management Buyout.

[3] European Private Equity & Venture Capital Association, (November 2007). In the Indian context, see Enhancing Resource Flow :Role of Private Equity. Retrieved April 9, 2008, from http://www.ficci.com/media-room/speeches-presentations/2002/Apr/april-capital-satish.ppt.

[4] "Awareness & Perceptions of the Venture Capital/Private Equity industry", conducted on behalf of EVCA by EOS Gallup Europe, April 2004.

Private Equity and venture capital plays a critical role in driving growth and jobs. e.g. since 2000 private equity and venture capital professionals have invested more than €270 billion in over 56000 companies in Europe. The year 2006 was one of record private equity investment of €71 billion in over 7500 European companies. [5]

The objective of this paper is to analyze the growing of private equity investments and also to establish that private equity investments are entering those sectors significantly which were the domain of strategic buyers until a few years ago. In light of the spurt witnessed in private equity market, the paper also aims to discuss the potential harnessed by the Indian market.

1.2 Economic contribution

Private equity and venture capital enables companies to grow and develop, and supports companies which would have a lower growth or would not have been able to survive without it. [6]It improves the performance of thousands of companies and allows the development of new technologies and their applications. The industry's focus on improving fundamental business performance means that private equity and venture capital investment may be one of the most potent forces driving economic-wide improvement in corporate productivity. Between 2000 and 2004, private equity and venture capital finances companies d 1 million new jobs [7] which translate to a compound annual growth rate of 5.4% per year (eight times the EU25 total employment growth rate of 0.7%).

European companies such as Skype, Mobistar and TomTom have benefited from private equity and venture capital to become global players. The big winners benefiting from the returns made by private equity and venture capital firms are their institutional investors, mainly pension funds, which in 2006 continued to be the industry's single largest source of capital. The latter accounted for 27.1% of the total funds raised, thus bringing the financial gains back to millions of pensioners and saving account holders. [8]

1.3 Alternatives to Private Equity

There are several alternatives to private equity: self-financing, debt or raising capital via stock market floatation.

1.4 Private equity versus self-financing

Self financing either by self-owned funds or by friends, family or business angels [9] can be relatively easy and quick but it is seldom a viable long term solution for a growth business. Personal relationships can become entangled with the business and the joint shareholders rarely play an effective role in supporting the entrepreneur. On the other hand, professional investors can mobilize a great deal of capital, support growth and help the entrepreneur but the process can be long and may mean giving up more of the equity of the company.

1.5 Private equity versus debt

As creditors of the company, lenders demand guarantees – either personal or from the company. Companies with few or no assets, or entrepreneurs already deeply involved in their project, will find it hard or even impossible to produce theses guarantees. However, the loan has no impact on the share structure of the company and the lender will not intervene with the running of the company.

A private equity investor brings capital, does not require interest payments, is subject to the risks of the company like any other shareholder and will only profit if company grows. Such an investor has specific controlling rights over how the company is managed.

1.6 Private equity versus raising capital via stock et floatation

A private equity investment is a medium to long-term investment, which does not provide the same liquidity as a stock market floatation and which ties the investor closely to the company. The investment is more secure because it is less vulnerable to external economic fluctuations. The closed structure of a private equity fund prevents fund managers from exiting prematurely and strengthens the term engagement of the fund in the companies in

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[5] Source: EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity

[6] Sources: EVCA "Survey of the Economic and Social Impact of Venture Capital in Europe", June 2002; EVCA "Survey of the Economic and Social Impact of Management Buyouts and Buyings in Europe", January 2001, for the American Picture. The Economic Impact of Venture Capital backed Companies to the US economy, 4th edition. Retrieved, April 10, 2008, from http://www.nvca.org/pdf/NVCA_VentureCapital07-2nd.pdf.

[7] Refer – EVCA survey 'Employment Contribution of Private Equity and Venture Capital in Europe", November 2005

[8] http://www.evca.eu/uploadedFiles/Home/Toolbox/Introduction_Tutorial/EVCA_PEVCGUIDE.pdf

[9] A business angel is a private investor who provides both finance and business expertise to an investee company.

which it invests. In comparison, a stock market flotation requires that the company has already reached a certain level of activity, as well as regular public reporting and control by stock market regulations.

1.7 Fund creation and underwriting by professional investors

After obtaining the agreement of the controlling authorities, private equity firms (known as private equity management companies or General Partners (GPs)), establish investment funds that collect capital from investors (known as Limited Partners or LPs). The private equity firms use this capital to buy high-potential companies (known as the portfolio or investee companies).[10]

Therefore, private equity managers invite institutional investors and individuals with particular expertise or significant assets, to subscribe to an investment fund et period (on average ten years), which will take equity stakes in high potential companies following a clearly defined investment strategy. This can be according to the size of the target companies, their sector, stage of development and/or geographical location. These investors are often known as "sophisticated or professional investors", because they understand the risks inherent in this type of operation.[11] The fundraising period lasts six months to one year.

Investment funds are mostly closed; hence institutional investors cannot leave those funds before their term. This element of financial stability is one of the clear advantages for the entrepreneur who seeks a private equity investment. [12] In exchange for money they provide, investors receive pre-negotiated stake in the equity of the investment fund and they become fully-fledged shareholders, sharing in the risks associated the private equity firm. [13] The aim of the investors, through the fund, is not to control of the portfolio company (with particular exception of majority shareholdings) but to help create value in order to realize a capital gain – shared with the owners – on exit. This type of financing is often called 'patie capital', as it seeks to profit from long term capital gains rather than short term regular investments.[14]

1.8 Investment of the Fund

Post realization of the target amount of capital, the is closed. The private equity investment managers then seek high growth companies to invest in, following the investment strategy they proposed to the institutional investors. In some cases (30% on an average) [15], private equity investment funds will come together and form a "financial syndicate" to make an investment. This will happen if the risks are high or if the amount of capital required in the operation is particularly substantial. On of the investment funds will represent the group in the syndicate's dealings with the entrepreneur. The representative will follow a mandate negotiated with the partners.

The average private equity fund size in 2006 was €322 million [16], ranging from small seed capital funds [17] of less than €10 million up to large buyout funds [18]managing several billion Euros. The private equity management team essentially makes investments in the first five years of the fund though this is variable.

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[10] References may be made to the several portfolios held by Private Equity, Venture Capital and Investment firms, e.g. Riverstone, a $6 billion private investment firm has invested in companies across the energy and power industry, some examples being Mariner Energy Inc and Vantage Energy LLC, Blackstone Group's investments in Klockner Pentaplast (in the manner of equity control), Nielsen (equity – Joint Control), Warburg Pincus's investments in Coaltek and Titan Petrochemicals.

[11] Fort Washington Capital Partners Group. Investing in Private Equity through a fund of funds : Important considerations in Portfolio Allocation to Private Equity. Retrieved April 8, 2008, http://www.fortwashington.com/pdf/FW280SO.pdf.

[12] The concept of financial stability in a private equity deal is very important. For a detailed comprehension of how such a deal accords financial stability to entrepreneurs, refer "Private Equity Investment Companies in Sweden".

[13] ndrew C. Quale Jr., Sidley Austin Brown & Wood. The Risks in Private Equity Investing. Private Equity Investment in Emerging Market Countries. Retrieved April 13, 2008, from www.baft.org/content_folders/asfsaf/presentation____Quale,%20Andrew PPT. (This includes both the risks to the investor as well the target companies). The collapse of the Carlyle Capital Corporation, a $22 billion mortgage backed security fund of the Carlyle Group is a good example where the senior managers face personal losses in excess of $135 million, see http://www.guardian.co.uk/business/2008/mar/16/equities.banking.

[14] Patient Capital : How venture capital investment drives revolutionary medical innovation" http://www.nvca.org/pdf/NVCAPatientCapital.pdf

[15] In 2006, 69.9% of the investments by number, €52.2 billion by amount, did not involve any syndication. Investment with national syndication increased to 22.8% by number of investments in 2006 from 19.1% in 2005. Transnational syndication increased by 7.3% by number of investments from 5.9% in 2005. Refer EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity & Venture Capital Activity.

[16] Thomson Financial Tables. Retrieved April 18, 2008, from http://www.thomsonfinancial.com

[17] "Seed Capital is planted in a financial structure so that it will grow",

[18] Matthew Quinn. "Buyout Funds: Conglomerates in old sheep's clothing" from http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070702/REG/70629041

1.9 Types of Private Equity Funds

Private Equity Funds differ in their areas of specialization, their shareholders and management structures. The source of a private equity fund can affect the structure of a deal offered, can determine whether the fund manager can make a rapid investment decision or not and even h an impact on the continuity of the people dealt with and their management style when the capital is invested.

Independent private equity funds are those in which third parties are the main source of capital and which no one shareholder holds a majority stake. An independent fund is the most common type of private equity fund.

Captive funds [19] are those in which one shareholder contributes most of the capital, i.e. where the parent organization allocates money to the fund from its own nternal sources. Captive funds can be subsidiaries of or departments in a bank, a financial institution, an insurance company or an industrial company. So-called corporate or industrial funds are launched by companies looking to invest in sectors relevant to their core activities and to identify new technologies. This can also be the case for banks that went to separate their role as a commercial banker from their role as investor.

Semi-captive funds are funds in which, although the main shareholder contributes a large part of the capital, a significant share of the capital is raised from third parties. Semi-captive funds can be subsidiaries of a financial institution, an insurance company, or an industrial company that operate as an independent company (certain corporate funds fall into this category).[20]

For captive and semi captive funds as a compensation for less independence for the management company, the parent company assumes most, if not all of the responsibility for finding the capital required for the investments.

A few funds come from the public sector. Their capital comes mainly or totally, directly or indirectly, from public bodies.

2.0 The Indian Private Equity Story

2.1 Emergence of Private Equity as a dominant force

The year 2007 saw Private Equity deals amounting to $ 19.03 billion being struck in India. [21] In recent years, India has increasingly attracted the business interest of several major internationally-acclaimed players in the field, some of them being GIC [22], Blackstone [23], Warburg Pincus, [24] Carlyle Group, [25] and Actis Capital. [26] Investments by overseas private equity funds have been projected to touch $48 billion in India by 2010. At the core of these investments is predicted to be the real estate sector attracting the maximum of the investments, with profit margins between 35% and even 50%. The infrastructure sector is also responsible for the increasing flows of private equity

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[19] Captive Funds are Private equity funds established by, and with strong links to, a particular investor, for instance, a financial institution, defined by the Practical Law Company,

[20] In 2006, independents provided two-thirds of the total European amount invested and captive funds invested €12.5 billion for 17.6% of the total investment amount. Semi-captives invested €10.4 billion, representing 14.6% of the European total, cited from EVCA Yearbook 2007 – Annual Survey of Pan-European Private Equity and Venture Capital Activity.

[21] Temasek Holdings accounted for $ 2.5 billion of this; Retrieved April 13, 2008, from http://www.assocham.org/prels/shownews.php?id=1376

[22] GIC is a global investment management company established in 1981 to manage Singapore's foreign reserves. Retrieved April 14, 2008, from http://www.gic.com.sg/aboutus.htm.

[23] The corporate private equity operation of Blackstone commenced in 1987 and from 1987 through September 30, 2007, the corporate private equity funds of Blackstone have invested in approximately 121 companies in a variety of industries and geographies in pursuit of their investment objectives. The total enterprise value of all transactions effected by these corporate private equity operations through September 30, 2007 was over $228 billion. As of September 30, 2007, its corporate private equity funds had significant equity investments in 44 different companies. Retrieved April 12, 2008, from http://www.blackstone.com/private_equity/index.html.

[24] Warburg Pincus currently has more than 100 companies in its portfolio in including energy, technology, media and telecommunications, financial services, healthcare and life sciences, retail, consumer and industrial and real estate. The firm is one of the largest global private equity firms, with total investments of more than $29 billion more than 585 transactions.

[24] It is an US-based private equity firm which has more than 600 corporate and real estate investments in global portfolio.

[25] It is an US-based private equity firm which has more than 600 corp and real estate investments in global portfolio. Retrieved April 14, 2008, from http://www.carlyle.com/Portfolio/Alphabetically/item8773.html.

[26] Actis is a private equity investor in emerging markets having US$3.5 billion of funds under management and over 100 investment professionals in 14 offices in Africa, China, Latin America, South and South East Asia. In the last ten years it has invested over US$2.9 billion in over 150 investee companies. One of its recent investments has been in Alexandr Forbes, a diversified financial services company in South Africa. The buy-out was at US$1.2bn. Retrieved April 13, 2008 from http://www.act.is/portfolio/index.asp

investments. [27]A total of 386 PE happened in 2007, mainly in real estate, infrastructure and financial services space. The IT and ITeS segments led the charts in terms of volumes, accounting for 66 deals. [28] Some of the top deals concluded in 2007 include Temasek Holdings $1096 million in Bharati Airtel, Deutsche Bank, Citi group and other international investors, $ 1000 million in GMR infrastructure and ICICI venture Funds $ 800 million in JP infratech. [29](Refer Annex 2)

2.2 Prime sectors attracting private equity/venture capital investments (Refer Annex 3)

Infrastructure

The bill for India's infrastructure work is approximated at around $350 billion and hence with the opening up of this sector, the private equity investors are lining up to explore the potential. [30]Financial powerhouses such as Citigroup and Blackstone are also part of this. IDFC Private Equity, a 100 per cent subsidiary of IDFC, manages an infrastructure focused private equity fund in the country with a corpus of $636 million. [31]The example of US-based private equity firm Clear Trade can be quoted which seeks to invest in infrastructure and power sector through its Clear Investments Power Infrastructure Fund, which starts with an initial corpus of $1 billion. Clear Investments Power Infrastructure Fund has already identified 11 power projects for investment purposes. The fund is also rumoured to be interested in picking up equity in upcoming as well as existing power and infrastructure projects. The fund also plans to form consortia with domestic players in power sector to bid for the upcoming 4,000 MW ultra mega power projects (UMPPs).The government has identified nine UMPPs, of which three have already been awarded.[32] Other instances of activity in this sector is reported with investment firm Quantum Equity Advisors launching a $500 million private equity fund focused on infrastructure in India. [33]Further, private equity players such as 3i, ICICI Venture, IDFC are also betting big on road sector and plan to either directly partner developers by jointly bidding for the highway projects or pick up stake in the infrastructure firms. 3i recently took a minority stake in Hyderabad-based engineering and construction company Soma Infrastructure for $101 million. [34]

Energy

Energy requirements have increased to support the huge spurt of mushrooming industries and hence this sector has also seen major growth in terms of private equity investments. To quote an example, a leading steel manufacturer has decided to offload around 25 % stake in its wholly-owned subsidiary, Ispat Energy to private equity funds to raise around Rs. 800 crore. [35]Another case is that of Bhilwara Energy wherein a consortium of investors has expressed an interest in and the company is in the process of striking a Rs.600 crore private equity deal. [36]The company has just bagged two new projects with 710 mw in Arunachal Pradesh, making it the second-largest hydropower generation firm in the private sector. [37]

Clean Technology

Due to global climatic changes and the finite nature of natural resources, the concept of clean technology has led to a demand in this sector. India's requirement of importing such technology to avert its increasing woes of pollution and shortage of clean water has made it one the prime destinations for investors with regards to clean technology as well.[38]

Logistics Sector

With the recent acquisition by Blackstone of 10.4% stake in logistics major Allcargo Global Logistics (AGL) for Rs 242 crore, a trend seems to have been sparked off with private equity investors making a beeline for investing

[27] [26] Retrieved April 15, 2008, fromhttp://www.assocham .php?id=1376
[28] Ibid.
[29] Ibid.
[30] Rejeshwari Adappa Thakur. Infrastructure Financing: Betting Big on India. Retrieved April 16, 2008, from http://www.ibef.org/download/funding.pdf
[31] Ibid.
[32] Retrieved April 10, 2008, from http://www.indiape.com/blog/_archives/2008/2/18/3530106.html
[33] The Economic Times, March 17, 2008. Quantum Equity launches $500 m infrastructure fund.
[34] The Economic Times, January 11, 2008. PE Firms on Road to Make it Big.
[35] The Economic Times, January 10, 2008. Ispat Energyto Sell 25 % to OE companies for Rs.800 crore.
[36] The Economic Times, January 9, 2008. PE Investors May Pick 8% in Bhilwara Energy for Rs.600 crore. Also, see http://www.bhilwaraenergy.com/press_releases.aspx
[37]Retrieved April 18, 2008, from http://www.bhilwaraenergy.com/press_releases.aspx
[38] Ernst & Young. Acceleration: Global Venture Capital Insights Report 2007. Retrieved April 12, 2008, from www.ey.com

in supply-chain systems in India and are betting on the robust pace of Gross Domestic Product growth.[39] The PE major had paid Rs 934 per share, a 30% premium on the 15-day traded price. [40]AGL is developing container freight stations and ICDs in different parts of India. It will invest around Rs 100 crore to acquire different capacity cranes used in construction activities.

Others

The recently-launched TVS Capital Funds is in the process of raising a corpus worth Rs. 400-500 crore. The fund will eye consumption sectors like health care and private education. [41]The sponsors of the fund include Shriram Group and the TVS Group.

2.3 Instruments of Investment by firms

Mezzanine funds

Private equity firms are increasingly being inclined towards instruments called Mezzanine Funds. These are debt-dominated instruments with some parts of equity.[42] Private equity (PE) majors are lining up a bevy of 'mezzanine funds' for the Indian market. These funds are typically debt-dominated instruments with some parts of equity and their basic advantage lies in their providing medium-to-long term capital to promoters without significant ownership dilution. While from the lenders' perspective, mezzanine funds offer a measure of downside risk protection, these funds are widely predicted to gain f with mid-cap Indian firms, where promoters would relish the opportunity of not ceding considerable shareholding while raising funds. For instance, India is to witness the launch of its first mezzanine fund, which is being taken care of by ICICI Venture which also happens to be India's largest PE. ICICI Venture's 'India Advantage Fund VII' would offer $110 million in its first round of fund raising, over half of which has already been committed by limited partners. The fund is among the single largest country-focused mezzanine fund in Asia's emerging markets and corpus could be scaled up to $1 billion in the second round of fund raising, according to industry sources.[43]

IPO Convertibles

Another frequently used instrument which finds use for most IPO deals is the IPO convertible, which is more of a debt instrument. The instrument provides the edge to the investors by allowing companies to not freeze the price at the time of the deal and thereby rendering the investors the freedom to buy equity at the IPO price at a later date, when the companies go public.[44] However, the concept is under the focus for regulation since the Securities Exchange Board of India has directed those companies that are going for IPOs to freeze pre-IPO pricing and to fix their IPO pricing independently. This is to ensure the prevention of sidestepping of restriction imposed on external commercial borrowings. [45]There are upper limits prescribed for the extent to which external commercial borrowings [46]may be sought. However, by this route, investments sought from PE firms which as such do not come under ECB can flout the limits. Half of the PE deals struck last year were via IPO convertibles [47] and hence such a change might affect the propensity of the PE firms to invest.

2.4 Regulatory Environment

India does not profess a very stringent regulatory framework for private equity firms, however, it is the venture capital aspect of private equity investments that captured the attention of regulators and hence regulations such as the SEBI (Venture Capital Funds) Regulations, 1996 and the SEBI (Foreign Venture Capital Investor) Regulations, 2000 exist. The rationale behind such distinction can perhaps be attributed to the fact that the law-makers are reluctant to ward off foreign investors who often opt for the route of private equity. But when it comes to Venture Capital, the role of foreign venture capital investors is particularly regulated so as to be able to track down the inflow of funds. With respect to the funds' regulation, the law is applicable to domestic companies as well and the intention behind the regulation is perhaps more directed to regulate the domestic aspect and foreign

[39] Retrieved April 17, 2008, from www.blackstone.com/news/press_releases/2-20-2008.pdf

[40] The Economic Times, February21, 2008. Blackstone picks up 10% in Al go for Rs 242 cr,

[41] Retrieved April 13, 2008, fromwww.vccircle.com/2007/09/19/tvs-capital-funds-launched-likely-corpus-150-million/

[42] Retrieved April 17, 2008, from http://www.indiavca.org

[43] Retrieved April 18, 2008, from http://www.indiape.com/

[44] Private Equity Majors Line Up Mezzanine Funds For Indian Market. Retrieved April 14, 2008, from http://www.indiape.com/

[45] Retrieved April 19, 2008, from http://www.vccircle.com/2008/02/07/sebi-to-regulate-pre-ipo-placements-it-sees-it-as-debt-in-the-garb-of-equity/

[46] Hereinafter, ECB.

[47] Supra note 45

parties are not the specific targets. The provisions of the above-mentioned regulations merit some deliberation presently.

The SEBI (Venture Capital Funds) Regulations, 1996 [48]

Registration

As per the SEBI VCF Regulations, anybody corporate, trust or company is eligible to carry on activity as a venture capital fund. For the same purposes, the concerned bod has to make an application to the Securities and Exchange Board of India [49] for grant of certificate authorizing such activity. [50]

Eligibility criteria

For registration as a Venture Capital Fund [51], certain conditions have to be fulfilled as a prior and necessary step. For instance, the main objective of the applicant company or the trust should be to carry on the activity of a venture capital fund [52] which should be mentioned in its constituting document. [53] Further, the company should be one which is prohibited by its memorandum and articles of from making an invitation to the public to subscribe to its securities. [54] The director [55] of the applicant should not be involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant [56] neither should they have been convicted of any offence involving moral turpitude or economic offence at any point of time.[57] Significantly, the applicant should be a fit and proper person. [58]Also, in case the applicant is a trust, the instrument of trust should be registered under the provisions of the Registration Act, 1908 of India. [59]

Investment conditions and restrictions

With respect to investments made by such a VCF, certain guidelines have been provided to regulate the investment structure to an extent and to ensure that the funds are not exploited. A VCF is free to accept money from any investor, [60] by way of issue of units such that the minimum investment accepted from such investor is Rs 5 lakh ($ 12,500).[61] An exception may be made where the concerned investor an employee, principal officer or director of the VCF or director of the trustee company or trustee where the VCF has been established as a trust. [62]

The VCF should have firm commitment from its investors for minimum contribution of Rs.5 crore ($ 1,250,000) [63]Any investment made by the VCF is subject to the certain conditions which are detailed as follows:[64]

- At the time of application for registration, the investment strategy has to be disclosed.
- In a single venture capital undertaking not more than 25% of the corpus of the fund can be invested.
- Investments cannot be made in associated companies.
- The duration of the life cycle of the fund has to be disclosed by the VCF [65]
- The investment scheme [66] should be such that at least 66.67 % of the investible funds have to be invested in unlisted equity shares or equity linked instruments of venture capital undertaking. Further, not more than 33.33% of the investible funds may be invested in the following ways:
- Subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed.

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[48] Hereinafter 'SEBI VCF Regulations'

[49] Hereinafter, 'SEBI'

[50] Regulation 3, SEBI VCF Regulations.

[51] Hereinafter, 'VCF'

[52] Regulation 4(a)(i) and Regulation 4(b)(ii), SEBI VCF Regulations.

[53] That is, memorandum of association in the case of a company and the trust deed in case of a trust. It should contain a prohibition from making an invitation to the public to subscribe to its securities

[54] Regulation 4(a)(ii), SEBI VCF Regulations..

[55] Or principal officer or even the employee in the case of a company.

[56] Regulation 4(a)(iii) and Regulation 4(b)(iii), SEBI VCF Regulations

[57] Regulation 4(a)(iv) and Regulation 4(b)(iv), SEBI VCF Regulations

[58] Regulation 4(a)(v) and Regulation 4(b)(v), SEBI VCF Regulations

[59] Regulation 4(b)(i), SEBI VCF Regulations

[60] Irrespective of whether the investor is Indian, foreign or non-resident Indian.

[61] As per exchange rate as on March 20, 2008.

[62] Regulation 11. SEBI VCF Regulations

[63]]Regulation 11(3), SEBI VCF Regulations

[64] Regulation 12, SEBI VCF Regulations.

[65] Regulation 12(e), SEBI VCF Regulations

[66] These conditions for investments shall be achieved by the VCF by the end of its life cycle, as provided by Explanation to Regulation 12, SEBI VCF Regulations.

- Debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity.
- Preferential allotment of equity shares of a listed company subject to the lock-in period of one year.
- The equity shares of a financially weak company [67] or a sick industrial company whose shares are listed.
- Special purpose vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations.
- No VCF is entitled to get their units listed on any recognized stock exchange until expiry of three years from the date of the issuance of the units by the VCF. [68]

General Obligations and Responsibilities

The VCF is expected to comply with certain responsibilities and obligations during the course of its functioning. It is prohibited from inviting offers from the public for subscription or purchase of any of its units [69] and therefore, amounts for investments can be received only through private placement of these units. [70] A memorandum containing details of the terms and conditions as per which the money are to be raised from investors is to be issued and these details are to be in a subscription agreement entered into with the investors, and a copy of these documents along with a port of the money actually collected is to be submitted with the SEBI. [71]

2.4.1 *The SEBI (Foreign Venture Capital Investor) Regulations, 2000* 72

A Foreign Venture Capital Investor [73] is an investor incorporated or established outside India, which is registered under the SEBI FVCI Regulations and which proposes to investments in India. Unlike the VCF Regulations which seem to make it mandatory for VCFs to register with the SEBI, the FVCI Regulations does not make it mandatory for an offshore venture capital investor to register with SEBI as an FVCI. Also, SEBI's intention is really not to regulate the FVCIs but to monitor the foreign investments coming into the domestic venture capital sector. [74]

Eligibility criteria

To register as a FVCI, the investor has to file an application to the SEBI for the grant of a certificate; the SEBI in turn, before accepting the applications has to consider determinants such as [75] the applicant's track record, professional competence, financial soundness, experience, whether the applicant has been granted approval by the Reserve Bank of India for making investments in India, whether the applicant is an entity or investment vehicle[76] incorporated outside India, whether the applicant is authorized to invest in VCF or carry on business as a FVCI, whether it is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer, whether the applicant has been refused certificate by the Board and lastly, and, whether it is a fit and proper person.

Investment conditions and restrictions

The investment scheme applicable to FVCI is similar to those applicable to VCFs under the VCF Regulation 12, as detailed before. Other conditions that are required to be fulfilled include [77]:

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[67] Financially weak company means a company which has at end of the previous financial year accumulated losses which has resulted in the erosion of more than 50% but less than 100 % of its networth as at the beginning of the previous financial year, as provided in Explanation 1 to Regulation 12(d)(ii)(d), SEBI VCF Regulations

[68] Regulation 13, SEBI VCF Regulations

[69] Regulation 14, SEBI VCF Regulations

[70] Regulation 15, SEBI VCF Regulations

[71] Regulation 16, SEBI VCF Regulations

[72] Hereinafter, SEBI FVCI Regulations.

[73] Hereinafter, FVCI.

[74] Siddharth Shah, Private equity investments in India: a Legal and Structural Overview, International Financial Review, Supplement, Yearbook 2001. Retrieved 1 12, 2008, from http://www.iflr.com/?Page=17&PUBID=213&ISS=16398&SID=514520&SM=&SearchStr=

[75] Regulation 4, SEBI FVCI Regulations.

[76] The applicant can be an investment company, investment t, investment partnership, pension fund, mutual fund, endowment fund, charitable institution, asset management company, investment manager or investment m ompany,

[77] Regulation 11 of SEBI FVCI Regulations.

- Disclosure of investment strategy to SEBI.
- The FVCI can invest its total funds committed in one venture capital fund..

General Obligations and Responsibilities

The FVCI Regulations make it mandatory for a FVCI to appoint a domestic custodian to act as a custodian of securities. The domestic custodian has to monitor investments of the FVCI in India, furnish periodic reports of the same to the SEBI and furnish information as may be called for by the Board. [78] Further, the FVCI has to enter into an arrangement with a designated bank [79] for the purpose of opening a special non-resident Indian Rupee or foreign currency account. [80]

The answer to why most venture capital investors would opt for registration with Securities and Exchange lies in the incentives offered by such registration which include[81]:

- Income is passed through to investors without tax in the case of Trusts registered under the Indian Trusts Act and Venture Capital Companies.
- FVCIs can freely remit funds to India for investments in Indian venture capital undertakings and SEBI registered DVCFs.
- FVCIs are exempt from both the entry and exit pricing regulations that otherwise apply to foreign investors, such as market-related pricing on divestment.
- The sale of shares by VCFs to company insiders post-listing is exempt from the SEBI Takeover code.
- VCFs automatically obtain Qualified Institutional Buyer ("QIB") status, which is useful for participating in new security placements.
- Exemption from one-year lock-in for divestment post-IPO for shares purchased prior to the IPO.
- VCFs do not get treated as promoters for purposes of IPO.

2.5 Emerging Issue: Proposed changes to Venture Capital/Private Equity Regulation in India

Proposal to treat PE investment as portfolio investment rather than FDI has been put forth by the Prime Minister's Economic Advisory Council. On the same lines, foreign funds might be required to report their investments and repatriation.[82] The standard practice is to treat investments of below 10% in corporations as portfolio investments; however the debatable issue presently is hat these PE firms often end up purchasing controlling stakes in companies and take-over the management. This merits that they be given FD nt.

Another foreseeable development is that in the future, only professionals are likely to be allowed to float venture capital funds in future. This can be attributed to a view expressed by certain officials at SEBI as per which no business house, financial services group or big corporate would be allowed to set up a VCF. The rationales which has been provided is that since VCFs operate under a special regime in relation to taxation, foreign capital and investment lock-in and are meant to encourage new entrepreneurs, the vehicle should not be misused by established players to invest in companies where they e strategic or business interests. The suggestion hasn't yet been concretized however such a change is likely to affect India's venture capital market in a significant manner since it would eliminate several of the possible investors. In India, VCFs can be structured in such a way that they function as tax-transparent entities, where the original investors pay tax and not the fund's trust. [83]

If the door to VCF is shut down for corporation and large groups, they will be moved to float private equity funds. A few large groups have already announced their decisions to set up PE funds. Unlike VCFs, PEs do not enjoy tax and some of their benefits however the advantage is that PEs don't come under any regulatory framework.

2.6 Emerging Issue: Effect of the Credit Crunch on Private equity Investments

Despite the recent worldwide credit crunch, private equity is here to stay. Ample committed but not yet invested equity capital is available. Cost of debt has no doubt risen, however it is still only at levels reached at 2005 (when private equity was already booming), and many financial institutions are willing and still able to provide debt. It is to be remembered that, in comparison to capital markets, the way private equity creates value is increasingly

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[78] Regulation 14 of SEBI FVCI Regulations.

[79] Such bank shall be a branch of a bank approved by the RBI as designated bank for the purpose.

[80] Regulation 15 of SEBI FVCI Regulations.

[81] Report of the Committee on Technology Innovation and Capital¸ Government of India Planning Commission, New Delhi, July 2006.

[82] The Economic Times, January 18, 2008. Soaring PE Flows Must get Portfolio Investment Tag: EAC. Also, refer: http://eac.gov.in/pressrel/prjan21/eac_press%207.pdf.

[83] The Economic Times, March 10, 2008. Only Professionals May Get VCF License.

shifting toward fundamental value creation.[84] Many observers who opine that the credit crunch has ad y affected private equity refer to the recent cancellation of some high profile private equity deals which has led to doubts about the sector's ability to sustain its current high levels of growth. "The private equity gravy train has jumped the tracks," the *New York Times* reported in September 2007, in an article that reflects the controversial wisdom. "The buyout bubble has burst," the *Times* added in October. [85]This pessimism is unwarranted. Despite recent troubles, the basic elements of the private equity business model remain very much in place. Although the credit crunch has caused a drop in the largest private equity deals, it is unlikely to retard the long term growth of the sector. A report by The Boston Consulting Group estimates that the private equity sector will grow by 15 – 20 percent per year until 2011. [86] The fact is that private equity is here to stay.

It is to be noted that there are still substantial amounts of money available for investment. Though 2006 the private equity sector in the United States and Europe ulated nearly $300 billion in uninvested capital. This committed capital will be a powerful impetus to future deals. The influx of Sovereign Wealth Funds the Middle East with investment capacities of trillions of dollars also should not be forgotten. Sovereign Wealth Funds have already picked up stakes in Blackstone (the new $200 billion SWF of China acquired a 10% stake in Blackstone) and Carlyle (Sovereign Wealth Fund of Abu Dhabi acquired a 7.5 percent stake in the Carlyle Group), two prominent private equity groups.

Another very important aspect to be remembered is that the value created by private equity is less and less the result of debt arbitrage. Increasingly, private equity firms are creating value not through high leverage but through increase in fundamental value as a result of operational improvement and profitable growth.

Also, the middle market players are the ones who have benefited owing to the credit crunch and as a result mid-sized deals are relatively flourishing. The strong stock market and economy of the last several years had pushed corporate valuations to lofty levels and thus raised the prices that private equity investors had to pay to do deals. [87] Now, valuations are returning to normal. At present, giant commercial and investment banks like Citigroup,[88] Merrill Lynch [89] and J.P.Morgan [90] are struggling due to their losses from subprime mortgages, and hence are not very inclined to participate in big buyouts. According to research by U.K.-based Dealogic, which tracks investment activity, mega-deals slowed nearly to a stop in the second half of last year. Deals in the middle market continued, though at a slower pace because such transactions are often financed by regional and community banks, which so far haven't been sapped by subprime losses.[91]

2.7 Analysis of the Indian Market

The investments made by Indian private equity and venture capital industry including deals through Q or Qualified Institutional Placements, participatory notes and transactions of hedge funds, mezzanine funds and proprietary funds – touched $ 19.5 billion in 2007 overtaking the comparable investment in China. This represents a 156.6 % growth over the $7.6 billion worth of investments made in 2006. This shows that private equity investments are gaining a significant foothold in India and funds and buy-out firms are strong contenders in the bidding process. Investments are coming in a structured manner and the regulations have not hindered investments in anyway. The regulations have sought to only regulate the venture capital sector. The private equity segment largely remains unregulated and the firms can therefore gain unrestricted entry into the market a great extent. So far as the regulations are concerned, they have ensured that solvent companies which are fit and proper to carry on business and which have a proper history of corporate governance are allowed to float Venture Capital funds.

A second issue concerns the necessity for regulation concerning Foreign Venture Capital Investors (FVCIs). Such an importance can be attributed to anonymity linked with the foreign investors. The recent

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[84] Refer - The Advantage of Persisitence – How the best Private Equity firms "Beat the Fade", BCG Report (Jointly done by The Boston Consulting Group and IESE Business School, University of Navarra), February 2008. Retrieved April 12, 2008, from http:// www.bcg.com

[85] Andrew Ross Sorkin, "The Ranks of the Comfortable Are Still Thinning," New York Times, September 9, 2007, and "After the Parity," New York Times, October 3, 2007.

[86] The Growth Dilemma:Global Asset Management 2007, Bosto onsulting Group Report, November 2007.

[87] Peter Taft, partner with Morgenthaler Partners, in Wharton Private Equity Conference; Forget Those Big Deals (and Headlines): Private Equity Firms Are Shopping the Middle Market. Retrieved April 13, 2008, from http://knowledge.wharton.upenn.edu/article.cfm?articleid=1908

[88] Citigroup's $9.8bn sub-prime loss , January 15, 2008. Retrieved April 17, 2008, from http://news.bbc.co.uk/1/hi/business/7188909.stm

[89] Merrill Lynch posts $7.8bn loss, January 17, 2008. Retrieved April 17, 2008, from http://news.bbc.co.uk/2/hi/business/7193915.stm.

[90] JP Morgan's $1.3bn sub-prime hit, January 16, 2008. Retrieved April 16, 2008, http://news.bbc.co.uk/1/hi/business/7191795.stm

[91] Forget Those Big Deals (and Headlines): Private Equity Firms Are Shopping the Middle Market¸ Wharton Private Equity Conference. Retrieved April 15, 2008, from http://knowledge.wharton.upenn.edu/article.cfm?articleid=1908

suggested-regulatory changes can be analyzed from that perspective. Why is it of significance to limit venture capital funds to professionals? The answer could perha n the trend that big corporate houses often misuse the benefits such as taxation which investments through these vehicles offer, to expand the business of companies which are directly linked to their strategic interests. Therefore it is important that regulation encourages new players in the market and not just further the interests of those investors who are well-established. One of the primary objectives behind the change in regulatory sce is also to ensure prevention of asset stripping to erode value of the companies (SEBI). Since the identities of foreign investors involved in such PE funds are often not disclosed, such investments may lead to asset strippin For this it has been suggested that the duration of investment and entry as well as exit patterns would be tracked. Since foreign investment in several segments is allowed though the automatic route, one way of sourcing information is to ask foreign PE finds to report their investments and repatriation. However such tracking of funds may not be feasible since it may send wrong signals to foreign investors. However, FCI regulation in a systematized manner has conferred many benefits on FVCIs. FVCIs are exempt from the usual practice of valuing their shares on the basis of their listed price or on the basis of their net asset value (in the case of an unlisted company). This exemption immensely helps exit processes since instead of paying a price based on the net asset value of the investee company, it could pay a negotiated price. This definitely makes commercial and business sense since the shares acquired by an FVCI in an unlisted company are not subjected to the one year lock-up period upon the Initial Public Offering (IPO) of the shares of the company. Therefore, the FVCI would be able to exit the investme without having to wait for a lock-up period. Also to be noted that FVCIs are Qualified Institutional Buyers (QIBs) as per SEBI (Disclosure & Investor Protection) Guidelines, 2000. Hence, they are able to participate n the primary issuance process, meaning that they will be able to subscribe for the securities in an IPO under the typical book building process.

It has been often seen that foreign PE funds take over management rather than staying as investors. The Government, in such cases, is concerned with the outcome of such management takeover on the health of the company. While PE funds are focused on turnaround and profitability, the government's concern extends to areas such as job creation. In this context, the proposal to treat private equity as portfolio investment gains importance since portfolio investment necessarily indicates that such a foreign entity will have a maximum of 10% ownership of the total issued and paid up share capital. This wa management does not pass into the hands of these investors. With respect to the new funds in the market, more flexible options have been provided to the promoters to invite investments. Therefore, private equity seems more attractive. Indian markets are gaining more popularity in these terms as well. However, it is required that more such be introduced so as to provide the promoters as well the investors a wide range of choices.

The effect of sub-prime crisis has been of prime importance. The big buy-outs have all been shadowed by the mid-sized deals which in the light of the credit crunch ha become more target-worthy. As discussed, India houses the potential for several such deals, in the infrastructure, technology, real estate, energy and such other sectors. The above in brief are the most prominent effect of the venture capital regulations in India and they have contributed to a massive growth in this sector.

3. Conclusion

The quality of their acquisitions and portfolio management will determine whether private equity players will be able to sustain the growth rate. It is true that the credit crunch have hit the private equity industry hard and as with banks, sovereign wealth funds have emerged as saviors private equity firms too. Private equity investments will continue to rule since it is often seen that it is the management team's interest to be bought by a private equity fund rather than by a strategic buyer, and when it has a say in the decision, it often welcomes the bid. This is primarily because private equity funds bring along with them professional expertise which contributes a lot to value enhancing growth of a company. Private equity firms have more ambitious business plans, particularly in terms of the speed of improvement programs, they expect to realize their returns more rapidly and provide management with significant incentives to deliver on time. It is also to be noted that private equity firms and funds have a more rigorous and professional approach to assessing the potential upside of a deal and to optimizing the cost and flexibility of the financing of the transaction, providing them with a competitive edge over strategic bidders. These reasons account for a revolution in the global deal markets including India. Major investments as mentioned in the paper including those of Blackstone, Pincus, KKR, Carlyle and the like have significant portfolios in India, which project India as one of the most lucrative destinations of Private Equity.

In India, during the last year, almost all venture capital and private equity giants have either established an on-ground presence in India or raised significant India dedicated funds. The most important fact is an GDP growth coming within striking range of double-digits. Annual growth rates of 7-9% are unheard of in mature western economies, and global investors want high returns. Furthermore, several key sectors of the Indian economy (IT/BPO, telecom, pharma/healthcare, financial services, retail and automotive components) that are investment targets are experiencing even higher growth than the said levels (of 7-9%). Other key attractions include: an economy well positioned to mine the opportunities of globalisation, an increased appetite for

innovation and entrepreneurship, well-regulated and fully functional capital markets and a spurt in consumerism powered by the young demographic profile. Clearly, the liberalisation of the economy has also had a significant impact, laying the foundation for a relatively stable environment in combination with high growth.

However, on the regulatory side, many investors would to see the government use the current momentum to push forward with further deregulation. Some recent regulations, they fear, have not been well thought through. Examples of these include the introduction of FBT on stock options and the recent news on preference share capital requiring compliance with ECB guidelines on interest/dividend coupon caps and end-use restrictions (that is, compliance with external debt norms, unless the shares are fully-convertible). For the PE/VC industry, the new end-use restrictions are particularly harmful as funds raised via preference shares cannot be used for general corporate purposes, funding of working capital, repayment of existing loans and acquisition of shares and/or real-estate. At present, it is estimated that about 30% of Indian VC/PE investments are structured as preference share capital. Unless this gets revised, th percentage might well come down. This is in sharp contrast with many western markets, where an even higher and ever-increasing percentage of VC/PE investments are structured with a layer of preference share capital—also referred to as 'hybrid capital', since it bears elements of both debt and equity in an attempt to achieve a unique mix of risk and reward.

The most common forms of preference include liquidation preference and/or dividend preference. The rationale is to grant flexibility in risk and reward distribution amongst different types of shareholders (investors and management). In most cases, financial structures involving preference shares tend to increase the overall ownership level and upside of the ordinary shares held by management. However, on the flip side, they also tend to increase the risk profile of ordinary shares, while the preference shares held by PE/VC investors tend to carry lower upside but more downside protection.

Given the economy's growth, many investors have shown higher than average risk appetite on investing in India. Hence they might well decide that the opportunity is too interesting to ignore, and might invest in ordinary shares instead. Furthermore, Indian PE/VC activity has hit record levels in spite of the fact that leveraged buyout levels continue to be low in India—on account of another set of regulations that restrict banks from lending money for the acquisition of shares. In mature markets, buyouts typically account for more than 80% of total PE/VC transaction value, but the corresponding figure India is just 15%. This is not just the result of regulatory differences. It is first and foremost the result of different growth stages of the respective economies. Low growth in western markets reduces high-growth investment opportunities, making investors that much more dependent on the use of financial engineering and high levels of leverage for their returns. In contrast, high growth in the Indian market makes the use of leverage less important in achieving overall investor returns. Still, should regulations be eased in this area, one would expect a considerably higher level of buyout activity in India. This could then trigger another significant step-up in overall PE/VC investments levels in India.

All said, although the above regulations can sometimes be a hurdle for PE/VC investors, India's legal environment, regulatory regime, corporate governance levels and maturity of markets, all compare rather well with many other emerging markets. And with PE/VC players in possession of record levels of funds, they are looking to deploy the money in markets that offer them what they cannot refuse: returns.

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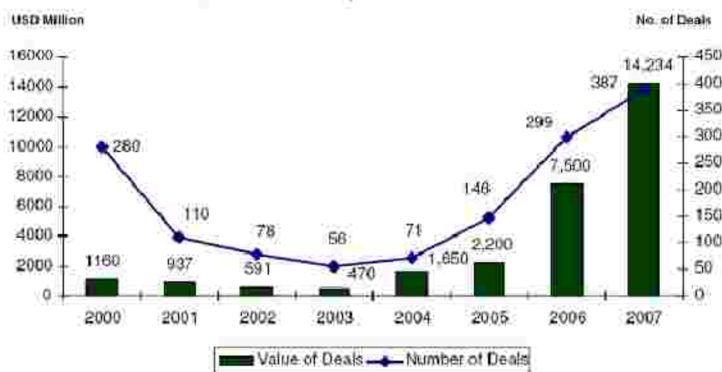
Annex 1: PE investment structure

Different steps in the private equity investment process

STAGE	ENTREPRENEUR	ENTREPRENEUR & PRIVATE EQUITY FIRM	PRIVATE EQUITY FIRM	REPORTS
Approaching the private equity firm/evaluating the business plan	• Appoint advisers • Prepare business plan • Contact private equity firms		• Review business plan	• Business plan
Initial enquiries and negotiation	• Provide additional information	• Meet to discuss business plan • Build relationship • Negotiate outline terms	• Conduct initial enquiries • Value the business • Consider financing structure	• Offer letter
Due diligence		• Liaise with accountants • Liaise with other external consultants	• Initiate external due diligence	• Consultants reports • Accountants reports
Final negotiation and completion	• Disclose all relevant business information	• Negotiate final terms • Document constitution and voting rights	• Draw up completion documentation	• Disclosure letter • Warranties and indemnities • Memorandum and articles of association • Shareholders agreement
Monitoring	• Provide periodic management accounts • Communicate regularly with investor/s		• Seat on Board/ • Monitor investment • Constructive input • Involvement in major decisions	• Management accounts • Minutes of Board and other meetings
EXIT				

Annex 2:

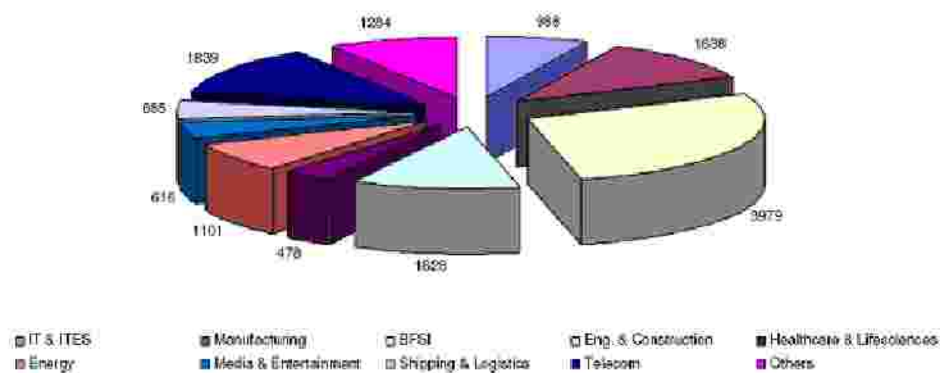
Growth of PE/VC in India
2000 – 2007 (US$ millions)



Source : www.indiavca.org

Annex 3:

2007 PE/VC Investments by industry
Total US$14.2Bn



Annex 4

PE Investments by Stage : 2007

PE Investments by Stage

Stage of Company Development	Volume / No. of Deals		Value / Amount (US$ M)	
	2007	2006	2007	2006
Venture Capital	98	94	542	505
Growth PE	32	14	1321	304
Late	136	104	6070	3398
Pre-IPO	14	4	434	43
PIPE	90	60	4210	1401
Buyout	7	13	172	370
Buyout-Large	3	1	474	785
Other*	17	8	2010	312

* includes infrastructure investments