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COVID-19 and the Indian Private Equity Industry: Time to Use the Dry Powder

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Abstract

The article throws light on the impact of the pandemic on the major funding industry for the country, that is, private equity (PE) firms. About 59% of the FDI comes via this route, and growth of major sectors is impacted by their investment. Last few years, there have been discussions about dry powder availability with the PE firms. This is the time to create opportunity in crisis for both the parties (the investors and the target firms). As seen during the 2008 crisis, many deals which materialized gave huge benefits to the investors. The article motivates the industry not to take a backseat and make the best out of the situation.

Key Words

Business Environment, Economics, Management, Management Cases

Introduction

Private equity (PE) and venture capital (VC) investors have been a vital part of India's growth story since a long time. Dhankar and Malik (2015) in their study empirically proved how companies backed by PE have consistently shown better performance compared to other companies in terms of high performance, job creation, growth and tax revenues. From 2005–2020, there has been an investment of US$20 mn by the PE and VC industry in India. In 2019, there was an investment of US$30 bn. About 59% of FDI investment in India comes via the PE route. Bordia and Blau (2015), Bloom et al. (2015), Clarkson (2009) and Smith (2018) have found out in their studies that PE- and VC-backed firms create more employment opportunities and pay more taxes compared to non PE-backed firms. Due to the start-up wave, there has been an increase in direct jobs with fresh graduates and lateral recruits joining the new firms. With the next generation of entrepreneurs, they are not building on debt. In terms of deal making, there is far more diligence in deal signing. The arrival of the pandemic is a time for the PE industry to make use of their rising dry powder. Dry powder is a term used for VC and PE companies means the funds available for the general partners for investing.

Dry Powder = Capital Commitments – Invested Capital

The dry powder has been on a rise and being available for deal making. The Indian government has understood the importance of the PE industry and has created a conducive environment for the growth of the industry. Some of the key recommendations for the industry in the year 2019 which have also been accepted by the government have been pass through of end of fund losses of AIFs to their investors, extension of tax exemptions in IFSC's to AIF's, exemption of Angel Tax (Section 56). The same has been accepted by the government. Flagship programmes such as Startup India and Digital India continue to improve landscapes for the start-ups.

Globally, the PE industry has a record of US$1.5 trillion cash pile of dry powder or undeployed capital in 2020.

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Figure 1. Dry Powder Data

Source: Preqin.

According to Venture Intelligence, private company data tracker, 2019 recorded 86 deals valued at US$36.96 bn compared to 937 deals worth US$36.14 bn in 2018. India's ranking in ease of doing business has risen from 130 in 2016 to 63 in 2019, boosting investor confidence. As per Figure 1, dry powder has been on a rise since 2000. The high rise can be seen post 2015, when the companies recovered from the global financial crisis and thereby had extra capital available for investment.

Changing Landscape of Private Equity Performance and Statistics in India

PE companies such as Blackstone, KKR and Carlyle had a stock piling in cash with rising markets had a record pile of dry powder. These industries buy undervalued companies with borrowed money, taking them private to increase operations for an eventual sale.

PE investors can enter through bridge financing, secondary purchase, replacement equity and leveraged buyout. But as debt-laden Indian promoters are wanting to clean their balance sheets and deleverage, PE companies are looking for more buyout options. It helps the fund managers to have a better control on the performance of their investments. According to E&Y in 2019, 34% of all PE/VC investments were via buyout. For 2017–2019, buyouts were US$26.7 bn in deal value, which was more than the value of buyouts in the last 12 years. About 80% of VC investments have been concentrated on consumer tech, software/SaaS, Fintech and B2B customers. Secondary sales have been the leading mode of exits with average exit value being US$39 bn. Other focus areas have been Foodtech, Healthtech, Edtech, etc. Also, transactions known as private investment in public equity (PIPE) help companies under distress to raise cash quickly. The buyers get shares at discount, and it dilutes the stakes of the existing shareholders. One of the examples of PIPE in 2008 crisis has been buying of 17% stake of Leonard Greens and Partners in Whole Foods for US$425 mn which yielded a profit of US$1 bn when shares recovered after a few years.

Impact of COVID-19 on the Private Equity Area in India

The coronavirus pandemic is shutting down entire sectors of the economy and putting millions of people out of work, but there is one sector which is finding opportunity among the carnage: PE. Vulture investors, especially in PE are waiting in the wings to scoop up scores of struggling business on the cheap.

The spread of COVID-19 has had a significant impact on the economy, with trade and supply chains being hampered and domestic consumption demand in affected countries and around the world being depressed. There would be hiccups as the ones are right now. There have been political issues between 2012 and 2014 when there

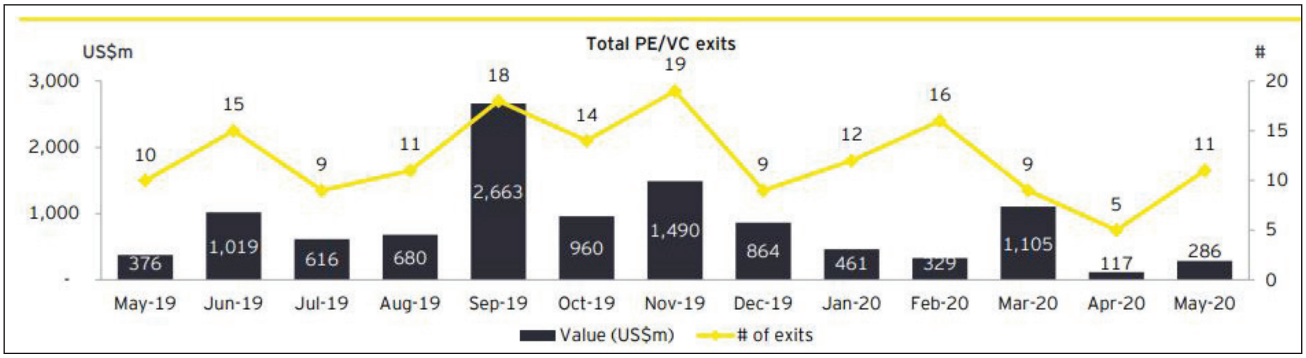

Figure 2. Total PE Exits

Source: EY analysis of VCCEdge data.

were scams which brought Indian story down for a year or two. But for long-term average, Indian growth story is considered intact making it an attractive destination for the global investors. These are hurdles, not the walls.

One of the positive outlook is that some of the best companies for investments are within an attractive value range. Cheaper valuations and positive long-term growth projects are the positive side for PE investments, but the funds would be worried for poor corporate governance and exits. Insolvency and bankruptcy code has been introduced which will help in creditors rights being enforced and allowed to be enforced.

Though Moody slashed India's GDP growth forecast for 2020 to 2.5% and G20 released its GDP forecast for 2020 putting global growth at –2.2%. Even so according to G20, India would have highest growth rate of 2.2% in 2020. Many of the deals have closed in 2020 like TA Associates investment in Accion Labs and Vivriti Capital which got 350 cr from LGT Lightstone Aspada. The pandemic quickly turned into an economic crisis. The pandemic has influenced two kinds of shocks: a health shock and an economic shock. Rapid global spread of the virus lead to a significant downturn in the capital markets around the world, bringing high volatility to home markets of global and regional fund managers and sovereign wealth funds and pension funds that had been investing US$100 mn in India. Though intrinsic value of business are strong, valuations are expected to lower. General partners have been trying to negotiate changes in fund documents to adjust for the effect of pandemic. They are looking for flexibility to offer more solution in the form of redeployment of proceeds in the portfolio companies or expand investment strategy. Investments made by PE firms are expected to give them higher returns than in an upcycle, but the most challenging area would be exits for the firm.

The firms which would garner interest are Edtech, Healthcare, insurance, digital and automatic opportunities. As for now, general partners would be focused on their current portfolios, helping the company management in business continuity. As the news stuck, there has been fall in deal value to US$2.1 bn in January to March 2020 from US$9.1 bn in the same period last year. Exits are an important factor for success of a PE deal. As per Figure 2, there has been decline in exits compared to last year. Currently, PE exit through primary market via initial public offering would be delayed due to subdued environment. Most of the funds would prefer to wait and get listed at a later date rather than reconciling to lower valuations. There have been exits for 15 deals valued at US$321 mn with 83% of total value of exits through the open market. Exit value in February 2020 was 30% lower than that of January 2020, when funds exited US$461 mn from their investments. Largest exit in February 2020 has been Baring India PE sell of 4.9% stake in Manappuram Finance Ltd for US$101 mn. Current low valuations might interest few India-focused funds to invest in companies for opportunistic bets.

The Road Ahead

Main factors to look forward are as follows:

1. With the onset of economic uncertainity, how to accurately determine the price or value of the new deals?
2. If COVID-19 constitutes a 'material adverse effect', or will it be considered as ' material adverse change'?

For PE deals in listed companies, regulatory floor price is computed on average of weekly high and low stock prices of target company during lookback period of six weeks from the date of shareholders approving the deal. As the impact of COVID-19 has been recent, the pre-COVID-19 period would be taken as lookback period resulting in floor price being higher than the current market price. As a number of listed company deals are under negotiation, they may not take off until the stock price improves or lookback period comes within the COVID-19 space bringing down the regulatory floor price. SEBI has asked for public comments to reduce the lookback period to two weeks for stressed companies. Though the extent of the impact would vary across different sectors, a general slowdown is bound to impact all sectors. It is going to be a challenge for investors to correctly value their target business.

MAE/MAC clauses are provided in the PE deals and are a condition precent to closing. Until now, no MAE has occurred prior to closing of transaction. It provides investor an option to walk out of the deal. It is beneficial for the target company as well. It ensures that value on basis of which investor has agreed to invest is protected and the business risks in case of unforeseen circumstances would be allocated between the investors and the target company. MAE is influenced by factors such as sector to which the target company belongs, negotiation power of the parties and its requirement. The implementation depends on quantum of economic impact of COVID-19 and the durational significance on the business of the target company.

Investors can explore investing in convertible instruments, with conversion linked to future performance of target company. In the current scenario, regulatory floor price is expected to be low so investors can invest in tranches, giving them an option of not to invest further in case of underperformance by the target company. Investors can consider breaking their investments in debt and equity. The scenario looks different for early stage companies with nil revenue and significant cash burn rates. VC investors would focus on conserving capital and so funding would be an issue. They would be stringent on 'due diligence' and more sceptical on 'growth projects'. Education and healthcare sector is going to be an attractive area. Education has been a top sector attracting US$311 mn. In 2020, largest announced deal has been General Atlantic investment of US$200 mn in Byju's followed by Warburg Pincus investment of US$150 mn in Apollo Tyres Ltd. Earlier this year, Edtech start-up Unacadmey raised US$1100 mn from social networking giant Facebook and US PE firm General Atlantic and Akash Educational acquired Meritnation. Warburg believes that India offers the best risk return ratio compared to rest of the world. Traditionally, financial services had been the top sector which slipped to fifth place with US$162 mn across nine deals.

Conclusion

COVID-19 has created many challenges for PE investors for deals which were in advanced stages of negotiation. But it has also given an option to invest in companies which had a steep fall in their revenue and are in the need of financing. Investors can reap benefits of the economic uncertainty with the right investment strategy backed by a sound transactional structure. Huge opportunities exist in sectors such as education, healthcare, FMCG and financial services which can withstand economic and social uncertainties with robust business structure. COVID-19 can accelerate the growth in India's e-health market with predictions of reaching around US$16 bn by 2025. The impact being brought is a debate between life and livelihood. Being a consumption-led economy, a large amount of investments can be expected in India. This is the time when PE companies can use their dry powder and bring capital to the table, restructuring debt, preserve jobs and help the managers lead the company through for the coming months. As long as a PE firm has dry powder and knows how to source deals, there are plenty of opportunities available. It is time to learn from the 2007–2008 crisis when many opportunities that existed were lost as things looked bleakest.

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