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Nature and Drivers of Buyout Transactions in India

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Abstract—*Leveraged Buyout (LBO) market in India is currently considered underdeveloped but research suggests that it possesses a huge potential to grow exponentially in the near future. This paper presents a review of the Indian buyout market by assessing prior studies and by analyzing the available statistics in this area. Our findings suggest that the Indian buyout industry, unlike its mature European and US counterparts, is neither in its natal stage nor anywhere close to maturity. Moreover, we find that as opportunities and market conditions for buyouts continuously improve, there is no reason that the buyout market would remain neglected, as it has been the case so far. This paper contributes to the existing research on the Indian private equity industry, an area presently suffering from a dearth of research, by providing an improved understanding of the current scenario of the Indian buyout market, the essential roles played by the public agencies, buyout effects, the available opportunities, and the challenges associated with such opportunities.*

1. INTRODUCTION

The Private Equity (PE) landscape in India has changed in the aftermath of the global financial crisis. PE activity in India may currently be on the rise, amid expectations that it will return to the $10 billion levels of the past, but buyouts are yet to become a significant part of the Indian PE landscape. Buyout activity has been low not just in India, but across the Asia-Pacific region, except in Australia. In the pre-2000 era, there was an absence of buyouts and many acquisitions were considered hostile. Blackstone was one of the first global buyout firms to enter India; its most notable buyout being that of Gokaldas Exports Ltd. Though the term, 'Buyout' suggests gain of majority control over the target company, mostly all major investments by traditional buyout firms have been for minority stakes, providing growth capital. Buyouts in India have been more of an exception than the rule and are largely limited to opportunistic acquisitions of small and medium sized family businesses.

Lately, conditions have begun to change: increasing availability of high yield debt, strong deal flow across major sectors, growing entrepreneurial mindset, up-hill GDP growth, multitude of exit routes including IPOs and mergers & acquisitions, a positive viewpoint of strategic investors about the market and the entry of international big players - all make a strong case for the sound development of the buyout industry in India.

As the global scope of private equity has increased over the past few years, more studies that explore specific aspects of private equity in the context of emerging economies, such as India, will prove insightful [1]. At such a time, a better understanding of the Indian buyout industry will prove to be of major importance. This paper tries to paint the current scenario of the Indian buyout market by highlighting the roles played by the public agencies, buyout effects, the opportunities present, and the challenges associated with such opportunities. We begin with an introduction to the current state of the buyout market in India.

2. INDIAN BUYOUT MARKET: A BIG BABY OR AN ADULT?

While buyouts are one of the most favoured PE investments in developed markets, they are comparatively rare in India, accounting for only 9% of total funds invested and 3% of the total number of deals. Table 1 compares financing stage-wise investments in firms across different markets (for the year, 2007).

Table 1: Financing Stage wise investment across different markets in 2007 [13]

Financing Stage	India (%)	Asia (%)	North America (%)	Europe (%)
Early	12.5	8.0	6.0	3.0
Expansion (Growth + Late)	45.3	20.0	11.0	13.0
Other (PIPE + Pre-IPO)	37.2	24.0	12.0	5.0
Buyout	5.0	48.0	71.0	79.0
Total	100.00	100.00	100.00	100.00

The share of buyouts, at about 5%, still remains minimal in case of India as opposed to about 80% in the North American and European markets. This trend has been consistent over the five year period, from 2004 to 2008. The trend is also consistent across industry classes, except for IT & ITES. Opportunities for corporate control are rare in India because of regulatory and other constraints [13]. The above facts are illustrated in Tables 2 and 3 which show, respectively, PE investments categorized by stage of investments during 2007 and industry-wise split-up for investments at different financing stages for the period of 2004 to 2008.

Table 2: Private Equity Investments by stage of investment in India during 2007 [8]

Investment Stage	Percentage
Early	1
Growth	11
Late	38
PIPE	28
Pre-IPO	1
Buyout	5
Others	16

Table 3: Financing stage wise investment across different industry sectors in India [13]

Industry	Financing stage wise investment in US $million as a percentage of total investment in the industry				
	Early	Growth	Pre-IPO	PIPE	Buyout
IT & ITES	10.5	16.9	1.2	10.2	42.6
Computer Hardware	10.9	44.7	6.1	11.7	4.6
Healthcare	5.1	17.9	2.3	26.0	1.4
Manufacturing	0.6	8.7	1.2	44.8	5.0
Engineering & Construction	10.4	23.7	6.0	17.9	1.7
Telecom & Media	1.1	8.2	1.7	29.1	1.5
Transportation-on & Logistics	9.5	7.8	7.7	22.6	10.7
Financial Services	17.1	22.5	1.6	40.9	3.2
Non-Financial Services	11.9	23.8	4.2	14.8	12.3
Others	0.5	7.1	18	34.6	15.5

India has about 400 general private equity funds and each one is competing for good deals. In the past few years, access to deals has greatly improved and so has the competition for them. Moreover, the favorable Indian economic environment, fat profits, higher valuations and weakening of government regulations on overseas acquisitions have all helped in successful takeovers. Some of the other reasons for the spurt in foreign acquisitions in India, such as, the desire to compete on the world stage and the need to grow beyond the scale possible in India, remain solid as well[11].

Outsourcing companies, service companies and high technology companies are attractive sectors for the LBO industry. The two largest LBOs in India have been those of business process outsourcing (BPO) companies – Flextronics Software Systems (renamed Aricent after the LBO) and GECIS (renamed Genpact). Table 4 lists the major buyouts in India in past few years.

Table 4: List of buyouts of Indian Companies [5]

Company	Financial Investor	Value	Type
Flextronics Software Systems	Kohlberg Kravis Roberts & Co. (KKR)	US$900m	LBO
GE Capital International Services (GECIS)	General Atlantic Partners, Oak Hill	US$600m	LBO
Nitrex Chemicals	Actis Capital	US$13.8m	MBO
Phoenix Lamps	Actis Capital	US$28.9m	MBO
Punjab Tractors	Actis Capital	US$60m	MBO
Nilgiris Dairy Farm	Actis Capital	US$65m	MBO
WNS Global Services	Warburg Pincus	US$40m	BO
RFCL (businesses of Ranbaxy)	ICICI Venture	US$25m	LBO
Infomedia India	ICICI Venture	US$25m	LBO
VA Tech WABAG India	ICICI Venture	US$25m	MBO
ACE Refractories (refractories business of ACC)	ICICI Venture	US$60m	LBO
Nirula’s	Navis Capital Partners	US$20m	MBO

The majority of private equity deals in India is growth-related deals or minority investments, as illustrated in Fig. 1. Buyouts are few in India as most promoters are keen on minority stake sales to bring in funds while retaining management control. In a large number of Indian companies, management control rests with promoters, who may not want to divest their controlling stake for additional capital [8]. Attitudes are beginning to change, but slowly. According to India Private Equity Report 2011 [1], the average PE deal size, although did increase modestly in 2010, remains small at about US$24 million and buyouts remain exceedingly rare. The cultural attitudes of the Indian promoters coupled with restrictions on the amount of debt PE investors can use to finance purchases have caused the acquisition of minority holdings to be more popular than outright buyouts.

It has also been reported that there is a consensus among industry experts, including Limited Partners, that the number and proportion of buyouts would increase only marginally. Minority positions will continue to dominate as promoters’ reluctance to cede control changes very slowly. An interesting indicator of this gradual shift is the increasing number of first-generation Indian entrepreneurs selling off their businesses to strategic buyers. It is likely that India will continue to be among the developing world’s largest destinations for growth capital, while control and buyout deals will be sought only by the largest funds [10].

Foreign acquisition is an area in which the Indian companies have vastly remained inexperienced. The financial crisis of 2008 has proven their immaturity. Before the crisis, the easy liquidity available in the market made them invest in foreign acquisitions, influenced by illogical motives and lack of careful estimations of returns on their investments. The failure of these deals has brought the Indian companies at the brink of trust of the lending institutions, which now have stepped back to the traditional way of lending using the valuation of the core assets rather than using cash flow or assets as collateral. This reversal in the lending practices has slowed down the cross-border M&A activity, seen from Indian firms between the period of 2001 and 2007. Unfortunately, academic research also suggests that approximately half of all M&A deals fail, and the failure rate increases with increasing size of the deal and the rate is drastically high in case of international deals. The failure of foreign acquisitions can largely be attributed to the management practices of the Indian firms, which still work on a corporate top-down model. Indian firms effectively manage the manufacturing functions, which fortunately work well for serving the volatile local market requiring speedy decision making, but the creative functions required to become a successful global player have rarely been their strength. Innovations in branding and promotions are unheard of as they have to be managed with a long time horizon, but the Indian companies are primarily focused on a quick return on their investments.

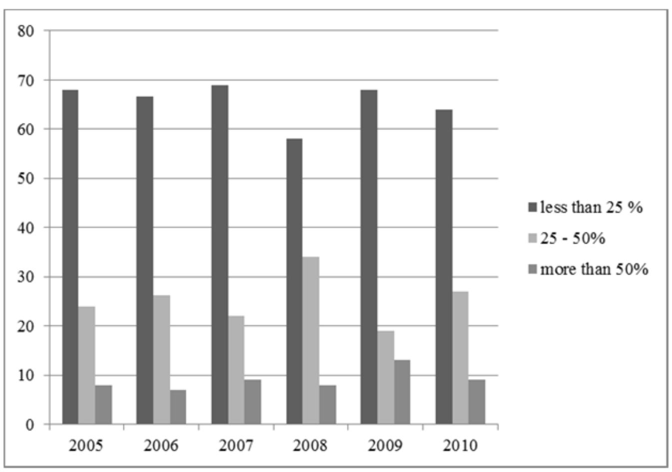

Fig. 1: Total Deals by Stake Size [1]

3. DEBT MARKET IN INDIA: HOW MUCH ‘LEVERAGED’ ARE THE INDIAN LBOS?

Leveraged buyout levels continue to be low in India due to regulations that restrict Indian banks from lending money for acquisition of shares. While debt-financed deals are a handful, financing of acquisitions using high-yield bonds is non-existent in India. Many of the buyout deals are financed by placing debt instruments with mutual funds and foreign institutional investors. Though the corporate debt market in India has been in existence since independence, state-owned public sector undertakings account for nearly 80% of the primary market for debt issuances [5]. The Government has ruled that MNCs would have to bring-in funds from abroad rather than raise money from local banks for acquisitions. This has made big buyout deals disappear due the credit crunch and thence, the Indian buyout market is populated with mid-sized deals which have become more target-worthy. In mature markets, buyouts typically account for more than 80% of total PE transaction value, but the corresponding Fig. in India has been a mere 15% [16]. The corporate bond market in India is small and marginal in comparison with corporate bond markets in developed countries which is evident from the fact that the proportion of bank loans to GDP is approximately 36%, while that of corporate debt to GDP is only 4%. The bond-spreads of Indian bonds in low-investment and non-investment grades are influenced by the limited number of such bonds in circulation and the lack of liquidity in those segments of the corporate debt market.

Another noteworthy trend in the corporate debt market is that a bulk of debt raised has been through private placements. According to Raju et al. [14], private placement is not suitable for raising debt because the market does not have adequate number of informed investors and the public issue route may create regulatory arbitrage and higher compliance costs, sometimes resulting in migration of markets. In India, private placement route is highly popular owing to its flexibility in structuring, ease of the issuance process and lower issuance costs. Another interesting feature of the Indian corporate debt market is the preference for rated paper. The data on ratings suggest that lower-quality credits have difficulty issuing bonds. The concentration of turnover in the secondary market also suggests that the investors' appetite is mainly for high-rated instruments, with nearly 84% of the secondary market turnover being in the AAA - rated securities. Moreover, the use of credit derivatives, which allows lenders to transfer an asset’s risk and returns from one counter party to another without transferring the ownership, is virtually non-existent in India due to the absence of participants on the sell-side for credit protection and the lack of liquidity in the bond market [5].

4. MBOS VS. MBIS: WHICH ONE MAKES A STRONGER CASE FOR INDIA?

There exist differences between the buyout deals of the West and those of India. In the West, buyout deals are usually followed by a change in management, but usually such is not the case in India. An LBO originated and led by a target’s existing management team is referred to as a management buy out (MBO) [15]. In this case, the team that is running the business continues doing so. If the team is replaced, the LBO is referred to as a management buy in (MBI). This kind of distinction is not yet seen in India. In India, promoters are unwilling to release control of their businesses, and are driven by family interests rather than financial motives. Ownermanagers rarely retire and all the members of the subsequent generations are de-facto heir apparent. Furthermore, the pool of human capital is also limited, causing further difficulties when management is to be replaced. In the West, almost always, changes in management and organizational structure happen, unlike the case in India. Incentive compensation, usually in the form of providing shareholding to key managers in order to align their interests with those of the common shareholders, is perhaps one significant similarity between practices in the West and in India. The business owners in India, perhaps, still do not view senior executives as potential co-owners of their businesses. The employer-employee relationship is somewhat of a cast-in-stone type reality in India [12]. Though, making major changes in the management is not a practice here, PE firms have a belief that recruiting for senior level positions adds value to their investment. Since 2007, MBOs have gained stable momentum and till date numerous deals have been cut, with many small and large scale firms having benefited from such deals .

5. CHALLENGES BEFORE THE INDIAN BUYOUT INDUSTRY

The factors crippling the Indian buyout industry, despite the availability of a wide range of quality deals, have been analyzed in this section. Immature domestic capital markets and regulatory barriers prevent easy access to domestic and foreign debt. This significantly reduces the returns from transplanting the western model, in which debt typically accounts for anywhere between 55% and 85% of the capital base for private equity buyouts [4]. The underdeveloped corporate debt market along with restrictions on foreign direct investments (FDIs) in all major sectors are the two major regulations hindering the development of the buyout market in India.

Foreign direct investment (FDI) has been hindered by a difficult business climate as well as by caps on FDI in most sectors [3]. Because of this, the private equity players tend to prefer the foreign institutional investor (FII) route to make minority investments in Indian companies. The limit on FII investments as of now is about 10% but the limit on FII investments in publicly listed companies may at times be even lower. Regulations relating to foreign investments continue to get formulated as the country is gradually becoming a hotspot for foreign investments [8]. The FDI route, in which the investment horizon is longer than that in an FII and the intent is to exercise control, is generally used by foreign companies for setting up operations or for making investments in publicly listed and unlisted companies in India. Sectors in which FDI is not permitted include railways, atomic energy and atomic minerals, postal service, gambling and betting, lottery and basic agriculture or plantations with specified exceptions [9]. Table 6 presents the list of sectors where FDI is limited to less than 100%. The infrastructure sector, mainly roads and ports, where 100% FDI is permitted, is experiencing a boom in PE activity, though not specifically in buyouts. Home and host governments should seek to establish common and specific collaboration platforms to raise information flows and coordinate the negotiations and execution of investment projects [2].

The underdeveloped corporate debt market limits the debt available for financing. The non-existence of high-yield bonds, preference for rated paper, and restrictions on government banks on financing acquisitions made by foreign companies in India, have all made the case against maturing of the buyout market in India. Moreover, the Reserve Bank of India (RBI) has issued a number of directives to domestic banks in regards to making advances against shares. The RBI only allows accepting securities, such as primary security of shares and debentures, as collateral for secured loans granted as working capital or for other 'productive purposes' from borrowers. Companies Act, 1956, Section 77 (2) states that a public company (or a private company that is a subsidiary of a public company) may not provide either directly or indirectly through a loan, guarantee or provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person by or for any shares in the company or in its holding company. Under the Companies Act, 1956, a public company is different from a publicly listed company. The restrictions placed by this section on public companies imply that prior to being acquired in a LBO, a public company, if listed, must delist and convert itself to a private company. Delisting requires the company to follow the Securities and Exchange Board of India (Delisting of Securities) Guidelines – 2003. While exits of private equity investments through domestic public listing is under the process of liberalization, laws still hold back exits through foreign listing. SEBI guidelines require mandatory listing of Indian companies on domestic exchange prior to foreign listing.

Table 6: List of sectors where the FDI limit is less than 100%

Sector	Ownership Limit (%)
Domestic Airlines	49
Petroleum refining-PSUs	26
PSU Banks	20
Insurance	26
Retail Trade	51
Trading (Export House, Super Trading House, Star Trading House)	51
Trading (Export, Cash and Carry Wholesale)	100
Hardware facilities – (Unlinking, HUB, etc.)	49
Cable network	49
Direct To Home	20
Terrestrial Broadcast FM	20
Terrestrial TV Broadcast	Not Permitted
Print Media – Other non-news/non-current affairs/specialty publications	74

Newspapers, Periodicals dealing with news and current affairs	26
Lottery, Betting and Gambling	Not Permitted
Defense and Strategic Industries	26
Agriculture (including contract farming)	Not Permitted
Plantations (except Tea)	Not Permitted
Other Manufacturing – Items reserved for Small Scale	24

Furthermore, there are other restrictions on the use of investment instruments. Usage of innovative customized instruments while investing in private limited companies requires the prior approval of the government. Hence, private equity investors mostly subscribe to traditional instruments while investing in private companies. Even within the available instruments, investing in preference shares and debentures raises several regulatory restrictions. Also such instruments need to have a minimum maturity period and a cap on the coupon payable, if they are to be issued without approval [7].

As stated earlier, the bulk of the private equity transactions in India is minority transactions. The current focus of private equity investments in India is largely growth capital, followed by venture transactions. Unless private equity shifts gears and starts focusing on buyouts – the MBO (and MBI as well) market will not get traction. LBOs would become necessary to boost returns for PE firms when current levels of returns in India turn modest. Also, many businesses in India are traditionally family-controlled businesses. In many cases, there is an emotional bonding of the Indian businessmen to their businesses. There will be more successful buyouts in the future when more and more entrepreneurs and family businesses are open to selling their businesses or relinquishing control so that the businesses are managed more professionally.

6. CONCLUSION

The Indian buyout market largely remains underdeveloped but it possesses a huge potential for future growth. The exponentially growing market in India has already attracted the American, European and Japanese strategic investors into the country. A range of exit options, in addition to IPOs, have now been successfully tested in many transactions. These include buybacks, strategic sales, and mergers and acquisitions with Indian or foreign buyers. A large spectrum of Indian companies are promoter managed, with virtually no separation between their ownership and management. The prevalence of buyouts will increase as ownership of companies becomes widely held by the public, with professional managers, distinct from the company owners. Almost all buyout transactions so far, leaving few cases, have been minority acquisitions in mid-size family businesses. Family businesses in India, unlike their western counterparts, are a vehicle to promote family interests and there is a clear lack of willingness to cede management control. But for businesses which have transcended generations, there is a growing transition where the new generation no longer wants to be involved in the business. As this phenomenon grows, more possible opportunities will emerge for the buyout players.

Reforms in regulations allowing for debt financing of acquisitions by the availability of cheap debt and junk bonds, and more cooperation from the Reserve Bank of India (RBI) to the foreign players will encourage more buyout players to set up shops in India. Though, the industry is doing a lot better because of the quality of target companies, significant improvement in their operations and flexibility of their capital structures, buyouts remain more an exception than the rule and are largely limited to opportunistic acquisitions of small businesses. Diversified conglomerates in India operate in a number of non-core business areas that they are constantly looking to divest. These businesses make ideal LBO targets in India since they have established operations, business processes and professional management in place, required for buyouts [5]. There is a large interest among private equity players to buy non-core businesses from conglomerates. Thus, as pressure increases on conglomerates to fully divest their non-core assets, we will get to see an increase in LBO activity in the region.

Rapidly developing capabilities, evident in emerging markets, provide fertile grounds for experimenting with new business strategies and structures [6]. The buyout concept is no longer viewed as solely emphasizing downsizing efficiencies, but is a significant vehicle for upside growth and wealth generation [18]. More academic research in this area, in the Indian context, will help in the development of better management models for tapping into the huge potential of this market, as opportunities and market conditions for buyouts continuously improve. The Indian buyout industry, unlike its mature European and US counterparts, is neither in its natal stage nor anywhere near maturity. Right now, only about 5% of the total PE deals are control transactions. As we witness growth of the private equity market in India, there is no reason that the buyout market would remain largely neglected, as it has been the case so far.

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