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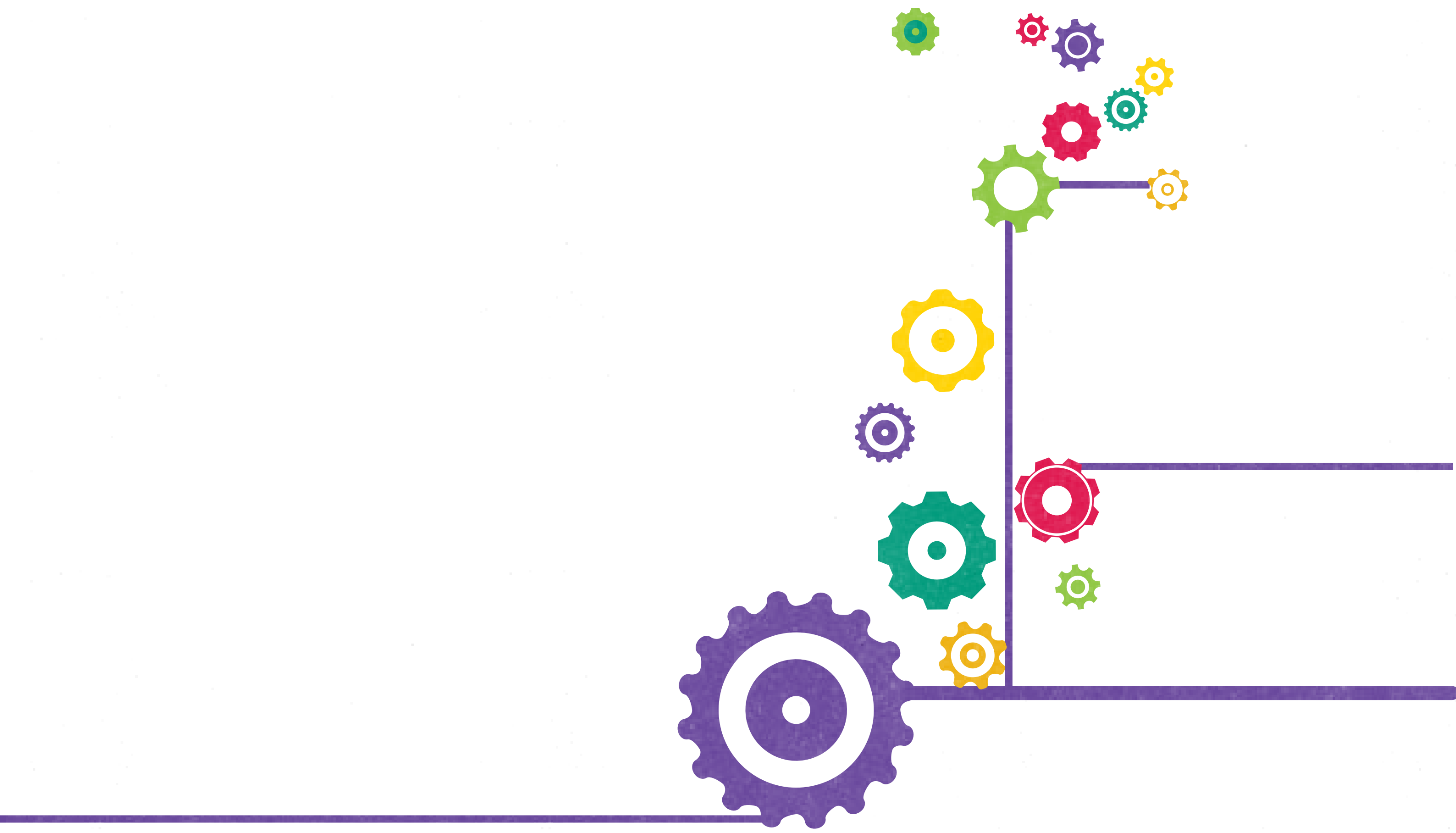
The Fourth Wheel 2016

Private Equity in the Corporate Landscape



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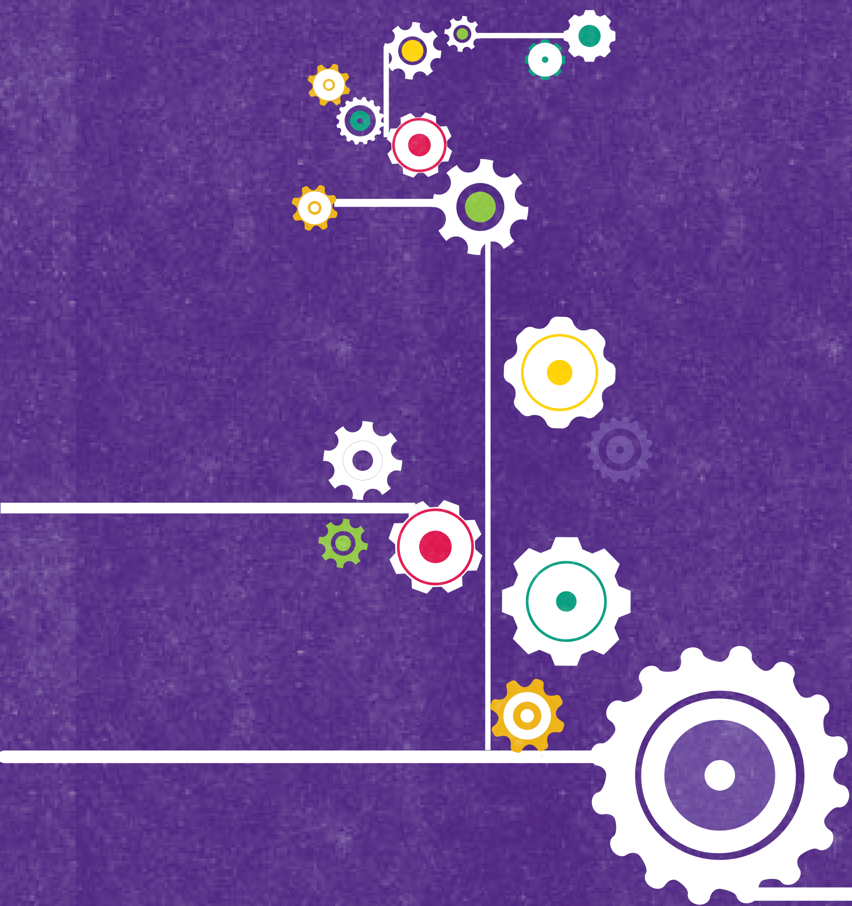


Message from IVCA

Sanjay Nayar
Chairman, IVCA
KKR India Advisors Pvt Ltd

The Indian private equity (PE) space has gradually transformed from a miniscule source of funding to a formidable source of funding for the Indian market over the past decade. IVCA's mission is to continuously promote and enlighten the private equity industry and venture capitalists on the developments and market opportunities. Thus it is our constant endeavour that we fortify the PE industry and venture capitalists (VCs) with knowledge and numbers that depict the true picture of the Indian market.

Thus, it is with great pleasure that we, along with our member and partner, Grant Thornton in India, present the fourth edition of the PE report titled 'Fourth Wheel'. IVCA is delighted to associate with Grant Thornton in India to bring out this resourceful report.

Over the past one decade, the Indian market has matured to become one of the world's most reliable and credible investment markets. In such a scenario, the report will be most helpful for the existing and new private equity firms and venture capitalists.

The current economic scenario of the country is definitely the one that promises growth to all the PE/VCs in the medium to long term. The reforms being undertaken by the current government indicate fiscal and economic stability and growth. This presents an investment opportunity to all global and domestic investors.

The report showcases and presents some very interesting facts and datasets on PE/VC investments in the country. The report also tracks the deal sizes, provides an in-depth analysis on the deals and investments across sectors. Grant Thornton reached out to PE/ VCs to get insights on the current trend and future outlook. Grant Thornton also shared their views on the areas which are relevant for PE/ VCs and the investee companies covering areas like tax and regulatory framework, structuring, frauds and sector insights.

IVCA believes that the report will guide everyone and help us understand the opportunities and challenges in the market. I look forward to your feedback and continued support in our efforts.

We look forward to feedback and continued support.

Foreword by Grant Thornton

Harish HV
Partner
Grant Thornton India LLP

As we bring to you this year's edition of Fourth Wheel a term coined in 2010, we look back and see how the market has changed and accepted the new Investors who have helped create a new generation of entrepreneurs and generated significant value. The Fourth Wheel which was the new addition to the Indian Corporate Sector and was dominated by three other Wheels (PSU, MNC and Indian Private Sector), no longer needs justification as to why it is a wheel and at the rate it is growing it is not just another wheel but has became an integral part of the engine driving the corporate world in India.

The Global economy is going through a turbulent phase as the world is facing economic challenges on multiple fronts. While the US Federal Reserve has already begun its monetary tightening, Europe is struggling to manage the migrant influx and rising debt crisis. China including other BRICS counties such as Brazil and Russia are facing economic slowdown. India with improving economic conditions and recent series of reforms has become an attractive and reliable investment market. However, there is lot more to be done on the policy and ease of doing business to get an even larger share of investments, which have been growing by leaps and bounds year after year since 2010 and have reached nearly US$ 50 bn last year.

According to the data available with Grant Thornton, 2015 clocked US$ 16 bn value across 1,049 deals compared to 2014, where in US$ 12 bn value was witnessed across 608 transactions. Primary investments and acquisition activity was focused around energy and natural resources, IT and ITeS, banking and financial services and pharmaceuticals, healthcare and biotechnology sectors. These sectors have contributed around 80 percent of the overall deal value in 2015. The number of deals has grown significantly and the average deal size has come down due to the increased investments in startups.

For a robust market we need both the ends firing i.e. the startup end which funnels new thoughts/ideas and helps generate new businesses and an active IPO market where funds which have invested can exit through listing. Indian PE was suffering because of the lack of adequate activity in both these ends. However, we have seen both these correct in 2015 which is good news for the Industry.

2015 has seen the startup ecosystem take off and we saw several unicorns emerging. The Government of India has realised the potential and came up with a Startup Action Plan and we expect more initiatives in this space. We also saw a number of large IPOs from companies, which had raised capital from PEs in the past and one of the key drivers for the IPO was the need to give the PEs exit.

The report, 'Fourth Wheel', the fourth edition, is an effort by Grant Thornton in India in association with IVCA to highlight the activity of PEs in India. The study also provides an insight into the vibrant and dynamic entrepreneurship ecosystem and the outlook. According to the report, the country is one of the most attractive countries among the emerging economies for PE investments. The data presented in the study is based on Grant Thornton's Dealtracker Report and views from across leading PE/VC fund houses. This makes the report abundantly rich with datasets and analysis.

I am thankful to all persons involved in preparing the report and I am hopeful that you will find the report insightful and useful.

Editorial

Prashant Mehra
Partner
Grant Thornton India LLP

New milestones were achieved for deals involving private equity investment in Indian companies during 2015, with record levels of (PE) activity primarily focused around startups.

2015 witnessed PE activity at an all-time peak with substantial increase in volume (1,049 investments - over 70 percent year-on-year) was due to an impressive level of interest among PE and VC investors in India's startups (over 600 investments of the total PE volume). The year witnessed evolved startups such as Flipkart, Snapdeal, Olacabs and Paytm raising funds in excess of US$ 500 mn at huge valuations. This year also saw various investor classes like angel investors, angel networks, venture capitalists and some of the more established PE funds betting on the startup growth story. For instance, Warburg Pincus invested US$ 133 mn in Ecom Express during the year in order to expand its operations in tier 3 and 4 cities among other aspects.

In 2015, IT and ITeS sector has been the main driver for growth as it witnessed 38 percent growth year-on-year, thereby reaching the highest record in this segment (US$ 7bn accounting to 45 percent contribution to total PE investments). Top 15 deals (above US$ 100mn size) contributed to around 50 percent of total deals in the sector. BFSI sector also witnessed growth of over 56 percent year-on-year in 2015 on the back of seven over US$ 100mn deals (accounting for more than 60 percent of total investments in this sector). Real estate investments have declined by more than 20 percent year-on-year, however, it continues to attract substantial investments from PEs being this year's third largest sector by value. Energy & Natural Resources and Pharma, Healthcare & Biotech also attracted fair deals valuation during the year.

Interestingly, where there has been a huge increase in the total deal volume and value in 2015, the average deal size has come down from around US$ 20mn to US$ 15mn on the back of investments in startups, which are relatively small deal sizes. Despite the sheer quantum of funds raised, slight pessimism started setting in the second half of 2015 with some startups shutting-up shop or laying-off employees. Going forward, the start-up ecosystem in India is likely to witness more rationalisation, funding may get tougher and the focus will increasingly be on fundamentals, with justification around valuations and scalability being key. There is a risk that we will see fewer unicorns in the making in the short-term. Investors' ability to mentor and nurture a start-up idea rather than just provide financial investment will be key to finding the right early-stage opportunities.

With inflation in control and GDP growth being revised to now end higher than anticipated, all the necessary ingredients seem to be in place for growth in deal activity as well. The recent FDI norms and the much awaited GST will perhaps be a game changer and will further accelerate the deal activity from an inbound investment, domestic M&A and PE perspective. Indian assets are expected to remain in focus as Inbound and Domestic M&A accelerate on the back of pickup in alternate buy out financing by PEs and increased capital market activity – both volume and value will clearly be on an uptrend here. More visibility on on-ground action and visibility of economic growth and reforms will push domestic corporates to look at inorganic growth. Government's actions on key policy issues and reforms such as GST, the new Companies Act, ITP for Tech startups, land acquisition, unblocking stalled projects, etc should improve the 'ease of doing business' in India and therefore may further accelerate the transaction activity in India. Having said that, specific measures around simplification of regulatory environment including bankruptcy laws and a more conducive tax environment would further drive the private equity investment in the country which has both historically and will continue to play a fundamental role in the overall growth of the country.

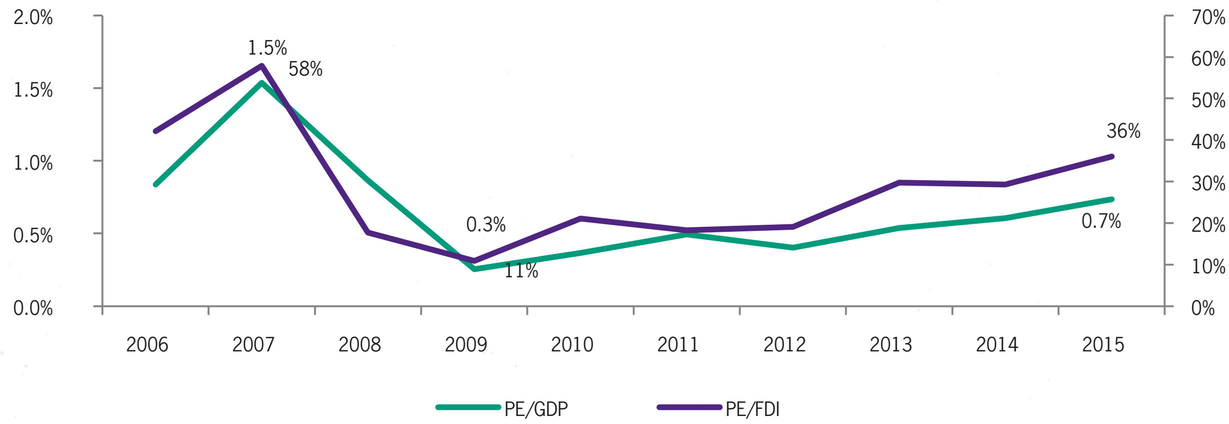
Overview of PE Environment

- PE contribution to the Indian economy
- PE fund raise

PE contribution to the Indian economy

The opportunity ahead!

Trend in PE Investments to Gross Domestic Product (GDP) and Foreign Direct Investments (FDI)



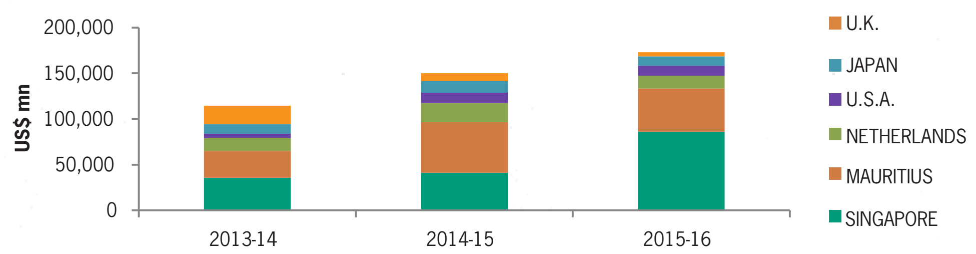
Post 2007-08 global economic downturn, India's economic parameters are on an uptrend with GDP picking up pace on the back of number of economic and political factors and structural reforms promoted by Centre over the last few years. On the back of the positive investment sentiment in the country, the PE investments consistently increased, hence increase in PE to GDP ratio from a low of 0.3 percent in 2009 to 0.7 percent in 2015 clearly suggesting the dominant role PE industry is playing in the growth of the Indian economy. However, compared to the PE to GDP ratios of the developed markets, which are greater than 1 percent, the ratio for India is currently much lower. Also, India's experience of high PE to GDP level of 1.5 percent in 2007 indicates that there is still lot of scope for PE investments scaling up in India.

Similar to GDP share, the PE fund inflow as a share of FDI has also been consistently increasing post 2008. The ratio is currently at 36 percent in 2015 compared to 11 percent in 2009. India witnessed a high of 58 percent in 2009 indicating that there is scope for higher contribution.

However, a look at the geographic break-up of the source of FDI shows some interesting trends.

In 2015, Singapore emerged as the top source of FDI in India replacing Mauritius which ranked at number one in 2014. At present a significant portion of FDI comes from Singapore, Mauritius and Netherlands. This is primarily because of favourable tax treaties of these countries with India. In comparison to these countries, there has been a decreasing trend in FDI from USA and Japan on a yearly basis. It is interesting to note the declining trend of FDI from the UK which was one of the top three source in 2013, but has reduced over 88 percent since then.

Source of FDI in India

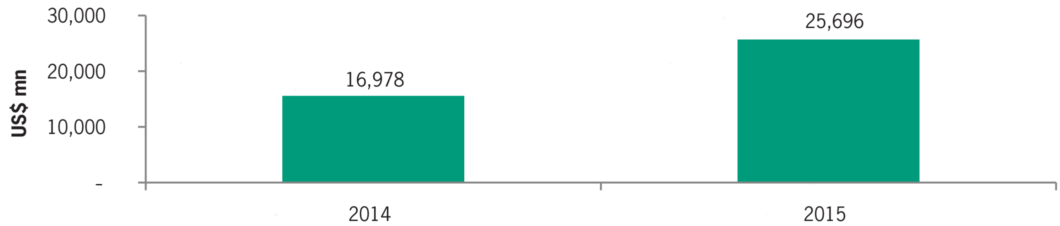


Source: FIPB

PE contribution to the Indian economy

The opportunity ahead!

Funds raised by PEs & VCs



Fund raising activity in the PE and VC space has been positive. PE's and VCs with a focus to invest in India and other South East Asian countries have raised close to $26 bn in 2015 compared to US$17 bn in 2014 with the intention of deploying them across various sectors. Out of the total funds raised approximately 60 percent is expected to be invested in India. PE firms were successful in raising funds as they started setting up startup focussed funds following the trend set by VC's, who were focussing on technology startups. These startups have attracted the most amount of investments over the past eight quarters.

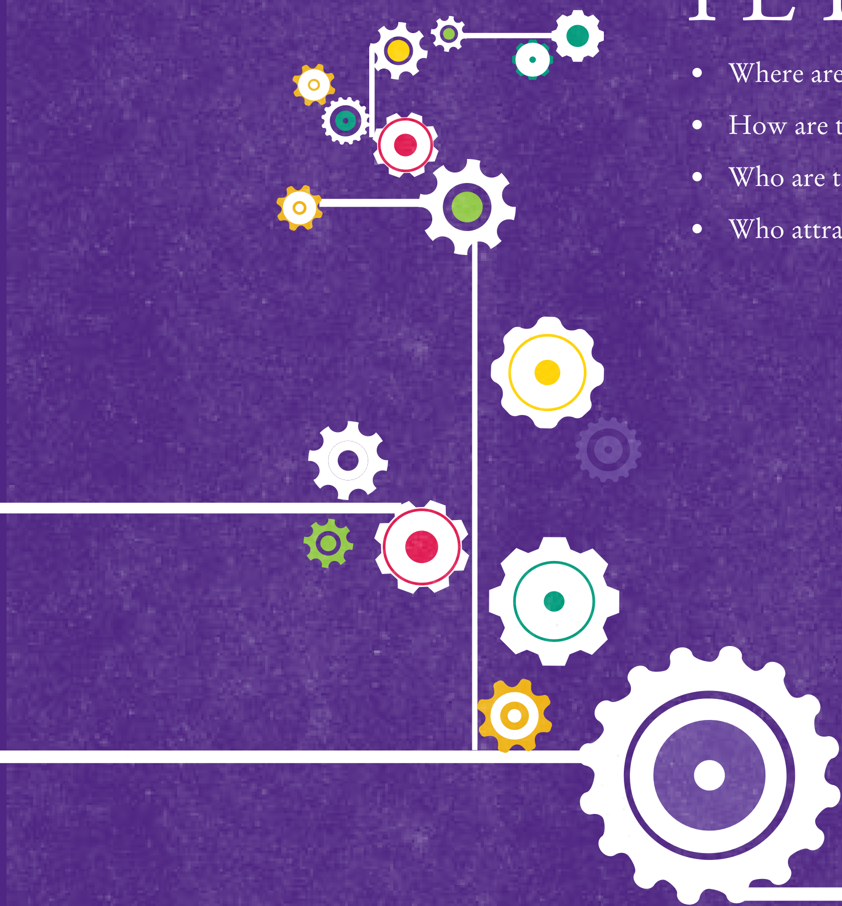
In 2014, PE firms such as Aloe private equity, ASK Group, Everstone Capital, Realterm Capital, HDFC Property Fund, HDFC Alternatives, IFL Wealth Management, Indiareit Fund Advisors, Jones Lang LaSalle - Residential Opportunities Fund-I, Infuse Ventures, Kotak Investment Advisors, Lighspeed Venture Partners and others have raised over $16 bn collectively to invest across sectors such as cleantech, real estate, consumer, banking, pharma, infrastructure, logistics and IT and ITeS.

In 2015, PE /VC firms that planned to focus on technology startup companies were able to raise funds. These funds include YourNest Angel Fund, Global venture capital and Bessemer Venture Partners (BVP) - BVP IX, Trifecta Capital, SAIF Partners, Astarc Ventures, YouWeCan Ventures, Accel India IV-Accel Partners, Sequoia Capital, India Realty Excellence Fund II (IREF II)- MORE, Zodius Capital II, Edelweiss Financial Services Ltd- Special Opportunities Fund II (ESOF II) and others.

Another trend that emerged is the corporates and multinational companies setting up funds to invest in smaller startups. Marquee entrepreneurs too are making investments in their personal capacity. Looking at the present scenario there is enough funds to be deployed, but the challenge still remains to identify an attractive investment opportunity.

Fund raising activity has not been easy for PEs. Whilst exit environment continues to improve it is still someway to establish a credible track record. Having said that India continues to be an attractive destination for good investments in a nebulous global market. India also offers great potential for growth in services business.

Srinivasan Nagarajan
Regional Director - South Asia
CDC Group Plc



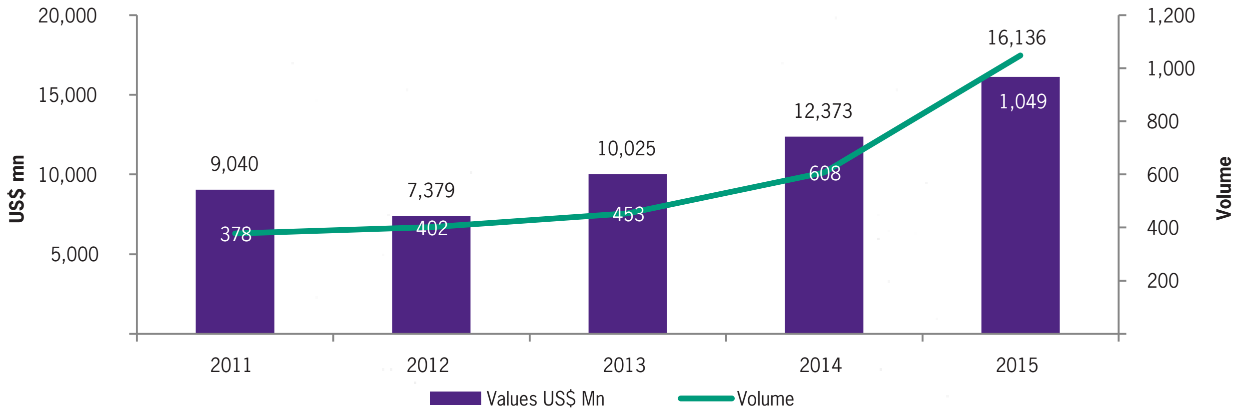
PE Dealscape

- Where are the PE firms investing?
- How are the PE firms investing?
- Who are the active PE firms?
- Who attracted the most PE money?

Trends in PE investments

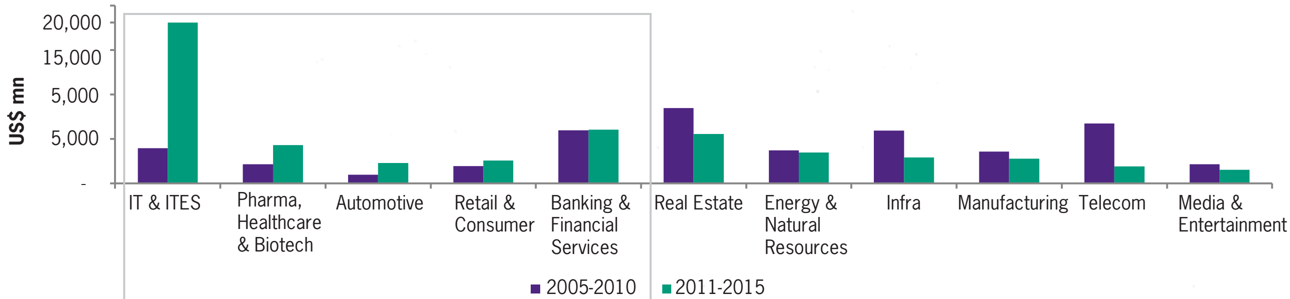
Where are the PE firms investing?

PE investments since 2011 (Volume and Value)



PE investments drove the deal momentum in 2015 in the Indian deal space with over US$ 16 bn invested in more than 1,000 investments. This year witnessed tremendous year-on-year growth in almost each month of the year. While, the significant increase in volume (over 70 percent percent) was due to an impressive level of interest among PE and VC investors in India's startups (over 600 out of the total of 1,049 investments), deal value growth (over 30 percent year-on-year) was driven by large investments (accounting for around 3 percent of volumes but contributed to around 50 percent of the total investment values).

Trends in PE investments pre and post e-commerce era



There has been a marked change in the investment trend in sectors across pre (prior to 2011) and post e-Commerce era.

Sectors that attracted investments in post e-Commerce era are IT and ITeS, pharma, automotive, retail and consumer and banking and financial services. These sectors attracted collectively over 61 percent of the total investment values and 68 percent of total investment volumes. IT and ITeS alone contributed to over 45 percent of the deal volumes with 33 percent of total deal values in post e-Commerce era. Around 70 percent of the total investment in IT and ITeS was in e-Commerce companies.

Core sectors like real estate, energy and natural resources, infrastructure, manufacturing and telecom consumed around 58 percent of the total investments in terms of value in the pre e-Commerce era. However the investments into these core sectors have reduced considerably as e-Commerce companies have attracted investments over the last three years.

Trends in PE investments

Where are the PE firms investing?

Top deals for pre e-commerce era (2006-2010)

Year	Investor	Investee	Sector	US$ Mn
2007	Temasek Holdings	Bharti Airtel	Telecom	1,907
2006	Kohlberg Kravis Roberts & Co	Flextronics Software Systems	IT and ITeS	1,035
2007	Temasek Holdings, The Investment Corporation of Dubai, Goldman Sachs, Macquarie, AIF Capital, Citigroup and India Equity Partners (IEP)	Bharti Infratel (subsidiary of Bharti Airtel Ltd)	Telecom	1,000
2007	ICICI Venture Funds Management Company	Jaypee Infratech (subsidiary of the Jaypee Group)	Infrastructure	800
2007	George Soros,hedge fund Eton Park Capital,Deutsche Asset Management,Capital International, Citigroup, T Rowe Price, Credit Agricole, UBS and Kotak Mahindra	GMR Infrastructure Ltd	Infrastructure	767

Top deals for post e-commerce era (2011-2015)

Year	Investor	Investee	Sector	US$ Mn
2013	Qatar Foundation Endowment	Bharti Airtel Ltd	Telecom	1,260
2012	Bain Capital	Genpact Ltd	IT and ITeS	1,000
2014	Morgan Stanley Investment Management, GIC, Accel Partners, DST Global, Iconiq Capital and Sofina	Flipkart Online Services Pvt Ltd	IT and ITeS (E-commerce)	1,000
2011	Bain Capital,Government of Singapore	Hero MotoCorp Ltd	Automotive	848
2014	Baillie Gifford, Greenoaks Capital, Steadview Capital, T Rowe Price Associates, and Qatar Investment Authority and existing investors include DST Global, GIC, Iconiq Capital, and Tiger Global	Flipkart Online Services Pvt Ltd	IT and ITeS (E-commerce)	700

Trends in average deal size – PE investments

How are the PE firms investing?

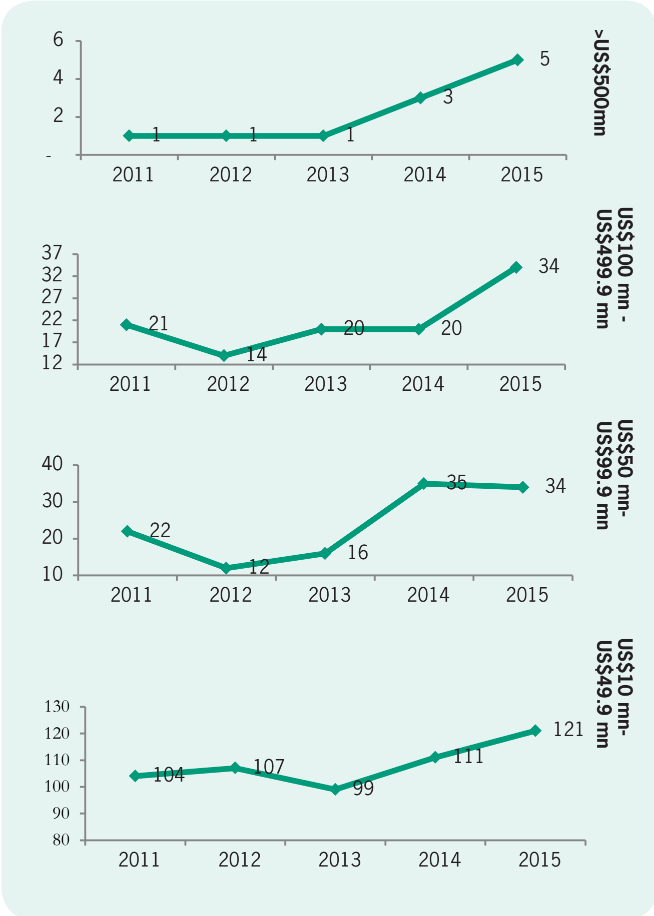
PE highlights

PE investments in 2015 saw increased big ticket deals valued over US$ 100 mn each, showing that promising businesses can attract big investments. However, the levels are yet to match the big ticket investment levels in 2007.

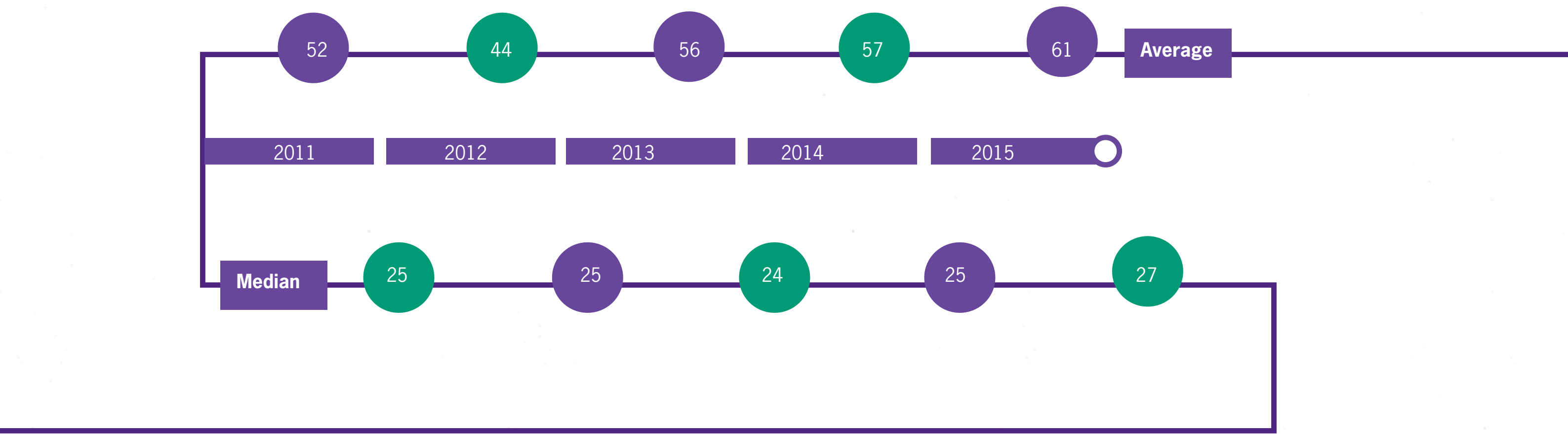
2015 attracted 194 investments valued at US$ 10 mn and above, a growth of 15 percent from the previous year, across sectors such as BSFI, infrastructure, real estate, manufacturing, pharma, energy and retail along with upcoming e-commerce companies.

The median deal size of PE investments rose from US$25 mn in 2014 to US$27 mn in 2015, showing continued PE investors interest in India. One of the reasons for the increase in deal size is due to higher number of majority or control transactions in the year 2015. Given the investor sentiment it is likely that there will be more big ticket deals in the next couple of years.

PE investment by deal size



Trends in PE deals size (in US$ mn)

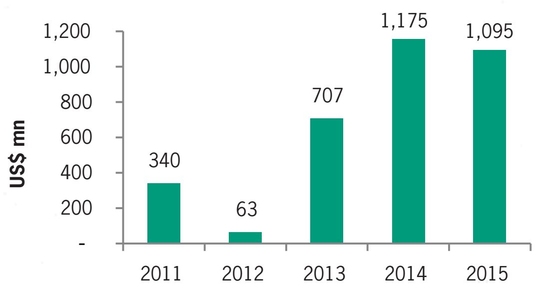


Note: For the purpose of the above analysis we have classified investments above USD 10 million as Private Equity investment (PE) and investments value below USD 10 million as Venture Capital investments (VC).

Trends in average deal size – PE investments

How are the PE firms investing?

Trends in large PE buyouts



With an experience of investing in India for more than 15 years, many PE funds are now seeking to attain majority/control over the investee companies. This arrangement gives them greater control over the investee companies, thereby, allowing smoother exits.

Buyout/control deals, which are common in the US or European countries, are gaining momentum in India in light of the above.

The number and the value of buyout deals has increased significantly from 2011-2012 to 2013-2015 with the volume of buyouts increasing more than fivefold between the two time periods.

The top majority/buyout deals (value above US$ 100 mn), over the last three years are summarized in the table below. Sectors that saw the most buyouts include telecom, banking and financial services, IT and ITeS, energy & natural resources and real estate.

Top buyout /control deals

Year	Investor	Investee	Sector	% Stake	Investment Value in US$ mn
2015	TA Associates and India Value Fund Advisors	Atria Convergence Technologies	Telecom	95.00%	500
2015	JP Morgan Asset Management	Canaan Partners-portfolio in India	Banking & Financial Services	100%	200
2015	KKR and Co. Lp	Avendus Group	Banking & Financial Services	60%	105
2014	Brookfield Property Partners	6 IT Parks in India	Real Estate	100%	347
2014	Capital Square Partners, CX Partners etc	Aditya Birla Minacs Worldwide	IT and ITeS	100%	260
2014	Xander Group	7.8 lakh sq.ft. commercial space - Infinity Tech Park	Real Estate	100%	108.33
2013	Partners Group	CSS Corp	IT and ITeS	80%	270
2013	Blackstone	Agile Electric Sub Assembly Pvt Ltd-Igarashi Motors India Limited	Automotive	98%	110
2011	Blackstone	DLF Ackruti Info Parks (Pune) Ltd	Real Estate	100%	176.09
2011	Cerberus Capital Management, L.P	Regulus Group and J&B Software, Billing & Payments unit of 3i Infotec-Global	IT and ITeS	100%	137

Note: For the purpose of analysis on buyouts we have considered the following criteria: All the transactions resulting in controlling stake of more than 50% and are publicly disclosed are included.

Trends in average deal size – VC investments

How are the VC firms investing?

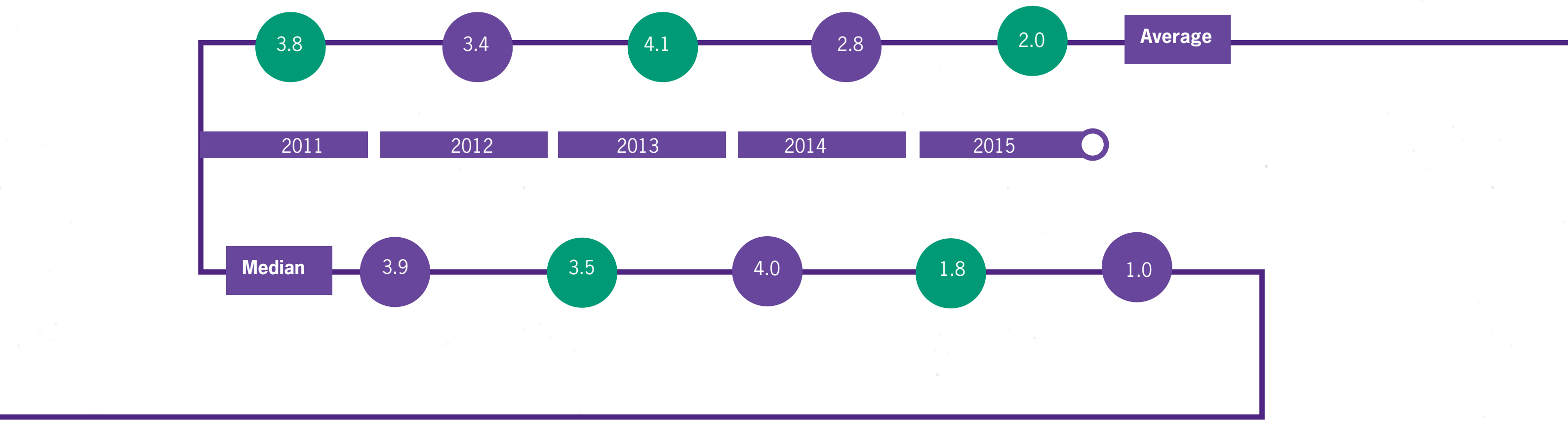
VC highlights

2015 saw a huge number of investments in startups varying from angel, seed, growth, bridge, crowd, pre series A, series A and series B funding rounds ranging between a few thousand US$ to US$10 mn. 2015 investments were double the number of investments in 2014, clearly indicating an increased activity in the venture capital space in India.

While the number of deals increased from 439 in 2014 to 855 in 2015, the median deal size of VC deals decreased from US$ 1.8 mn to US$ 1.0 mn on the back of increased investment volumes.

VC investments by deal size

Trends in VC deal size (in US$ mn)



Note: Average deal size of the VC investments does not include deals where the investment values are not disclosed.

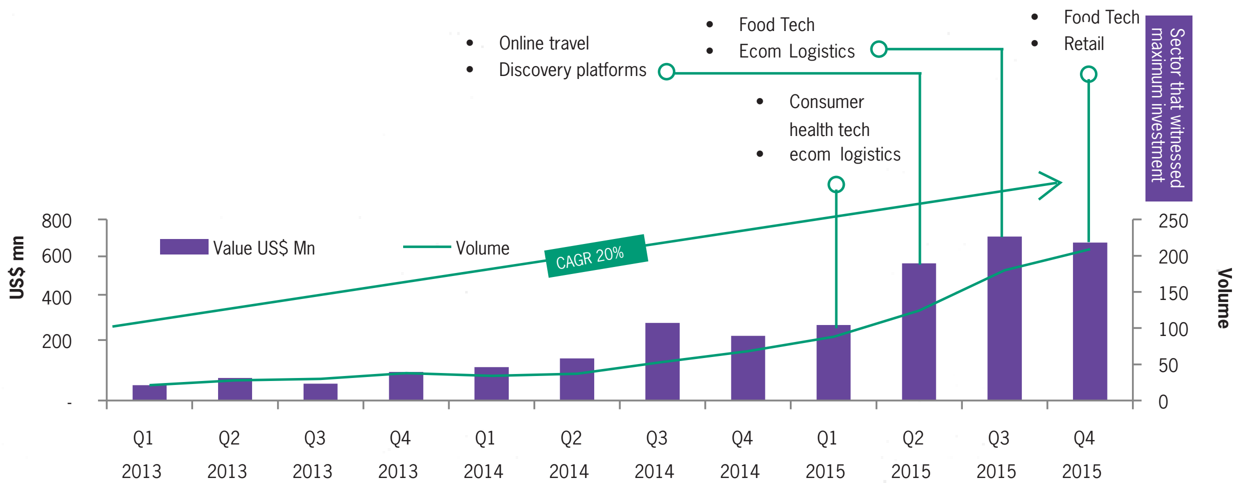
Investments in startups

Will the startup trend continue?

The Indian startup ecosystem has really taken off and has come into its own—driven by factors such as massive funding, consolidation activities, evolving technology and a burgeoning domestic market. As discussed earlier, 2015 witnessed the maximum traction with US$2 bn investments in over 600 startups; accounting for over 50 percent of the total 1,049 investments in 2015 in PE/VC space compared to 2014, where it was only 32 percent of the overall investment activity. Though, the year kicked off on a relatively slower pace, around the second quarter of 2015, investment activity (volume) increased substantially and sustained this pace throughout the year.

Investment momentum in the startups has been building and has increased rapidly over the last five years with investment values increasing at a CAGR of more than 57 percent between 2011 and 2015 while investment volumes have increased at a CAGR of over 62 percent.

Quarterly trend in investments in startups since 2013



Sub sectors such as ecom logistics, food tech, online retail, discovery platforms and travel & transport have garnered most amount of investment in the last four quarters. Most investments in startups were in the pre series A and series A categories, which is consistent with the age of startup ecosystem in India.

The startup ecosystem continues to be concentrated in NCR, Bangalore and Mumbai, which together contribute to 87 percent of total investment value and 84 percent of total investment volume in 2015. We highlight alongside the key startups by region that attracted most amount of investments.

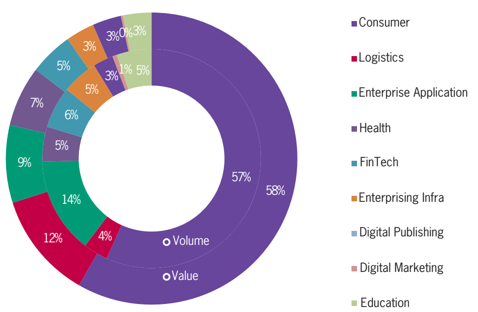
Funding round	Volume of investments	Average deal size (in US$ mn)
Angel, bridge, Seed & Pre series A	350	1.5
Series A	78	5.5
Series B	24	15.1
Not disclosed	149	-

NCR	Bengluru	Mumbai
Ecom Express	Little Internet	Culture Machine
Foodpanda	Portea Medical	TinyOwl
Peppertap,	Blackbuck	CredR
Rivigo,	HouseJoy	GOQii
UrbanClap	Swiggy	Coverfox

Investments in startups

Will the startup trend continue?

Investments into startups in B2C segments in 2015



Driven by factors such as increase in availability of funds, higher smart phone penetration and younger demographics, investments in the B2C segment has seen additional momentum over the last few years.

There has been a huge influx of funds into B2C focussed startups in the consumer, logistics, health, education and fintech sectors. B2C verticals, within these sectors, that have had the maximum traction are food tech, on demand and hyperlocal services, discovery platforms and retail, which accounted for around 50 percent of the total investment flow in this space in 2015. In addition, the B2B vertical also witnessed investment activity in key segments such as logistics, enterprise applications and enterprise infrastructure.

However, some sub sectors are getting overcrowded such as online groceries, on demand home services, food deliveries and online real estate. Companies have to continue to innovate; failing which it might be difficult to raise fresh funds, resulting in consolidation in the next couple of years.

Investments by verticals in B2C segment

Investments in startups

Will the startup trend continue?

Grant Thornton View

Start-ups in the B2B as well as the B2C segment have witnessed significant deal momentum in 2015. However, in the B2C space one will need to watch out for ambiguity around FDI and tax laws and its impact going forward.

Slight pessimism started setting in the second half of 2015 with start-ups shutting down and retrenching employees. It is expected that in 2016, innovative new start-ups will continue to attract investor interest. There will be increased rationality in this ecosystem and focus will increase to business fundamentals, justification around valuations, consolidation and scalability.

An investor's ability to mentor and nurture a startup's idea will attract young entrepreneurs compared to pure financial investors; this will also lead to a win-win situation for both.

Kinnari Gandhi
Director
Grant Thornton India LLP

Most active PE/VC firms

Who are the active PE/ VCs?

Top PE/ VC in 2014 and 2015 by number of investments

Rank\ 2014	Last year	Move	Investor	Count
1	1	↔	Angel investor	86
2	3	↑	Accel Partners	23
2	6	↑	IDG Ventures	23
3	2	↓	Sequoia Capital	19
3	5	↑	Helion Private Limited	19
4	3	↓	Blume Ventures	15
5	New	★	SAIF partners	14
5	4	↓	Nexus Venture Partners	14
6	7	↑	Kalaari Capital	13
6	6	↔	Tiger Global	13
7	5	↓	Matrix	11

Rank 2015	Last year	Move	Investor	Count
1	1	↔	Angel Investors	352
2	3	↑	Sequoia Capital	47
3	2	↓	Accel Partner	35
3	6	↑	Tiger Global	35
4	5	↑	SAIF partners	29
5	6	↑	Kalaari Capital	22
6	2	↓	IDG Ventures	21
7	3	↓	Helion Ventures	18
8	New	★	Indian Angel Network	17
8	5	↓	Nexus Venture Partners	17
9	New	★	Mumbai Angels	15

The recent uptick in the startup investments has opened room for lot of angel investors who now provide startups with the required capital, typically at the seed round. The angel investors are more active now with the quantum of investments rising by more than 600 percent from 49 investments three years ago. This reflects the ongoing greater trend of investing into the entrepreneurial startup ecosystem.

Sequoia Capital, Accel partners, Tiger Global Management, SAIF Partners, Kalaari Capital, IDG Ventures and Helion Ventures have been most active PE/VC investors in 2015.

The industry sources have projected the number of startups to increase from the current 4,300 to 11,500 by 2020 on the back of the impressive investment activity and also the general investor interest in India; on the back of consumer growth driven by the mobile/ internet revolution.

Most active recipients of investments

Who attracted the most PE/VC investments?

Largest recipients of PE Funding (2011 – 2015)

Investee	Volume	Value US$mn
Flipkart Online Services Pvt Ltd	11	3,392
Jasper Infotech Pvt Ltd- Snapdeal.com	8	1,404
Olacabs.com -ANI Technologies Pvt Ltd	8	1,394
Bharti Airtel Ltd	1	1,260
Genpact Ltd	1	1,000
GMR Infrastructure and its subsidiary	7	951
Hero Investment Private Ltd	2	848
Kotak Mahindra Bank	2	606
Shriram City Union Finance Ltd	2	565
Hexaware Technologies Ltd	3	541
Magna Energy Ltd	1	500
Atria Convergence Technologies	1	500

E-commerce companies have raised significant investments over the last five years and these companies continue to raise further capital in follow-on funding. With the increase in investments in the past 12 months in young companies the relatively older companies in the sector such as Flipkart, Snapdeal and Ola cabs have now matured to the private equity stage and have attracted marquee international investors such as Alibaba and Softbank.

Both in terms of value and volume the e-Commerce players received the most amount of money from the PE/VC players. The big players are getting bigger and with increased investor activity certain smaller startups may start to consolidate either to close technology gaps, skill gaps or consolidate to become a bigger competitor to the larger players.

While e-Commerce companies have been able to raise subsequent round of investments within the same year, certain deals are now taking months to close as investors have started to step back and question how consumer technology startups plan to turn profitable before investing significant amounts in them. However, according to investors, all startups, both big and new, will have to work harder to get funds and achieve higher valuations.

In addition to the e-Commerce players, we can also see large investments raised by companies in the core sectors such as Bharti Airtel, Genpact, GMR Infra, Kotak Mahindra Bank, Hero, Hexaware, Magna & ACT.

Grant Thornton View

The current reset in valuation maybe reflective of the realism in valuation but cannot be acknowledged as a trend yet. Having said that, execution will become even more important to set any future benchmarks of valuation in this space.

Siddhartha Nigam

Director

Grant Thornton Advisory Private Limited

Most active recipients of investments

Emergence of Unicorns on the back of PE/VC funding

Current Unicorns in India and their valuations

Company	Valuation (US$ bn) as of Dec 2015	Reached US$1 bn valuation	Year of incorporation	Industry	Select Investors
Flipkart	15	8/6/2012	2007	eCommerce/ Marketplace	Accel Partners, Digital Sky Technologies, Iconiq Capital
Olacabs	5	10/27/2014	2010	On-Demand	Accel Partners, Matrix Partners, Sequoia Capital
Snapdeal	4.8	5/21/2014	2007	eCommerce/ Marketplace	Intel Capital, Kalaari Capital, Nexus Venture Partners
One97 Communications	3.4	5/12/2015	2000	Fintech	Intel Capital, Sapphire Ventures, Alibaba Group
Quikr	1.5	4/7/2015	2008	eCommerce/ Marketplace	Tiger Global Management, Norwest Venture Partners
Mu Sigma	1.5	2/7/2013	2004	Big Data	Sequoia Capital, General Atlantic
Shopclues	1.1	1/12/2016	2011	eCommerce/ Marketplace	Nexus Venture Partners, GIC Special Investments, Tiger Global Management
Zomato Media	1	4/10/2015	2010	Social	Sequoia Capital, VY Capital

Source- Unicorns and Valuations: cbinsights

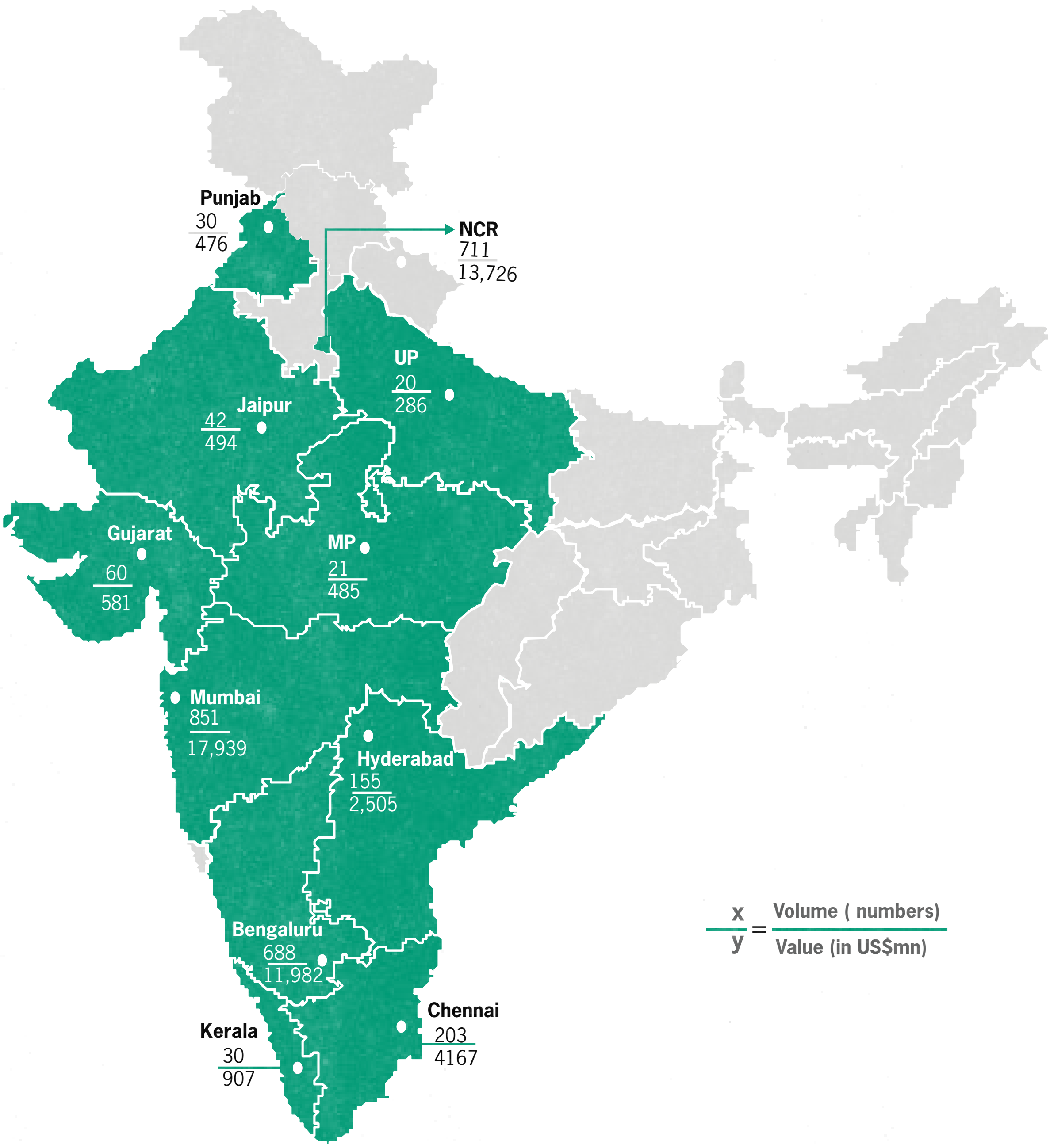
India is now home to eight 'Unicorns' (startups with over a US$ 1 bn valuation) with many younger firms such as Swiggy, Grofers, UrbanClap and OYO Rooms, which have raised multiple rounds of funding in 2015, inching close to joining the unicorn club.

The Unicorns have also started to look at venture debt as a source of funding as it helps them manage the working capital requirements without diluting stake. The market for venture debt, which currently is at less than 5 percent of the total capital raised – compared to 10 percent in developed markets, is expected to grow in the future.

According to industry sources there were 388 enterprise tech startups, 435 retail startups, 192 fintech startups that were founded last year. While only a fraction of these have received funding, the startup ecosystem is growing significantly every year. With the investor interest, consumer interest and innovative business models the startup ecosystem is expected to build many more such Unicorns in the immediate future subject to demonstrating the business fundamentals and roadmaps to cashflow generation.

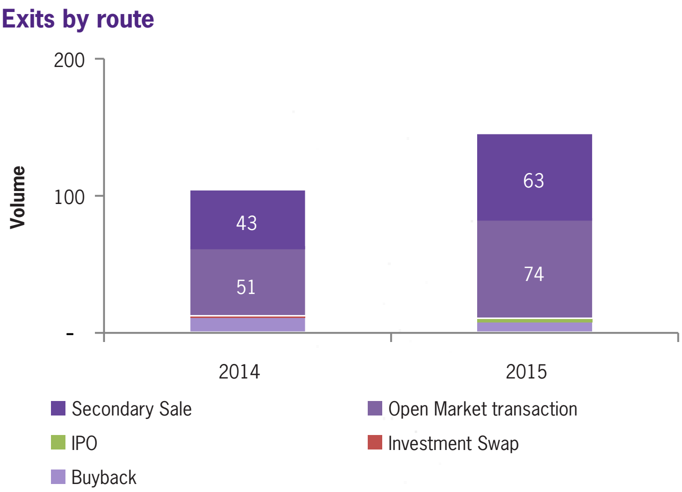
PE investments by city- 2011 to 2015

Which city has attracted the investments?



2015 PE exits roundup

Have the PEs been successful in exits?

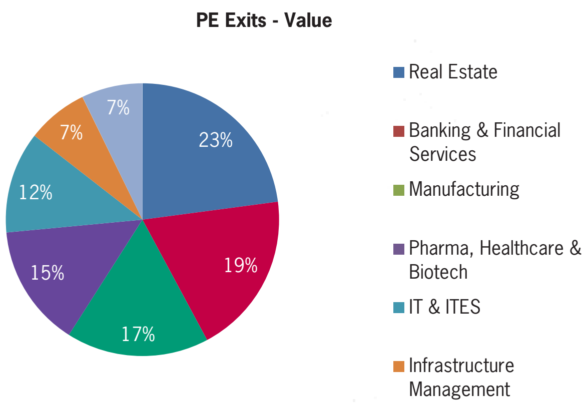


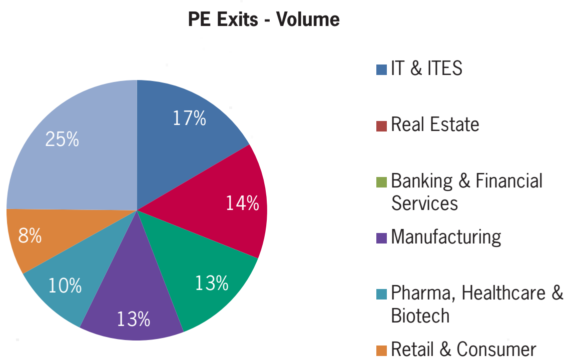
While the industry was not very conducive for exits in the last couple of years, the average holding period of investments in companies have been increasing for the investors. However, 2015 has witnessed over 140+ exits, much higher compared to the last couple of years.

Exit route: In 2015, preferred exit routes for PE/VCs were open market stake sale of listed companies followed by secondary stake sales (where one PE firm, buys another PE firm's share in the company). There are quite a few instances of promoters buying back the stake from the PEs. M&As and IPO led exits have also gained pace.

Sector exit trends: During the year, IT and ITeS sector witnessed the highest PE exits in terms of volume and a number of international and domestic PE investors made profitable exits from these companies.

PE investors also gained better returns by selling their stakes in publicly listed BFSI companies. Exits in Telecom and Media and entertainment sector also saw high value exits.

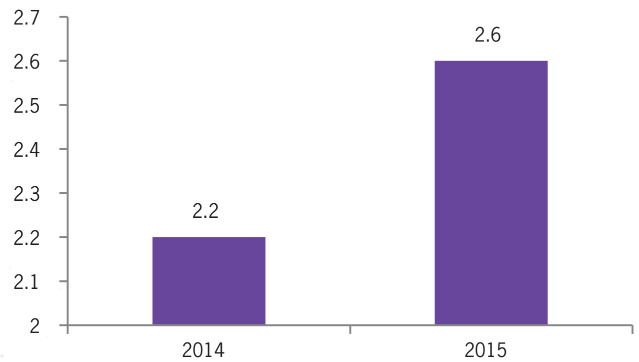




2015 PE exits roundup

Have the PEs been successful in exits?

Median exit multiples



On analysing the exit multiples we see that 2015 witnessed better exit multiples compared to 2014.

Private equity exits: Majority of the PE investors (57 percent) fully exited their investments during the year while the remaining continued to retain a part of their investment. Top sectors that witnessed full exits during 2015 were Real estate followed by IT and ITeS and BFSI industry.

Note: For the purpose of arriving at the median exit multiples we have considered publicly available data, which is limited to cases of exits with positive returns. Hence, the data needs to be read accordingly.

Notable exits in 2015

Investor exited	Investee company	Part/ full exit	Sector
TPG Capital	Shriram City Union Finance	Full Exit	Banking and Financial Services
Avantha Holdings	Crompton Greaves Ltd	Full Exit	Manufacturing
Barings Private Equity	Lafarge India Pvt Ltd.	Full Exit	Manufacturing
Kolhberg Kravis and Roberts	Bharti Infratel	Part Exit	Infrastructure
ChrysCapital	Mankind Pharma	Full Exit	Pharma, Healthcare and Biotech
Helion Venture Partner and IDG Ventures	Flipkart	Part Exit	IT and ITeS
Electra Partners	Zensar Technologies Ltd.	Part Exit	Manufacturing
Bain Capital Partners	Hero MotoCorp Ltd.	Full Exit	Automotive
Blackstone	Agile Electric Sub Assembly Pvt Ltd- Igarashi Motors India Ltd.	Full Exit	Automotive
ChrysCapital	ING Vysya	Part Exit	Banking and Financial services

With the economy growth expected to improve in 2016, we would possibly see more activity in the IPO market.

With new funds entering the Indian market, secondary market transactions could also see good growth. Exits would therefore continue to remain key focus for many PE Funds and we do expect better outcomes given better economic growth expectations, better IPO market and better inbound M&A market.

Sector Snapshot

- Sector trends over the years
- Top sectors in 2015
- Sector insights

Trend in PE investments by sector

Which sectors have attracted the investments?

Investment values (US$ mn) by key sectors from 2011 to 2015

	2011	2012	2013	2014	2015
IT and ITeS	1,602	2,003	1,992	5,249	7,225
Banking & Financial Services	848	767	1,115	1,293	2,023
Real Estate	962	718	954	1,659	1,280
Energy & Natural Resources	1,053	364	478	473	1,107
Pharma, Healthcare & Biotech	281	907	1,400	628	1,099
Manufacturing	829	221	514	338	874
Retail & Consumer	215	528	597	733	514
Telecom	61	1	1,260	110	500
Media & Entertainment	305	322	338	232	351
Infrastructure	1,123	360	210	894	328

Investment volumes by key sectors from 2011 to 2015

	2011	2012	2013	2014	2015
IT and ITeS	105	135	151	261	657
Banking & Financial Services	32	50	46	48	56
Retail & Consumer	28	22	36	43	44
Education	23	22	19	36	44
Media & Entertainment	18	23	18	27	42
Pharma, Healthcare & Biotech	19	38	73	49	40
Real Estate	22	24	30	42	34
Professional / Business Services	4	5	7	11	29
Hospitality & Leisure	14	13	9	16	22
Manufacturing	28	20	21	20	20
Infrastructure	23	12	12	17	17

Trend in PE investments by sector

Which sectors have attracted the investments?

Top 6 sectors contributed over 80 percent of PE investment values and over 80 percent of PE investment volumes in 2015.

Top 6 sectors in 2015

IT and ITeS

657 deals
US$ 7.2 bn
63 percent of PE volume in 2015
45 percent of PE value in 2015

Energy and Natural Resources

12 deals
US$ 1.1 bn
1 percent of PE volume in 2015
7 percent of PE value in 2015

Real Estate

34 deals
US$ 1.3 bn
3 percent of PE volume in 2015
8 percent of PE value in 2015

Banking and Financial Services

56 deals
US$ 2.0 bn
5 percent of PE volume in 2015
13 percent of PE value in 2015

Retail and Consumer

44 deals
US$ 0.5 bn
4 percent of PE volume in 2015
3 percent of PE value in 2015

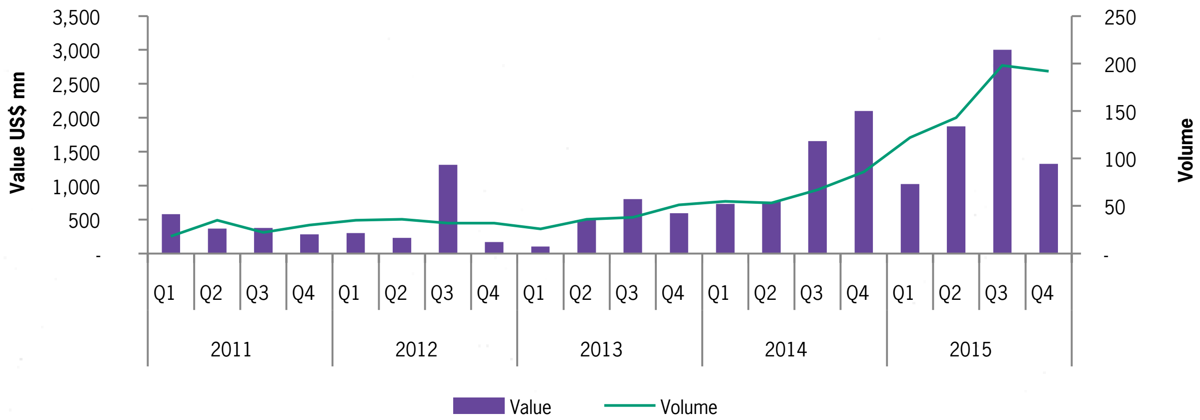
Pharma, Healthcare and Biotech

40 deals
US$ 1.1 bn
4 percent of PE volume in 2015
7 percent of PE value in 2015

Sector insights: IT and ITeS

How has the PE deal activity been in the sector?

Quarterly trend in PE deal activity

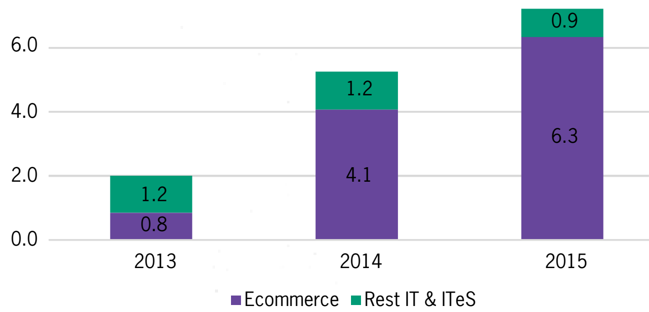


The IT and ITeS sector has been very active both in terms of overall deal volume and value. In the year 2015, the sector saw a total of 657 deals worth a whopping US$7.2 bn which is around 63 percent of the total overall deal volume and around 45 percent of total overall deal value.

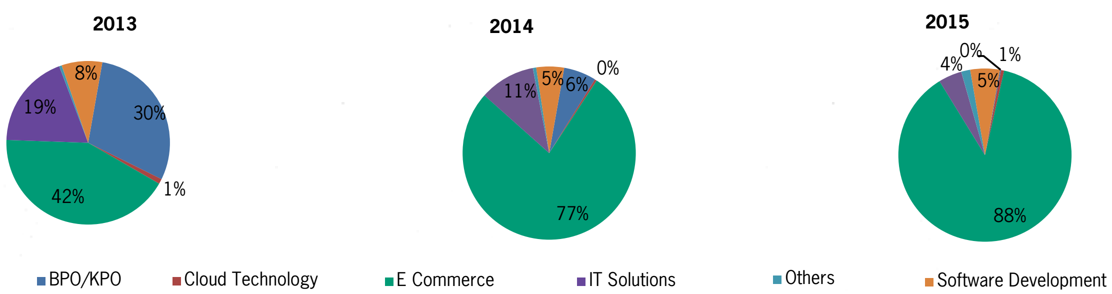
The private equity deal space in this sector gained a lot of momentum in 2015 driven by an increasing number of small ticket investments in technology startups.

E-commerce companies such as Flipkart and Snapdeal, online travel businesses, taxi hailing services and other providers who channel services via mobile phone and internet attracted significant chunk of investments in the sector in 2015. The top five deals in this space accounted for 1/3 of the total deal value in the sector, displaying a continuous growth pattern.

Investment Value (US$ bn)



Yearly trend in PE deal value by sub sectors



Sector insights: IT and ITeS

How has the PE deal activity been in the sector?

Top 5 PE deals in 2015

Investor	Investee	Stake %	Deal value (US$ mn)
Baillie Gifford, Greenoaks Capital, Steadview Capital, T Rowe Price Associates, Qatar Investment Authority, DST Global, GIC, Iconiq Capital, and Tiger Global	Flipkart Online Services Pvt Ltd	N.A.	700
Foxconn, Alibaba and SoftBank	Jasper Infotech Pvt Ltd- Snapdeal.com	N.A.	500
Baillie Gifford, Falcon Edge Capital, Tiger Global, SoftBank Group and DST Global	Olacabs.com -ANI Technologies Pvt Ltd	N.A.	500
DST Global,Accel Partners, Tiger Global and Steadview Capital	Olacabs.com -ANI Technologies Pvt Ltd	N.A.	400
Falcon Edge Capital, Tiger Global , Softbank,Steadview Capital, the Hong Kong-based hedge fund, ABG Capital, FII LTR Focus Fund, JS Capital (M) Ltd, Parkwood Bespin,angel investor Daniel E. Neary	Olacabs.com -ANI Technologies Pvt Ltd	N.A.	222.5

Grant Thornton View

In the wake of a fall in global equity markets in the latter part of 2015 and uncertain economic outlook around the globe, even as the Indian Government is focused on improving the investment climate, ease of doing business, regulations and other initiatives - it remains to be seen whether this will give confidence to PEs to deploy funds or will make them adopt a wait and watch approach, early into 2016.

Foreign investments have been the primary source of capital for most funds and are expected to grow further next year. India is still the bright spot in the global economy and LPs are expected to maintain or increase allocation to India.

Looking ahead into 2016, private equity firms will continue searching for proprietary deals, high quality entrepreneurs (to fund) and scalable disruptive startup businesses with better entry valuations.

We can expect continued activity in businesses that received funding during 2013 to 2015 and need additional funding due to growing competition and to stay ahead in the race to be market leaders. Early stage investments, investment in startups and other technology businesses will continue but may be somewhat subdued due to the growing competition and PE/ VCs being selective in allocating capital – this could lead to shutting down or consolidation of few firms and result in valuations trending down.

Vibhor Sharma

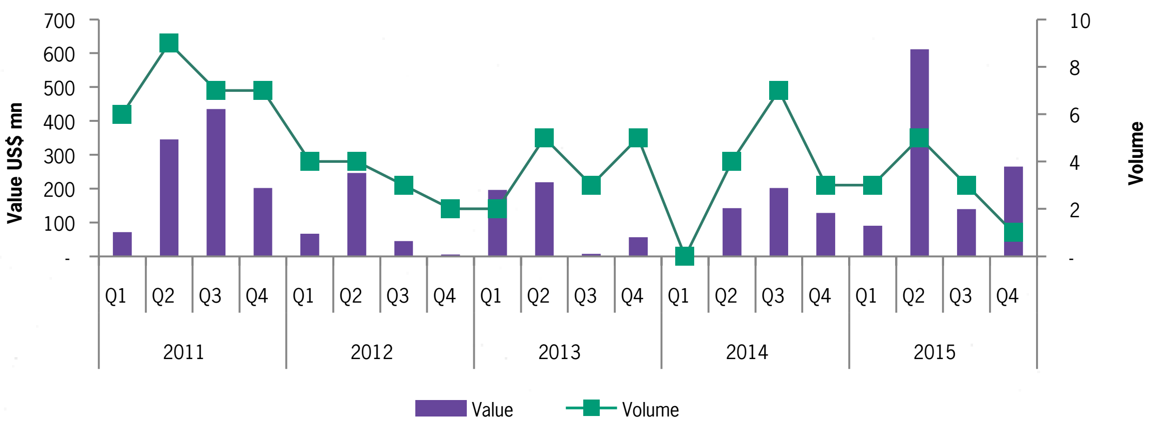
Director

Grant Thornton India LLP

Sector insights: energy and natural resources

How has the PE deal activity been in the sector?

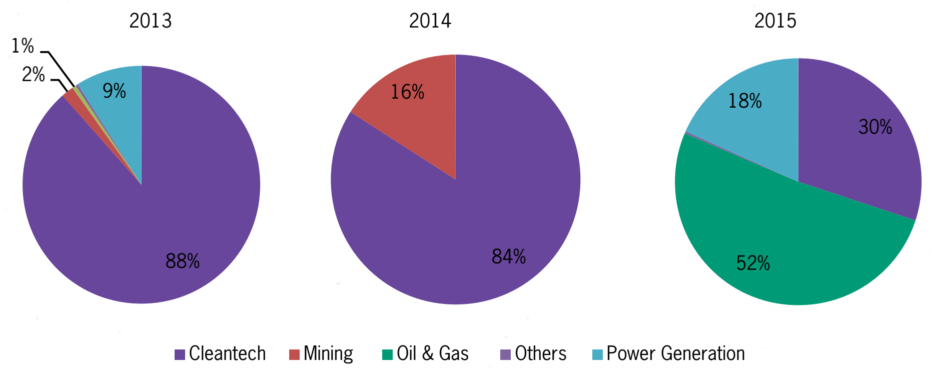
Quarterly trend in PE deal activity



The PE deal space in this sector witnessed 12 transactions amounting to US$ 1.11 bn compared to 14 transactions amounting to US$ 473 mn in the year 2014. The average deal size tripled in 2015 from the level of 2014 primarily on account of two high value deals which accounted for approximately 69 percent of the total deal value in this space.

The interest in the clean tech sector in India continues to be high, primarily driven by high oil and coal prices in the past and initiatives by the government to help the renewable sector. However, with the recent lower levels of oil prices, we are now seeing a resurgence of investments in the traditional oil and gas sector. This sector saw some marquee large ticket investments in the oil and gas, power generation and cleantech sub sectors which resulted in over two times of growth in the aggregate deal value in the sector.

Yearly trend in PE deal value by sub sectors



Sector insights: energy and natural resources

How has the PE deal activity been in the sector?

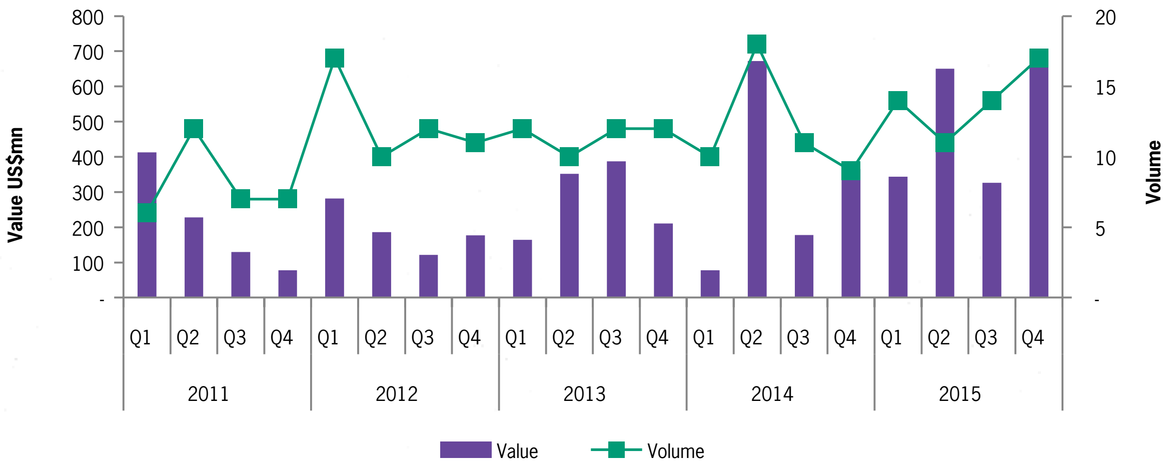
Top 5 PE deals in 2015

Investor	Investee	Stake %	US$ mn
Carlyle Group	Magna Energy Ltd	N.A.	500
Goldman Sachs, The Global Environment Fund, Abu Dhabi Investment Authority	ReNew Power Ventures Private Limited	N.A.	265
Macquarie Infrastructure & Real Assets	Ind Barath Energy Utkal Ltd unit - Ind Barath Power Infra Ltd	N.A.	122
IDFC -India Infrastructure Fund II	DB Power Limited- Diliigent Power Pvt. Ltd.	15%	80
IDFC Alternatives	ONGC Tripura Development Company Ltd	24%	68

Sector insights: banking and financial services

How has the PE deal activity been in the sector?

Quarterly trend in PE deal activity



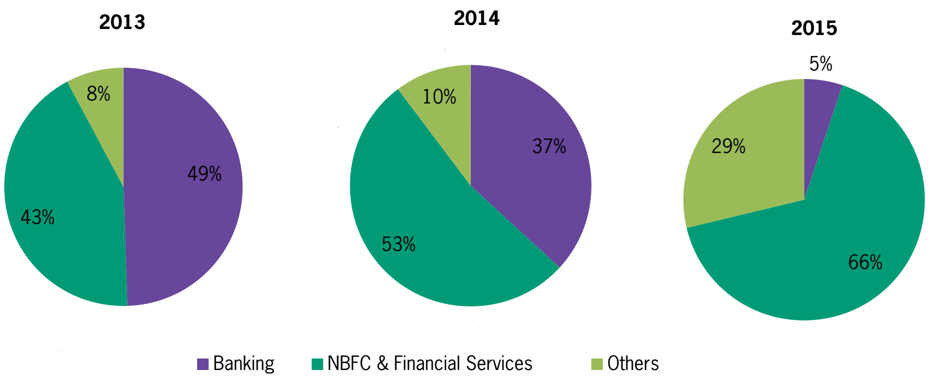
The period between 2014 and 2015 recorded a steep increase in the deal values within the Banking and Financial services sector. 2015 recorded 56 transactions amounting to US$ 2.02 bn. Additionally this sector saw seven deals of US$ 100 mn in 2015 compared to only one deal in 2014 resulting in a sharp increase in deal values.

The sector has been very active over the last two years in terms of both investments and profitable exits. The sector has gained focus with a large amount of equity funds being dedicated to this sector.

The increase in investments in the Banking and Financial services sector was helped by the central government's initiative for financial inclusion, a stable regulatory regime and capital requirements by the banks to meet BASEL III norms. As banks do not allow shareholding of more than 5 percent, the focus has moved to NBFCs where they offer products such as vehicle finance, home finance, consumer finance and microfinance.

Fintech however is a developing sector that has captured the limelight and has attracted a good share of VC funds. With the increased traction and various technological advancements in this sector, traditional banks are offering more diversified services, thus being considered under the ambit of financial services.

Yearly trend in PE deal value by sub sectors



Sector insights: banking and financial services

How has the PE deal activity been in the sector?

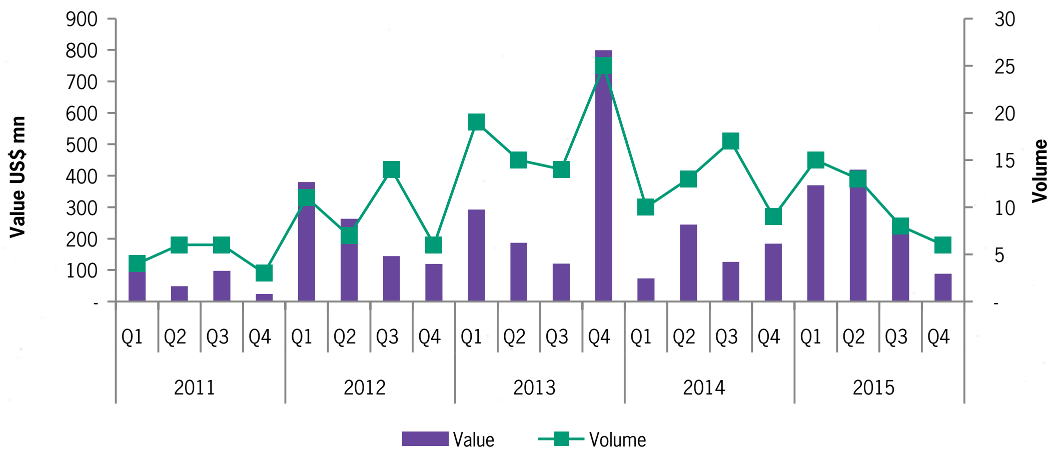
Top 5 PE deals in 2015

Investor	Investee	Stakes in %	Deal value (in US$ mn)
Apax Partners Llp	Shriram City Union Finance Ltd	20%	370
PremjiInvest and its affiliates	ICICI Prudential Life Insurance	4%	197
General Atlantic LLC	IIFL Wealth Management Ltd	22%	173
IFC, GIC, SIDBI	Bandhan Financial Services Pvt Ltd	N.A.	164
Bain Capital	L&T Finance Holdings Ltd	5%	107

Sector insights: pharma, healthcare and biotech

How has the PE deal activity been in the sector?

Quarterly trend in PE deal activity



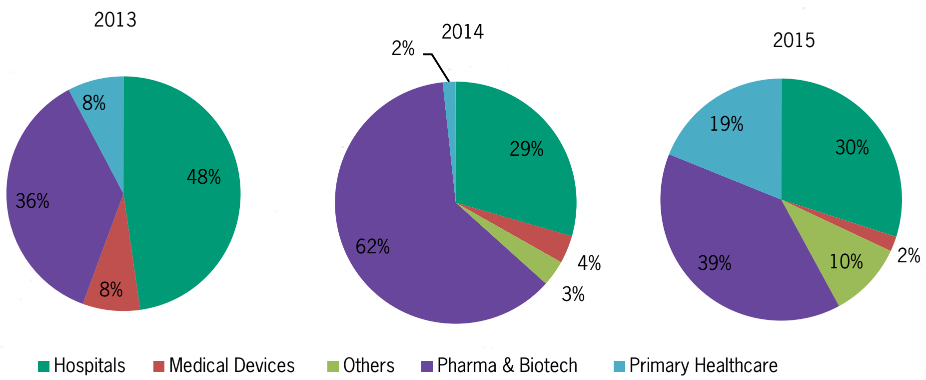
The Pharma, Healthcare and Biotech sector witnessed a 76 percent increase in aggregate deal values in the year 2015 despite a 14 percent decrease in deal volumes compared to 2014.

According to a report by CARE Rating dated 10 September 2014, India's pharmaceuticals industry is likely to grow at an average annual pace of 14 percent, supported by a rapidly growing domestic market and emerging export opportunities as patents of at least a dozen bestseller drugs in the US expire in the next three years.

Investors have reaped high returns from this sector previously and hence have placed high bets in this sector. Additionally, the domestic formulations market continues to exhibit high single-digit growth on a sustainable basis. Hence, attracting PE players to invest in the fast growing pharma companies with a focus on the national market.

Multi-specialty hospitals, pharmaceuticals, and primary healthcare attracted majority of investments in 2015. Looking at the existing trends, most of the PE houses have set aside dedicated funds to invest in this sector.

Yearly trend in PE deal value by sub sectors



Sector insights: pharma, healthcare and biotech

How has the PE deal activity been in the sector?

Top 5 PE deals in 2015

Investor	Investee	Stake %	Deal value (in US$ mn)
Capital International	Mankind Pharma	11%	205
Temasek	Glenmark Pharmaceuticals Ltd	4%	151
TPG Capital	Manipal Health Enterprises Private Limited.	25%	150
OrbiMed and MAPE Advisory Group	Net-Meds Marketplace Pvt Ltd-Netmeds.com	N.A.	50
CDC Group	Narayana Hrudayalaya Hospitals	N.A.	48

Grant Thornton View

The deal scenario across healthcare and pharma sector has remained active and resilient primarily on account of the overseas M&A led deal activity. In 2015, the total deal value in the sector hit a five-year high. Singapore's state-owned investment firm Temasek was the most active PE investor in the pharma space, and successfully invested upto US$ 730 mn into pharma companies.

While the pharma companies were shopping for global targets, some of the PE funds were busy making investments into large hospital assets in India and the single specialty hospitals were closing out on their Series B and Series C funding primarily to fund their expansion plans. Additionally, the home healthcare sector witnessed reasonable deal activity.

In the medical consumables space, although we didn't see much action this year, in an extremely rare case of cross border acquisition India based Sutures acquired CliniSupplies, a UK based surgical consumables company.

We believe 2016 is going be another active year in the deal space for Indian healthcare sector as we could potentially see Series B rounds in the healthcare delivery sector, acquisition of pharma formulation companies and Series A investment in med-tech space.

Santhosh Chandrasekaran

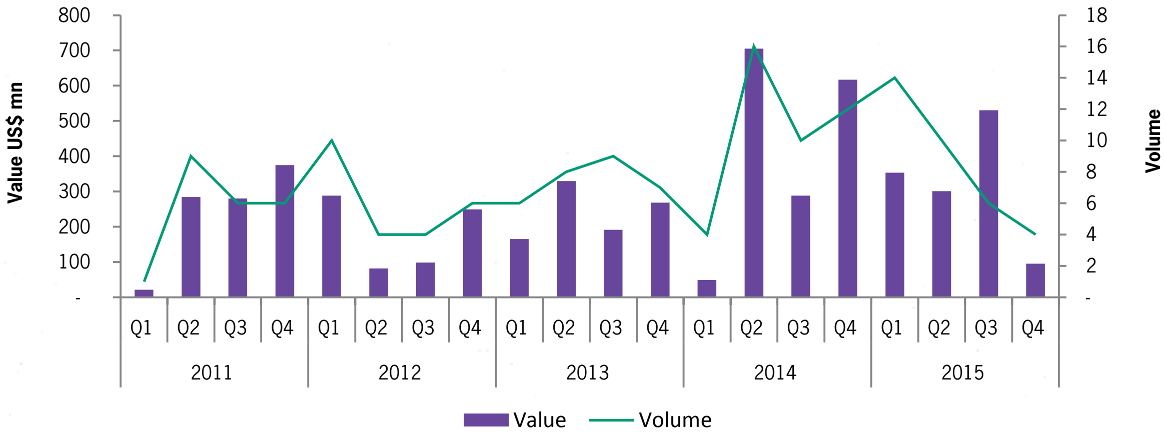
Director

Grant Thornton India LLP

Sector insights: real estate

How has the PE deal activity been in the sector?

Quarterly trend in PE deal activity

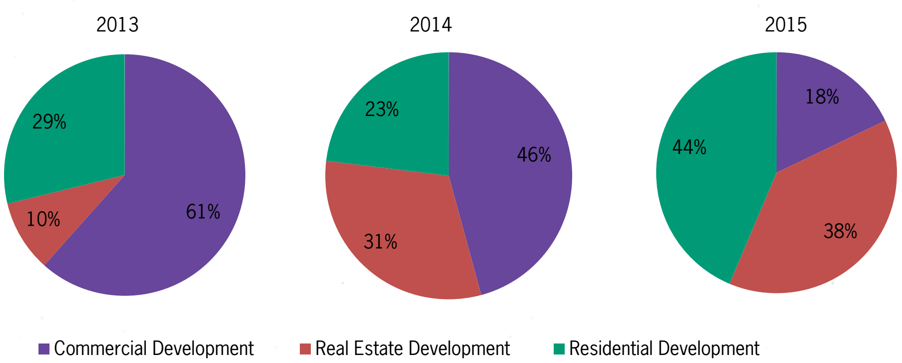


Foreign institutional investors (FIIs) and Private Equity (PE) funds made some investments in the residential and commercial projects this year, amid a slowdown that continues to see reduced activity during the year. PE funds invested US$1.3 bn (23 percent decrease compared to last year) across 34 investments (19 percent decline year-on-year).

Money that is being raised by the realty firms is primarily being used to refinance existing loans, as cash flows remain weak on the back of slow sales and in rush to complete existing projects.

Indian real estate sector has been under stress due to slow sales of residential properties across major cities in the country.

Yearly trend in PE deal value by sub sectors



Sector insights: real estate

How has the PE deal activity been in the sector?

Top 5 PE deals in 2015

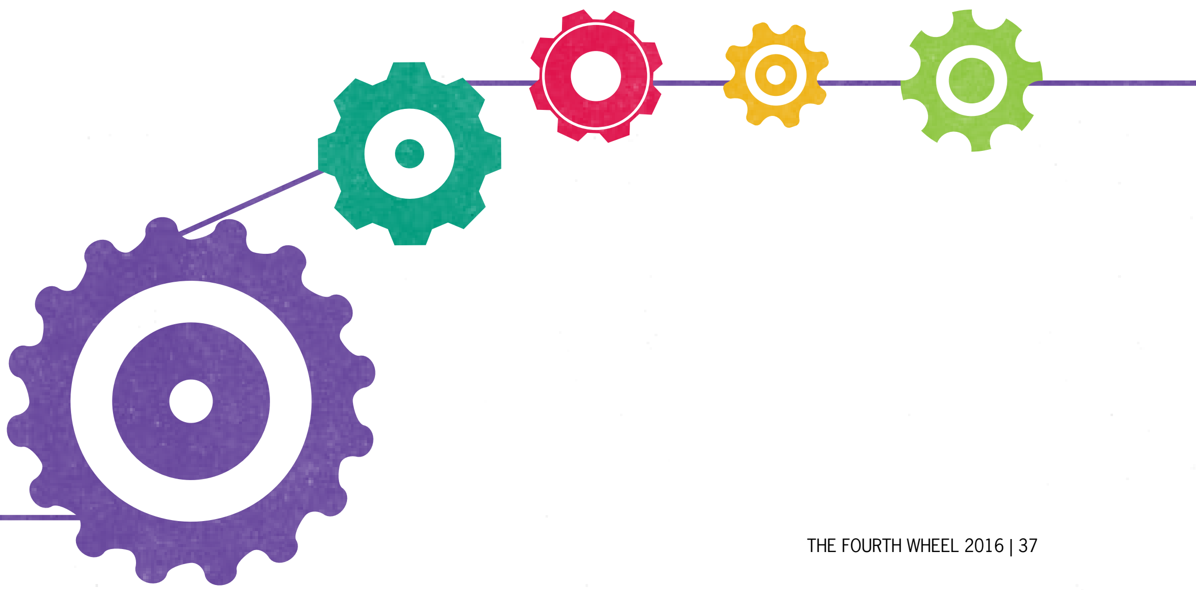
Investor	Investee	Stake %	Deal value (in US$ mn)
Warburg Pincus	Piramal Realty	N.A.	283
Goldman Sachs	Piramal Realty	N.A.	150
Equis Funds Group	Assetz Property	N.A.	116
Piramal Fund Management	Ozone Group - Urbana project	N.A.	92
GIC	Nirlon Ltd	30%	90

Grant Thornton View

Despite continued slow down across markets driven by weak consumer sentiment and oversupply in select residential pockets, 2015 cannot be seen as a period of capital scarcity. Large size platform deals emerged as the central theme for the year as big investor groups forged partnerships with established players with a long term exit view versus immediate term appreciation. While structured investment products continue to dominate mid-market deals driven by refinancing needs of developers in the face of declining sales velocity, equity investments came back in larger deals after a long gap, auguring positively for sector prospects.

In terms of asset classes, built up commercial assets continue to be the preferred category for investors, though volumes here are likely to remain low due to mismatch in yield expectations. Alternate asset classes with similar yield characteristics like warehouses, hospitals, hotels and schools could see increased traction from institutions, while mid-market deal momentum is expected to remain subdued over the next 12 months as markets search for big triggers to galvanise the residential demand. Also, large pools of capital raised by funds in conjunction with correcting valuations will ensure sector flows remain robust throughout the year.

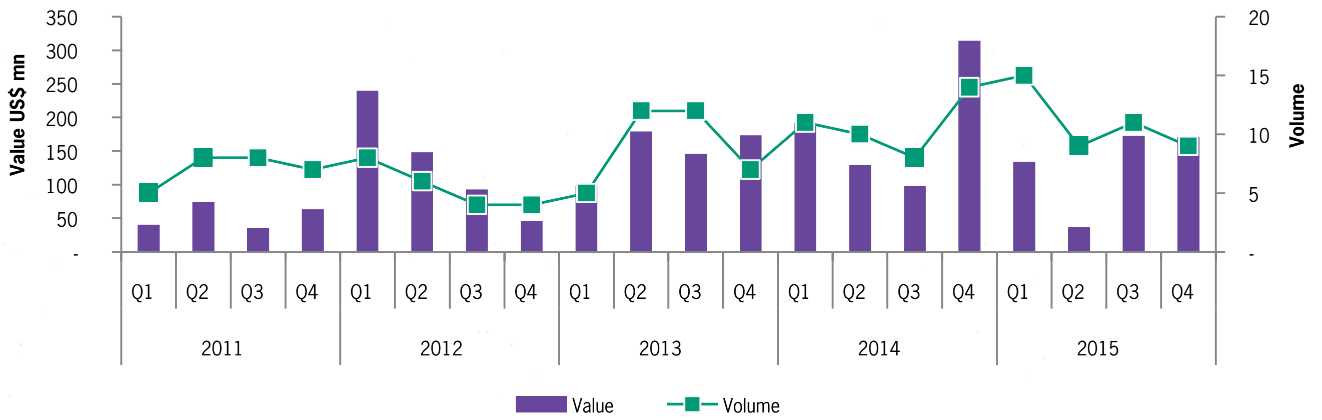
Sumeet Abrol
Director
Grant Thornton Advisory Private Limited



Sector insights: retail and consumer

How has the PE deal activity been in the sector?

Quarterly trend in PE deal activity



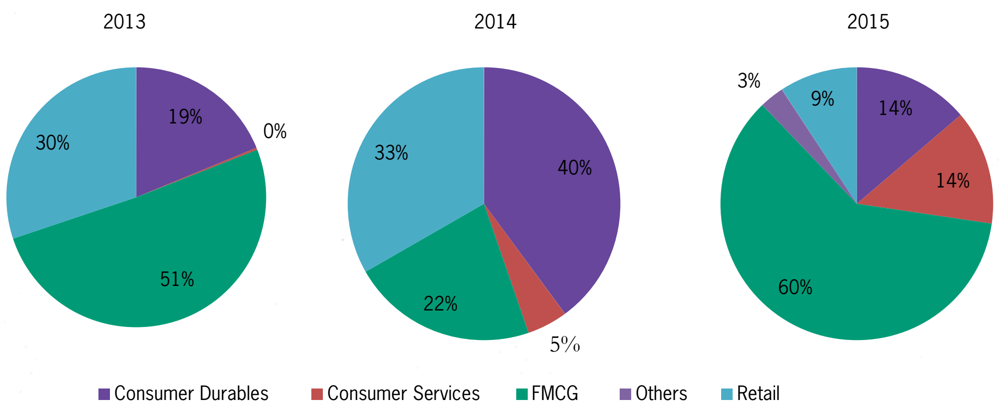
In 2015, 44 PE transactions amounting to US$ 514 mn were executed as against 43 PE transactions amounting to US$ 733 mn in 2014. The decrease in deal activity was due to the perception that a new pro-business government at the centre will ease FDI norms in multi brand retail which existed in 2014, but did not materialise in 2015. Additionally, investor interests have shifted from physical retailing to e-tailing driven by the e-Commerce boom.

According to industry sources, the FMCG sector has grown at an annual average of about 11 percent over the last decade.

The overall FMCG market is expected to increase at CAGR of 14.7 percent to touch US$ 110.4 bn during 2012-2020 .

Growing consumer awareness, easier accessibility and changing lifestyles have been key growth drivers for the consumer market. The Government of India's policies and regulatory frameworks such as relaxation of license rules and approval of 51 percent foreign direct investment (FDI) in multi-brand and 100 percent in single-brand retail are some of the major growth drivers for the consumer market.

Yearly trend in PE deal value by sub sectors



Sector insights: retail and consumer

How has the PE deal activity been in the sector?

Top 5 PE deals in 2015

Investor	Investee	Stake %	Deal value (in US$ mn)
CX Partners and Others	Cremica food industries ltd	48%	100
CX Partners and Gateway Partners	Mrs. Bectors Food Specialities Ltd	N.A.	67.5
India Value Fund Advisors (IVFA)	Meru Cabs	N.A.	50
AION Capital Partners	Varun Beverages Ltd	N.A.	45
Premji Invest	Hygienic Research Institute Pvt Ltd	N.A.	33

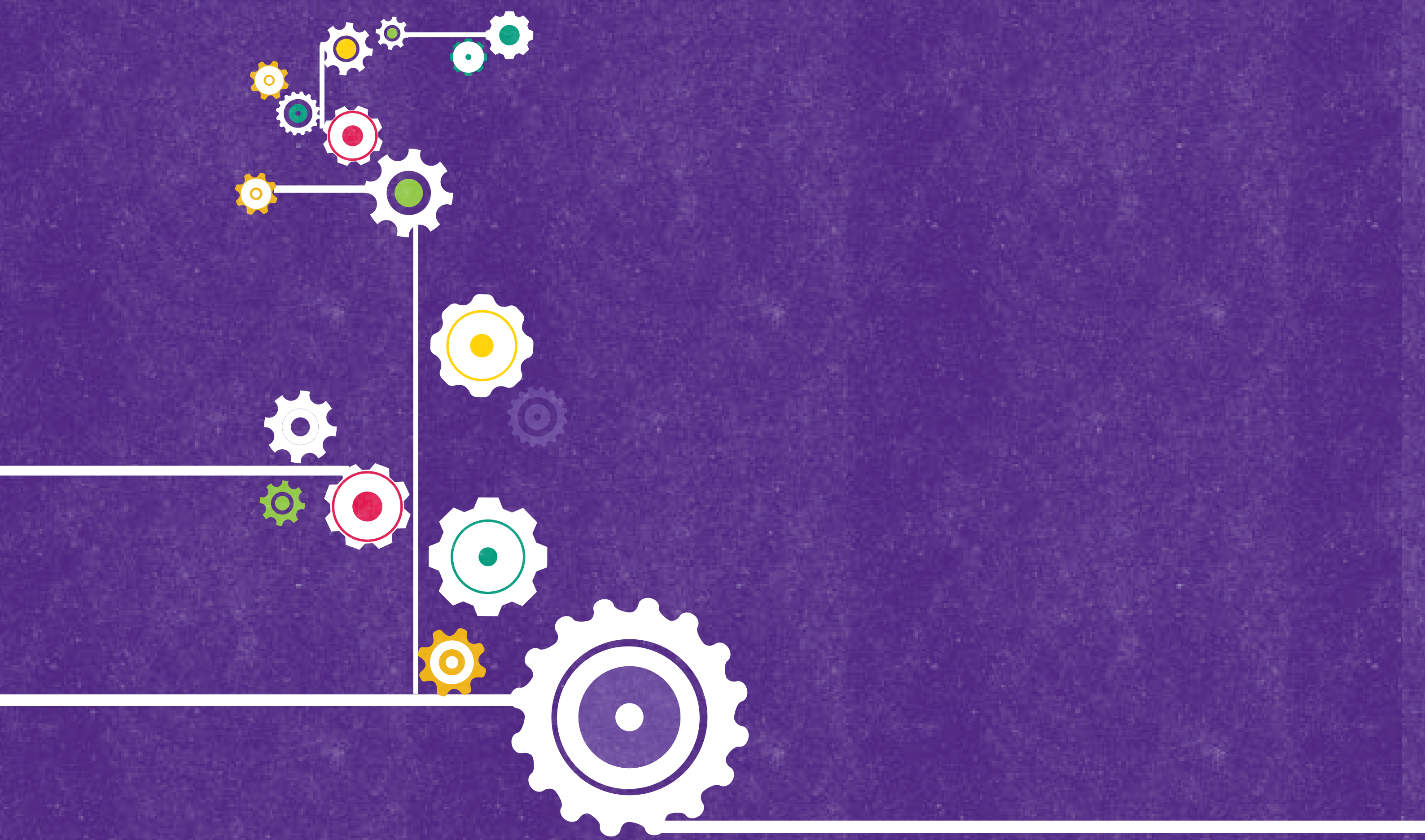
Grant Thornton View

While PE/VC firms have shifted focus to online startups, they have shown steady interest for this sector due to the underlying key economic indicators – rising disposable income, growing middle class households, change in lifestyle preferences and opportunity to tap into the rural market. However, lack of good brands and high valuation expectations have limited the fund raising activity in the last years.

With the emergence of food processing business and various startups in food and beverage sector, expansion expected in organised retail and the emergence of online retail, there is scope for deal activity in 2016. These factors would drive further mushrooming of private label businesses as various sales channels are available to a consumer products business in this space.

Shanthi Vijetha
Director
Grant Thornton India LLP

Industry Insights



Investor speak

Parag Dhol
Managing Director
Inventus Capital Partners

How do you describe the PE investment activity in 2015? While volume and value increased, average ticket size reduced in 2015 – is it higher share of startups funding and/ or risk mitigation approach adopted by PE/ VCs? What were the key challenges faced by and opportunities arisen for the PE industry in India?

Most likely not the case with technology investing (the segment we operate in). 2015, for that segment, was defined by some gravity defying business models (based on landgrab, high discounts, crazy marketing spends etc.). The dust started settling in late 2015 and the "correction" continues. 2016 is likely a "cautious" year as a result and should be good for "steady" investors like ourselves.

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

In the early-stage technology segment, innovation (in technology, business models etc.) is taking place across the board/sectors/verticals. Our approach is bottoms-up, as long it is broadly technology (software, Internet, mobile, tech-enabled services) driven.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about the much needed consolidation in certain sectors?

Three key things will continue to matter to us:

- Team
- Market segment - size, growth etc.
- Competitive advantage

In early-stage investing consolidation, M&A etc. are overheads. Organic growth is the mantra.

How do you view the Indian entrepreneurship in recent times? How are you addressing the challenges in managing the relationship with Indian promoters and also the challenges of corporate governance?

Again, not much of a challenge in early-stage technology investing. The intent is hardly ever wrong. That said, tech founders (generalising a bit) do take compliance somewhat lightly.

What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

Amazingly, the new Companies Act has brought more overhead than less. Even the fineprint in the startup policy seems to have touches of bureaucratic thinking from the 80s/90s. Ease of doing business, exits, easier bankruptcy laws need to be addressed at the earliest.

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

Exits continue to be the biggest unanswered question for India VC. That said, each of Amazon, Yahoo, Twitter and Facebook has acquired a company in India. JustDial and Quick Heal have gone public. The Indian software majors now have teams looking for acquisitions. Some of the scaled companies/unicorns are also acquiring using stock (jury still out on sustainability though, given they don't generate cash from operations). The Microsoft's and IBM's are spending considerable time to engage with startups - partnerships, inevitably, lead to M&A. So, the outlook on this front is better than it has ever been.

Investor speak

Vishal Tulshyan
Managing Director & CEO
Motilal Oswal Private Equity

How do you describe the PE investment activity in 2015? While volume and value increased, average ticket size reduced in 2015 – is it higher share of startups funding and/ or risk mitigation approach adopted by PE/ VCs? What were the key challenges faced by and opportunities arisen for the PE industry in India?

2015 did witness a significant rise in number of transactions thanks to the burgeoning Angel/VC transactions. For an economy as well as PE industry to prosper having a robust Angel/VC platform to support budding entrepreneurs is critical. Early exposure to institution money establishes discipline of capital allocation as well as setting desirable standards of corporate governance. These startups are our future potential investment opportunities. The key challenge faced by the industry is the overall uncertain tax/regulatory environment.

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

Businesses driven by the domestic consumption story continues to be a key theme of interest. India presents a unique opportunity of secular organic growth through conversion from unorganised to organised and unbranded to branded, over and above the normal consumption growth. Let's take an example: a country with 250 mn households has an organized mattress industry of a mere ~ Rs 2,500 Cr (10% market share) – with bulk of the market being unorganised and / or cotton mattress presenting huge growth prospects. And the same is true in almost majority of the consumption items.

The current financial infrastructure isn't deep enough to cater to low and middle income segment of the country. NBFCs/MFIs/HFCs (and now Small Finance Banks) fill this void and cater to this unbanked or under-banked segment. The opportunity to provide fund based or non-fund based services are manifold and thus are a key sector of interest.

In addition, the thrust of 'Make in India' and promoting Indian entrepreneurship should present some interesting niche manufacturing opportunities in the future.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about the much needed consolidation in certain sectors?

Motilal Oswal Group through its deep rooted research culture and 'Knowledge First' approach is a unique investing platform in India. Investing culture of over 30 years has helped us to evolve our investing practice to 4 key tenets and we call it 'QGLP'.

Quality: Quality of business and management

Growth: Growth in earnings and sustained RoE

Longevity: Longevity of the competitive advantage/ economic moat of the business

Price: Buying a good business for a fair price rather than buying a fair business for a good price

All investment opportunities whether funding organic growth or financing domestic deals or even secondaries are scrutinized thoroughly through the prism of 'QGLP'.

How do you view the Indian entrepreneurship in recent times? How are you addressing the challenges in managing the relationship with Indian promoters and also the challenges of corporate governance?

Unlike western counterparts, Indian entrepreneurs nurture businesses like their own children and keep them close to their hearts. Thus they have been unwilling to share or sell even if the offers are lucrative or made business sense. Recent M&A/PE activities has increased awareness and has made them amenable to raise equity or even sell which

Investor speak

augurs well for the PE industry. At a fundamental level principles of frugality and 'jugaad' still can be ascribed to them.

Key to managing relationships with promoters is to speak the same language and show empathy towards challenges of working in the Indian environment. They thrive when the investors are seen as partners and not reporting authorities.

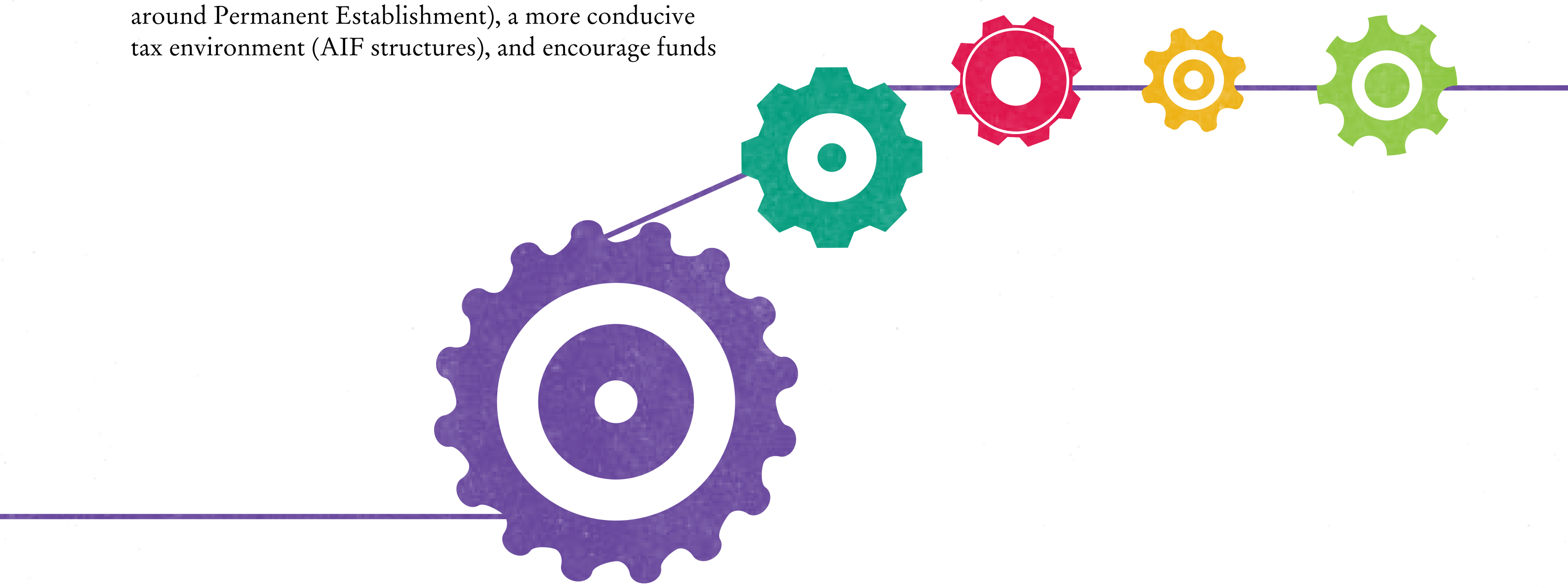
What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

In general, India can do much better with clarity on key issues like retrospective tax, GST etc. as it helps image 'India' as a whole. One has to realise and understand that Private Equity in India has played a pivotal role in the overall growth. They are not only providers of long term patient capital, but have also played a key role in improving the overall corporate governance in their portfolio companies, higher tax revenues for the government (companies backed by PE exhibit higher growth rate vis-à-vis companies without PE backing), employment generation, etc.

We have to create a level playing field for private equity investors in India, as it is an absolute requirement for Indian economy. There has to be simplification of regulatory environment (whether it is the POEM issue or issues around Permanent Establishment), a more conducive tax environment (AIF structures), and encourage funds manager to be bothered more about the investments and value addition rather than an uncertain regulatory/tax environment.

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

One can only address the challenge of portfolio company exits at the time of entry. The QGLP framework enables stringent filtering process weeding out weak proposals. Quality companies are always in demand whether in public or private equity. The challenge though sometimes is the limited life structure wherein the funds have to exit at times when it may not be most lucrative. We prefer to invest in proposals which don't restrict us with a particular type of exit thus keeping all options like secondary, IPO or strategic sale open.



Investor speak

Arvind Malhan
Partner
NSR Advisors

How do you describe the PE investment activity in 2015? While volume and value increased average ticket size reduced in 2015 – is it higher share of startups funding and/ or risk mitigation approach adopted by PE/ VCs? What were the key challenges faced by and opportunities arisen for the PE industry in India?

2015 witnessed the highest ever level of PE/VC investments, and investment value increased strongly to US$ 18.5 bn from US$ 10.4 bn in 2014. Average deal size increased to US$ 43 mn in 2015, from US$35 mn in the prior year. The year saw a boom in PE/VC investments in consumer technology, with US$ 6.4 bn invested in this sector over the course of the year. Companies such as Flipkart, One97 Communications (Paytm), Snapdeal and Ola raised very large financing rounds of US$ 500 mn or more. At the same time, the fundraising environment became much more difficult for many startups, with an increased focus by investors on unit economics and differentiation, resulting in consolidations and workforce reductions in several startup companies.

After several challenging years, 2015 was a landmark year for exits of PE/VC backed firms, and PE firms focused on the critical objective of delivering profitable exits to Limited Partners. PE exits in 2015 generated more than US$ 6 bn, the highest in 10 years. There were 21 successful IPOs on the BSE, compared with only five in 2014, with nearly all the companies being PE backed. The share price of some of the newly listed companies such as VRL Logistics, nearly doubled over the issue price, while on average the newly listed companies gained nearly 24percent from their issue price over the year.

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

We will see increasing focus on funding businesses with a very clear competitive edge, and run by high quality entrepreneurs looking to create significant shareholder value. We expect investors to intensify their focus on the viability of the unit economics and capital intensity of business models. Sectors of the highest interest to investors include Information Technology and IT enabled Services; Healthcare Services and Medical Devices; Logistics; Education and Skill Development; Solar and Wind Renewable Energy.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about the much needed consolidation in certain sectors?

The most important evaluation criterion is that the business have created a significant and sustainable competitive edge, resulting in a combination of superior outcomes or quality for customers, greater efficiency and lower operating costs. We also focus sharply on whether the unit economics, and return on invested capital, of the business model is attractive, and on the market's size and growth potential. We have invested both in businesses with high organic growth rates, as well as in businesses that have grown through acquisition and achieved profitability improvement through consolidation synergies. Partnering with entrepreneurs of the highest quality is of great importance to us, and we favour situations where we can work closely with the founders to improve the company's operations after we invest.

How do you view the Indian entrepreneurship in recent times? How are you addressing the challenges in managing the relationship with Indian promoters and also the challenges of corporate governance?

Investor speak

We are very focused on backing great entrepreneurs, who are aligned with us on both achieving business objectives and operating at the highest level of governance. We seek to only partner with entrepreneurs and promoters who welcome our active contribution on corporate governance, business strategy, talent management, operational efficiency, and achieving growth.

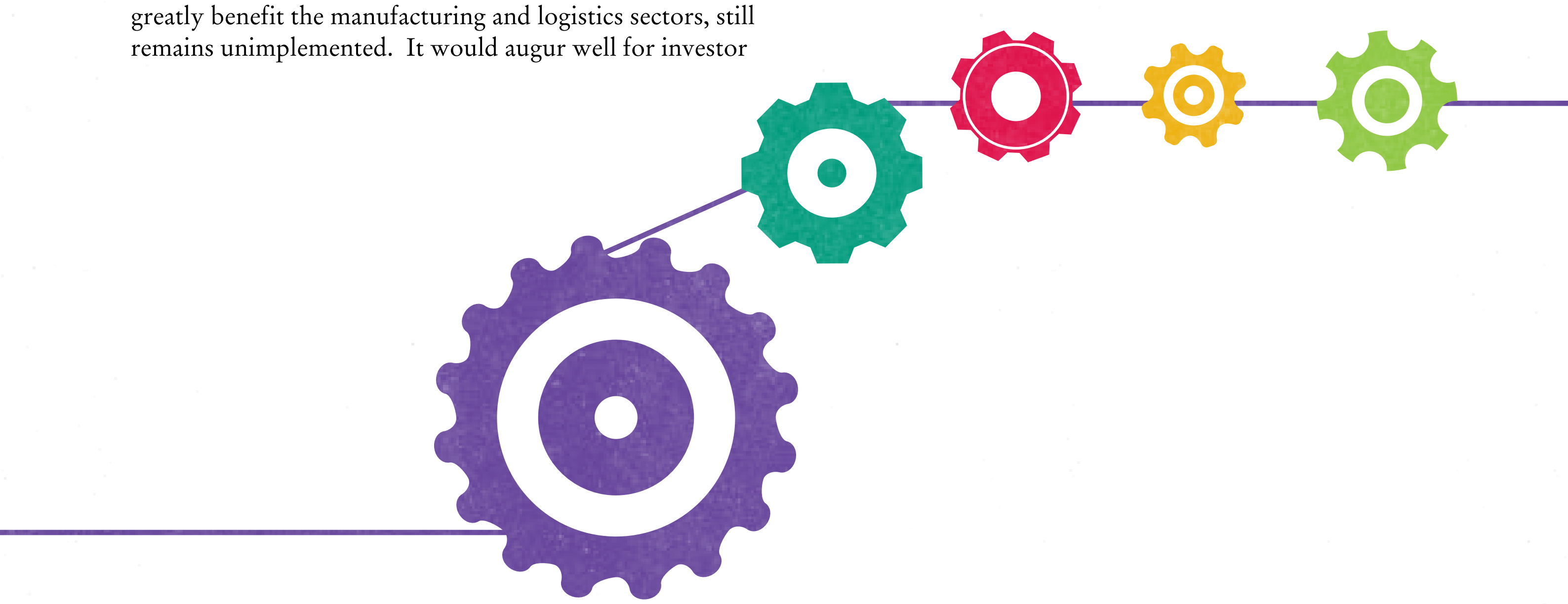
What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

PE Investors stand to benefit from the easing of Foreign Direct Investment (FDI) norms announced by the NDA government in November 2015, including in banking, broadcasting, civil aviation, construction, defence and single brand retail. The government also raised the threshold limit of approvals from FIPB.

At the same time, India significantly lags behind countries like China and Japan in the amount of domestic capital committed to private equity funds, in part due to regulatory restrictions on certain pools of capital from investing in the VC/PE asset class. Easing this would help increase the domestic fundraising capacity of VC/PE firms. In addition, investing in or exiting investments in many heavily regulated sectors, such as education, media and retail, remains challenging. The GST bill, which would greatly benefit the manufacturing and logistics sectors, still remains unimplemented. It would augur well for investor confidence if the government were to ease regulations that stifle raising capital for VC/PE funds domestically, increase the ease of doing business in certain heavily regulated sectors, and implement important legislation like the GST bill.

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

After several years of restricted exit options resulting in extended holding periods, PE exits in 2015 generated more than US$ 6 bn, the highest in 10 years. We (NSR) had four liquidity events across the financial services, consumer, logistics and cable/broadband sectors in 2015. Upon opening of the market window for IPOs, three of our portfolio companies (VRL Logistics, Café Coffee Day, and Ortel Communications) completed successful IPOs. We also successfully completed a strategic sale of a financial services business. We are optimistic on the continuation of the positive environment for IPOs and strategic sales of PE backed companies in 2016.



Investor speak

Vishy Chebrol
Managing Director
InvAscent Capital Partners

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

The sectors we operate in Pharma, Healthcare and Medical Devices continue to provide attractive investment opportunities and likely to do so in the future.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about much needed consolidation in certain sectors?

Given that we are focused fund, growth potential coupled with reasonable valuation together make an attractive investment opportunity. We will certainly consider financing domestic deals if there is an underlying rationale for consolidation and the company that is seeking acquisition financing is in a position to execute the consolidation

What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

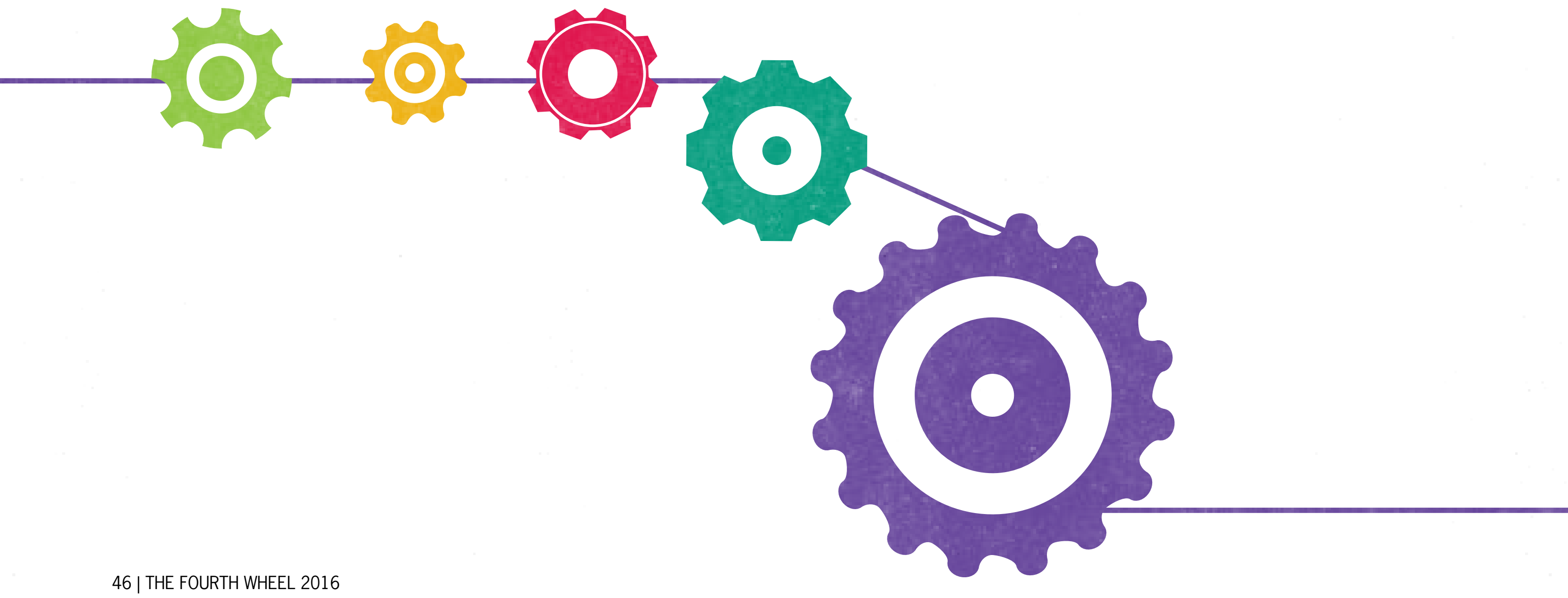
The regulatory framework needs to be consistent, easy to interpret and predictable as this would help in adjusting the investment approach regardless of the specifics of the framework.

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

We are seeing consistent exits from our portfolio. The key challenge has been the Rupee depreciation. If you recollect in 2007 Rupee was below 40 to the dollar. Exits on investments made in 2007 to 2012 have been particularly impacted by the Rupee depreciation post the financial crisis.

On a broader note, India PE firms are facing challenges due to

- high entry valuations based on aggressive projections of growth in top and bottomline of the company. Subsequently this growth did not match up expectations
- rupee depreciation
- lack of public markets as an avenue for exits from 2008 to 2014



Investor speak

Srinivasan Nagarajan
Regional Director – South Asia
CDC Group Plc

How do you describe the PE investment activity in 2015? While volume and value increased average ticket size reduced in 2015 - is it higher share of start-ups funding and/or risk mitigation approach adopted by PE/VCs? What were the key challenges faced and opportunities faced by the PE industry in India in 2015?

The deal activity has gone up, but if one looks at the number of Indian funds which have raised money, there are handful, who have actually completed the process. Fund raising environment has been challenging. The firms, which have consistently delivered value , retained talent and stuck to their core principles and values have been successful in raising funds.

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

Real estate, e-Commerce, healthcare has seen number of deals.

There has been lot of activity in e –commerce, but hopefully there will be more sanity setting in valuations. Additionally there is likely to be more consolidation in this sector.

Healthcare is one sector where India has to go a long way. There are few healthcare companies who really can provide affordable healthcare services of scale at reasonable price points with highest clinical standards.

Retail financial services, SME, financial inclusion and agri financing will continue to play a prominent role in the country - though this segment is subject to vagaries of monsoon. This segment has huge potential for scaling up and is capital intensive.

Food and Agriculture still requires scaling up to attract more players and help producers achieve better realisations. Logistics is a big growth area and it is not only cold chains but also private freight, inland container depots. Indian Railways might look to privatise certain services or enter into a PPP arrangement.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about much needed consolidation in certain sectors?

CDCs core investment principles are job creation and funnelling capital to low income emerging states and not to crowd out private capital. Focus in 2016 will also be renewables and healthcare (trying to focus on affordable healthcare).

Investor speak

In financial services sector, CDC would focus on those institutions which are turning to become small finance banks and to provide support build their long term liability side of the business.

The other interesting area is South-South cooperation i.e to link India to geographies in South Asia like Bangladesh, Myanmar etc. and Africa.

How do you view the Indian Entrepreneurship in recent times? How are you addressing the challenges in managing the relationship with Indian promoters and also the challenges of corporate governance?

Indian Entrepreneur's knowledge of how PE players operate is very high, which helps in the investment process and also improves the environment. Corporate governance is still a journey and has commenced. Currently, the standards are being followed more for compliance and as we move forward hopefully they will strive towards building sustainable businesses.

What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

Complete Regulatory clarity around AIF will be very useful mainly for SFBs who have to raise money domestic capital.

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

The exit avenues over the last three years were mainly through financial investors, strategic exits were very limited. While, public markets opened in 2015, it was for a short while; one more year would have been helpful – hopefully the trend continues in 2016.

Good news is that one can see visibility on exits because of the capital markets and also realisations have been better.

Investor speak

Anand Narayan
Senior Managing Director
Creador Advisors

How do you describe the PE investment activity in 2015? While volume and value increased average ticket size reduced in 2015 – is it higher share of startups funding and/ or risk mitigation approach adopted by PE/ VCs? What were the key challenges faced by and opportunities arisen for the PE industry in India?

Think the lower values could be due to the challenging environment.

Challenges - valuation, competition for deals, lack of high quality deals

Opportunities - New emerging sectors, good IPO traction, digital disruption

What are the key sectors of interest and themes you see providing attractive investment opportunities for PE funds in India?

Creador focus has been on consumer, financials, building materials, healthcare etc.

What would be the most important feature for an attractive investment opportunity for you in the next 12 months? Will it be growth potential of a specific sector or a business or any other factor? Will you consider funding organic growth or financing domestic deals and thereby bringing about the much needed consolidation in certain sectors?

As above. Yes.

How do you view the Indian entrepreneurship in recent times? How are you addressing the challenges in managing the relationship with Indian promoters and also the challenges of corporate governance?

More open to changes. Align investor and promoter interest - rest will follow.

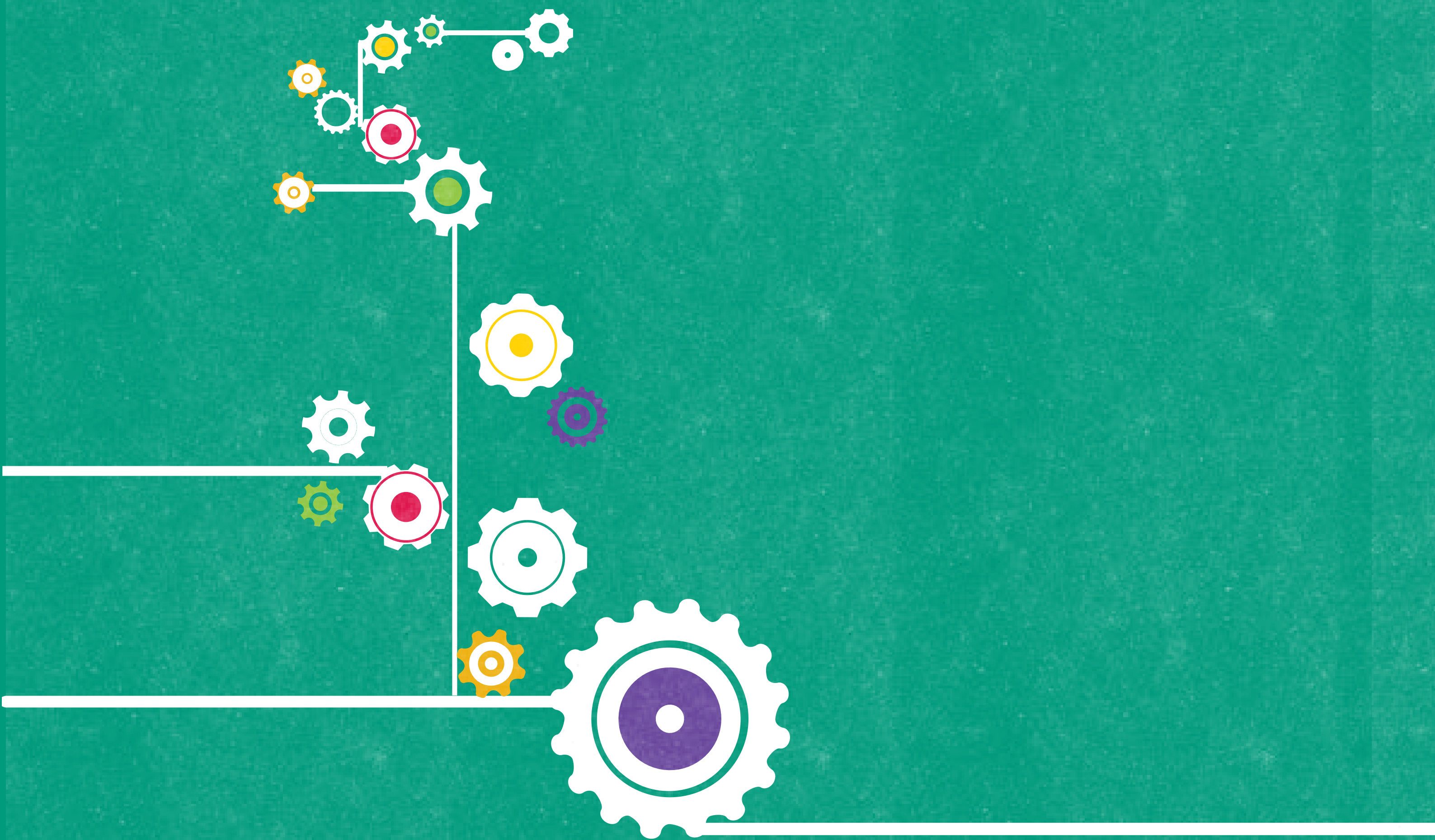
What are the key challenges for PE from regulatory framework and what in your view should be the changes in the regulatory framework?

Simplify taxation, open up sectors for financial investors, facilitate approvals

How are you addressing the challenges in portfolio company exits? Has the investment horizon for PEs extended given the fact that India is looked at a slow (as compared to earlier thought process) but consistent performer?

Focus on business growth & profitability. Yes.

Grant Thornton views



Tax & regulatory developments and key asks for boosting the deal activity

Ravi Mehta
Partner
Grant Thornton India LLP

Private equity (PE) and Venture Capital (VC) investments have been a part of India's growth story for several years, during which there have been a multitude of events shaping the investment climate including several tax reforms. In 2015, India witnessed strong upward trends in PE and VC's transactional activity –both in terms of volume that saw a 73 percent year-on-year growth, as well as value, which grew by 30 percent.

One can attribute these upward trends to the improvement in India's economic fundamentals (inflation being under control and GDP growth being revised to now end higher than anticipated) coupled with the reforms (proposal to bring Goods and Services Tax, opening up of regulated sectors, transparent tax laws, 'single window' approvals mechanism, ease of doing business, Make in India, Digital India, etc.) agenda being pursued by the current Government. All these reforms are aimed to transform the Indian economy and boost the investor's sentiment – both domestically as well as globally. While the Government has achieved success in implementing some of these reforms, there is a lot of ground that still needs to be covered.

For maintaining momentum in the deal-making activity, a lot depends on the government's ability to ensure ease of doing business and providing clarity on tax and regulatory reforms. We have highlighted below some of the key areas that are likely to act as catalyst in boosting the PE/VC activity in the coming years.

Startup India, StandUp india initiative

- This initiative launched in January 2016 unveiled the action plan for startups in the country. The key tax reforms included benefits in form of tax holiday and easier regulatory compliance regime for eligible 'startups'.
- To ensure that only deserving companies benefit out of the Scheme, 'Startup' companies have been defined to cover such companies whose innovative nature of business has been endorsed by a SEBI-registered - incubation, angel or private equity fund having at least a 20 percent equity participation, an accelerator or an angel network. Such companies would need to obtain an eligibility certificate from the Inter-Ministerial Board of Certification and will classify as 'startups' up to five years from the date of incorporation as long as their turnover does not exceeded INR 25 cr.
- The thrust of such companies should be innovation by engaging in development, deployment and commercialisation of new products, processes or services driven by technology or intellectual property.
- Such startups won't have inspection in the initial 3 years from the launch of the venture and have easier regulatory compliances in form of 'self-certification' scheme in respect of the nine labour and environmental laws.
- Any Patent Applications from these Startups would be considered on a fast-tracking basis with an 80 percent exemption in the Patent fees.
- To provide funding support to such enterprises, the Government will also set up a fund of Funds with an initial corpus of INR 2500 cr and total corpus of INR 10000 cr. over a four year period.

REGULATORY INITIATIVES

- Capital markets act as the economic barometer of the country and a useful platform for making exits as well as entry by PE/VC. A robust and well regulated capital market can go a long way in improving the ease of doing business and deal activity in India. Discussed below are a few imperative changes (some of which are in the pipeline) that are critical for the development of the capital markets.

Tax & regulatory developments and key asks for boosting the deal activity

Key SEBI initiatives include:

- Allowing delisting, open offers and buybacks on stock exchange platform: This is a noteworthy step as it makes the process easier and at par with taxation on secondary trading.
- Easing up the delisting regulations: Ability to undertake a direct delisting while acquiring control and reduction in delisting timeline from 135 days to 91 days are progressive steps as it provides a choice to acquirers to structure their business as per their needs
- Softening the listing guidelines for startups: The startup ecosystem in India has been strengthened with an alternative Institutional Trading Platform (ITP). Further, the listing norms on ITP has been relaxed with no cap on funds needed for general corporate purpose, elimination of promoter concept, lower lock-in requirements and water-down of disclosure requirements (just key objects of the issue is required to be disclosed). Simultaneously, the retail investors remain protected with SEBI keeping the minimum investment size of a million (INR10 lakh).
- REITs and InvITs: REITs and InVITs Regulations were introduced with the objective to help real estate and infrastructure developers in raising funds. Owing to certain tax and regulatory uncertainties, REITs/ InvITs hasn't got operationalised so far in India. However, once these aspects get clarified by the relevant authorities, it won't take long for these new instruments to become an investment opportunity for the real estate and infrastructure sector. SEBI had also put up a consultation paper on its website in August 2015 soliciting the comments/views from public on suggestions for making amendments/providing clarifications on InVITs regulations.
- Aligning corporate governance regulations: SEBI has made its regulations on corporate governance and similar matters consistent with the corporate law, thereby removing unnecessary compliance burden on listed companies.
- Tightening insider trading regulations: New insider trading regulations duly aligned with the international practices have been announced. The definition of Unpublished Price Sensitive Information (UPSI) have been strengthened by providing a test to identify price sensitive information and aligning it with the listing agreement to provide a platform for disclosure. The 'insider' definition has also been widened so as to include persons having contractual, fiduciary or employment relationship and gaining access to UPSI.
- Introduction of Foreign Portfolio Investment (FPI) regime: The various routes of foreign portfolio investments such as FII, QFI and FII sub accounts have now been rationalised under one category – FPI. These regulations have made it easier for foreign entities to enter and operate in Indian capital markets.

Key exchange control initiatives include:

- Increasing the FDI limit in defence, insurance, and railway infrastructure.
- Removal of separate caps for FPI and FDI and moving to a composite cap to provide greater flexibility to foreign investors to structure their investment. The compliance burden on the investee company also gets reduced.
- Foreign investments in AIF are now allowed under automatic route which will help the fund raising for startups, SMEs and early stage ventures.
- The Government recently announced 'Big Bang' Foreign Direct Investment (FDI) reforms, easing 35 norms across 15 sectors.

Tax & regulatory developments and key asks for boosting the deal activity

- Some of the key sectoral changes brought introduced were the following:

1. Banking: A composite cap (covers FDI/FPI/QFI without any sub-limits) of foreign investment up to 74 has been introduced provided there is no change of control and management of the investee company. The new rule will give the banks and investors considerable flexibility in raising funds and investing respectively.
2. Construction sector: Several conditions including the floor area restriction of 20,000 sq.m. and minimum capitalisation of US$ 5 mn were removed. Subject to a three-year lock-in, foreign investors are now allowed to exit their investment before project completion under automatic route. This liberalisation should facilitate boosting demand of steel, cement and spur the economic and investment activity, ultimately aimed to Government's agenda of building 50 million affordable houses for the poor.
3. Defence: Foreign investment, including FPI and FVCI, up to 49 percent has been allowed under automatic route from the earlier government approved route.
4. e-Commerce: Manufacturers have been allowed to sell their product through wholesale and/or retail, including through e-Commerce without government approval.
5. Plantation: Except for tea plantation, the government has now allowed FDI in plantation activities (viz., coffee, rubber, cardamom, palm oil tree and olive oil tree plantations) up to 100 percent under automatic route.
6. Broadcasting: FDI limit increased from 26 to 49 percent in FM Radio and News-based television channels under approval route whereas the non-news channels were allowed to receive 100 percent FDI under automatic route. In broadcasting services, FDI has been raised from 74 percent to 100 percent, with foreign investment beyond 49 percent requiring prior approval.
7. Non-resident Indians (NRIs): Investment by companies/ trusts/partnerships owned and controlled by NRIs on non-repatriation basis will now be treated as domestic investment.
8. Retail: Several conditionalities of single brand retail trade (SBRT) and e-Commerce have been eased. Sourcing norms (viz., 30 percent of value of goods to be sourced from India) has been relaxed subject to government approval for segments involving state of art and cutting edge technology. Companies like Ikea could benefit from this move. Entities that have been granted permission to undertake SBRT, are now permitted to also do e-Commerce. 100 percent FDI is now permitted in duty free shops.
9. Aviation: Scope of Aviation has been enhanced so as to cover Regional Air Transport Service apart from Scheduled Air Transport Service/Domestic Scheduled Passenger Airline. Additionally, FDI limits in Non-Scheduled Air Transport Service, Ground Handling Services, Satellites-establishment and operation and Credit Information Companies have now been increased from 74 percent to 100 percent. Further, sectors other than Satellites- establishment and operation are now covered under the automatic route.

- Other changes in rules:

1) No government approval is required for investment in automatic route by way of swap of shares.

2) LLP: 100 percent FDI in LLPs has been permitted under automatic route, in sectors where 100 percent FDI is allowed and there are no FDI linked performance conditions.

3) For facilitating faster approvals on most of the proposals, the government also raised the threshold limit of approval by Foreign Investment Promotion Board from the earlier Rs 3,000 cr to INR 5,000 cr. Those above INR 5000 cr are placed for consideration of the Cabinet Committee on Economic Affairs.

4) For infusion of foreign investment into an Indian company which does not have any operations and also does not have any downstream investments, government approval will not be required for activities under the automatic route and without FDI-linked performance conditions.

5) The crux of these reforms is to further ease, rationalise and simplify the process of foreign investments in the country, which in turn could foster the M&A activity.

TAX INITIATIVES

- The key tax benefits included in the 'Startup India, Stand-up India' Scheme are - a 3-year tax holiday to the eligible companies and a waiver of Capital Gains Tax to the investor. This however becomes effective only after a formal Parliamentary nod in the upcoming Budget session.

Tax & regulatory developments and key asks for boosting the deal activity

- The announcement of MAT not being applicable to FIIs retrospectively brings the much awaited clarity around taxation reform
- The permanent establishment norms have been modified to remove adverse tax implication for offshore funds with a fund manager in India
- It is reported that the renegotiation of the India-Mauritius tax treaty is at an advanced stage and certain 'substance' or 'limitation of benefits' criteria are expected soon. Once concluded, this may have a major impact on the debate surrounding Singapore and Mauritius structures.
- The deferment of GAAR till 2017 is likely to improve the overall tax environment in the country.
- The government has assured that there will ordinarily be no retrospective taxation and has refrained from appealing against the adverse decision of Bombay High Court in case of Shell and Vodafone Transfer Pricing cases.

Key tax and regulatory reforms which are in the pipeline:

- GST: This game-changer reform is anticipated to boost up the Indian GDP by 1-2 percent. Once implemented, GST is expected to facilitate in removing inter-state barriers and boosting interstate trade in volumes. Additionally, simplification in tax procedures will increase the tax revenue collection. GST will create a level playing field between imports and Indian manufacturing, and help realise the vision of 'Make in India'. Non-compliance in trading sector is expected to get reduced under GST regime thereby bringing the trading and manufacturing at par and increasing competitiveness.
- Rationalisation of corporate tax rate to 25 percent: The government recently unveiled an ambitious reform plan to lower the corporate tax rate from 30 to 25 percent and bring the rate closer to global levels. The draft plan - presently open for public comments - aims to clarify the income tax law, which is laden with tax exemptions and deductions thereby giving rise to abuse and tax disputes. This is a good step towards simplification of tax laws, which is expected to bring about transparency and clarity.
- Crowd funding norms for startups: Crowd funding essentially means solicitation of funds from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause. Crowd funding mode of fund raising is quite prevalent in countries such as the US, China, and the UK. SEBI is in the process of finalising crowd funding norms for startups which are aimed to create funding avenues for startups and small companies.
- International Financial Service Centre (IFSC): IFSC is a dedicated hub of financial services participants within a country, which has its own earmarked laws and regulations. IFSCs generally have low tax rates and flexible regulations to keep them attractive for foreign investments. The Finance Minister, Arun Jaitley has announced in the last Union Budget that India's first IFSC will be set up in Gujarat International Finance Tec-City (GIFT), near Ahmedabad. GIFT has now been launched and this initiative could have a far reaching impact on the growth of Indian financial sector. Government, SEBI, RBI and IRDA will be coming up with a regulatory framework for governance of the IFSCs.
- Indian Financial Code: The Financial Sector Legislative Reforms Commission (FSLRC) has laid down a draft framework, 'Indian Financial Code' proposing to substantially replace the existing financial laws. Various steps are being taken in this regard - For instance merger of FMC with SEBI. The second revised draft has been opened for public comments.
- Development of new capital markets products: The use of new and innovative products such as gold-backed schemes and deposits, REITs and InVITs should be incentivised. Since these products replicate the returns from physical assets, they are likely to get a lot of interest from retail investors and will help in channelising household savings to capital markets.

The link between the policy initiatives and Deal activity can be clearly sensed from the fluctuations in deal values over past years. Much, therefore, now depends on how quickly the government can build its policy momentum to boost the investor's sentiments.

With all the macro indicators looking positive, the current PE/VC traction will continue to grow. Moreover, amidst the visibility of more on-ground action around government's key policy reforms, the stage is set to witness a high growth in the deal activity in the coming year.

Startup – challenges and opportunities

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Challenges

India ranks at 130 according to The 2016 World Bank Ease of Doing Business (out of 189 economies). On an average, Indian businesses need to make 33 tax payments annually with around 243 hours spent to prepare and pay taxes in a year. In contrast to this, China requires just nine tax payments annually, while the US doesn't trouble its taxpayers more than 11 times annually for their tax payments. The stringent policies and regulatory environment pose a major restriction for companies to start their business in the country. Taxation, multi window clearances, red-tapism and bureaucracy are some of the issues associated with the country in general. Moreover, historically the government's role was fairly limited to providing funding in terms of grants and loans. However, the eco system and the operating environment is expected to undergo a change due to our Prime Minister – Narendra Modi's focus on policy initiatives and restructuring to enable the right environment for this space to foster and grow. Key challenges currently faced by the startup space in India can be broadly classified as follows:

Culture and Awareness Issues

The Indian culture has conditioned people to look down upon failure. Entrepreneurship is often about failing and learning from those failures and starting all over again. Hence, the right environment is imperative to overcome this mentality. The most common questions for anyone to become an entrepreneur are:

- Most common questions for anyone to become an entrepreneur
  - What to do: problem related to creating a business idea, finding business opportunity or having a vision
  - Why to do: issues related to reward/incentive analysis, risk evaluation or any other benefits
  - How to do: issues related to legalities and requirements such as clearances, licenses, approvals required. Issues related to resource availability including finances, technology and manpower supply

- What to do: problem related to creating a business idea, finding business opportunity or having a vision
- Why to do: issues related to reward/incentive analysis, risk evaluation or any other benefits
- How to do: issues related to legalities and requirements such as clearances, licenses, approvals required. Issues related to resource availability including finances, technology and manpower supply

Social Issues

- Mentorship/Guidance: Most founders of failed startups feel that the lack of proper guidance and mentorship is a major reason behind their failure.
- Market structure: Indian markets are largely unorganised and fragmented that create a roadblock for a startup to succeed
- Consumer behaviour: Behaviour of Indian consumer changes in every 30-50km that makes it really difficult for a startup to create business or market strategy for their products or services. Most startups generally get stuck in stagnancy and gradually shut down.
- Location: An important problem faced by startups is related to location of their business. India is a place of varied culture and taste and thus every product might not be welcomed equally in every region.

Technology Issues

- Market structure: Indian markets are largely unorganised and fragmented that create a roadblock for a startup to succeed.
- Consumer behaviour: Behaviour of Indian consumer changes in every 30-50 km that makes it really difficult for a startup to create business or market strategy for their products or services. Most of the startups get stuck in stagnancy and gradually shut down.
- Location: An important problem faced by startups is related to location of their business. India is a place of varied culture and taste and thus every product might not suit every region.

Startup – challenges and opportunities

- Cyber security
  - Technology infrastructure- Appropriate IT-infrastructure has become a need for Indian businesses, given the growing number of consumers online. Hence, its vital for new startups to train their employees for handling critical customer information such as that of credit card numbers and related sensitive data.
  - Cyber security - Most startups have a B2B business model and are unaware of the cyber risks that may arise. Also, with the absence of a back-up plan to keep the statrtup business running in case of exigencies, makes them prone to a potential shutdown.

Financial Issues

- Operational finance:
  - Most startups are self/family funded with limited workforce which makes it difficult to maintain records both financial and operational.
  - Flawed business models and lack of innovative revenue strategies have led to the failure of many startups and they are forced to shut down operations
  - Overcoming unnecessary business steps to manage business operations
- Funding/capital deficiencies:
  - Capital and access to capital has been a perennial problem for startups
  - Government and private sector investors have set aside funds through investment channels but they are not available for all forms of business.
  - In the initial phase of operations, startups do not get funding from banks given no credit history of the firm. In addition, there is limited number of credit rating firms for small and medium sized enterprise
  - Despite having raised good investments, startups struggle to survive the competition. Startups are unable to mitigate the gap between burn rate and revenue
- Cash flow management
  - Effective cash management is an important factor to achieve objectives both short term and long term. Cash is still a preferred option for payments owing to the fact that electronic payment has not achieved complete penetration to Tier 2 and Tier 3 cities
  - Gap between burn rate and revenue: Given rising competition from peers both from big as well as small, it becomes imperative for startups to scale up the business and require external funding for the sustainability/growth in the market.

Sustainability Issues

The level of knowledge that business advisers have about ecological issues and their willingness to discuss this with their clients is important in creating business ventures.

- Lack of information - provision of more information directly to business founders could help in the adoption of more sustainable business practices.
- Not aware of potential that might exist for their startup business.

Opportunities

Policy Initiatives

Make in India

In September 2014, Prime Minister Narendra Modi introduced a big initiative "Make in India" to promote the manufacturing sector by promoting companies to invest in the sector. The intent of the campaign is to attract foreign investments and encourage domestic companies to participate in the manufacturing thereby contributing to the growth story. The government also took various steps to build a favorable environment to do business in the country. For example, an online system for environment clearances, filling income tax returns and extension of validity of industrial licenses to three years have been put in place.

StartUp India

The Prime Minister also aims to build systems for enabling startups and wants to make the country as a number one destination for startups. In August 2015, he announced a new campaign "Standup India" to help startups with bank funding and encourage entrepreneurship among the young Indians. He also requested all 1.25 lakh bank branches to fund at least one startup founded by tribals and dalits.

Startup – challenges and opportunities

Standup India:

On 6th January 2016, the Union Cabinet has given approval to Standup India campaign which aimed at promoting entrepreneurship among women and scheduled castes and tribes. Some of the salient features include:

- Loans under the scheme would be given for greenfield projects in the non-farm sector,
- Intention of the scheme is to facilitate at least two such projects per bank branch,
- The scheme is expected to benefit at least 250,000 borrowers in 36 months from the launch of the Scheme.

Digital India

This is an initiative led by the Indian government to ensure that government services are made available to every citizen through online platform. In July 2015, the PM announced the Digital India initiative that aims to connect rural areas by developing their digital infrastructure. This translates into a huge business opportunity for startups.

In September 2015, PM Modi visited Silicon Valley, US and had meetings with a number of founders of technology firms and industry leaders such as Satya Nadella and Sundar Pichai to talk about his ambitions of developing a better startup ecosystem

According to NASSCOM startup report 2015, every year more than 800 tech startups are being set up in India. By 2020, a projected 11,500 tech-startups are going to emerge and will employ around 250,000 people.

Financial assistance

In his Union Budget speech for 2015-16, Finance Minister Arun Jaitley announced government's plan to set up Micro Units Development Refinance Agency (MUDRA) Bank and a Credit Guarantee Fund with a refinance capital of INR 20,000 cr and INR 3,000 cr.

- In April 2015, the government launched Mudra Bank to boost growth of small businesses and manufacturing units
  - The new Bank would provide a credit facility of up to INR 50,000 to small businesses, loan of up to INR 5 lakh to little bigger businesses and loan of up to INR 10 lakh to the MSME sector

MUDRA Scheme: On 6th January 2016, the Union Cabinet has given approval to the following proposals:

- The cabinet has approved the creation of a Credit Guarantee Fund for MUDRA loans
  - It is expected that the fund will guarantee loans of over INR 1,00,000 cr to micro and small businesses in the first instance
  - According to the finance minister, the MUNDRA scheme is expected to provide benefits to 1.73 cr. People
  - The fund will guaranteeing loans sanctioned under Pradhan Mantri Mudra Yojana w.e.f. 08th April'15
- The cabinet also given its go ahead to convert MUDRA Ltd. into MUDRA Small Industries Development Bank of India (SIDBI) Bank as a wholly owned subsidiary of SIDBI

Additionally, the government has set a target to provide a total loan of INR 1.22 Lakh cr. to promote new entrepreneurs and fund the unfunded businesses with the help of banks.

India Aspiration Fund: The finance minister also announced the India Aspiration Fund to encourage the startup ecosystem and allocated INR 400 cr. to various venture funds. He also launched another program called SMILE (SIDBI Make in India Loan for Small Enterprises) with an allocation of INR 10,000 cr. The objective of the scheme is to offer soft loans in the form of quasi-equity and term loans on soft terms to MSMEs.

Startup Exchange

The SEBI announced a new set of listing norms for startups, including e-Commerce ventures, planning to raise funding from listing on stock exchanges. These new norms will provide relaxations in disclosure related requirements, takeover and Alternative Investment Fund regulations for IT, data analytics, and intellectual property, bio-technology or nano-technology companies

Self-Utilisation and Talent Utilisation (SETU)

The government is planning to set up a mechanism called SETU, under the newly formed NITI Aayog, to provide technical assistance and incubation to startups. In 2015 Union Budget, Finance Minister, Arun Jaitley, has set aside INR 1,000 crore for support startups.

Startup – challenges and opportunities

Role of large businesses

Big corporates primarily focus on innovation, performance excellence and risk management in order to compete in the dynamic global business environment. Issues related to tightening of research and development budgets, increasing digital disruption and organisational bureaucracy make it difficult for large companies to innovate on their own.

- Many corporates are now shifting their focus from investments into their own research and development to investments in multiple source of innovation, focusing in particular on technology based startups.
- Nandan Nilekani plans to invest US$ 1-2 mn in startups in sectors including telecom, aerospace, publishing, logistics etc.
- Ratan Tata recently invested an undisclosed sum in Tracxn, a Bengaluru-based startup intelligence firm
- Corporates collaborate with other small firms including startups by investing fully or partially to access to their pool of talent, assets and capabilities.
- Big firms often look at smaller companies as they are more agile, with less bureaucracy and fewer approvals required to develop innovative products.

Startups in India have managed to get funding from various informal channels including corporate, angel/seed or VC funding. There are a few startups with innovative business ideas which have managed to raise funds through "crowdfunding", where a large number of investors contribute capital through various channels including internet, mail-orders, events etc. For example, startups such as Ketto, BitGiving and Wishberry have raised money through this concept. Over the few recent years, "crowdfunding" as a concept has gained popularity globally, however, in India, it is still at a nascent stage and is expected to pick up as a regular funding channel with an increase in awareness.

Possible impact of startup incubators

Startup incubators are companies that assist new startups in their initial phase of development by providing various services. Incubators share both tangible and intangible resources such as equipment, office space, services such as accounting, computing and legal services. They also assist startups in raising startup capital and perform various networking activities to reduce the financial burdens and resource issue. Incubators help entrepreneurs in building sustainable business environment while benefitting the broader corporate communities.

According to NASSCOM report, there has been a 40 percent growth in the number of incubators and it is expected to reach approximately 110 in 2015 as against around 80 in 2014.

- Around 50 percent of the total incubators are set up in non-metro cities i.e. outside NCR, Bengaluru and Mumbai.
- Growing number of educational institutes have started setting up incubator programmes independently or jointly. Shri Ram College of Commerce, New Delhi for instance has set an incubator to help their students in their own startups; VESIT College of engineering has set up an incubation centre with the same objective.
- Big corporates are also setting up incubator programmes to help startups. Tata Group launched T-Hub, Google, Microsoft Ventures etc.
- The Tata group has come up with country's largest technology incubator centre 'T-Hub' in Hyderabad.

Government's initiative towards startups under the Startup India Action Plan (Launched on 16 January 2016):

The 'Startup India' Action Plan strives to create an entrepreneurial ecosystem through:

- Self-certification Compliance Regime - Aim: To reduce regulatory burden on Startups.
- Startup India Hub - Aim: To create a single point of contact for the entire Startup ecosystem
- Relaxed norms for Public Procurement - Aims To provide an equal platform to startups (in the manufacturing sector) vis-à-vis the experienced entrepreneurs/ companies in public procurement.
- Legal support and fast-tracking patent examination at lower costs - To promote awareness and adoption of IPRs by startups and facilitate them in protecting and commercialising the IPRs the governments aims to provide access to high quality Intellectual Property services and resources, including fast-track examination of patent applications and rebate in fees.

Startup – challenges and opportunities

- Faster exit policies, to make it easier for startups to wind up operations.
- Exemption from capital gains tax – exemptions shall be given in case capital gains are invested in the fund of funds recognised by the government. In addition, existing capital gain tax exemption for investment in newly formed MSMEs by individuals shall be extended to all startups.
- Tax exemption for startups – To promote growth of startups, profit of startups, set up after April 1,2016, shall be exempted from income-tax for a period of three years.
- Tax exemption on investments above fair market value – In line with the exemption available to venture capital funds to invest in startups above fair market value (FMV), investments made by incubators above FMV shall also be exempted.
- PPP model is being considered for 35 new incubators; 31 innovation centres at national institutes and seven research parks along with five new bio-clusters.
- A mobile app will be launched on 01 April 2016, through which startups can be registered in a day. There will be portal for clearances, approvals and registrations as well.
- In order to provide funding support to startups, Government will set up a fund with an initial corpus of INR 2,500 cr. and a total corpus of INR 10,000 cr. over a period 4 years (i.e. INR 2,500 crore per year) . This fund will be in the nature of fund of funds, which means that it will not invest directly into startups, however shall participate in the capital of SEBI registered Venture Funds. The fund shall ensure support to a broad mix of sectors such as manufacturing, agriculture, health, education, etc.
- Credit guarantee fund for startups - To catalyse entrepreneurship by providing credit to innovators across all sections of society. Debt funding to startups is also perceived as a high risk area and to encourage banks and other lenders to provide Venture Debts to startups, credit guarantee mechanism through National Credit Guarantee Trust Company (NCGTC)/ SIDBI is being envisaged with a budgetary Corpus of INR 500 cr. per year for the next four years.
- Organising startup fests for showcasing innovation and providing a collaboration platform - To galvanise the startup ecosystem and to provide national and international visibility to the startup ecosystem in India.
- Launch of Atal Innovation Mission (AIM) with Self-Employment and Talent Utilising (SETU) programme - To serve as a platform for promotion of world-class innovation hubs, Grand Challenges, Startup businesses and other self-employment activities, particularly in technology driven areas.
- Harnessing private sector expertise for incubator setup - To ensure professional management of Government sponsored/funded incubators, Government will create a policy and framework for setting-up of incubators across the country in public private partnership.
- Building innovation centres at national institutes - To propel successful innovation through augmentation of incubation and R&D efforts.
- Setting up of seven new research parks modelled on the research park setup at IIT Madras - To propel successful innovation through incubation and joint R&D efforts between academia and industry.
- Promoting startups in the biotechnology sector - To foster and facilitate bio-entrepreneurship.
- Launching of innovation focused programmes for students - To foster a culture of innovation in the field of science and technology amongst students.
- Annual incubator grand challenge - To support creation of successful world class incubators in India.

Valuing startups: an e-Commerce perspective

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e-Commerce Industry: Valuation Perspective

Characteristics of Startups

Traditional valuation methods are only reliable and efficient under the assumption of a going concern. The characteristics of startups are unique and pose a challenge to the traditional valuation methods.

The key characteristics of startups which are responsible for posing these challenges are:

1. Nascent Operations or No operating history –The state of operations in startups is so nascent that very limited historical data is available. Most of them have only one or two years of operations and in many cases, for only a portion of the year.
2. Small or no revenue stream – The usefulness of the little operating history that startups have is further reduced by the fact that Revenues are small or non-existent for such companies.
3. Operating Losses – In the startup stage of the company, the focus is more on establishing the product/ service and capturing a market share, rather than generating revenues.
4. High Cash Burn Rate – The investment needs of startup companies is extremely high, therefore, these companies usually have a high cash burn rate.
5. Complex Shareholding Structure – The need to raise funds in the initial stages of the company leads to a relatively large number of capital providers within both debt and equity.
6. Illiquid Investments – Investments in startup companies are highly illiquid, especially as compared to publically listed companies, as the investments are more than often privately held and in non-standardized units.

To deal with these valuation impediments, innovative valuation approaches have evolved over time. In the sections below, we closely look at these valuation methods.

Valuation of Early Stage Companies

a. Venture Capital Method

Venture Capital (VC) represents the money provided by investors to fund startups with perceived long term potential. This represents a very important source of funding for startups that do not have access to capital markets or bank funding.

The method starts by setting a target rate of return on investment (ROI), which is typically between 30-70 percent, due to the high risk factors inherent in startup companies. After seeing potential in the business, the growth is forecasted and expected future earnings are calculated.

Further a Terminal Value (TV) is estimated by projecting revenues, and estimating profits based on industry standard or comparable profit margins for the exit year. Based on these projected revenues, earnings and terminal value, a present value of the company is estimated, and the stake to be held by the investor is estimated by dividing the investment amount by the equity value of the firm. The following example summarizes the VC Method:

ASSUMPTIONS	
Annual Earnings	US$5,000,000
Exit Year	5
P/E Ratio	15x
ROI	50%
Initial Investment (a)	US$3,500,000
Current Shares Outstanding (b)	1,000,000

Valuing startups: an e-Commerce perspective

The Terminal Value of the firm is calculated by multiplying the terminal year earnings by the terminal year PE ratio.

TV = Annual Earnings x PE Ratio

Value of the Firm

The value of the firm is then calculated by discounting the Terminal Value at the required ROI for the investment period.

Value=(Terminal Value)/(1+ROI)^(No.of Years)

Value of the Firm (c)	US$ 9,876,543
Equity Stake (d) = (a)/(c)	35.44%
Total Outstanding Shares (e)	1,548,887
Shares held by VC	548,887
Share Price (f) = (c)/(e)	US$ 6.38
Pre-Money Valuation (g) = (f)*(a)	US$ 6,376,543
Post-Money Valuation (h) = (f)*(e)	US$ 9,876,543

b. First Chicago Method

The First Chicago Method starts by defining 3 future scenarios, looking forward 3 to 7 years. These scenarios are Success, Survival and Failure. Different revenue growth rates and profit margins are assumed under each scenario, based on which earning for the exit year is projected.

Based on the above projections, a fair equity value of the company is estimated under each of the 3 cases by calculating present value of the company using appropriate discount rates. Once, the present values are calculated, the value of the company is taken as a weighted average of the 3 values under each case, weighting them based on the probability of occurrence of each of the scenarios. An example of the First Chicago Method is summarised below:

ASSUMPTIONS	Success	Survival	Failure
Base Year Revenues	US$100	US$100	US$100
Revenue Growth Rate	100%	50%	5%
Net Income Margin	20%	10%	-ve
P/E Ratio	10x	10x	NA

The discount rate used under each scenario is 25 percent. Also, the probability of occurrence of each scenario is the same i.e. 33 percent. The investment amount is US$20 and is assumed to be held for 5 years, which is the Terminal Year (TY) of the company.

For the Terminal Year, Revenues are calculated by compounding the Base Year Revenues at the respective Revenue Growth rates. Net Income is calculated based on the respective Net Income Margins and Revenues (TY). The Value of the Firm under each scenario is then calculated by applying the respective PE Ratio to each of the Net Incomes in the Terminal Year.

	Success	Survival	Failure
Revenue (TY)	US$3,200	US$760	US$128
Net Income (TY)	US$640	US$76	-
Value (TY)	US$6,400	US$760	US$5*
PV of Company	US$2,097	US$249	US$2
Weights	33%	33%	33%
Weighted PV	US$692	US$82	US$0.50

*Assumed Liquidation Value

Equity Value of Company	$774.50
Equity Stake	2.59%

c. Scorecard Method

The Scorecard Method compares the target company to companies at similar stages of development, typically comparable angel funded start-up ventures.

The method begins by estimating an average of the pre-money valuations of the companies shortlisted which could be based on actual transactions data in the industry, after which the target company is compared to such companies and scored on certain value drivers. These value drivers and the range of weights (indicative) considered for each of them are mentioned in below example.

Value Driver	Weight	Score	Value Factor
Strength of Management	30%	1.35	0.405x
Size of Opportunity	25%	1.80	0.450x
Product/ Technology	15%	1.00	0.150x
Competitive Environment	10%	0.45	0.045x
Marketing/ Sales/ Partnerships	10%	0.60	0.060x
Need for Additional Investments	5%	1.00	0.050x
Others	5%	1.00	0.050x
TOTAL	100%		1.210x

Assuming an average pre-money valuation of $1,500,000 of companies at similar stage of development based on actual transactions in industry, the equity value of the target company is estimated by multiplying the total value factor (1.210x) by the average pre-money valuation ($1.50mn)

d. **Backsolve Method**

The Backsolve method uses the Black-Scholes-Merton option pricing equation to estimate the value of the company. However, this method can only be used when the value of at least one class of equity securities is known. Thus, this method uses the value from the most recent transaction or round of funding as a benchmark to value the remaining classes of equity securities.

The following table summarised the capital structure of a Company ABC Limited

CAPITAL STRUCTURE	
Series A Preferred Stock	
Issue Date	31/12/2015
Issue Price	$30,000,000
No. of Shares Issued	30,000,000
Liquidation Price (per share)	$1.00
Conversion Ratio	1:1
Common Stock	
No. of Shares Outstanding	45,000,000

Since preferred stock have liquidation preference over common stock, ABC's total equity value will first be allocated to preferred stock up to a value of US$ 30 mn, with no value being allocated to common stock. Any incremental value beyond US$ 30 mn up to US$ 45 mn will be allocated to common stock. Above the total equity value of US$75 million, it is economically advantageous to convert preferred stock to common stock; therefore, any incremental equity value above US$ 75 mn will be allocated to both equity holders based on their proportionate ownership in ABC's fully diluted shareholding. Therefore, based on these payoffs, the breakpoints or thresholds for value allocation in the waterfall are determined.

PAYOFF BREAKPOINTS		
1st Payoff	US$0	100% - Preferred Stock
2nd Payoff	US$30,000,000	100% - Common Stock
3rd Payoff	US$75,000,000	60% - Common Stock 40% - Preferred Stock

Now that the thresholds are established, the Option Pricing Method (Black-Scholes-Merton Model) will be used to value common stock via the Backsolve method. The Black-Scholes-Merton equation is employed where the value of the common stock is based on the value of the optionality of the common stock, over and above the value of the preferred stock at each of the three breakpoints.

Valuing Startups: an e-Commerce perspective

OPTION PRICING INPUTS		
Variable	Assumption	Source
1st Exercise Price	US$0	Beginning Value
2nd Exercise Price	US$30,000,000	Preferred Stock Liquidation
3rd Exercise Price	US$75,000,000	Preferred Stock Conversion
Term	3.5 years	Expected Time to Exit
Volatility	40%	Comparable Public Company Data
Risk-Free Rate	2%	US Treasury Rate

OPM BACKSOLVE METHOD				
OPM Variable	Breakpoint 1	Breakpoint 2	Breakpoint 3	
Asset Price	US$ 55,576,793	US$ 55,576,793	US$ 55,576,793	
Exercise Price	US$ 0.00	US$ 30,000,000	US$ 75,000,000	
Term	3.5	3.5	3.5	
Volatility	40%	40%	40%	
Risk Free Rate	2%	2%	2%	
Call Option Value	US$ 55,576,793	US$ 30,353,635	US$ 11,942,106	
VALUE ALLOCATION				
Preferred Stock	100.00%	0.00%	40.00%	
Common Stock	0.00%	100.00%	60.00%	
				Total Value
Incremental Value	US$ 25,223,158	US$ 18,411,528	US$ 11,942,106	US$ 55,576,793
Preferred Stock	US$ 25,223,158	US$ 0	US$ 4,776,843	US$ 30,000,000
Common Stock	US$ 0	US$ 18,411,528	US$ 7,165,264	US$ 25,576792

The call option value for Breakpoint 1 i.e. the beginning value is back calculated based on the value of the known equity security ($ 30 million of preferred stock in this case) through iterations using softwares (such as goal seek in MS Excel). Based on this call option value, the asset price for the company is again back calculated using iterations. This asset price remains constant for all Breakpoints.

The Black-Scholes-Merton equation then uses this asset price and other inputs mentioned above to estimate the call option value for each Breakpoint. The incremental value is calculated as the difference between 2 subsequent call option values, and is allocated to different classes of equity as mentioned in the payoff table on the previous page.

IndAS: Impact on investment accounting

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A. Investment in business

Each organisation needs funding for business at some stage of its business cycle. Investment in business is a very crucial decision, since it not only requires business analysis but also investments outcome and its status at each stage. To understand position of investment, lender would need financial statement or disclosures of utilisation of its funding.

One of the lenders for business is Venture capital (VC). VC does funding to support companies at various stages which may be either at early stage of business, or at emerging stage or at growth stage. Funding can be in various formats:-

- equity in the investee;
- plain lending in the form of debt of investee;
- lending in the form of debt with option to convert it into equity;
- lending in the form of debt with lesser rate of interest but with an option to put it back to investee with pre-determined IRR;
- lending with many exit options; etc

The typical venture capital investment occurs after a seed funding round as the first round of institutional capital to fund growth in the interest of generating a return through an eventual exit event, such as an IPO or trade sale of the company. Venture capital is akin to private equity but many a times with many options either to exit or to convert to pure equity.

B. Preference of VC for funding

VC is attractive especially for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. VC for accepting the high risk by investing in smaller and less mature companies usually get significant control over decision matters, irrespective of the company's ownership. VC not only provides funding but also guidance and direction so that reasonable return can be access through that investee.

As discussed earlier, how VC needs to ensure its funding's output and whether utilisation is as per agreed criteria. There are very few ways in which VC can do so, for example:-

- Regular management information data
- Financial statement
- Observing the business relevant activities via nominee director

However, in all cases at the end result proves the final outcome and for that the only adequate way is reliable financial statement. This note discusses various accounting approach which can be useful information for VC while evaluating financial statements of the invetsee.

C. Prescribed Accounting Standards:

The Ministry of Corporate Affairs (MCA) has notified two sets of Accounting Standards till date

- Companies (Accounting Standards) Rules, 2006 (2006 Rules) and;
- Companies (Indian Accounting Standards) Rules, 2015 (Rules 2015).

Rules prescribed in 2015 are applicable to all listed companies and all unlisted companies whose net worth is more than INR 2500 mn. These rules are very recently notified by MCA and its applicability is from 2016 in phased manner so that it may cover all such companies by 2018. Rest of the companies would be within the bracket of Rules, 2006.

To provide guidance on investments, Rules 2006 prescribes Accounting Standard (AS) 13 Accounting for Investments and Rules 2015 prescribes Indian Accounting Standard (Ind AS) 109 Financial Instruments for accounting of Investments. Accounting of investments under AS 13 and Ind AS 109 can broadly be classified as historical (cost) based approach and fair valued based approach respectively.

IndAS: Impact on investment accounting

D. Investment accounting by investee companies:

AS 13 classifies investments into two categories: (a) "Current Investments" and (b) "Long Term investments'"

a. Current Investments: An investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. Current investments are valued at lower of cost or fair value.
b. Long term investments: An investment other than a current investment. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline.

Ind AS 109 prescribed classification of financial assets or investments into two categories: (a) "at amortised cost", and (b) "fair value". Fair value category is further defined as either 'fair value through other comprehensive income' or 'fair value through profit or loss'. However Under Ind AS 109, on initial recognition all the investments are valued at fair value.

a. Amortised cost: Investee may classify the investment into this category, provided both of the following conditions are met:

- The financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows, and;
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

b Fair value through other comprehensive income: : Investee may classify the investment into this category, provided both of the following conditions are met:

- The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, and;
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

c. Fair value through profit or loss: If any investments fail to classify either at amortised cost or at fair value through other comprehensive income, it can be valued at fair value through profit or loss. Apart from this, investee may also select an option to designate any investment into this category. There are classification criteria which should meet for such designation.

E. Understanding and way forward:

Objectives of investments are different at different investee, hence we have to understand the business model to identify the different categories of investments.

Few objectives are as below:-

- To eliminate or reduce the liquidity risk
- To mitigate or ensure that there is no credit risk
- To manage the performance of the equity in the market
- To ensure growth of Capital i.e. yielding higher values at the time of sale
- To ensure constant rate of yield

The basic objective of accounting is reflection of business and strategy under which investments are made. It is given that under all fundamental objective and business model of investments there are any of the following criteria

- To keep it till the maturity of investment, i.e. generally pure debt investments in good rated instruments, Or;
- Gain from sell of investments in the mid to long term, Or;
- Trading.

Accounting should also be in such way that regulators can keep track of underlying with its value to observe the value add in investments. Business model based classification

IndAS: Impact on investment accounting

will provide more relevant information to users of financial statements as one can depict the underlying principles for making investments in particular class of instruments.

F. Debt V/S Equity:

The terms of a financial instrument / Investments into investee may contain elements which are representative of both equity and liability classification. Where this is the case, the instrument is known as a compound financial instrument from an investee perspective. How investee will do the accounting of such instruments?

We will look at the accounting for compound instruments, discussing:

- the principle of classification in accordance with substance rather than legal form
- 'split accounting' for the equity and liability components of a compound instrument

The standard requires the principle of substance over legal form to be applied in accounting for compound financial instruments. This involves separating the compound financial instrument into its separate components on initial recognition, a process which is often referred to as 'split accounting'.

Let us understand the accounting by investee with the help of an example. Taking the example of a convertible bond, split accounting is performed by first determining the carrying amount of the liability component. This is done by measuring the net present value of the discounted cash flows of interest and principal, ignoring the possibility of exercise of the conversion option. The discount rate is the market rate at the time of inception for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by the conversion option is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. The split of the instrument between debt and equity and the amount of the respective components is determined on initial recognition and is not altered subsequently to reflect the likelihood of conversion of the instrument. This approach is consistent with the definition of an equity instrument because equity is the residual interest after deducting liabilities

Other examples of possible compound financial instruments include instruments with rights to a fixed minimum dividend and additional discretionary dividends, and instruments with fixed dividend rights but with the right to share in the residual net assets of the issuing entity on the entity's liquidation.

Split accounting is always done from the issuer's perspective. However the classification done by issuer is also applicable to holder of the instrument.

Most of the investments done by venture capitalists may be within the format of compound financial instruments.

Accounting in the books of Investee, if following criteria given in the investment document:-

Scenario	Monetary value of consideration provided by investor	Number of equity shares to be given to investor	Classification in the books of an invetsee
1	Fixed	Variable	Financial liability
2	Variable	Variable	Financial liability
3	Variable	Fixed	Financial liability
4	Fixed	Fixed	Equity

IndAS: Impact on investment accounting

If the instruments are classified as financial liability, it will have impact on debt equity ratio and companies may find it difficult to raise funds from Banks and other financial institutions, since pay out on such instrument would be accounted as finance cost in the profit and loss account.

If the same is classified as an equity it will tantamount to sharing of control by the company and will also improve the debt equity ratio of the company. However investor may need to assess control for consolidation purpose.

G. Based on discussion above here are some of the commonly issued instruments and accounting thereof in the books of investee:-

Some guidance for VC on how investee will account their investment if they invest in the following instruments

1. Compulsorily redeemable preference shares

The basic principle is that the shares which have a fixed date for redemption, or which give the holder an option to redeem the shares at some point in time, are classified as financial liabilities in the books of investee. This is because the invetsee is not able to avoid the obligation to pay cash upon the redemption of the shares.

2. Compulsorily convertible preference Shares at a fixed number of shares with mandatory dividend payments

The standard contains specific guidance on non-redeemable preference shares. It clarifies that when preference shares are non-redeemable; the classification depends on a careful analysis of the other rights attaching to them. If distributions are mandatory then the shares are compound financial instruments. Investee has to apply split accounting. Dividend will be classified as financial liabilities and the convertible portion of preference shares will be classified as equity.

However, if distributions to holders of the preference shares (whether cumulative or non-cumulative) are at the discretion of the issuer, the entire above instruments is equity instruments.

3. Perpetual debt instruments with mandatory interest payment

The non-redeemable preference shares in the above example are one type of ‘perpetual’ debt instrument. Other forms of perpetual debt instrument include some bonds, debentures and capital notes.

Perpetual debt instruments normally provide the holder with the contractual right to receive payments of interest at fixed dates extending indefinitely. Holders normally have no right to receive a return of principal. A perpetual debt instrument which has mandatory interest payments is a liability in its entirety. The value of the instrument is wholly derived from the mandatory interest payments.

However, if perpetual debt instruments with no contractual right to receive payments of interest then the same would be accounted as equity instruments in the books of the investee.

Be wary of fraud risks

Vidya Rajarao
Partner
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Introduction

In 2015 deal value clocked US$ 47 bn across 1,600 transactions as compared to 2014 that witnessed US$ 49 bn in deal value across 1,200 transactions. In 2015, primary investments and acquisition activity was focused on services sector, energy and natural resources, IT and ITES, banking and financial sector, pharmaceuticals, healthcare and biotechnology. These sectors have contributed around 80 percent of the overall deal value in 2015. Further, 2015 witnessed increased investments in startups.

Against this backdrop, it is clear that the factors that attract investments (e.g, expectations of growth, early stage enterprises that require capital for expansion etc.) also pose significant risks in terms of fraud, leakage and abuse. For example, diversion of cash and assets to non-core activities, related parties, associated companies and competing entities are not uncommon. So, it is critical that an investor balances risk and reward before investing. However this requires a deep understanding of fraud risks that are possible and fraud mitigation measures that one can adopt prior to investment.

Beware of these fraud risks

First and foremost is cash leakage or diversion of cash to other companies, related parties, associated entities etc. or for plain personal enrichment or use. This is an area that is fraught with complexity with the ever expanding labyrinth of colleagues, former employees, relatives, family members, close friends etc. as well as maze of related entities (including trusts, partnership firms, and sole proprietorships). In addition, there can be competing business entities that are not part of the transaction and monies invested are likely to be diverted to such other competing business at the cost of the investee company's business.

Second, fraud in the procurement cycle is an all-time favourite especially given long-standing informal vendor relationships and weak or ineffective controls. Further, bid rigging or kickback schemes imply that the investee company is not benefitting from true competition and hence, paying above market prices or getting low quality.

Third, revenue fraud i.e. fictitious sales, bogus customers and/or products, suspicious high sea sales, book entries, false invoicing schemes etc. can erode deal value quickly and also lead to increased regulatory scrutiny.

Fraud mitigation measures

Given the increased risks to deal value from the above illustrative fraud risks, it is imperative than an investor undertake robust fraud mitigation measures. Further, anti-fraud controls must be tailored to the industry/sector specific issues and cover fraud schemes and scenario based reviews rather than plain vanilla transaction diligence based on ostensible audited financial statements.

It is critical that fraud mitigation measures are included at every stage in the investment cycle i.e., pre-deal, during deal closure and post-deal as set forth below:

Pre-deal

a) Conduct comprehensive background check on the investee entity and its key individuals including promoters and key members of management; The check should go beyond a routine desktop checks and include discreet field visits and checks on its employees, vendors and customers to truly understand possible undisclosed motivations and triggers for the deal from the investee company and promoters perspective.

b) Conduct forensic review of revenues, customers, key spend, vendors and employees in addition to standard financial due diligence or FDD. The forensic review should

Be wary of fraud risks

primarily gather information using discreet checks that can then be corroborated with information shared by the investee company and being reviewed by the FDD teams .

During deal closure

c) Adjust for deal value and build contingencies in the Share Purchase Agreement or governing document. Include staggered payments, escrow for consideration withheld for contingencies etc.

d) Obtain proper and clear representation for past acts and ensure that such representations are tailored to the deal at hand and not merely a 'copy paste' from other deal documents

e) Include relevant clauses for alternate dispute resolution (i.e. mediation or arbitration) in case of a dispute and ensure that litigation counsel (not corporate counsel) review these clauses so that the dispute resolution clause itself does not become an item of dispute'

Post -deal

f) Ensure periodic (e.g., quarterly, bi-annual) monitoring of cash flows, revenues and spend

g) Undertake a fraud schemes and scenarios review of key processes to assess vulnerabilities and effectiveness of controls

h) Go beyond data or documents shared at Board meeting and engage in a dialogue with external and internal auditors.

i) Once an issue is identified, investigate thoroughly and take proper and timely remedial action

Conclusion

As outlined above, there are significant opportunities as well as risks in investment. Investors should follow the maxim of 'Trust, but verify' before making an investment and take adequate measures to protect and monitor their investment in these uncertain times.

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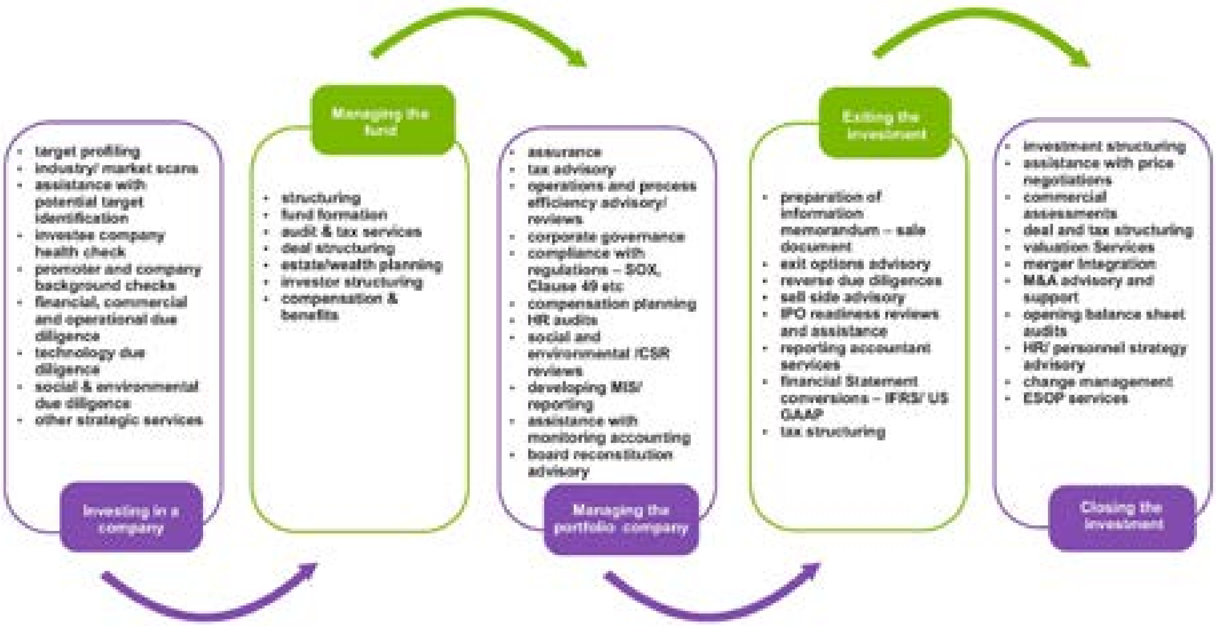

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About this publication

Methodology

The deal data for this report has been sourced from Grant Thornton's Dealtracker report. This report includes views from experts across leading Private Equity (PE) / Venture Capital (VC) funds. We highlight that the views of the investor are their personal views and may not always necessarily reflect the views of the organisation. The reference to PE in the report includes VC unless mentioned otherwise. Deals have been classified by sectors based on certain assumptions, wherever necessary. If different assumptions were to be adopted, the classification would therefore be different.

Please write to contact@in.gt.com for details on the list of private equity deals in India

Disclaimer:

This document captures the list of deals announced based on information available in the public domain and based on public announcements. Further, our analysis of the deal values is based on publicly available information and based on appropriate assumptions (wherever necessary). Hence, if different assumptions were to be applied, the outcomes and results would be different. Grant Thornton India LLP does not take any responsibility for the information, any errors or any decision by the reader based on this information.

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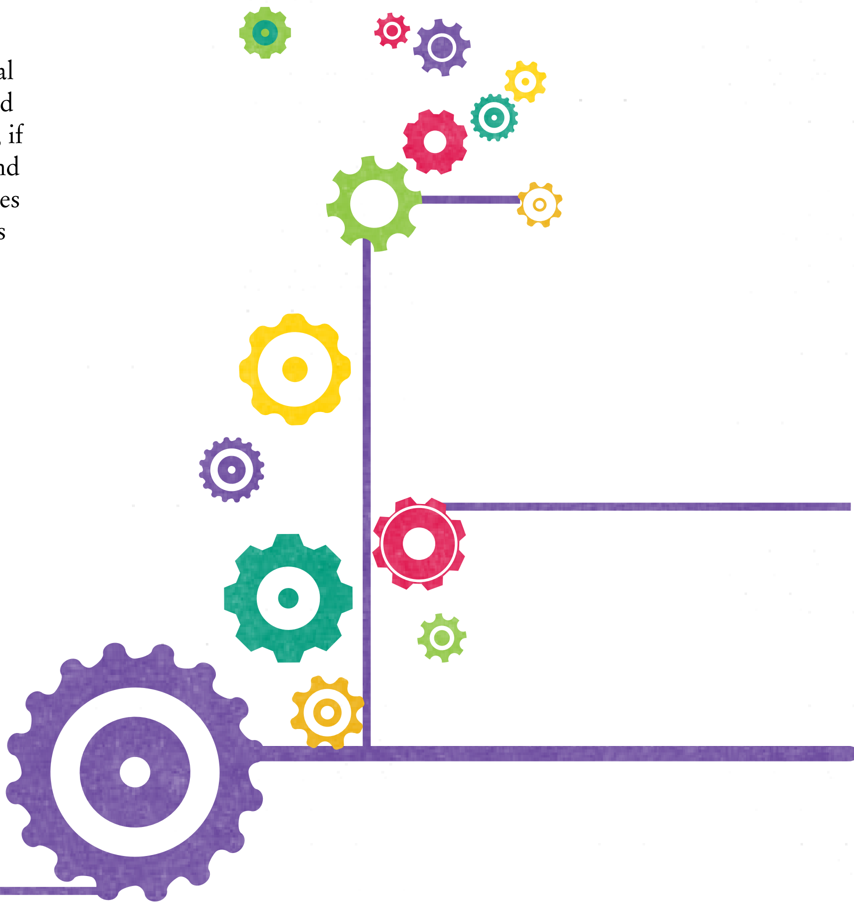

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