The Fourth Wheel 2015

Private Equity in the corporate landscape

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

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Foreword by IVCA

Sanjay Nayar
Chairman IVCA, KKR India Advisors Pvt. Ltd.

It has always been our endeavour at IVCA to provide timely insight for the Indian Venture Capital (VC) and Private Equity(PE) Industry. Thus, it is with great pleasure that we, along with our member and partner, Grant Thornton, present the third edition of the PE report titled "Fourth Wheel." Previous Fourth Wheel issues and the current one have also been produced by Grant Thornton in association with IVCA.

At a time when the VC/PE industry is well poised to become the funding of choice for dynamic companies in their growth plans, this report will be very useful for understanding the role of VC/PE in India's growth.

The report has significant data on investments by VC/PEs and tracks the growth of the industry across sectors and sizes based on the Grant Thornton Dealtracker, which has been a pioneer in deal tracking and VC/PE deals over the past decade. Through this report, Grant Thornton has also shared an analysis of the industry based on the experience of Grant Thornton professionals on due diligence, frauds, structuring and sector insights. In addition to this, Grant Thornton also interviewed some reputed PE professionals for their insights.

The present time is clearly one which holds promising growth opportunities for India Inc. With a stabilising capital market and hopes of new reforms, we expect heightened interest from global investors in the India opportunity in the coming year.

We believe the report provides insights on the current opportunities and challenges in the industry, along with providing a detailed analysis of investment trends.

We look forward to your feedback and continued support.

Foreword by Grant Thornton

Harish HV
Partner
India Leadership Team
Grant Thornton India LLP

"…we have seen PE investors investments are nearly at $100 billion over the past 15-20 years…"

We are pleased to present the third edition of the "Fourth Wheel", a publication on PE in India along with IVCA who have been our partners in this endeavor from the beginning. This report aims to set out the key emerging trends in the Indian PE industry deal data based on Grant Thornton's Dealtracker report, and views from experts across leading PE/VC funds and entrepreneurs.

I would like to restate the logic behind using the title "Fourth Wheel" for those of you who are first time readers. The Indian corporate landscape had been dominated by 3 different types of companies for a long period of time; the public sector, the private sector and multinationals, over the past decade-and-a-half. Now, however, we are seeing the emergence of the fourth variety, which is companies owned/supported by PE, we call this segment the "Fourth Wheel.". For the sake of clarity, we have used the word PE to include all institutional investors whether they are VC or PE, buyout, distress etc.

As we stand in 2015, we have seen PE investors investments are nearly at $100 billion over the past 15-20 years. Our own Dealtracker, which was launched in 2005 has covered about $ 90 Billion of PE investments. PE investment in India is growing steadily and stood at over US$12bn seen in 2014 alone. Presuming that they own an average of 25% of the companies they have invested in, and there is no appreciation or depreciation in the value, the value of the companies invested by PEs can be estimated at US$ 400bn. This is about 24% of the total market capitalisation of BSE as compared to 15% when we first launched the Fourth Wheel. Hence the "Fourth Wheel" can justifiably be a separate category within India Inc and the size of the fourth wheel is clearly increasing.

Earlier we had funds which were focused on providing only growth capital. Today, we have funds at all stages of the lifecycle be it seed, venture, growth, buyout or distress. Moreover, PE investors have developed sector focuses and are increasingly playing key roles in the investee companies' strategic decisions be it revamp of top management or hiring talent, inorganic growth plans (domestic and crossborder), providing product or market related insights etc. Hence, young and early stage companies are keen to have such sector focused PEs on their board to enhance their position and perception in the industry.

Foreword by Grant Thornton

"PEs are in the forefront of creating new businesses, particularly in the tech and e-commerce space which is making some fundamental changes in the way businesses and economies function.

Today dynamic companies seek PEs not just for capital but the significant value addition they bring in to the business and their ability to drive growth and value. PEs have also been a critical part of creating the new age and first generation entrepreneurs and enabled them to unleash their energies in creating and scaling businesses rapidly and generating value for themselves and the investors and obviously helping the economy. **PEs are in the forefront of creating new businesses particularly in the tech and e-commerce space which is making some fundamental changes in the way business and economy function.**

Having highlighted the increased interest from PE investors in the India growth story, it is important to note that we are stepping into a crucial year in terms of exits for the investments made thus far. While there have been good examples of successful exits in the past year despite the lacklustre IPO market, a majority still awaits an exit. This is possible only when companies are able to fundamentally improve business and operational metrics and there by open up attractive routes for secondary sale or IPO. For this to happen, we hope to see changes on several fronts to materialise. I have highlighted these earlier too, and would not mind reiterating them:

- improvement in corporate governance benchmarks in the investee companies
- clarity and eventual implementation of regulatory changes in taxation and other areas
- entry valuation linked with fundamental growth opportunities in order to result in meaningful exits
- emergence of new sectors catering to inclusive growth

We are extremely positive about the industry and the role it has played and will play in the growth of the Indian economy. We are also optimistic about the future of investing in India and the growth potential of Indian companies and are sure the industry will see its returns growing in the coming years with the positive economic sentiment that prevails in India today.

I hope you find this report insightful and wish you all the success!

Editorial

Raja Lahiri
Partner
Grant Thornton India LLP

It is not an overstatement to say that PE has become more than just a provider of capital to companies looking for funding for various reasons. PEs have started playing key operational and advisory roles in the success of their investee companies. We are currently witnessing an evolved and a matured PE market in India with increased focus on returns/exits and buyouts.

During 2014, we witnessed PE investments of US$12bn (604 deals) as against US$ 10bn (450 deals) in 2013. The top three PE deals in 2014 were in the ecommerce sector which had Flipkart securing US$1bn and US$700 mn in back to back rounds of funding and Snapdeal securing US$627 mn.

Currently, the theme around ecommerce and technology enabled consumer sectors appears to be attractive for investment This is due to the significant potential for this sector to play out, given the opportunity to increase internet penetration in India. IT & ITES has contributed close to 50% of the total deal values in 2014 with ecommerce alone driving most of the sector deal values. We expect this wave to continue in the coming year too along with significant consolidation activity as competition intensifies and companies should start showing results and returns for the funds invested. 2015 could also be a key year for infrastructure and real estate as we hope to see a slew of much awaited reforms being implemented in the sector.

With investments returning towards the heightened activity levels seen in 2007, focus on exits and new rounds of fund raising has become key for the PE industry. While PE firms compete with each other in chasing quality assets and promising sectors, a lot of care has also been taken by them to carefully monitor existing and new investments in order to avert unpleasant surprises when the investment are due for exits.

With the new government in place, we are already seeing a revival in business sentiment with aggressive push in reforms in various sectors such as infrastructure, real estate, medical devices, insurance and banking etc. This could result in a gush of inflows into companies in these sectors and PEs have an important role to play in making meaningful investment and exit decisions in the coming year.

I believe that the PE Industry in India will continue to play a very active role as a key partner for entrepreneurs in India's growth story.

Overview of PE Investments

10 year trend analysis

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2014 PE round up

E-Commerce topped the PE investment charts in 2014; the wave is expected to result in consolidation trends in 2015 within the segment

$12bn, 604 deals

34%↑ in volumes over 2013

23%↑ in values over 2013

IT/ITES, REI and BFS were key sectors in 2014

Top PE Investments in 2014				
Investor	Investee	Sector	Stake	US $ mn
Morgan Stanley Investment Management, GIC, Accel Partners, DST Global, Iconiq Capital and Sofina	Flipkart Online Services Pvt Ltd	IT & ITES	N.A.	1,000.00
Baillie Gifford, Greenoaks Capital, Steadview Capital, T Rowe Price Associates, and Qatar Investment Authority and existing investors	Flipkart Online Services Pvt Ltd	IT & ITES	N.A.	700.00
Softbank Corp	Snapdeal	IT & ITES	N.A.	627.00
Canada Pension Plan Investment Board	Kotak Mahindra Bank	Banking & Financial Services	3%	366.67
Brookfield Property Partners	6 IT Parks in India	Real Estate	N.A.	347.00
Capital Square Partners, CX Partners etc	Aditya Birla Minacs Worldwide	IT & ITES	100%	260.00
Naspers Ltd.; Tiger Global Management; DST Global; ICONIQ Capital	Flipkart Online Services Pvt Ltd	IT & ITES	N.A.	210.00
Softbank Corp	Olacabs	IT & ITES	N.A.	210.00
Warburg Pincus	Kalyan Jewellers India Pvt Ltd	Retail & Consumer	24%	195.60
Temasek, IDFC Alternatives	GMR Infrastructure	Infrastructure Management	12%	183.00

Key PE Exits in 2014

Secondary sale was the preferred route of exit in 2014

100+ exits

>US$5bn

Led by IT/ITES

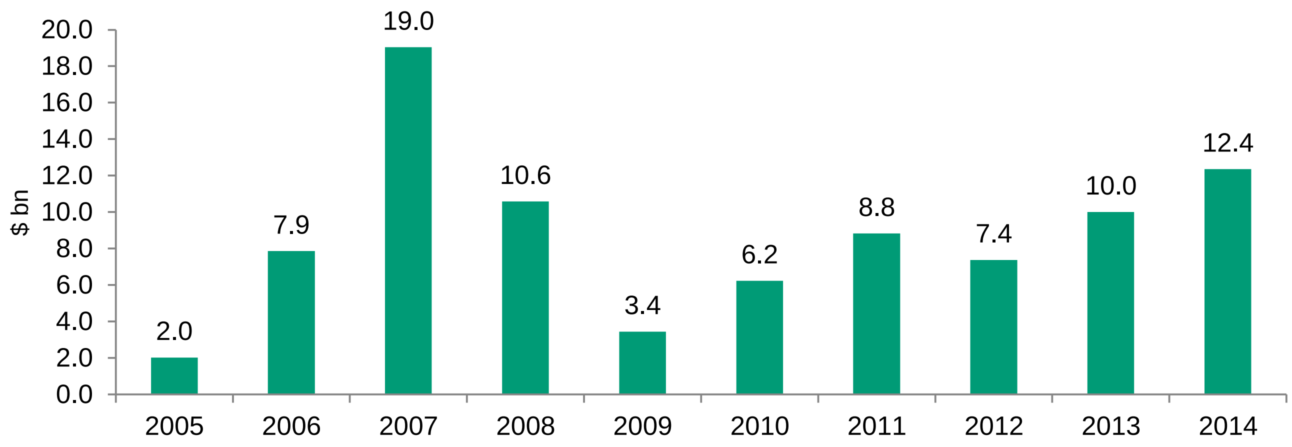
Investor Exited	Investee	Sector	Comments
IDFC Alternatives	Galaxy Mercantiles Limited & Blueridge SEZ	Real Estate	IDFC Alternatives has made a complete exit from these investments and by selling assets to realty funds managed by Blackstone.
Essar Global Fund Limited	Aegis Limited USA Inc - Aegis Group	IT & ITES	Essar Global Fund Limited is selling Aegis USA Inc, outsourcing company for a consideration of US$610 Mn to Paris-based outsourcing firm Teleperformance.
Chrys Capital	HCL Technologies	IT & ITeS	The fund, which invested US$180 million for HCL stake, offloaded 2% for close to $500 million in open market deals .
Bain Capital Partners	Hero MotoCorp Ltd	Automotive	Bain Capital Partners has sold 7.08 % of its remaining holding in Hero MotoCorp Ltd via secondary market share sale taking its total exit value to over US$700 million (including dividends),
Temasek	Medreich Ltd	Pharma, Healthcare & Biotech	Temasek held close to 33 % in Medreich, which it had picked nine years ago for around US$25 mn. Japanese Meiji Seika Pharma acquired Medreich for US$290 mn
The Carlyle Group	Tirumala Milk Products Private Limited	Retail and Consumer	Lactalis acquired Tirumala giving Carlyle an exit from its original investment in May 2010
Providence	Idea Cellular	Telecom	The PE firm exited through open market sale
SAIF Partners	Just Dial Pvt Ltd	IT & ITES	SAIF Partners, one of the early investors in local search provider Justdial, has sold one third of the stake held
The Carlyle Group	Cyberoam Technologies	IT & ITES	Carlyle is exiting its seven year old investment in Ahmedabad based Cyberoam Technologies. The PE fund is selling its 80% stake in the company to UK's Sophos Group

*This list is not exhaustive and information on exits is based on data from public sources. The list does not highlight exit values and returns

10 year PE investment trend

Steady increase in PE investment values since 2009. 2007 remains the year that attracted maximum PE funds

Investment Value – $ bn

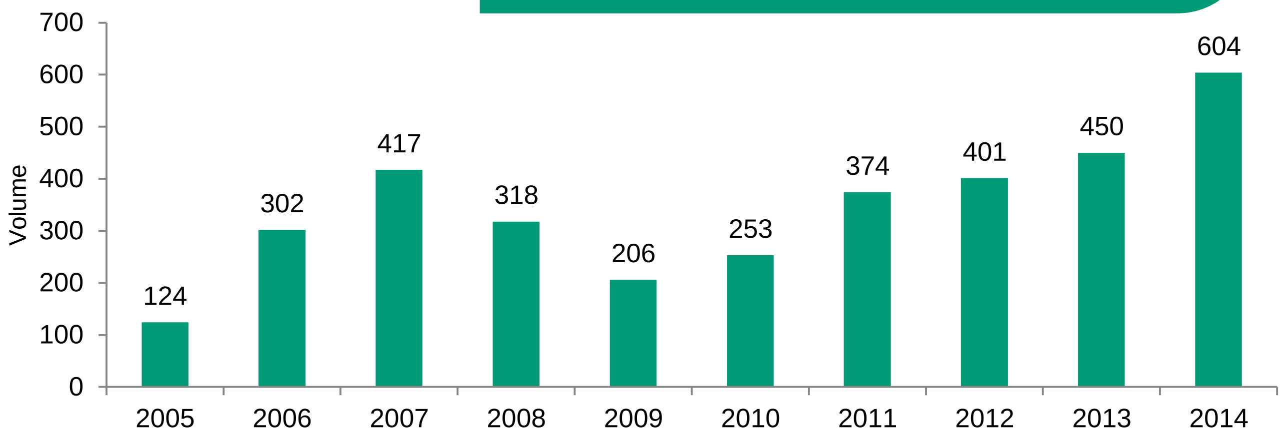


Volumes in 2014 have touched all time high in a decade with close to 604 deals. This was largely due to increase in investments in the technology enabled consumer space including e-commerce.

"I do see increased positivity towards Indian PE opportunities. As far as LPs are concerned, while they appear more open to investing in Indian funds, at this stage this has not yet translated into significant additional allocations. However, direct investors have certainly become more active. As a result, the Indian PE industry should witness greater investments and, very importantly, more exits. "

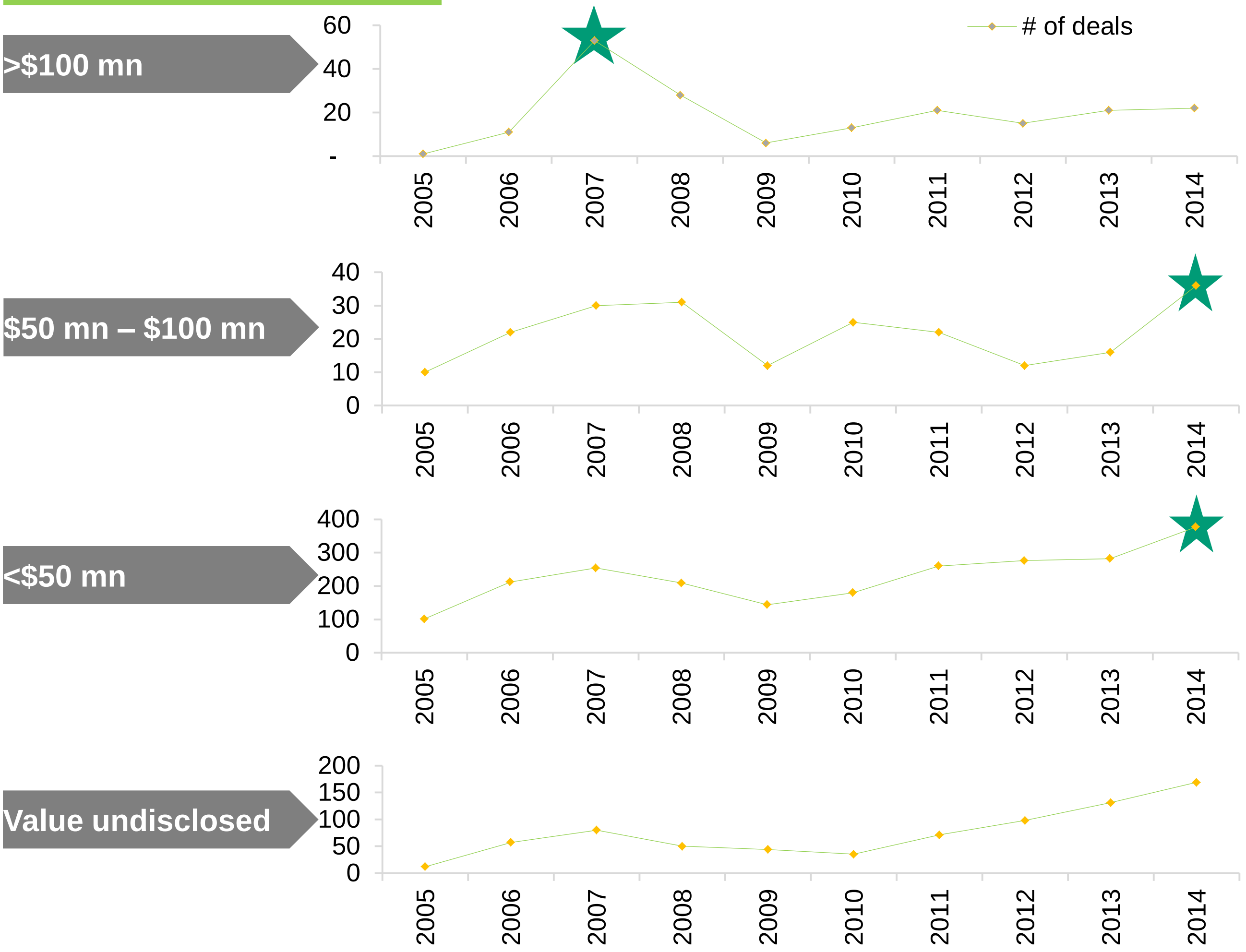
Jayanta Banerjee
Managing Partner, ASK Pravi Capital

Number of deals

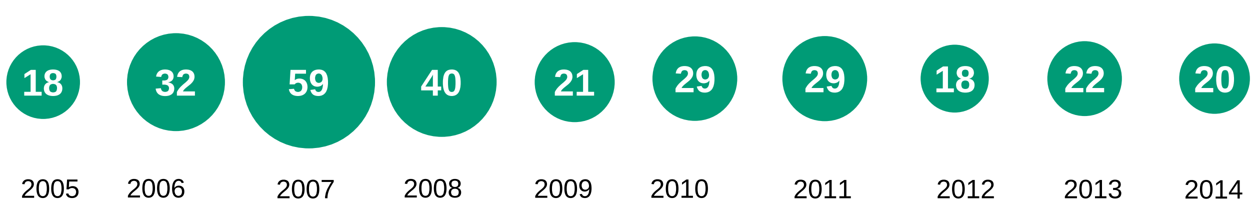


2014 recorded maximum sub $100mn deals while 2007 continued to lead the big ticket (>$100mn) deal pack

Value Range Analysis



Average deal size US$ mn

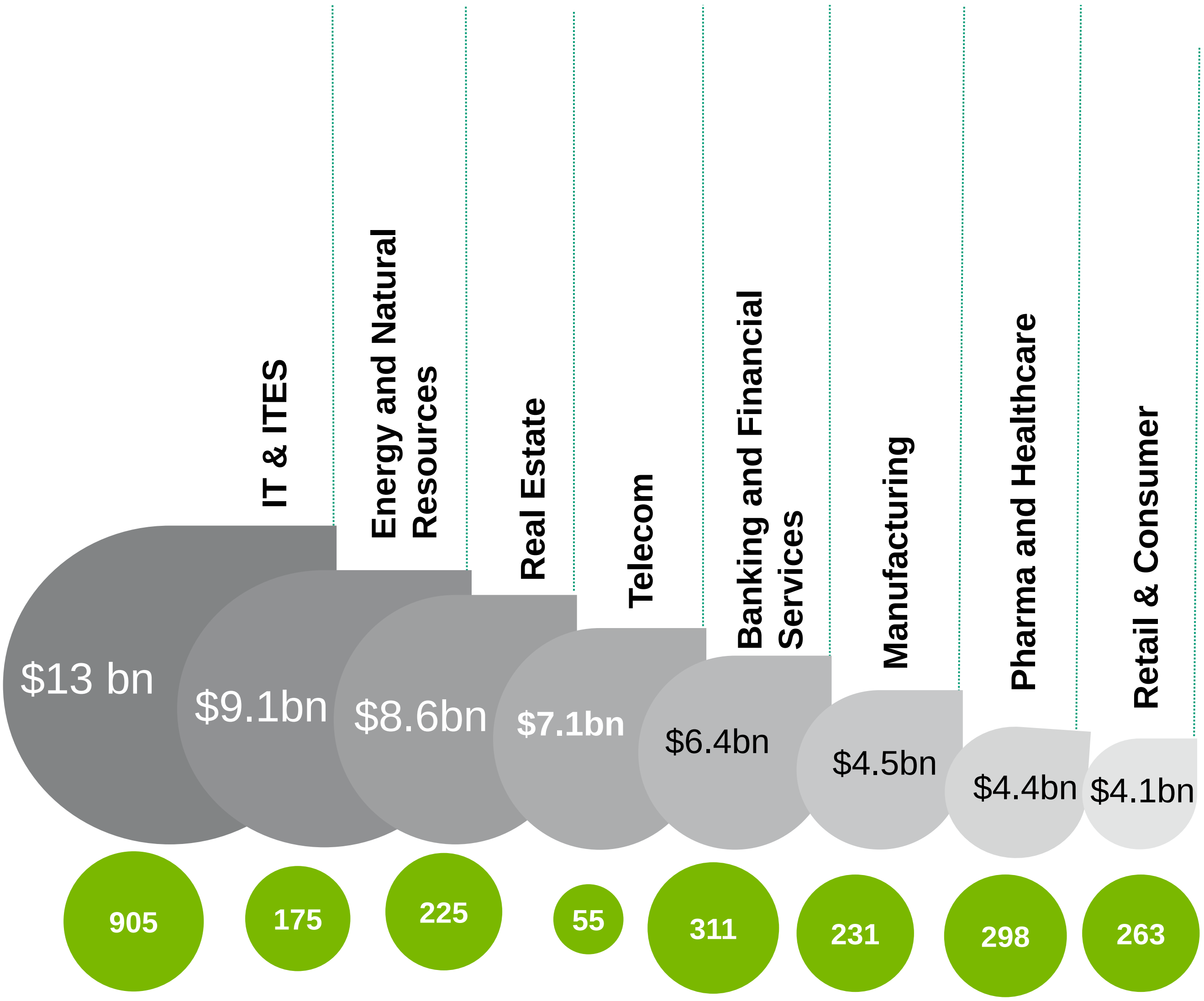


10 year chart toppers

Four out of the top ten largest PE deals during 2005-14 came from the year 2007 and 2 of them from 2014

Top 10 deals 2005-2014					
Year	**Investor**	**Investee**	**Sector**	**$ mn**	**Stake**
2007	Temasek Holdings	Bharti Airtel Ltd	Telecom	1,907	5%
2013	Qatar Foundation Endowment	Bharti Airtel Ltd	Telecom	1,260	5%
2006	Kohlberg Kravis Roberts & Co	Flextronics Software Systems	IT & ITeS	1,035	85%
2007	Temasek Holdings, The Investment Corporation of Dubai, Goldman Sachs, Macquarie, AIF Capital, Citigroup and India Equity Partners	Bharti Infratel (subsidiary of Bharti Airtel Ltd)	Telecom	1,000	10%
2014	Morgan Stanley Investment Management, GIC, Accel Partners, DST Global, Iconiq Capital and Sofina	Flipkart Online Services Pvt Ltd	IT & ITES	1,000	N.A.
2012	Bain Capital	Genpact Ltd from GA and Oak Hill Capital	IT & ITES	1,000	30%
2011	Bain Capital,Government of Singapore	Hero Investment Private Ltd	Automotive	848	30%
2007	ICICI Venture Funds Management Company	Jaypee Infratech (subsidiary of the Jaypee Group)	Real Estate & Infrastructure Management	800	N.A.
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	Real Estate & Infrastructure Management	767	N.A.
2014	Baillie Gifford, Greenoaks Capital, Steadview Capital, T Rowe Price Associates, and Qatar Investment Authority and existing investors	Flipkart Online Services Pvt Ltd	IT & ITES	700	N.A.

Sectors attracting highest PE investment in the last decade



IT&ITES has attracted investments worth $13bn from over 900 deals

Industry insights

Jayanta Banerjee
Managing Partner,
ASK Pravi Capital Advisors Pvt Ltd

With the new Government in place, business sentiment has clearly improved and this augurs well for overall investment climate in India. Do you see any impact of this on the PE investments.

Yes, I do see increased positivity towards Indian PE opportunities. As far as LPs are concerned, while they appear more open to investing in Indian funds, at this stage this has not yet translated into significant additional allocations. However, direct investors have certainly become more active. As a result, the Indian PE industry should witness greater investments and, very importantly, more exits.

What are the key themes you see providing attractive investment opportunities for PE funds in India

The Indian consumer theme and its derivatives. I include the e-com rush within this theme. Some positive government action could also give impetus to the infrastructure theme, though it is not evident at the moment.

How do you see the Indian entrepreneurship in recent times. What are some of the challenges in managing the relationship with Indian promoters ?

The key challenge is the way the Indian entrepreneur views a PE fund that has a minority shareholding. In most of the cases, the entrepreneur views the fund as a mere investor, and not a partner. Most of the conflicts that emerge are on account of this approach.

Whilst there is a level of optimism that can be drawn from this year's performance, there remain some key challenges fundamental to the industry such as fundraising, regulation and deal flow. What do you believe are the key challenges facing PE at this point in time?

Fundraising, exits, integrity of promoters, lack of clarity on tax matters for domestic funds.

What is your view of the new PE fund raising environment expected in 2015 ?

Slightly better than 2014

As we know, 2007-08 saw significant PE investments at high valuations – and as we are approaching the end of the average 5-6 year investment horizon in 2014-15, do you expect the level of exit activity to increase in the coming year, with the upbeat market condition? Which would be the most preferred exit route?

Secondary sale to another PE.

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

Clarity on tax matters for domestic fund and on pooling for international funds

The risk of fraud is often ignored, having a larger impact on the investment. With reference to the pre and post investment risks faced by PE firms in the Indian market, what do you view as the key issues to corporate governance?

High control over business by promoter.

Sector snapshot

Changing landscape

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Sector snapshot

IT/ITES and retail & consumer sectors continue to see upward trend while banking and financial services (BFS), real estate and infrastructure (REI) and pharmaceuticals are expected to be attractive opportunities in 2015

By Value US$mn	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
IT & ITES	78	851	371	488	215	398	1,443	2,057	2,046	5,274	13,222
Energy & Natural Resources	2,332	879	476	947	431	1,676	1,053	360	476	473	9,102
Real Estate			82	3,313	801	627	962	718	954	1,559	9,015
Telecom	2,100	1,406	114	1,397	144	515	61	1	1,260	110	7,107
Banking & Financial Services	183	416	84	819	364	594	810	707	1,106	1,356	6,440
Manufacturing	744	104	231	939	155	491	829	217	514	338	4,562
Pharma, Healthcare & Biotech	177	10	225	337	148	320	281	907	1,376	632	4,415

By Volume	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
IT & ITES	21	25	59	59	36	41	104	137	161	262	905
Pharma, Healthcare & Biotech	13	4	25	18	16	30	19	38	70	50	283
Retail & Consumer			18	52	19	20	29	27	36	44	245
Banking & Financial Services	9	7	3	17	4	6	30	45	43	43	207
Real Estate	8	24	27	32	26	33	22	24	30	41	267
Education	28	20	44	24	14	12	23	22	16	34	237
Media & Entertainment	17	16	28	22	15	23	16	22	18	26	203

Top sectors in 2014

Top 5 sectors contributed 79% of PE investment values and 67% of volumes in 2014

IT&ITES

262 deals $5.2 bn

43% of PE volumes in 2014
43% of PE values in 2014

Pharma and Healthcare

50 deals $0.6 bn

8% of PE volumes in 2014
5% of PE values in 2014

Retail & Consumer

44 deals $ 0.7 bn

7% of PE volumes in 2014
6% of PE values in 2014

Real estate & Infrastructure

57 deals $2.4 bn

9% of PE volumes in 2014
20% of PE values in 2014

Banking & financial services

43 deals $1.4bn

7% of PE volumes in 2014
11% of PE values in 2014

IT& ITES

Grant Thornton Insights

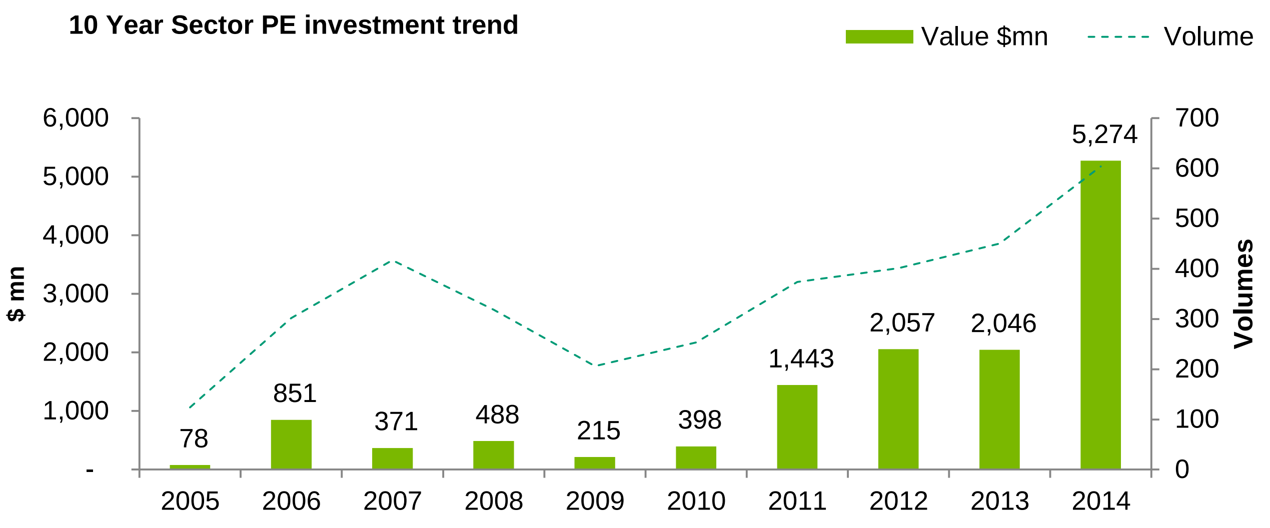
David Panna
Partner
Grant Thornton India LLP

In a year, considered by many as a period of sluggish economic growth and investments, the deal activity in the Indian IT & ITES sector during 2014 has been nothing short of spectacular. The deal value of both M&A and private equity investment in the sector has been more than the combined level witnessed in 2013 and 2012. While, M&A activity was dominated by the IT Solutions and BPO/KPO segments, e-commerce businesses drove the PE activity. The buzz around consumer internet businesses has been truly amazing and has been equally driven by investors willing to support the creation/expansion of these businesses and consumers.

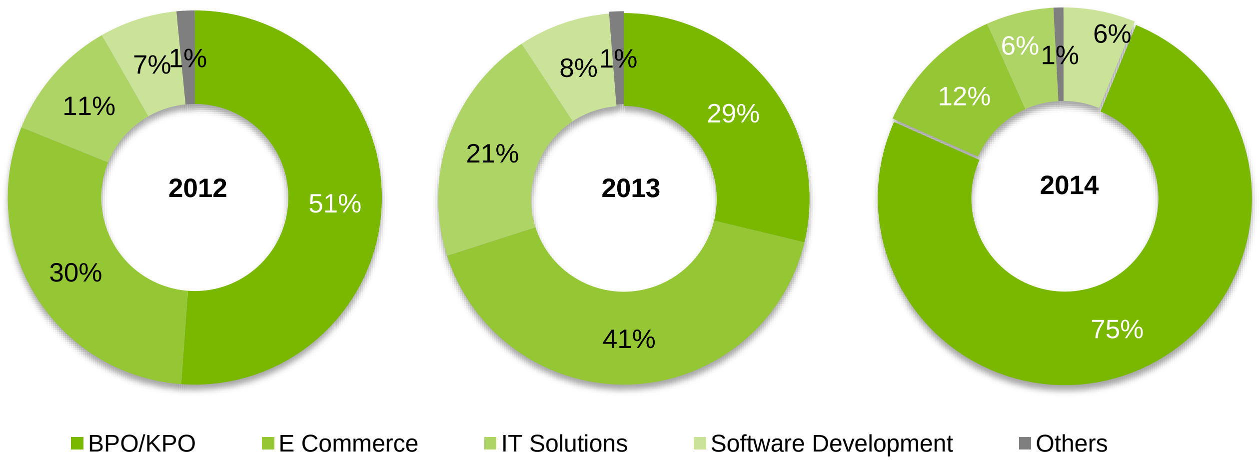
The eco-system for nurturing entrepreneurship has grown and strengthened over the years. Entrepreneurs, especially the first generation, with "new business" ideas around ITES have benefitted the most from this eco-system. Combined with access to capital and business relationships, this eco-system has mentored the entrepreneurs. There seems to be an explosion of investors wanting to back entrepreneurship in this sector.

Looking ahead, 2015 promises to be a year of higher deal activity in this sector. The businesses which raised money in 2013 and 2014 will require next rounds of funding as they grow. Segments, which have seen mushrooming of several ventures competing to deliver similar services and products to consumers, would be forced to look at consolidation. And the appetite of investors with risk capital to chase and support new business ideas would continue unabated. The challenge for consumer internet businesses to manage the cost of being discovered by consumers, gaining their loyalty and managing cost of delivery of product/ service while chasing growth would intensify further. On the positive side, the overall market is expected to grow exponentially as the number of smartphone and tablet users grow and internet accessibility improves. All in all, 2015 holds great promise for everyone associated with this sector be it the entrepreneurs, the investors, the consumers, the associated service providers and the advisors.

IT& ITES



Key sub sector trends: E-commerce hogs the limelight



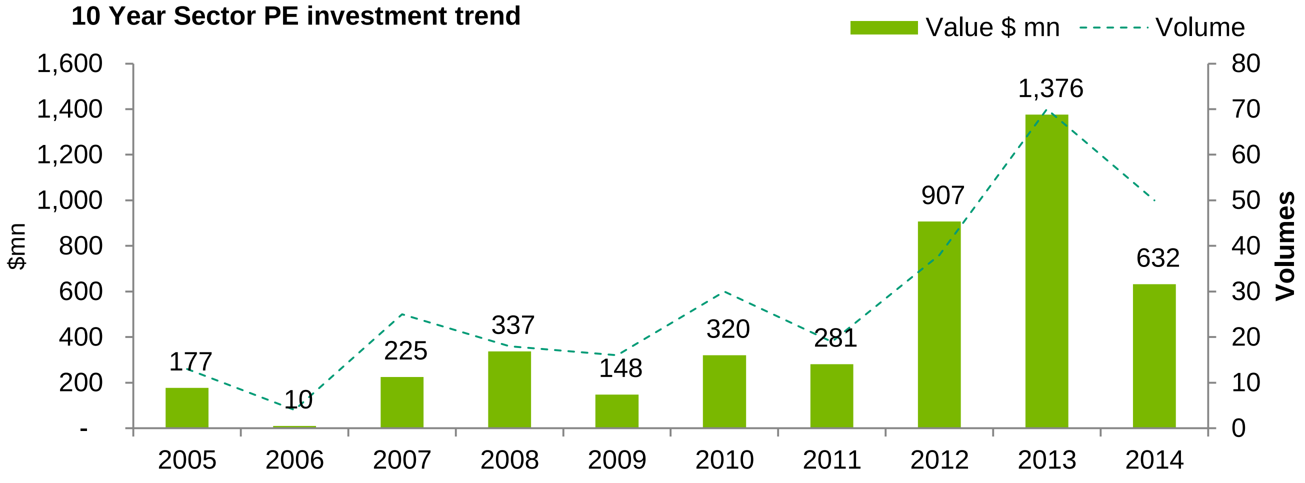
The above chart is based on investment values

IT& ITES

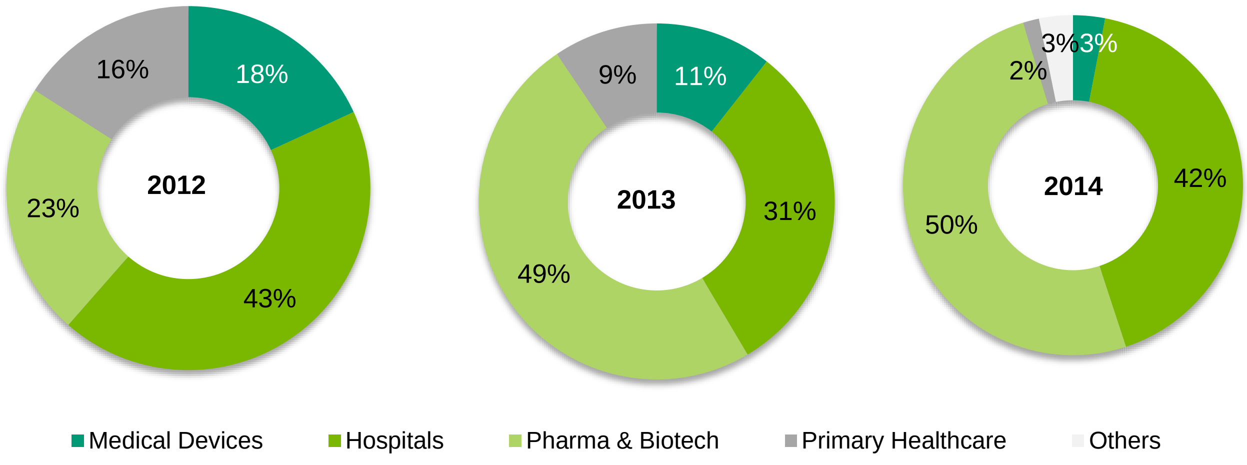
Large investments (2011-2014)

2014	Morgan Stanley Investment Management, GIC, Accel Partners, DST Global, Iconiq Capital and Sofina – Flipkart $1000mn	Baillie Gifford, Greenoaks Capital, Steadview Capital, T Rowe Price Associates, and Qatar Investment Authority and existing investors - Flipkart $700mn	Softbank Corp - Snapdeal $627mn
2013	Baring Private Equity Asia - Hexaware Technologies $400mn	Partners Group - CSS Corp $270mn	Naspers, Tiger Global, Accel Partners, ICONIQ Capital-Flipkart $200mn
2012	Bain Capital - Genpact Ltd $1000mn	Accel Partners and Tiger Global -Flipkart $150mn	Naspers and Tiger Global -Flipkart $150mn
2011	Apax Partners - iGate Corporation $480mn	Cerberus Capital Management, L.P - Regulus Group and J&B Software $137mn	General Atlantic - Mu Sigma $93mn

Pharma, healthcare and biotech



Key sub sector trends: Multispecialty hospitals and large pharma companies attract big ticket investments



The above chart is based on investment values

Grant Thornton Insights

In terms of Private Equity / Venture Capital investments, the year has seen a number of interesting early stage investments in the tech-enabled healthcare delivery space. Chain of single-specialty centres, such as eye care, dialysis care and primary care received small ticket investments, while multi-specialty hospitals such as Aster DM Healthcare and Asian Institute of Medical Sciences and day care surgery specialist Nova Medical attracted larger investments. In the hospitals space, the year ahead may see several secondary transactions with larger PEs/domestic and international strategic players coming at the forefront as well as a few IPO listing (Nova Medical day care surgery units acquired by Apollo towards the end of the year).

Vrinda Mathur
Director
Grant Thornton India LLP

contd.

Pharma, healthcare and biotech

The year also witnessed interest in the primary healthcare segment as well as in secondary care re-emphasising the potential of healthcare services in the country. Having said that, pharma investments topped the PE deal-board in 2014 with the $140mn Temasek - Intas investment marking an exit for Chrys Capital, investment by Warburg in Lauras Labs (aggregating to $92 mn) etc.

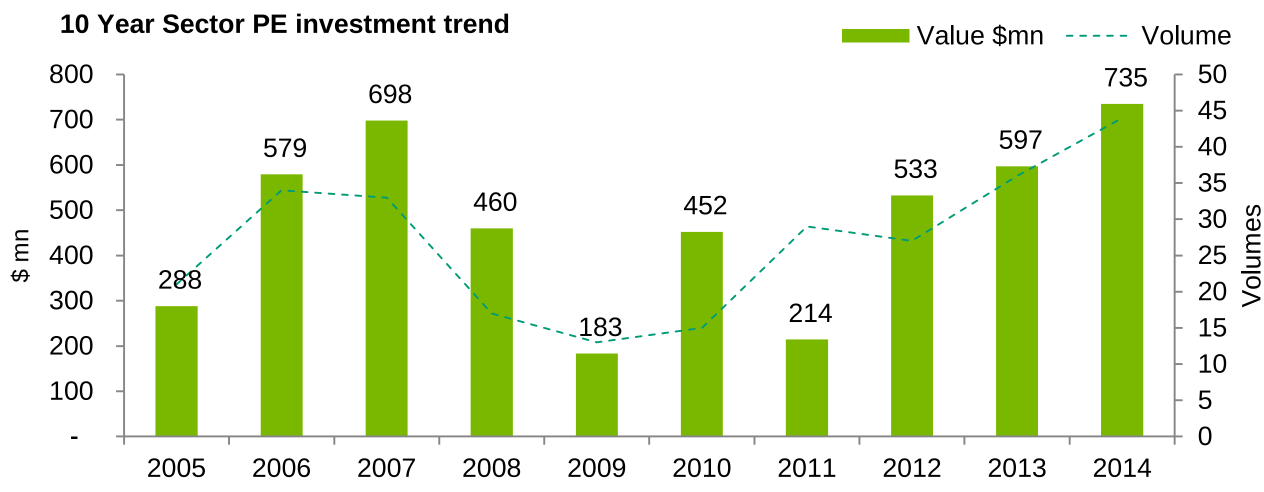
On the regulatory front, easing of norms for medical devices industry will encourage FDI inflows in this area in 2015 whether through strategic players entering the market for greenfield/ brownfield investments or investments by private equity to build adequate infrastructure and enable technology development by investments in domestic medical devices and consumable players.

In terms of outlook for 2015, while domestic formulations businesses, niche and scaled-up API businesses, medical devices companies should continue to see substantial deal activity, exits by PE funds could be a key deal driver in this segment in the coming year.

Large investments (2011 - 2014)

2014	Temasek - Intas Pharmaceuticals Ltd $140mn	Warburg Pincus - Laurus Labs Pvt Ltd $92mn	IndiaValueFund - Syngene International $63mn
2013	KKR - Gland Pharma Ltd $200mn	The Carlyle Group LP - Medanta The Medicity $154mn	Bain Capital, LLC - Emcure Pharmaceuticals $105mn
2012	Advent International Corporation - CARE Hospital - Quality Care India $105mn	Government of Singapore Investment Corporation -Vasan Healthcare $100mn	Olympus Capital - DM Healthcare Pvt Ltd $100mn
2011	Integrated (Mauritius) Healthcare Holdings - Apollo Hospitals Enterprise $102mn	New Enterprise Associates ,Omani industrial group & GTI - Nova Medical Centers Pvt Ltd $50mn	Avigo Capital Partners- Super Religare Laboratories Ltd $23mn

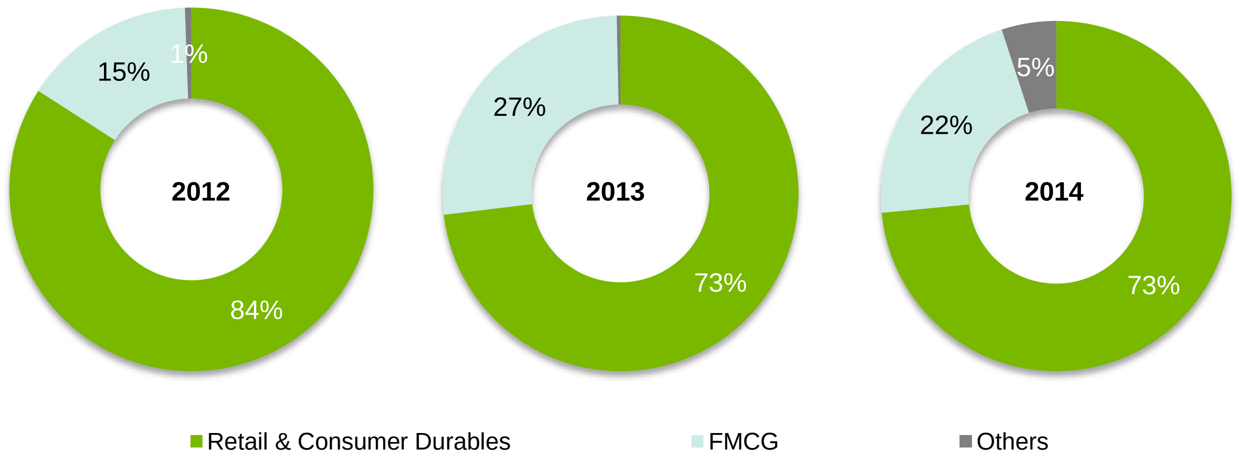
Retail and Consumer



Key sub sector trends

The number of transactions and emergence of new brands and players in the sector in the last few years is a testament to both the consumer and the investor confidence in the growth and potential of this sector. Continuing investment in supportive logistics infrastructure, sectoral reforms and real estate correction are the key requirements that will further boost the growth and keep the sector ticking with investments.

Prashant Mehra
Partner
Grant Thornton India LLP



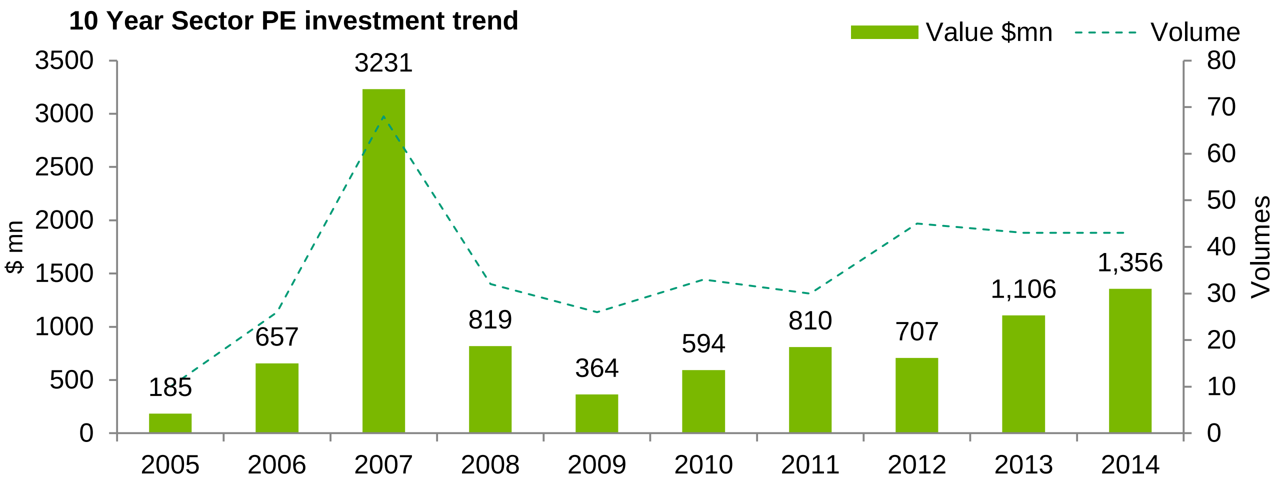
The above chart is based on investment values

Retail and Consumer

Large investments (2011 - 2014)

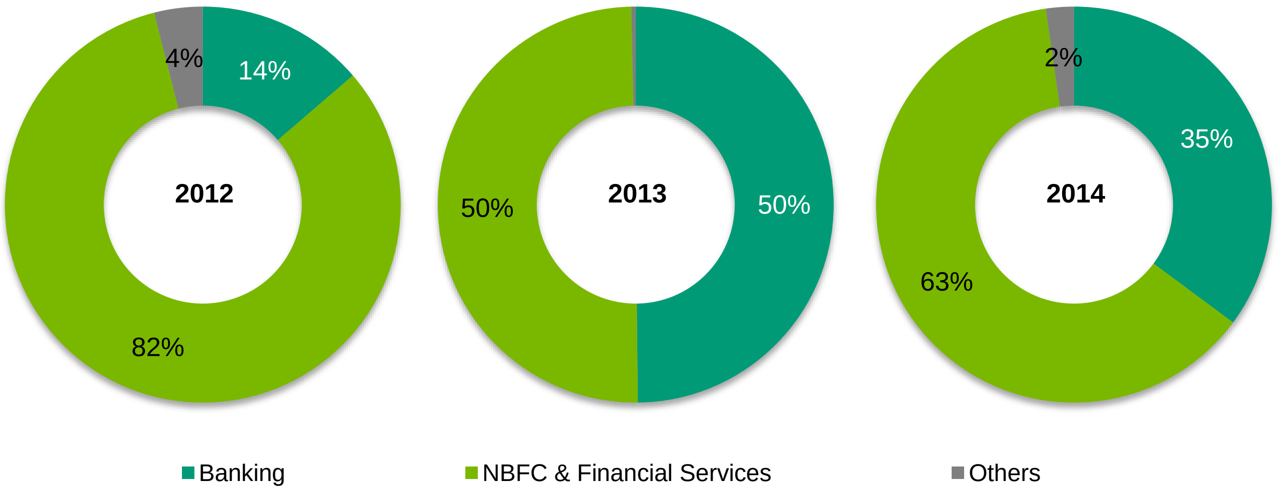
Year			
2014	Warburg Pincus - Kalyan Jewellers India Pvt Ltd $196mn	Goldman Sachs, Mitsui Global Investment - Global Beverages and Foods $51mn	Metmin Investment Holdings - Spykar Lifestyle $50mn
2013	Warburg Pincus - BIBA $56mn	Warburg Pincus and Faering Capital – BIBA $48mn	ChrysCapital - CavinKare Pvt Ltd $45mn
2012	Temasek Holdings Advisors India Pvt. Ltd - Godrej Consumer Products Ltd $137mn	Indivest Pte Ltd - Marico Ltd $75mn	Blackstone - SH Kelkar & Company Pvt Ltd $44mn
2011	Sequoia Capital - Prakash Snacks $30mn	Reliance Equity Advisors -VVF Ltd $30mn	Standard Chartered PE - Bush Foods Overseas $25mn

Banking and Financial services



Key sub sector trends

Higher confidence in deal making across segments resulting in increase in large size transactions and strengthening of interest from financial sponsors have clearly emerged as the two key sector themes in 2014. BFSI has been a market outperformer of sorts with a relatively secular traction in transaction rationale – deals being done for consolidation, growth and secondary exits. Expectation of an overall favourable regulatory regime such as licensing for new private sector banks to increase competition is expected to drive strategic activity in the sector on one hand and the existing mature eco system for exits will continue to be a propeller for financial interest in the near term.



The above chart is based on investment values

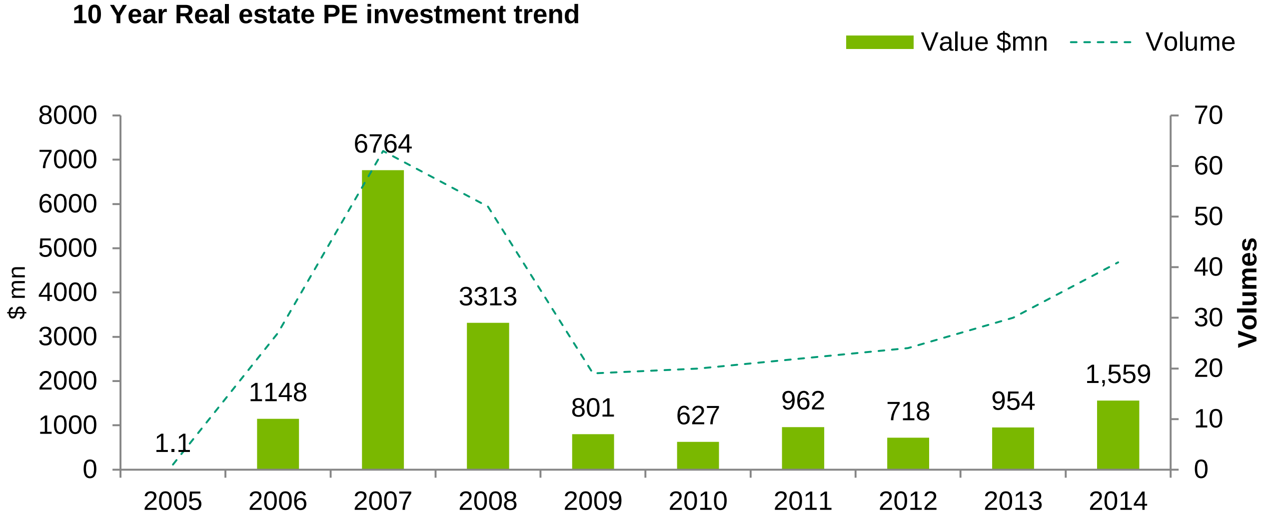
Banking and Financial services

Large investments (2011 - 2014)

2014	Canada Pension Plan Investment Board - Kotak Mahindra Bank $367mn	TVS Capital and Angel investors - Indian Energy Exchange $94mn	Vikram Pandit led global fund - FICS Consultancy Services $90mn
2013	Government of Singapore Investment Corporation - Kotak Mahindra Bank $239mn	TPG Capital - Shriram City Union Finance Ltd $194mn	International Finance Corporation - Yes Bank $125mn
2012	Warburg Pincus - Future Capital Holdings Ltd $84mn	IFC -Religare Enterprises Ltd $75mn	Warburg Pincus - AU Financiers (India) Pvt Ltd $50mn
2011	Texas Pacific Group (TPG) - Shriram Capital $257mn	HDFC Ltd , Norwest Venture Partners, Beacon India Private - The Ratnakar Bank Ltd. $157mn	Capital International - L&T Finance Holdings Ltd $74mn

Real estate and Infrastructure

10 Year Real estate PE investment trend

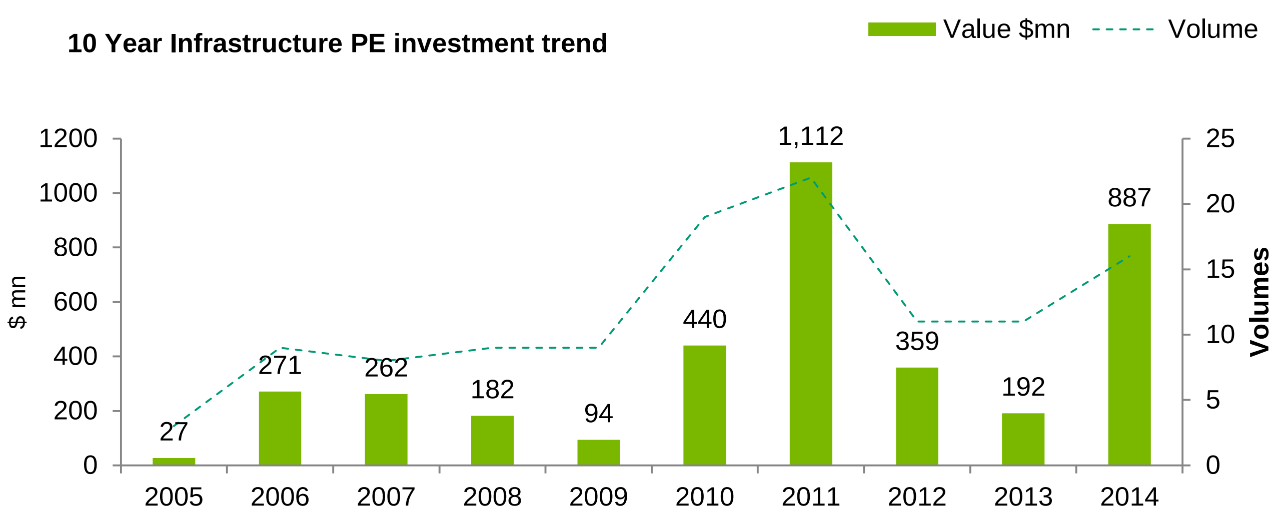


While off take on ground remained weak in most micro markets, 2014 has seen a resurgence in institutional fund raising with India focused RE funds seeking to raise over $6 billion in global markets, signaling a revival in investor sentiment after a gap of 4-5 years. Structured investments however have been the catalyst for driving investor activity as deal values surge by 40% over last year. As developers embrace mezzanine products offering reasonably assured IRRs of 18-20% in the absence of other sources of capital, deal momentum is expected to accelerate with NBFCs joining the investors club which itself is likely to be dominated by investors from Canada, Europe & Middle East."

With the series of reforms that have been announced in terms of REITs, relaxation in the FDI norms and giving affordable housing, a priority under the Land Acquisition Act. 2015 comes in with a string of hope and optimism for the sector.

Sumeet Abrol
Partner
Grant Thornton India LLP

10 Year Infrastructure PE investment trend



Real estate and Infrastructure

Real Estate large investments (2012-2014)

Year			
2014	Brookfield Property Partners -6 IT Parks in India $347mn	GIC- Reco Berry Pvt. Ltd -Nirlon Ltd $114mn	Xander Group- Infinity Tech Park project $108mn
2013	Blackstone - HCC Real Estate Ltd $169mn	Red Fort Capital - Lotus Greens Developers $161mn	IDFC Private Equity - BlueRidge Special Economic Zone $83mn
2012	Blackstone - Embassy Property $200mn	Morgan Stanley RE - Sheth Developer's Mumbai project $90mn	Brick Eagle Capital - Xrbia Developers $40mn

Infrastructure large investments (2012-2014)

Year			
2014	Temasek, IDFC Alternatives - GMR Infrastructure $183mn	KKR - GMR Holdings Pvt. Ltd $164mn	Canada Pension Plan Investment Board - L&T Infrastructure Development Projects Ltd $161mn
2013	AION Capital Partners - Jyoti Structures Ltd $48mn	Macquarie SBI Infrastructure Investments Pte, SBI Macquarie Infrastructure Trust - GMR Jadcherla Expressways $37mn	IDFC's India Infrastructure Fund - GMR Highways - GMR Ulundurpet Expressways $35mn
2012	Macquarie SBI Infrastructure Fund, SBI Macquarie Infrastructure Trust - Ashoka Concessions Ltd $150mn	Airro Mauritius, a fund affiliated to JP Morgan - Nandi Economic Corridor Enterprises Ltd. $65mn	3i India Infrastructure Fund Supreme Infrastructure India Ltd- BOT road projects $61mn

Industry insights

Parag Dhol
Managing Director,
Inventus Capital Partners

With the new Government in place, business sentiment has clearly improved and this augurs well for overall investment climate in India. Do you see any impact of this on the PE investments?

Overall business sentiment has a role to play in PE/VC deal making. This government, clearly, is seen as business friendly. The sharp contrast from the previous government also aids the cause.

The enhanced investment flows since May 2014 are a consequence. Despite the fact that the quantum of funding seems incredible in some cases, the truth is that ambitions of Indian entrepreneurs (particularly tech entrepreneurs) have been unshackled from a capital availability standpoint. We see even PE/growth investors, who have had little/no exposure to the tech segment till date, interested in some of our portfolio companies raising Series B/C rounds. We can't complain.

What are the key themes you see providing attractive investment opportunities for PE Funds in India?

We are broad-based technology investors - translates to Internet, mobile, software and tech-enabled services. We see increasing level of activity (not just quantity but quality, as well) in each of those segments.

One trend worth pointing out is that the technology is becoming a differentiator in some of these companies (as distinct from the traditional "application/tech-enabled" technology companies that is the mainstay). A good e.g. is eDreams Software in our portfolio. Essentially, we are beginning to see more of the eDreams kind of companies - not a majority yet but a healthy acceleration from the past, nevertheless.

How do you see the Indian entrepreneurship in recent times. What are some of the challenges in managing the relationship with Indian promoters ?

Should say that dealing with tech entrepreneurs, as we do, is largely devoid of some of the considerable conflicts that some of our PE brethren face. That said, some of the challenges are:

- ambition/persistence in carrying it through to the "end" – temptation to take the "gains" mid-way even before the story has not fully played out. Few substantial exits is the obvious cause for this behavioral trend.
- as the average amount invested in companies (across rounds) increases, low (single digit) founder stakes are increasingly becoming sources of some conflict.

Whilst there is a level of optimism that can be drawn from this year's performance, there remain some key challenges fundamental to the industry such as fundraising, regulation and deal flow. What do you believe are the key challenges facing PE at this point in time?

Lack of multiple exits is the key challenge. Confidence in one's ability to scale up is a challenge. Fund-raising, but for the chosen few that have scaled, is still not easy.

What is your view of the new PE fund raising environment expected in 2015 ?

The improved business sentiment helps – many LPs without exposure to India till date are actively considering doing something in 2015. Upcoming (IPO) exits (where the pipeline is as good as it has ever been) will help even more.

Industry insights

As we know, 2007-08 saw significant PE investments at high valuations – and as we are approaching the end of the average 5-6 year investment horizon in 2014-15, do you expect the level of exit activity to increase in the coming year, with the upbeat market condition? Which would be the most preferred exit route?

- **IPO**
- **Trade sale to a Strategic buyer**
- **Secondary sale to another PE**
- **Promoter or company buybacks**

First three for the PE/VC industry, overall. For an early-stage, tech-focussed VC like us trade sale will continue to be the most frequent exit route – still there are challenges. While Facebook, Yahoo, Twitter (rumoured) have opened their account, it has been a drought (or been a while) since the IBM's, Cisco's and Google's acquired in India.

Another point I should make is that our situation is different from the PE industry as we started investing in 2008 (made one investment that year). We started investing in earnest in 2009 – a very good time to do so. 3 / 4 portfolio companies, from 2009 vintage year, have gotten us exits (good ones at that).

What are the key challenges for PE from the regulatory standpoint and what in your view should be the changes on this front?

Changes in direction (on tax for e.g.) has been a challenge in the past– seems like this government intends on not letting that happen. The regulatory situation in underlying portfolio companies (e-Commerce and insurance for e.g.), and the delays in pending regulatory change/transparency therein, has a bearing, as well. Alternative Investment Fund regulations need a re-look to enable more GPs to access Indian capital.

The risk of fraud is often ignored, having a larger impact on the investment. With reference to the pre and post investment risks faced by PE firms in the Indian market, what in your view are key issues to corporate governance?

- **Financial reporting and accounting**
- **Lack of proper Board of Directors and Independent Directors**
- **High control over business by promoter**
- **Other**

One of the distinct advantages of investing in the tech sector is that most founders are exposed to, and embrace, the "expected" value systems – "wavelength match" as we Indians like to say. Can't say it won't happen (Satyam) but will wager that the risk is lower in the sector we operate in.

Encompassing the Fourth Wheel

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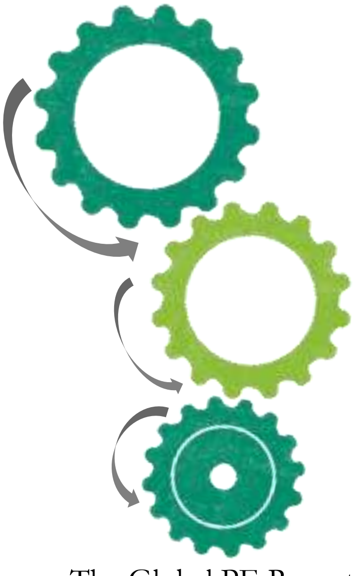
Extracts from Global PE report 2014/15 32

Extracts from Global PE Report

Creating growth: the challenge of buying well in today's market

Martin Goddard
Global services line leader – transactions
Grant Thornton International Ltd.



The Global PE Report 2014/15 summarises the results of interviews carried out with 175 PE firms from across the globe (including 10 firms from India), structured around the PE cycle.

Grant Thornton Global PE Report 2014-15- In Summary :

Private equity has always focused on creating value and helping promote growth in portfolio companies. Since the industry began, private equity firms have tried many ways to meet this ultimate objective – and with varying success. Now, post the global financial crisis, the question being asked more than ever is: how can private equity deliver its value-added promises?

Whilst the market has benefitted from wider exit options and an improvement in the fundraising climate, at the same time as debt finance markets have eased, finding good quality deals at good prices is proving a real challenge for many private equity buyers. There is so much more competition both in developed and emerging markets.

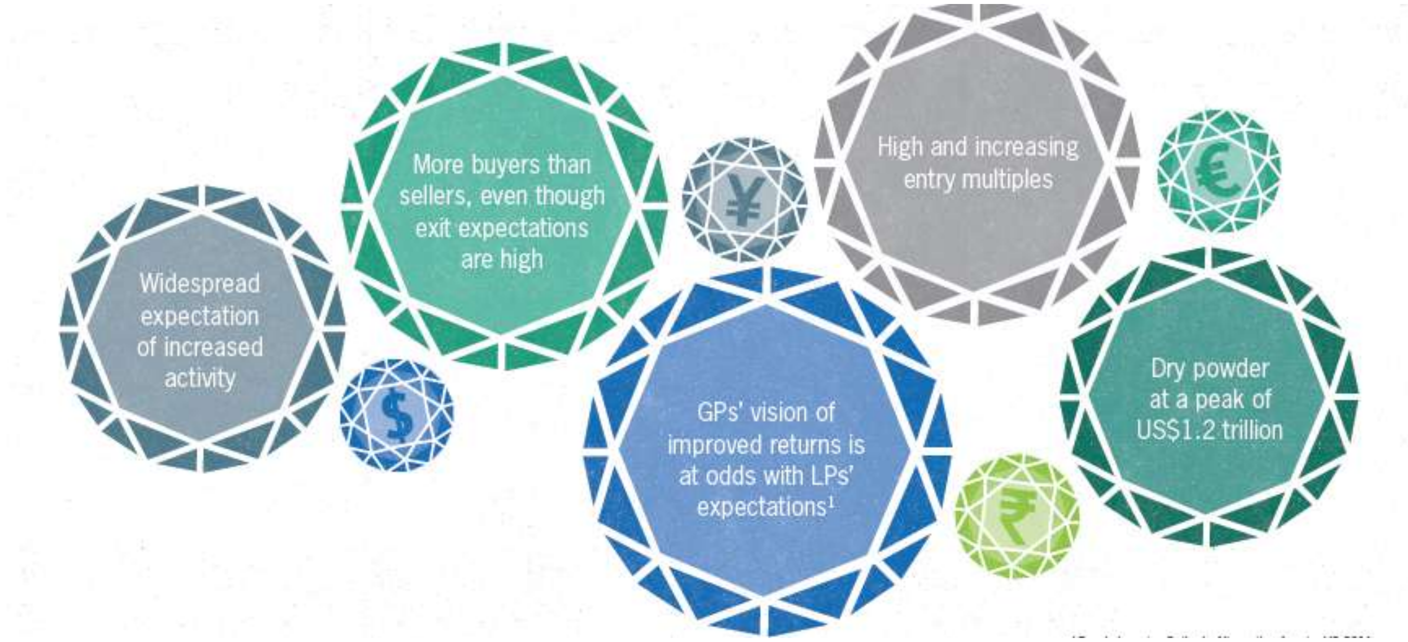
In addition to the private equity cycle adding to the pot of money looking for a home, LPs themselves are increasingly seeking to put funds to work directly, representing another source of competition for the best deals.

Then there are corporate buyers and such is their hunger in certain sectors right now that, even with favourable debt markets, it is tough for private equity to compete.

More competition means one thing: higher prices. And higher prices at entry make it harder to achieve attractive returns at exit. This means there is a growing and clear emphasis on how to generate the value needed to justify the commitment of further capital and costs to private equity.

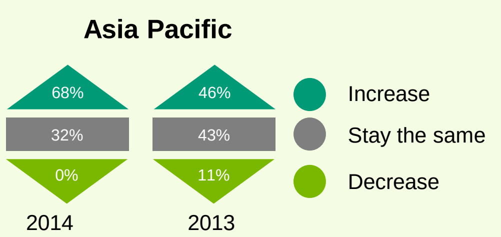
Put simply, the responsibility is with private equity firms to identify and pull the most important levers in the value generation machine that most now either have, or at least recognise, they need to build.

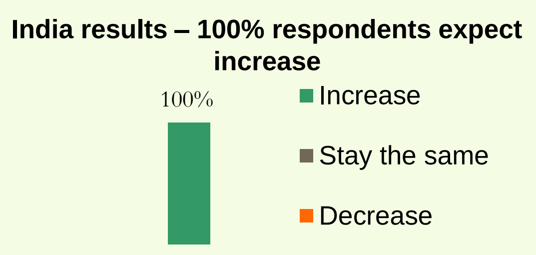
PE Overview: Global findings



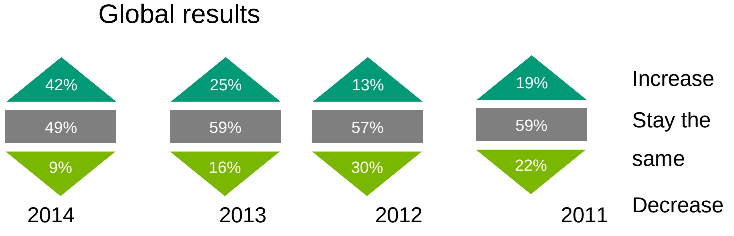
Indian perspective: Key findings

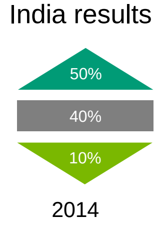
Q. Do you expect private equity investment activity in your country to increase, decrease, or stay the same over the next 12 months?





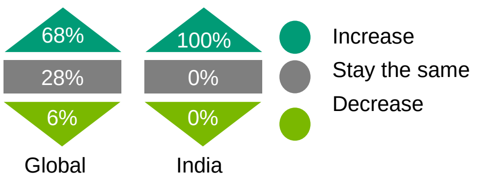
Q. Do you foresee entry multiples increasing, decreasing or staying the same in your market over the next 12 months?



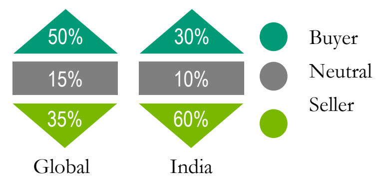


Indian perspective: Key findings

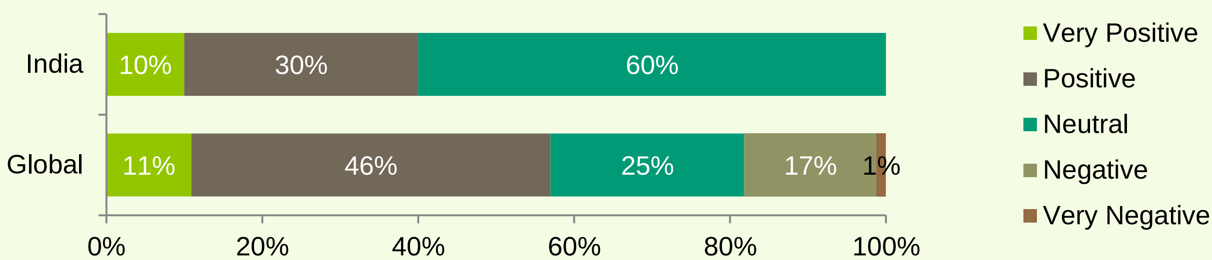
Q. Do you expect levels of exit activity across the market to increase, decrease or stay the same over the next 12 months?



Q. Do you expect to be a net buyer or seller of assets over the next year? (%)



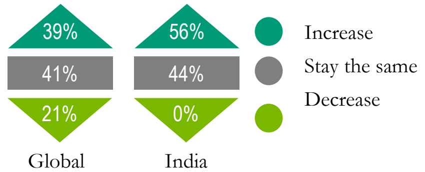
Q. How do you view the current fundraising environment?



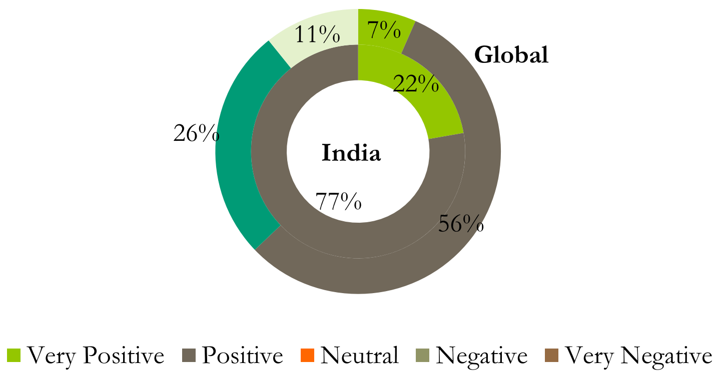
"Today, there is no level playing field between India-pooled VC/PE funds and offshore-pooled VC/PE funds. Offshore-pooled funds (Mauritius, Singapore etc.) have better regulatory regimes and better clarity on taxation whereas India-pooled funds have asset side restrictions and inferior tax regime. In other words, regulatory regime is such that pooling of capital in India (pooling of overseas capital in an India based fund) is effectively discouraged. We hope that policy makers and regulators will address this issue effectively in 2015."

Raja Kumar
Founder & CEO
Ascent Capital Advisors

Q. Do you expect average returns to increase, decrease or stay the same over the next 12 months?

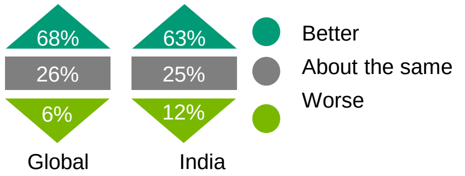


Q. How positive do you feel about the economic outlook over the next 12 months in your region for your portfolio businesses?

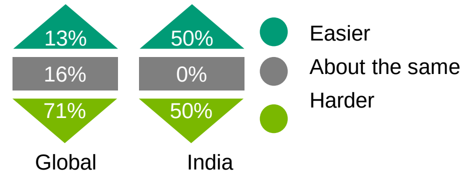


The role of secondary transactions: Indian perspective

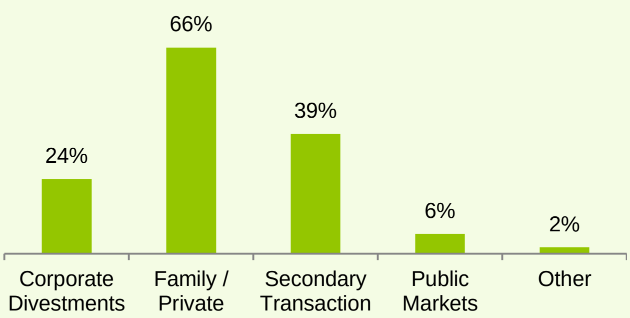
Q. How does the average 'quality' of businesses bought via secondary transactions compare to primary deals?

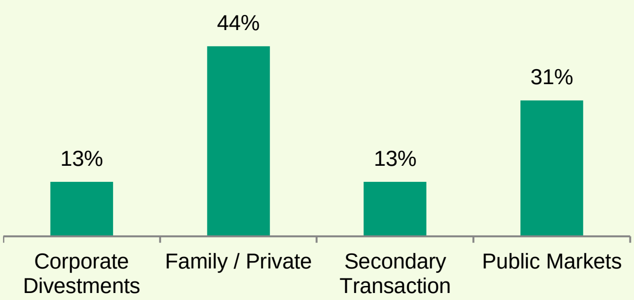


Q. Is it easier or harder, on average, to generate value rom secondary transactions compared with primaries?

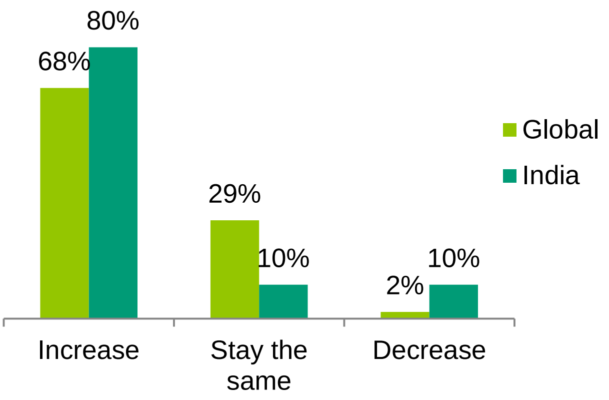


Q. What do you expect to be the most significant source of deals over the next 12 months?

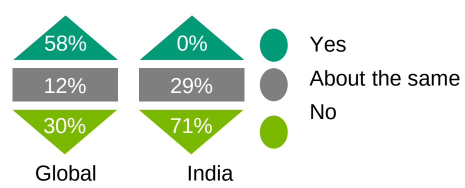




Q. Do you expect the number of secondary transactions in your market to increase, stay the same, or decrease over the next 12 months?



Q. On average, do you perceive that PE firms pay higher multiples for businesses acquired via secondary transactions than through other routes?

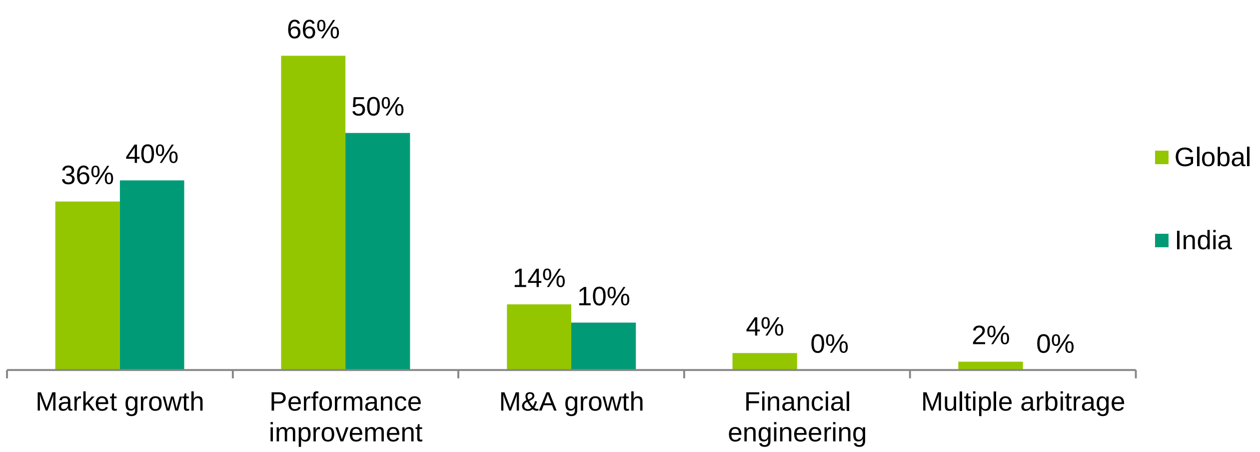


Challenges in Buying well

Indian perspective: Key findings

Q. As a house, do you consider yourself a growth investor, a value investor, or something else?

Q. Overall, What do you consider to be the most important drivers of value growth in today's market? Value uplift from:



Grant Thornton India Insights

The ten commandments of raising private capital

Providing insights on promoters' perspective in raising PE capital

Sumeet Abrol
Partner
Grant Thornton India LLP

Promoters are now increasingly looking at PE investors as 'partners in growth', with the 'providers of capital' approach making way for the **'Ten Commandments'**

If one was to single out one biggest factor that has propelled the growth of private businesses in India over the last decade-and-a-half, entrepreneurship is likely to be the obvious choice. And few would disagree that with over $90 billion firmly behind Indian entrepreneurs since 2000, PE has been the catalyst in transforming private Indian businesses from 'earnings generating' to 'value creating' platforms.

As India Inc takes the next leap in anticipation of decisive policy following restoration of political stability, there appears to be consensus on two broad issues relevant to the investment environment – (i) PE investments are likely to gain momentum as promoters revive expansion plans, and (ii) such investments will reflect a far more mature ecosystem where promoters and PE investors team up to create value as partners instead of coming together simply to create an event.

1. Need for 'smart' risk capital wherein intellectual capital comes for free:

PE investments seek to enhance the risk taking abilities of promoters while bringing in global experiences in calibrating growth. Promoters recognise that relationships with PEs can be maximised beyond capital to create great success stories such as the creation of one of the largest global telcos in Bharti Airtel from a single circle operator since it raised the first round of PE investment.

2. Privately held businesses can be endorsed as tangible value creators too!:

PE investments have emerged as the most credible maker of value creation for privately held companies. A key consideration for a promoter while raising capital is to see every dollar of earnings getting credibly re-rated to 10x-20x in value despite being privately held.

3. Vision is not enough, businesses need objective goals for value unlock!:

A natural consequence of a PE investment requires exit planning, resulting in objective goal setting for the business with the eventual end game of value accretion and unlock. Promoter alignment early on in the relationship creates a win-win over the investment lifecycle as the residual equity of the promoter stands to get significantly re-rated at the exit event.

4. Navigators have an equally important role to play as drivers in path to unlock:

Promoters are increasingly looking upon PE investors as partners in growth who are well positioned to navigate the business by driving financial market initiatives while the business itself focuses on its core of strengthening the foundation.

5. International experience & network can raise operational benchmarks:

Global experience and network access are generally strong collaterals that come along in any investment. This can typically be a significant value driver for a promoter as it enhances the competitive strengths of the business.

6. Governance can be a differentiator

Historically perceived as distractive, promoters are increasingly looking to leverage the best practices & governance standards both as a differentiator and a pivot for value creation and ultimate unlock.

7. Agility in the organisation is welcome:

It is well understood that induction of a financial investor keeps an organisation agile by creating accountability and focus, which are again essential ingredients for value creation over the investment lifecycle.

8. Recruitment proposition can be further sharpened to attract talent!:

PE relationships with senior executives can potentially be an effective funnel for top-level recruitments, something which promoters consider useful in investment partnerships.

9. Warchest can be the cutting edge for inorganic growth!:

Success of an acquisition can significantly depend on access to capital within desired timeframes. The ability to reinforce capital when required is often a key criteria for fund raising by promoters.

10. Raising profile doesn't hurt!:

Having a credible PE investor as partner tends to enhance the brand in the marketplace, which can be a soft yet important consideration for a promoter while raising capital.

Be wary of fraud risks

Prevention and mitigation of frauds at portfolio companies

PE firms that have invested in India are acutely aware that the Indian market presents issues that are unique and challenging. PE investments in India are generally in new and emerging sectors (i.e., clean-tech, energy, environment etc.) and/or in promoter-driven companies that are historically used to a different standard and level of governance, one that is markedly different from globally acceptable best practices. In addition, the nature, extent and quality of pre-deal checks at these companies and their owners is often short and mostly, driven by a check-list approach.

So, it is not surprising that issues develop at portfolio companies post-deal that perhaps, could have been identified and mitigated earlier. Some of the typical frauds that occur at portfolio companies include siphoning of cash by promoters to related parties and/or companies, generally weak control environment and specifically, weak or non-existent controls over cash, bank and assets, diversion of profitable projects or revenue from the portfolio companies etc. These issues have a direct bearing on actual profitability as compared with forecasted profitability, thus impacting cash flows, performance and valuation/price.

PE's have sought to protect themselves from these issues through two mechanisms. First, insist on and secure sufficient representations and warranties in the documents that govern investment (such as a SHA) including carve-out actions and dealings with related parties, right of audit, appointment of professional auditing firms as statutory auditor etc. and second – secure at least one seat as a member of the Board of the Directors at the portfolio company. However, these measures have not proven to be uniformly effective.

PEs have realised that absence of good governance with issues such as cash embezzlement, procurement frauds and kickbacks mean that the investee company is losing cash that would have otherwise factored in PE's returns on its investment.

Vidya Rajarao
Partner
Grant Thornton India LLP

Additionally, lenders in India are increasingly desisted from lending to sectors such as telecom and realty that are marred by governance issues, thereby bringing the financial stability of those investee companies under greater strain and further squeeze PE's exit options.

Finally, compliance with legislations such as the U.S. Foreign Corrupt Practices Act, 1977, and the UK Bribery Act, 2010, along with the Indian Prevention of Corruption Act, 1988 is making PE firms cognizant of the governance risks. When a PE firm invests in a company with or without the knowledge that the investee company or any third parties associated with the investee company engage in making illicit payments to foreign public officials, as per the global anti-corruption norms, the PE firm may also be held liable. PE partners who serve as directors in investee company (ies) or who may otherwise authorise or direct activities of the investee company (ies) may face individual liability, civil or criminal.

Against this backdrop, we list below some of the actions that PEs can undertake on a pro-active basis to monitor portfolio companies.

1. **Actively monitor the investee company's affairs**: While it may be too obvious, it is important for a PE investor to keep a close eye on the affairs of the investee company beyond just attending regular board meetings. It is important, for example, to know how the key assets are being purchased, how are revenues generated, or how is procurement being done in the investee company. In our experience, we have noted a number of cases where PE

Be wary of fraud risks

Prevention and mitigation of frauds at portfolio companies

investors have woken up too late to the affairs of the investee company and caught unaware of these issues. If it is too late, it is very difficult to salvage the situation by tracing assets that were diverted due to cumbersome legal and discovery framework in the country.

2. **Preserving and using audit rights**: Although audit rights clause is common in every SHA, enforcement of the rights available under clause has proved problematic. In many instances, promoters have either disallowed access or allowed access to limited documents for a narrow duration and only to the Board and not advisors to the fund. It is important to provide a well defined audit right clause and outline the mechanics of this clause in your investment documentation that will not allow the promoter to unnecessarily block access to books and records either to the PE or its advisors.
3. **Engage advisors early:** If the PE's suspect something, it is important to engage legal and forensic advisors earlier in the process. This is important because these advisors will rely on their past experience with such investee companies and guide the PE's through the process to preserve their legal position, should that be the case down the road.
4. **Keep an ear to the ground:** Most PE firms rely on conducting independent investigative assessment/intelligence at the time of making the investment. However, it is equally important to obtain intelligence after the investment (including information that is not necessarily in the public domain) to keep tabs on activities at the investee company.
5. **Obtain information early**: In our experience, the biggest challenge that is faced by the PE firms when they intend to conduct an independent investigation is access to information. Promoters use various tactics to either completely shut the flow of information or provide only partial information so that the process of conducting a review is never complete. It is therefore important to obtain information, at whatever pretext, during the course of the honeymoon period which would come in handy. Key information such as internal audit reports, procurement dump, and periodic dump of the ERP etc. comes in extremely handy at the first instance.
6. **Ask probing questions during board meetings**: Board meetings are not only meant to ask tough questions to promoters on operational aspects but also to pose key financial questions. Promoters tend to continue their financial reporting and analysis in the same manner when they were one tenth of the size and as sole owners. While the PE investors look to put in place systems and controls, it is important to take the help of an experienced forensic advisor to pose key questions to the auditors and the promoters of the investee company.
7. **Engage with key customers and suppliers:** In most instances of forensic review of investee companies, we have seen that the promoters are generally using key customers or suppliers to siphon cash out of the company. It is, therefore, extremely important to maintain relations with key customers and suppliers of the company.
8. **Perform regular proactive assessment**: Time is of the essence in such instances. It does not matter whether it is called an investigation or a special review, but conducting a proactive assessment in time helps in obtaining information and salvaging further losses, if any.
9. **Analyze financial indicators**: Financial statement analysis by a forensic expert can reveal a lot of information than what is obvious. Unusually low profit margins, high inventory ratios poor quality of disclosure in financial statements are some of the unusual alerts that should trigger an alarm. More importantly, the underlying reasons thereof for such anomalies should be probed further.

Be wary of fraud risks

Prevention and mitigation of frauds at portfolio companies

10. **Track industry trends**: Forensic issues follow an industry trend. If you have invested in an industry, it is important to keep an eye on the news of any malfeasance or investigation in the same sector. So, whether it is inventory and scrap issues in a typical manufacturing industry or siphoning of cash in quick service restaurants or distributor frauds in pharmaceutical industry, these issues tend to follow a trend and it is important to spot such trends and take proactive actions.

Clearly, the above procedures are well tested risk mitigation measures and it is imperative that PE Firms utilise such measures effectively since governance issues have a significant impact on both return and risk.

"PE investments in India are generally in new and emerging sectors (i.e., clean-tech, energy, environment etc.) and/or in promoter-driven companies that are historically used to a different standard and level of governance, one that is markedly different from globally acceptable best practices"

Scope of Due Diligence

Enhanced due diligence for investments during challenging times

Would the scope of due diligence be different for different set of investors is a question which is often asked and it can be said that it cannot be different since the basic fabric of diligence is the same for everyone, which is to confirm the matters of fact and also the interpretations as presented by the investee and providing guided comfort on all aspects of business, which requires going beyond the numbers. The facts could be anything ranging from their financial performance, status of assets and liabilities, the potential the business holds, operational effectiveness, the people factor and so on so forth. However, with the change in times and more experience behind us one would agree that the approach to a due diligence is fundamentally decided by the characteristics of the investor, primarily the answer to who is the investor, why is the investor looking seriously at a particular investment and what is the purpose of the investment. Added to this complexity of the business of the investment would tighten up the approach. Over the years and with more challenging times due diligence has at times taken the shade of audit, investigation, deeper analysis, outright verification from a simple confirmation process.

What does a PE expect out of a diligence process? From a financial diligence perspective the expectation is to get a logical consistent analysis of the financial statements so as to make an informed decision in relation to the investment. A financial investor primarily does deal as a vocation. As the investment horizon is short to medium term, mostly between 3-5 years, the focus is on the growth forecast for that period and the cash flow generating potential of the business. The reliance on the existing management team is high, though there is a board representation. If the PE is new to the industry, the understanding of the market risks may be low. Understanding this helps one to tailor the due diligence approach. The outcome of the diligence is expected to help the PE in obtaining a third party view (on the financial risks in a business) of the transaction, so that the value and the structure of the transaction are suitably determined by them.

While the essence of the due diligence exercise has not undergone a change, with the challenges faced by PE firms post 2008, there has been a certain rigour with which these exercises are carried out. Before we understand the changes it is imperative to acknowledge the circumstances which warranted the change. Post 2008, PEs have been facing immense challenges in exiting the investments made few years ago as they were finding it difficult to exit at values much below the forecast exit valuations or gains. Rupee depreciation was one of the reason as it automatically knocked off value of the investment as most of these investments were made during 2004 to 2007, when US dollar was hovering at INR 45 for 1 US dollar, compared to the end of 2012, when Rupee depreciated to around INR 55 for 1 US dollar and then on to current range of INR 60-62 for 1 US Dollar.

While, Rupee depreciation was the key reason, the 2008 bear phase has brought to the forefront some of the issues, which were existent, but ignored or not identified in the 'bull run' of capital markets. The optimism all around was reflected in the forecasts prepared by the management. However these forecasts and underlying business models did not stand the test of time. While it is true that the 2008 crisis was a significant unexpected development, it is equally true that the unbridled optimism did not encourage critical analysis of the forecasts and also did not adequately stress test the business models for unfavourable scenarios.

In the recent past the focus is on critically reviewing forecasts in light of the historical performance and overlaying it with the current or proposed sales pipeline and management's forecast model. A third party review of the forecast numbers played a 'Devil's Advocate' role in viewing the optimism of the management and also acted as a firm sounding

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board for PE's investment rationale. These review were either a plain vanilla review of projections based on historical performance and current status of foreseeable sales pipeline, significant events etc. or were designed to be a more detailed commercial due diligence covering competitive landscape and market position, industry growth and the target market, customer base and suppliers and the sensitivity it all brought to the forecast.

One other reason for the forecast numbers to not come through as expected was due to the unreliability of the historical numbers - there have been instances of dressed up accounting or misrepresentations, which have come to light post investments. These revelations were a major set-back to the PEs perception of the Indian businesses and also to the transaction advisors since there was a level of assurance placed on Management representations and information shared.

While it is a matter of debate whether such instances can be unearthed through an aggressively time barred diligence process, it is beyond doubt that there is a stronger focus to assess the reliability of the information. Additional procedures are put in place to verify and ensure that the information reviewed is essentially a product of robust and tested accounting and internal control environment. While, basic documents evidence the commercial transaction providing re-assurance, additional emphasis is laid on detailed verification of matters like

- Cash in the bank - It is the ultimate irrefutable evidence for the commercial transaction
- Reconciliation of revenue with the tax returns, especially sales and VAT returns as these documents help in tying up the numbers with the actual movement of goods and provision of services
- Deeper understanding and analysis of related party transactions, a need to go beyond the accounting definitions and challenge the management with respect to the relationships with key customers and vendors

PE firms have always stressed in assessing promoters and management's abilities before making an investment. However, in light of the developments mentioned above there has been an increased concern on the background of the promoters and also the investee company. In addition to the qualitative inputs to the decision making either from personal interactions and/ or feedback from market in general, there has been a significant shift to gather additional comfort through an integrity due diligence. Integrity due diligence essentially covers an independent assessment of promoters' background, their financial status, their holdings in other companies (from a related party perspective) and litigations against them using modern forensic tools. Integrity due diligence can help in identifying if there are any undisclosed cases/ litigations on the investee company and any unlawful trade practices followed by the investee company (e.g. facilitation payment, arrangements with agents etc.).

While professional skepticism is back in the industry, whether the same will be maintained in times of significant growth expectations needs to be seen. With the recent experiences, the investment and advisory community has evolved over the years and has risen up to the challenges. With these developments, embracing due diligence with its rigour and different perspectives would help in avoiding surprises and litigations post the investments.

Sridhar V
Partner
Grant Thornton India LLP

Shanthi Vijetha
Director
Grant Thornton India LLP

Deal Valuations

Key drivers to valuation

In an ever evolving and growing economy like India, companies continuously engage in transactions such as acquisition, merger, spin off, sale or joint venture. The transaction can be driven by various objectives such as growth, diversification, market capitalisation, tax advantage, among others.

Globalisation has opened the gates for foreign players to enter the country and for Indian companies to invest abroad. This has led to a string of cross-border deals. During the last six months itself, of the total 273 deals signed in India, 117 were domestic deals and 134 were cross-border deals.

Valuation is an integral part of every deal, right from evaluation of the proposed transaction to compliance with regulatory bodies and global standards. It is most challenging to determine the fair value of the target as valuation is subjective and depends on the nature of the target, and assumptions and perceptions of the valuer. The valuers are guided by their ability to identify and assess the key value drivers in the form of inherent strengths, weaknesses, opportunities and external challenges in a target. In determining the value for a transaction, a few key factors need to be considered such as:

- Past performance of the target
- Business plan / potential for growth in future
- Available manufacturing / operating facilities
- Overall economic environment and business condition
- Domestic and global demand for product / services
- Sustainable competitive advantage
- Capabilities and vision of management
- Synergy with the acquirer's business
- Similar transactions of comparable publicly traded companies

Valuations in the past were carried out using different methods which were not technically robust as per global standards. Further, there were no standardised processes / systems for valuation. A lot used to depend on the negotiations between willing buyer and willing seller, not providing any justification/ basis for valuation to the shareholders.

However, with increasing awareness amongst Indian shareholders and their understanding of the performance of the target, its peers and general market situation, there is now a need for the acquirer / seller to justify the value of asset / liability forming part of the transaction. Hence, there is an increasing need for consistency in valuation and benchmarking with global best practices.

With globalisation and widespread flow of funds across globe, the regulatory systems in India are also evolving that stress the need to adopt robust and transparent valuation process. They are switching over to newer sophisticated valuation techniques. There is a remarkable focus and change in the overall approach to valuations. There is a transition from historical performance based valuations to forward looking cash flow based valuations.

Similarly, market based value measurements are given precedence over entity specific value measurement. One of the examples is the introduction of a new chapter on Registered Valuers in the Companies Act 2013, which emphasises on standardisation and regulation of valuation practice to bring transparency and better governance in a valuation exercise. It also defines minimum qualifications for being eligible for registration as a valuer. Further, global valuation bodies / forums are being formed which are involved in providing guidance and training to valuers and updating and improving valuation standards by holding discussions with the experts and practitioners.

Of late, we are seeing more and more deals getting called off or taking longer than usual to consummate, due to valuation issues or value expectation mismatch. Amidst this, we also have the curious regulatory and accounting bodies overseeing transactions to ensure adherence to fair value and other valuation norms. Role of valuations therefore can no longer be undermined.

Darshana Kadakia
Partner
Grant Thornton India LLP

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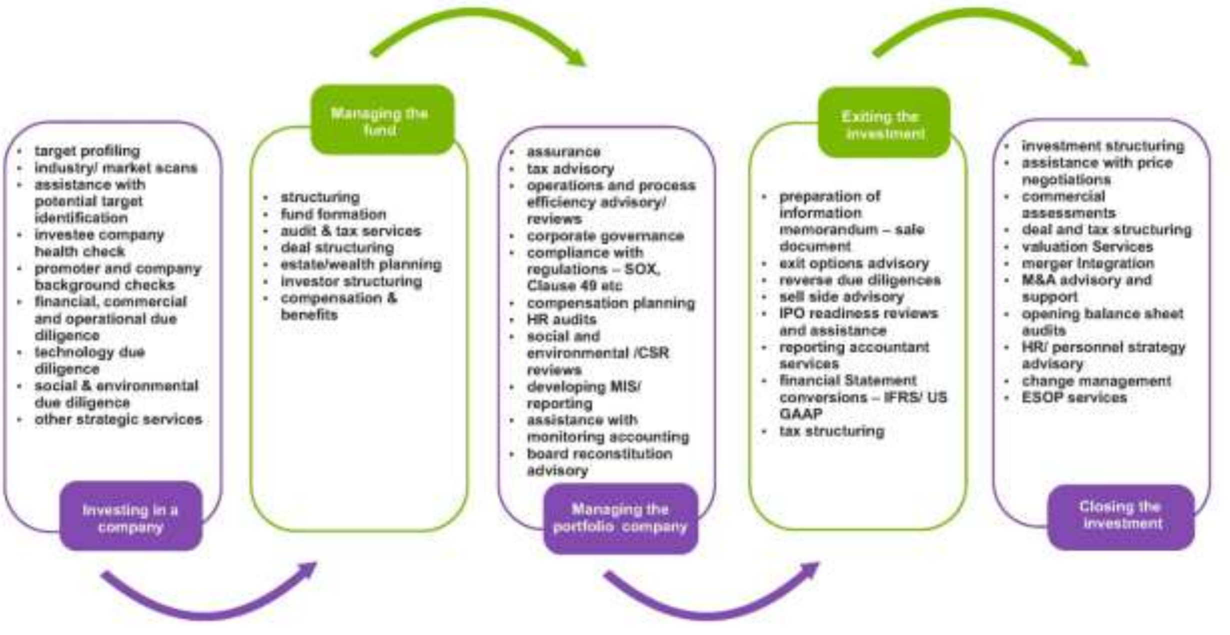

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Jayanta Banerjee - Managing Partner, ASK Pravi Capital Advisors Private Limited

Parag Dhol - Managing Director, Inventus Capital Partners

Raja Kumar - Founder & CEO, Ascent Capital Advisors

Grant Thornton India team

Darshana Kadakia – Partner, Advisory

David Panna - Partner , Advisory

Monica Kothari , Analyst, Advisory

Prashant Mehra - Partner, Advisory

Shanthi Vijetha - Director, Advisory

Sridhar V – Partner, Advisory

Sowmya Ravikumar - Manager, Advisory

Sumeet Abrol – Executive Director, Advisory

Vidya Rajarao – Partner, Advisory

Vrinda Mathur – Director, Advisory

Grant Thornton International's Global private equity report team

Contact us

To know more about Grant Thornton in India, please visit www.grantthornton.in or contact any of our offices as mentioned below:

NEW DELHI
National Office
Outer Circle
L 41 Connaught Circus
New Delhi 110 001
T +91 11 4278 7070

AHMEDABAD
BSQUARE Managed Offices
7th Floor Shree Krishna Center
Nr. Mithakali Six Roads
Navrangpura
Ahmedabad 380009
T +91 7600001620

BENGALURU
"Wings", 1st floor
16/1 Cambridge Road
Ulsoor
Bengaluru 560 008
T +91 80 4243 0700

CHANDIGARH
B-406A, 4th Floor
L&T Elante Office Building
Industrial Area Phase-I
Chandigarh – 160002
T +91 172 4338 000

CHENNAI
6th floor No.90
Arihant Nitco Park
Dr. Radhakrishnan Salai
Mylapore
Chennai 600 004
T +91 44 4294 0000

GURGAON
21st floor, DLF Square
Jacaranda Marg
DLF Phase II
Gurgaon 122 002
T +91 124 462 8000

HYDERABAD
7th floor, Block III
White House
Kundan Bagh, Begumpet
Hyderabad 500 016
T +91 40 6630 8200

KOCHI
7th Floor
Modayil Centre point
Warriam road junction
M.G.Road
Kochi 682016
T +91 484 40064541

KOLKATA
5th floor
10C Hungerford Street
Kolkata 700 017
T +91 33 4050 8000

MUMBAI
16th floor, Tower II
Indiabulls Finance Centre
SB Marg, Elphinstone (W)
Mumbai 400 013
T +91 22 6626 2600

MUMBAI
9th Floor, Classic Pentagon
Nr. Bisleri Factory,
Western Express Highway
Andheri (E)
Mumbai 400099
T +91 22 6176 7800

NOIDA
Plot No. 19A, 7th Floor
Sector – 16A,
Noida – 201301
T +91 120 7109001

PUNE
401 Century Arcade
Narangi Baug Road
Off Boat Club Road
Pune 411 001
T +91 20 4105 7000

For more information or for any queries, write to us at **contact@in.gt.com** or call us on +91 99300 01230.

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