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Evolution of Global Private Equity Market: Lessons, Implications and Prospects for India

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Venture capital and private equity industry has emerged as a potential source of capital for the corporate sector. They have been facilitating the productive use of existing assets and resources, usually by identifying companies with untapped potential and reorganizing their operations in ways that increase their value. Over the years, they have made their presence felt in the Indian economy too. Given their rising prominence in the financial sector, there have been concerns about their regulation, of late. This paper takes stock of the evolution of private equity market in the world and analyses its prospects and implications for India.

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Introduction

Financial globalization and increasing risk appetite among global investors has given birth to a new genre of financial intermediaries such as the private equity (PE). Growth in savings, abundant liquidity propelled by petrodollars, sovereign wealth funds as well as hedge funds and an accommodative monetary policy that enabled a low interest rate environment accelerated this process further. Moreover, regulatory changes such as pension fund reforms and financial innovations like securitization motivated the growth of alternative asset classes like private equity and more particularly, the leveraged buyout industry since 2000.

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However, the rapid growth of the private equity industry, of late, has raised concerns relating to the regulation of the sector. The secretive nature of private equity firm activity, limited research and dearth of regulatory control on the industry has raised several questions about the quality of the capital flowing in, the activities of private equity funds, impact on the firms' fundamentals and possibility of systemic risks emerging from the operations of private equity funds. Although, there is a rich literature illuminating the impact of venture capital financing on the firm's earnings, management, financial reporting practices, post IPO performance, *etc.*, due to institutional differences between venture capital firms and PE sponsors, the findings of such research cannot be completely extrapolated to assess the impact of private equity on the fundamentals of the firm. For example, while venture capital firms invest in early stage, low profitable firms and rarely use bank debt, PE sponsors, generally, buy mature, profitable businesses *via* leveraged/management buyout transactions, finance the transactions with large portion of bank debt and assume control of board of directors but are less likely to assume operational control. Further, these studies look into firm specific effects. Hence, the questions pertaining to private equity impact on the economic fundamentals, its benefits and systemic risks has remained more or less unanswered. This study makes an attempt to look into these aspects.

The paper has been organized into seven sections. Section II reviews the literature in this area. Section III gives an overview of the global private equity market including its historical background, definition and characteristics, benefits from PE and need for regulating the industry. Section IV describes evolution of private equity in India. Section V discusses implications of private equity market for India. Section VI elaborates on the prospects of the industry and Section VII concludes.

Section II
Review of Literature

Despite growing interest in the subject, academic studies and analyses of private equity finance has been relatively less. The main reason for this is that private equity has been a secretive economic sector and has been able to do so because it operates privately and does not have to provide accounts of what it does and how it is done. The available literature on private equity so far has covered a range of issues including the spread of the industry, risk-return characteristics, operation of economies of scale, demand-supply functions of a typical private equity firm, benefits from private equity and regulatory aspects of private equity.

Ljungqvist and Richardson (2003) produced one of the first analysis of private equity returns based on actual cash flows of venture and buyout capital funds. The study measures the timing and magnitude of investment decisions, how quickly capital is returned to investors and overall performance of private equity as a function of various characteristics. The author has found that it takes over three and six years, respectively, to invest 56.9 per cent and 90.5 per cent of the capital committed, and over eight and ten years, respectively, for internal rates of returns to turn positive and eventually exceed public equity returns. Further, private equity generates excess returns to the order of five to eight per cent per annum relative to the aggregate public equity market. Some other studies have found evidence that internal rate of return on realized investments of PE firms are high under syndication, incentive compatible financial instruments and strong legal environment.

Weidig and Mathonet (2004) analysed the risk profiles and estimated the risk-return characteristics of different private equity investment vehicles such as direct investment, funds and fund-of-funds**.** The study elaborates that calculation of risk as volatility of a time series of market price in different private equity investment vehicles is hampered by the lack of public and efficient market to price the product. Therefore, the risk is measured as the standard deviation around average return. The return is expressed as a measure, typically the internal rate of return or the multiple (the sum of all cash flows of an investment divided by the capital invested). The study concludes that there is a clear diversification benefit for funds, fund-of-funds, portfolio of funds and direct investments. The distribution of multiples of a direct investment is extremely skewed. About 30.0 per cent of all direct investments are total failure and all capital invested is lost. However, the distributions have very long, slowly decreasing and fat tails with extreme profits above multiple of 10. The multiple distribution of a fund-of-funds is nearly normally distributed with rapidly decreasing tails. Hence a fund-of-funds has a small probability of any loss.

Katz (2008) analyses how the ownership structure of a firm – that is PE-backed and non PE-backed firms - affects their financial reporting practices, financial performance and stock returns in the years preceeding and following an IPO. In other words, the author has attempted to analyse whether the alleged opportunistic behaviour of PE-backed firms coupled with their tighter monitoring and reputational considerations affect earnings management, conservatism and post-IPO performance as compared to non-PE-backed firms owned and controlled by their management teams. The author finds that presence of and monitoring by sophisticated PE-sponsors restrains upward earnings management and induces a higher frequency of timely loss recognition, both pre and post IPO. Further, majority ownership by a PE sponsor is associated with better stock price performance relative to management owned firms. Larger PE sponsor size is positively associated with both better long term financial and stock price performance when firm goes public.

Some studies have also brought out the economies of scale operating within the constituents of private equity industry – the buyout funds as opposed to venture capital (VC) funds. Metric and Yasuda (2008) have shown that the crucial difference between buyout and venture capital funds derives from the fact that a buyout manager’s skill can add value to extremely large companies, whereas a venture capital manager’s skills can only add value generally to small companies. It has been observed that a key feature of a buyout business is that once a buyout manager is successful in managing a US$ 100 million company, the same skills can be applied to handle a US$ 1 billion company. This scalability allows buyout funds to sharply increase the size of the fund while keeping the number of companies per partner and per professional fairly constant. On the other hand, venture capital skills that are critical in helping firms in their developmental infancy are not applicable to more mature firms that are ten times larger and already in possession of core management skills. So when successful VC firms increase the size of their fund, they cannot just scale up the size of each firm they invest in without dissipating their source of rent.

Cumming and Johan (2007) have analysed how the dearth of regulations in private equity has affected the Dutch institutional investor's participation in the private equity market and how regulatory harmonization may facilitate the investment in private equity. The author has concluded that low disclosure standards raise the screening, search, governance and monitoring costs of private equity investment, which in turn requires specialized skills on the part of the institutions to participate in the private equity class. Therefore, institutions that perceive the comparative dearth of regulations in private equity to be more important for their investment allocation decisions are essentially ranking the potential agency problems as being more pronounced and are less likely to invest in private equity. In particular, the study has found that an increase in the ranking of the importance of a comparative dearth of regulations in private equity by 1 on a scale of 1 (lowest importance) to 5 (highest importance) reduces the probability that the institutional investor will invest in private equity by up to 30 per cent, and reduces the amount invested by up to 0.8 per cent of the institution's total assets. The study has also shown that harmonization of existing regulations affecting institutional investors facilitates investment in private equity through enabling different type of institutional investors in different countries to act as limited partners for the same private equity fund.

Cumming and Walz (2007) analysed the drivers behind institutional investors investment in private equity firms. They conclude that institutional investors are inclined to invest in PE firms in economies which have strong disclosure standards, congenial legal environment, stable economy and robust financial markets. The authors are of the view that institutional investors face information asymmetries as PE fund holds illiquid assets in the form of portfolio firms that do not have a market value until disposition or a realization event. PE managers have an incentive to overvalue unrealized investments in order to attract capital from other institutional investors to raise follow-up funds. Further, in economies with unstable market conditions and less stringent regulatory standards, institutional investors are faced with an added difficulty of ascertaining whether a change in reported value of unrealized investment is a result of adverse changes in market conditions or overvaluation in reporting. The study finds that less experienced PE managers and those involved in early stage investments are more inclined to overvalue. Further, less stringent accounting rules and weak legal systems facilitate overvaluation.

Among the prominent Indian studies is the analysis of leveraged buyouts in India by Chokshi (2007). The study elaborates the major factors hindering the growth of leveraged buyouts in India such as the restrictions on foreign investments in India, limited availability of control transactions and professional management, underdeveloped corporate debt market, restrictions on bank lending, *etc.*

This paper attempts to add to the limited literature in private equity in Indian context. It takes stock of the PE industry including its inception, definitional issues, performance and regulatory issues and derives therefrom lessons, implications and prospects for India.

Section III
Evolution of the Global Private Equity Market

III.1. The Concept of PE and its Characteristics

III.1.1 Definition

There is no universally agreed definition of private equity. Different academic studies and private equity associations in various economies have defined private equity differently depending on the activities they engage in those economies. Lerner (1999) broadly defines private equity organization as partnerships specializing in venture capital, leveraged buyouts (LBOs), mezzanine investments, build-ups, distressed debt and other related investments. Fenn, Liang and Prowse (1995) have described them as 'financial sponsors' acquiring large ownership stakes and taking an active role in monitoring and advising portfolio companies. Ljungqvist and Richardson (2003) describes private equity as an illiquid investment since there is no active secondary market for such investments, investors have little control over how capital is invested and the investment profile covers a long horizon. The European Venture Capital Association defines private equity as the provision of equity capital by financial investors – over the medium or long-term – to non-quoted companies with high growth potential. It is also called 'patient capital' as it seeks to profit from long term capital gains rather than short term regular reimbursements. Similarly, the International Financial Services, London calls any type of equity investment in an asset in which the equity is not freely tradable on a public stock market as private equity. Private equities are generally less liquid than publicly traded stocks and are thought of as a long-term investment.

III. 1.2 Difference between Private Equity, Venture Capital and Hedge Funds

Presently there is lot of ambiguity surrounding the concepts of private equity and alternative investment channels like venture capital and hedge funds. Venture capital is a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business. It has a particular emphasis on entrepreneurial undertakings rather than on mature businesses. In fact, in most of the literature on private equity and venture capital, these two concepts are used interchangeably. Hedge Funds differ from private equity firms in terms of their time-to-hold, liquidity, leverage and strategic direction of investments which in turn dictates differences in their exit strategy, risk tolerance and desired rate of return of the two types of funds. Hedge funds seek a quick flip of their investments with the average length of their investments being 6-18 months, whereas private equity firms stay invested for around 3-5 years. Hedge funds are also inclined towards volatile withdrawal of investments as opposed to private equity firms which are focussed on long term returns. However, of late, it has been observed that the arena of activities of such institutional investors are not mutually exclusive. Many private equity groups own hedge funds and make long term investments in hedge funds. Further, attracted by the significant returns in buyout deals, many hedge funds have joined hands with private equity players to make large buyout deals. Given the differences in activities and risk tolerance of the two players coupled with the absence of any public reporting norms of their activities, the synergy between the two players has raised regulatory concerns, of recent.

III.1.3 Nature of Private Equity Firm

Virtually, all private equity firms are organized as limited partnerships where private equity firms serve as general partners and large institutional investors and high net worth individuals providing bulk of the capital serve as limited partners (Metrick & Yasuda; 2008). Typically such partnerships last for 10 years and partnership agreements signed at the funds inception clearly define the expected payments to general partners.

III.1.4 Market Structure and Activities of PE

Pratt (1981) has tried to categorise types of private equity activities in terms of the stages of corporate development, where PE financing is called for.

1. *Seed Financing*: Providing small sums of capital necessary to develop a business idea.

2. *Start-up financing*: Providing capital required for product development and initial marketing activities.

3. *First-stage*: Financing the commercialization and production of products.

4. *Second-stage*: Providing working capital funding and required financing for young firms during growth period.

5. *Third-stage*: Financing the expansion of growth companies.

6. *Bridge financing*: Last financing round prior to an initial public offering of a company.

7. *PIPE deals:* A private investment in public equity, often called a PIPE deal, involves the selling of publicly traded common shares or some form of preferred stock or convertible security to private investors. In the U.S., a PIPE offering may be registered with the Securities and Exchange Commission on a Registration Statement or may be completed as an unregistered private placement.

8. *Leveraged Buyout (LBO):* It entails the purchase of a company by a small group of investors, especially buyout specialists, largely financed by debt.

9. *Management Buyout (MBO):* It is a subset of LBO whereby incumbent management is included in the buying group and key executives perform an important role in the LBO transactions.

Fenn (1995) tried to further this idea by classifying the stages of corporate development in terms of revenues generated and the corresponding growth potential, finance requirement and access to various sources of finance of the firm. For example, an early stages new venture company is visualized as a firm generating revenues between zero and US$ 15 million, having a high growth potential with limited access to bank credit and greater dependence on alternative sources of finance such as the private equity. Private equity investments in firms in financial distress includes firms which are over-leveraged or suffer from operating problems with very limited access to other financial markets and the objective is to effect a turnaround.

III.1.5 Players in the Private Equity Market

Povaly (2007) has identified three major participants in a private equity market namely *i.* *Issuers* or firms where private equities invest in. As private equity is an expensive form of finance, issuers are generally firms that do not have recourse to an alternative source of financing such as a bank loan, private placement or the public equity market (IFSL Research, 2008). These firms vary in their size and reasons for raising capital. Firms seeking venture capital include young firms that are expected to show high growth rates, early stage capital for companies that have commenced trading but have not moved into profitability as well as later stage investments where the product or service is widely available but capital is required for further growth. Non-venture private equity investments include middle-market companies that raise private equity finance for expansion or change in their capital structure.

ii. *Intermediaries* which are private equity funds themselves. These are mostly organized as limited partnerships where investors who contribute to the fund's capital are limited partners, while the professional managers running the fund serve as the general partners. About four fifths of the private equity investments flow through specialized intermediaries, while the remainder is invested directly in firms through co-investments (IFSL Research; 2008).

iii. *Investors* who are contributing capital to private equity firms. These may include public and corporate pension funds, endowments, foundations, bank holding companies, investment banks, insurance companies and wealthy families and individuals. Most institutional investors contribute capital to private equity funds because they expect the risk-adjusted returns in private equity to be higher than the risk-adjusted returns on other investments and because of the potential benefits of diversification (Povaly; 2007).

III.1.6 Business Cycle of Private Equity

A private equity business cycle consists of four stages. The first stage of a private equity business cycle is to establish investment funds that collect capital from investors or limited partners. Limited partners include pension and provident funds, hedge funds, sovereign wealth funds, multilateral development banks like the Asian Development Bank and bilateral development financial institutions. These institutions, with the exception of hedge funds, do not have the professional staff nor the expertise to make such investments themselves and hence channel capital to private equity funds.

The partners commit funds for a set period (on average 10 years). The fund raising period lasts for six months to one year. There can be three types of private equity funds *viz.*, Independent, Captive and Semi-captive funds. Independent private equity funds are those in which third parties are the main source of capital and in which no one shareholder holds a majority stake. In a captive fund, one shareholder contributes most of the capital.

At the second stage, the capital thus raised is used to buy equity stakes in high-potential companies following a clearly defined strategy. The private equity management team makes investments essentially in the first five years of the fund (EVCA; 2007). A private equity investment takes place through one of the four investment vehicles *viz.*, direct investments, funds, fund-of-funds and more exotic products like collateralized fund obligations (CFOs), publicly quoted entities or mixed portfolios. Under direct investments, venture capital funds and informal private equity investors align interests with the founders or early round investors to avoid adverse selection and opportunistic behaviour. A private equity fund, on the other hand, collects capital from investors to choose and manage about 10 to 20 direct investments on their behalf. Investors decide to pool in funds based on due diligence including the quality of the management team, its track record, investment strategy and fund structure. Capital is drawn down as needed in order to pay set-up costs and management fees (typically 2.5 per cent p.a.) and to invest in a number of companies over an investment period of 4-5 years. Over the following years, the companies in the portfolio are further financed and managed for exit *via* trade sales, public offerings or secondary markets. Under the fund of funds, capital is collected from investors to invest in 20 or more funds on their behalf. They typically charge a management fee of around 0.5 per cent per year and participate in the profits upto 5 per cent to 10 per cent. Collateralised fund obligations are effectively securitization of mainly private equity fund-of-funds. Publicly traded products refer to those entities that raise capital from the public market like mutual funds and invest into private equity. Their net asset value is published regularly and the market price reflects the market's judgement on their fair value. These include listed companies whose core business is private equity such as 3i, quoted investment funds and specially structured investment vehicles (Weidig and Mathonet; 2004).

Private equity funds generally do not intend to maintain indefinite control of the target company. Instead they seek to acquire control of companies, implement value adding changes and then realize the resulting capital gain by disposing of their investment within a relatively short time frame which is generally 3-5 years. Hence the penultimate stage of a private equity business cycle is to exit the investment. They require timely and profitable exits not only to redeem capital and returns to their investors and themselves but also to establish and maintain their reputation, which in turn enable them to raise capital again for future funds from existing and new limited partners. Hence it is extremely important that there exists a smooth and functional public issues market where they can divest and capitalize their gains.

Finally, the capital recovered from the exit is redistributed to original investors on a pro-rata basis depending on the size of their initial investment. These reimbursements along with the capital gains, allow the institutional investors to honour their insurance contracts, pensions and savings deposits. This completes one private equity business cycle. When all the capital collected from the investors has been invested and when certain investments have already been exited, the fund managers may launch a second fund. Their credibility in attracting new investors depends on their historical performance because they will be in competition with other managers in the asset management market (EVCA; 2007). Successful private equity firms stay in business by raising a new fund every 3 to 5 years.

III.1.7 Risk Profile of Private Equity Investment

Private equity is regarded as a risky asset given the amount of leverage involved in the deals. However, private equity investments are not necessarily risky (Weidig and Mathonet; 2004). The risk profiles of private equity investment varies with the investment vehicle used in the process. For example, a direct investment has a 30.0 per cent probability of total loss whereas a fund has a very small probability of total loss.

In sum, private equity originally evolved as a conduit to finance young entrepreneurial firms which require substantial capital to drive growth and innovation. These enterprises are characterized by significant intangible but limited tangible assets, expect a period of negative earnings and have uncertain prospects which makes debt financing difficult (Povaly; 2007). Similarly, private equity organizations finance firms trapped in troubled waters which typically find it difficult to raise debt finance. Private equity organizations finance these high risk situations and expect high rewards in return. They protect the value of their equity investments by conducting careful and extensive due diligence before making an investment regarding business, financial, regulatory and environmental issues relevant for the company in question.

III.2. Benefits of Private Equity Finance

Private equity finance has become popular in recent times as it confers various benefits on the companies concerned, as well as the industry, economy and society at large. KPMG survey of 119 PE-sponsored firms in Asia has found that most private equities conceptualise ‘provision of capital’ as their most important contribution to growth of business followed by optimizing company’s financing structure, general management guidance at the board level, ability to recruit the best managers to run the business, improve corporate governance and improvement of business processes. Host companies also benefit from international network of contracts, injection of international know-how, *etc.* Several studies have also documented that private equity/venture capitalists speed up product commercialization (Hellman and Puri; 2000), adoption of human resource development policies and strengthens companies commercialization strategies (Gans, Hsu, Stern; 2002; Hsu, 2006).

Private equity also provide ‘venture capital’ and therefore PE funds are looked upon as ‘company builders’. They favour build-up of absorptive capacity preparing firms with the ability to identify, evaluate and absorb internally different forms of know-how which have been generated outside the firm. By investing in the build-up of absorptive capacity through in-house R&D, companies may therefore increase their ability to generate future innovations by remaining actively tuned on what others are doing and ready to exploit opportunities that scientific and technological advances create. In fact, a survey of firms receiving private equity investments in Australia in 2006 has shown that PE investors encourage collaboration with universities in R&D. They shape portfolio companies innovative strategies by investing at the right time and making them public at the right moment (Rin and Penas; 2007) and thus freeing of capital to reinvest it in new ventures (Michelacci and Suarez; 2004). Incentivisation of management coupled with control function of debt are prone to making executives rethink existing business models and inspire new ideas. They stimulate management for add-on acquisitions or for launch of new higher margin products or markets.

Private equity helps companies to perform better in several ways. Kaplan (1989) examined the post-buyout operating performance of 48 LBOs completed during 1980 to 1986. His results show that in comparison with the year before the buyout, operating income has increased by 42 per cent over a 3-year period after the buyout. Most of the studies have indicated that the pressure of servicing a debt load coupled with changes in incentive, monitoring and governance structure of firm also lead to improved performance. It has also been found that post-IPO, majority ownership by a PE-sponsor is associated with better long-term stock performance. A survey of PE-firms in Asia-Pacific by KPMG has shown that in India, the average share price of PE-sponsored companies trading for 501-616 days rose by

195 per cent, while non-PE sponsored companies' stock gained only 99 per cent.

Besides, PE-firms are said to extend several social benefits such as improving environment, building infrastructure, encouraging R&D and upgrading human capital. The survey of Australian PE firms has shown that investee companies are contributing to productivity improvements and ongoing Australian R&D. IFSL Research estimates that in UK, the companies that have received private equity backing, accounted for the employment of approximately 3 million people in 2007. This is equivalent to 16 per cent of UK's private sector employees. According to Venture Intelligence, the growth in employment in private equity firms (8 per cent) is greater than in other private sector firms (less than one per cent in FTSE 100 companies). A survey of Indian PE firms has also shown that PE-backed firms have shown higher annual wage growth of around 32 per cent as compared with 6 per cent growth in non-PE backed firms. Annual sales grew by over 22 per cent in PE-backed firms as compared with 10 per cent in non-PE backed firms. Private equity catalyzes innovation in the economy as is evident from the comparatively higher growth in research and development in PE-backed firms than non-PE backed firms. Many of the investee companies appear to be consistently environmentally aware and responsible. Private equity also benefits the economy at large by incentivising capital formation, optimizing allocation of resources, encouraging competition and thereby raising social welfare of the economy as a whole.

Above all, private equity firms are known as natural system stabilizers (Persaud: 2008). During a systemic crisis, while those with short term funding may indulge in risk trading, private equity firms can balance the system by being a risk trader because of their long term funding requirements. Private equity firms get the bulk of their funds from long term investors like pension funds and invest in illiquid assets.

In the same letter and spirit, the role of private equity in developing countries like India may broadly be described as 'enabling capital' given the potential support it can provide to capital starved sectors such as SMEs and infrastructure, emerging sectors like realty, telecom, IT, *etc*., restructuring of loss making companies as well as the high value agriculture sector. With policy support, private equity can revolutionise the disinvestment process in India. This will require policy support such as relaxation of archaic labour laws and land legislations that have hitherto disabled transfer of capital and other resources into more productive pursuits.

III.3. Country Experiences

The PE industry developed simultaneously in US and Europe soon after World War II. However, the degree and pace of development since then varied significantly on the two continents (Povaly; 2007). The first formal PE firm, ARD was established after World War II in 1946 in the US. Although the industry grew steadily since then, it experienced rapid growth after the 1970s post amendment to the so-called 'prudent man' rule governing the pension fund investments and lowering of capital gains tax rates in 1978. Private equity funds were raised specifically as venture capital funds or buy-out mezzanine funds. Initially, buyout funds raised around four-fifths of the money going to private equity, leaving around one fifth to be raised by venture capital. However, with the technology boom, the venture capital funds overtook buyout funds in terms of total mobilisation. Between 1979 and 1988, the US private buyout market expanded from less than US$ 1 billion to a peak of more than US$ 60 billion. This was largely facilitated by the creation of high yield junk bonds market. The industry used this high yield debt to finance huge corporate takeovers including that of RJR Nabisco, Inc by Kohlberg Kravis Roberts & Co. (KKR) for US$ 31.4 billion in 1988 (McKinsey, 2006). Together with the growing capital inflows, the number of private equity firms proliferated dramatically and firms began to specialize in the various aspects of private equity such as early stage venture capital, leveraged buyouts or mezzanine financing. However, the culmination of the Leveraged Buyout (LBO) wave was associated with many bankruptcies and fierce public and political resistance (anti-takeover legislation) such that PE activity slowed down abruptly to US$ 4 billion in late 80s (Renneboog, Simons and Wright, 2007). However, the market recovered by mid 90s due to strong public equity market environment and exit of many inexperienced venture capitalists. The revival was aided by cut in capital gains tax in 1994 on investments in smaller firms and opening of NASDAQ stock exchange which expanded exit perspectives for portfolio firms. The US market is today the biggest and most developed private equity market in the world. The number and value of US private buyout-related deals rose from 12 transactions in 1970, involving less than US$ 13 million in direct capital raised and invested, to 2,474 deals involving US$ 70 billion in 2007. The private equity investments in US amounted to US$ 105.7 billion or 0.8 per cent of GDP in 2007 (PwC, 2008).

The Canadian venture capital and private equity industry grew with the blessings of the Government of Canada. The growth of the indigenous venture capital industry was facilitated through the provision of subsidies to a particular group of venture capital funds better known as labour sponsored venture capital corporations. Under this program, investors received 15 per cent tax credit from the federal Government on their investments which is equivalent to 15 per cent subsidy on such funds. In addition, some provincial Governments added an additional tax credit, typically 15 per cent, making the total effective subsidy 30 per cent (Brander, Egan and Hellman, 2008). One of the major reasons for the tremendous growth in Canada's private equity market is the mounting demand for risk financing from established middle market firms in case of buyout/mezzanine activity and emerging technology firms in case of venture capital. Further, proximity to the massive and highly sophisticated private equity markets in the USA coupled with access to volume of assets of institutional investors has added fillip to the growth of the market. Private Equity investments in Canada rose to US$ 1.4 billion or 0.1 per cent of GDP in 2007 (PwC, 2008).

Till 1980's, the growth of the UK PE industry was constrained by a multitude of factors, including political environment where mainly socialist governments had created harsh entrepreneurial climate, cultural impediments such as higher risk averseness and lack of liquid stock exchange for small and mid-sized businesses (Povaly; 2007). Discouraging fiscal and legal rules of game added muscle to the stagnation of the industry. It was only in the mid 80's that the State took progressive steps to promote venture capital industry including development of missing markets, rationalization of marginal tax rates, *etc*. The establishment of the Unlisted Securities Market (USM) in early 80's proved advantageous for the exit of small firms because of relatively easier listing requirements. Private Equity investments in UK increased to US$ 40.1 billion or 1.5 per cent of GDP in 2007 (PwC, 2008).

In Latin America, private equity industry flourished in Brazil. The private equity industry in Brazil which developed in the early 90's did not receive much direct support from the Government at its preamble. Between 1992-94, there was only one player in the market. The focus of the industry was exclusively on buyouts and no venture capital was raised. The industry largely gained from deregulation of previously protected sectors like telecom, energy and utilities. Subsequently, many large regional funds came up and fund raising recorded a 343 per cent rise to US$ 3.7 billion. The industry troughed between 2000 and 2002 after Brazilian currency devaluation, crisis in Argentina, international macro-economic uncertainties and extended regulatory transition of local pension funds industry (Holman et al, 2006).

The private equity industry in Mexico originated in the early 1990's through foreign direct investment rather than as a result of organic growth (Holman et al., 2006). Between 1992-1996, many US-based funds made a foray into Mexico and initial investments were made in manufacturing, telecom and entertainment sector by firms like Chase Capital Partners, Blackstone Group and Banc of America Equity Partners. In the second wave of PE investment during 1997-98, several new sectors witnessed interest namely, retail, food, power and utilities. Between 1999-2001, private equity in Mexico was negatively impacted by Brazilian devaluation of 1999, Russian default in 1998 and the burst of the telecom bubble in 2000 and Argentine economic collapse of 2001. This led to withdrawal of investments from telecom and IT sector. The industry recovered in 2002 with a structural shift away from foreign investors to emergence of local funds. The latter sourced bulk of their capital from foreign institutional investors as well as indigenous high net worth individuals. The Mexican Government was also directly involved in financing private equity. Since early 1990's, Nacional Financiera (NAFIN), a branch of the Mexican Development Bank, has adopted an institutional strategy of direct and indirect financing. Under direct investment, NAFIN makes equity contributions, monitors and advises specific firms. Indirect investment refers to matching-fund equity investments in venture capital funds known as SINCAS and private equity funds. PE investment has been attracted by Mexico's relative economic and political stability, abundant workforce and economic integration brought about by North American Free Trade Agreement. The current fund size averages to US$ 100 million. Today, Mexico is the second largest private equity destination after Brazil. However, the penetration of the market remains thin at 0.04 per cent of GDP as on 2008 (EMPEA, 2009).

Just like in developed countries, the import and indigenous development of private equity in emerging markets like Malaysia and Singapore was aided by the growth enabling policies of the State as well as inflow of money from public sources. The growth of the private equity industry in Singapore, for example, was facilitated by institutional support from the Government of Singapore. In 1985, the Economic Development Board (EDB), an institution established to act as a facilitator to develop self-sustaining enterprises, created its own venture capital fund. The inflow of private equity got further boost and thrust after the exit possibilities were enhanced on the establishment of the Stock Exchange of Singapore Dealing and Automated Quotation System (SESDAQ) with less stringent norms for listing, which became useful for small and new companies.

The private equity industry in Malaysia developed under the tutelage of the Malaysian Government and support from the more advanced venture capital firms in Singapore. The first venture capital company, 'Malaysian Ventures' was established in 1984 by Singapore-based South East Asian Venture Investment (SEAVI). The Malaysian Government earmarked resources during the five yearly plans for developing the indigenous venture capital industry. The Government granted several tax incentives in addition to liberalizing equity ownership for venture capital corporations and venture capital management corporations. The Malaysian Venture Capital Development Council (MVCDC) was established in January 2005 to facilitate the development of the venture capital industry by co-ordinating Government initiatives and incentives towards charting the industry's strategic direction. Further, the Government also established its own venture capital companies to infuse resources into certain strategic sectors of the economy. As at end-2007, Malaysia had 98 venture capital companies and venture capital management companies registered with Securities Commission with total of RM3.3 billion committed funds under management (MVCA, 2008).

III.4 Performance of Global Private Equity Market

III.4.1 Growth of Private Equity Market

Private equity organizations specialize in the business of pooling funds from institutional investors and high net worth individuals and channelise capital and know how to unlisted start-up companies through buying of majority stake or partial/complete buyout of growth promising firms. According to an OECD report[1], approximately 3,000 private equity funds are currently operating worldwide managing over US$ 1.5 trillion. The assets under management and average annual returns of private equity firms compare favourably with other alternative investments such as global hedge funds thus making them popular asset classes (Table 1).

According to the Emerging Markets Private Equity Fund Association (EMPEA), global private equity fund raisings reached a peak of US$ 545 billion in 2007 with buyout funds constituting about half of the money committed**.** In the same letter and spirit, global

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[1] The Implications of Alternate Investment Vehicles for Corporate Governance', OECD, July 2007.

Table 1: Comparative figures for Private Equity and Global Hedge Funds (2007)

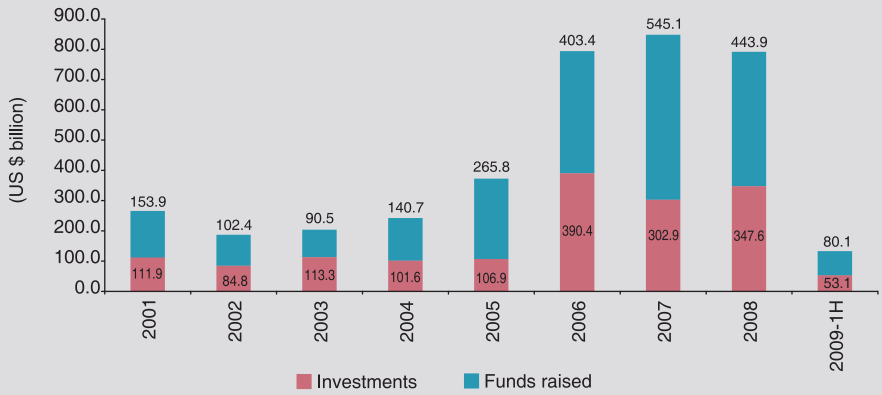
	Assets under Management (US$ trillion)	Average Annual Return (%)
1	2	3
Private Equity	1.5	12.3*
Hedge Funds	2.3	11.6**

*: In US; **: Global Hedge Fund Index.
Source : IFSL, CBS Hedge Funds, 2008.

private equity investments increased to US$ 303 billion in 2007 from just US$ 112 billion in 2001, recording a growth of over 170.0 per cent. During 2008, at the height of the US financial crisis, although global fund raisings moderated to US$ 444 billion, global PE investments recorded a growth of over 14.0 per cent to US$ 348 billion (Chart 1).

The global private equity industry is dominated by United States. United States accounted for around 65.0 per cent of total global fund raisings and more than 58.0 per cent of global PE investments in 2008. Western Europe, on the other hand, raised more than 18.0 per cent of total global PE funds and accounted for 22.7 per cent of total global PE investments in 2008 (Tables 2 and 3).

Chart 1: Global Private Equity Investments and Funds Raised



Source: Emerging Markets Private Equity Funds.

Table 2: Global Private Equity Fundraising

(US $ billion)

	2007	2008	2009-H1
1	2	3	4
United States	325.8	287.5	55.0
Western Europe	152.0	82.7	8.3
Developed Asia	8.1	7.2	0.6
Emerging Asia	28.7	39.7	11.1
CEE/CIS	14.6	5.6	1.8
Latin America	4.4	4.5	0.9
Sub-Saharan Africa	2.0	2.2	1.0
Global Total	545.1	443.9	80.1

Note : Developed Asia includes Japan, Australia and New Zealand.
Emerging Asia excludes Japan, Australia and New Zealand.

Source : EM PE Industry Statistics, EMPEA, September, 2009.

The emerging markets have also become substantially important in terms of both private equity fundraisings and investments over the years. While fundraisings have increased by over ten times from US$ 6.5 billion in 2001 to US $ 66.5 billion in 2008, PE investments in emerging markets have grown thirteen fold during the same period from US$ 3.7 billion in 2001 to US$ 47.8 billion in 2008. During 2008, emerging market economies accounted for 15.0 per cent and 13.8

Table 3: Global Private Equity Investment

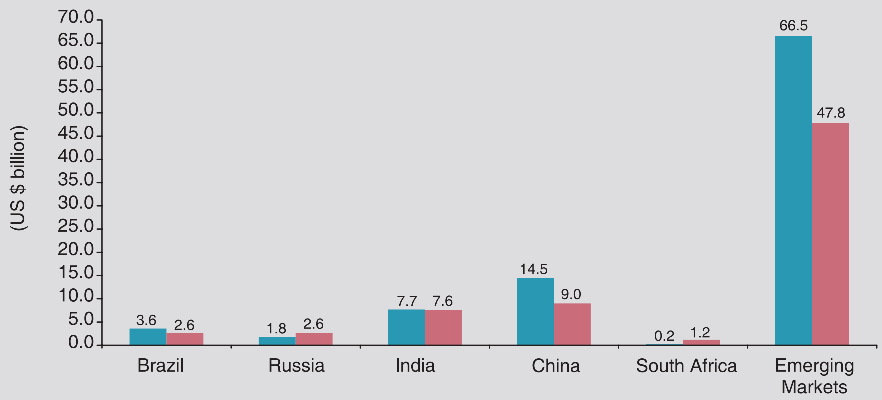
(US $ billion)

	2007	2008	2009-H1
1	2	3	4
United States	105.7	204.4	26.0
Western Europe	132.6	78.9	12.1
Developed Asia	11.0	16.4	2.3
Emerging Asia	30.4	28.3	10.5
CEE/CIS	8.3	6.3	0.5
Latin America	8.0	7.0	0.5
Sub-Saharan Africa	3.4	2.9	0.6
Global Total	302.9	347.6	53.1

Note : Developed Asia includes Japan, Australia and New Zealand.
Emerging Asia excludes Japan, Australia and New Zealand.

Source : EM PE Industry Statistics, EMPEA, September, 2009.

Chart 2: Private Equity Fundraisings and Investments in BRICS in 2008



Source: EMPEA.

per cent of total global private equity funds raised and investments, respectively. Among the EMEs, emerging Asia contributed 60.0 per cent of the total funds raised in the region and around 59.2 per cent of the total PE investments are from emerging markets (Chart 2). In the wake of the global financial crisis in 2008, however, private equity investments in emerging markets declined by 10.8 per cent over the previous year. Investment activity slowed particularly during the second half of the year as investors abstained from buyouts in view of the collapse of major equity markets in the world.

III.4.2 Structure of Investments

The structure of investments have undergone a sea change from 2000 to 2007. Around 89.0 per cent of the investments were in the form of buyouts in 2007 as opposed to 21.0 per cent in 2000. On the other hand, investments in early and expansionary stage have declined significantly (Table 4).

Table 4: Investments by financing stage

(Per cent share)

	Early stage	Expansion	Buyouts
1	2	3	4
2000	33.0	46.0	21.0
2007	2.0	9.0	89.0

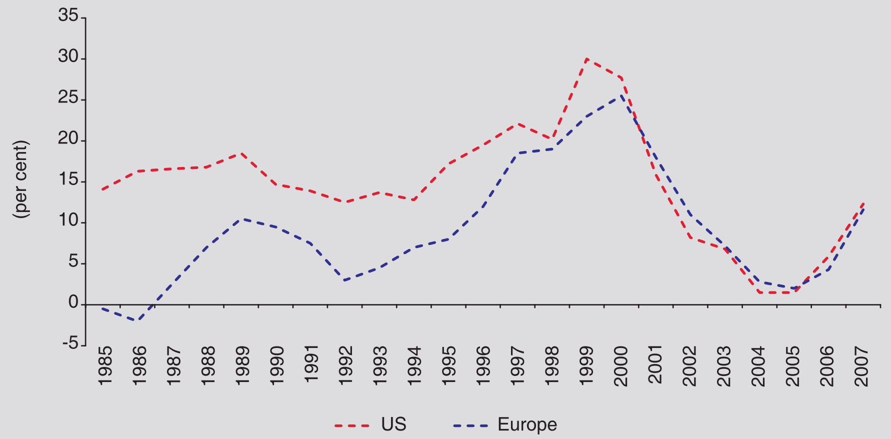
Source: IFSL, 2008.

III.4.3 Return on Private Equity Investments

Private Equity returns in US and Europe have been displaying a characteristic cycle. The returns witnessed a steady rise from 1985 to 1989, followed by a decline till 1995. The returns picked up thereafter and continued to rise to an average of 22.8 per cent till 2000 after which there was a steep decline probably due to the bursting of the dot-com bubble. The industry appears to have revived in 2006 with the average returns in US and Europe during the two years rising to 9.1 per cent and 8.0 per cent, respectively (Chart 3).

The year 2008, although marked by extreme volatilities, witnessed strong commitments from institutional investors investing in private equity funds. In 2008, 339 limited partners made 449 fund allocations, representing moderate increases of 7.2 per cent and 5.9 per cent, respectively, compared to those for 2007. In 2008, China was the most active player with fund allocations registering a rise of 68.1 per cent over 2007. On the other hand, institutional investments from USA witnessed a decline of 43.8 per cent in number of fund allocations during 2008. Government related agencies were the most active investor group. During 2008, US$ 46.3 billion in deal value have been transacted from 789 transactions as compared with US$ 46.9 billion from 907 transactions in 2007. The average deal size has increased to US$ 66.4 million during 2008 from US$ 57.6 million in 2007 (APER; 2008).

Chart 3: Private Equity 5-year Returns (1985-2007)

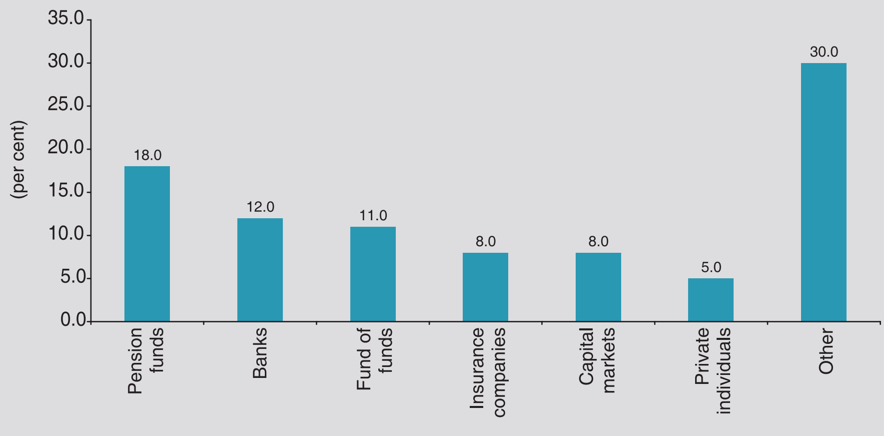


III.5 Regulation of Private Equity Market

III.5.1 Motivation behind Regulation

Private Equity firms' role as an intermediary for other institutions in leveraged investments along with the growth in size of buyout transactions and the involvement of banks has raised concerns about economy's vulnerability to a systemic financial market event if a large firm, or a series of firms purchased in highly leveraged buyout or a major private equity firm should suddenly fail (Shapiro and Pham; 2008). However, studies have shown that the debt to equity ratio of large private equity firms was much less (2.3 to 1) than investments of much larger financial institutions during the highly speculative period of late 1990s, when large subsequent losses did not produce systemic problems and even less than the debt-equity ratio of investment banks (27 to 1) that recently produced systemic problems. Further, a systemic crisis involves cascading effects transmitted across financial institutions. However, according to one school of thought, a private equity firm is unlikely to be so interconnected so as to cause ripple effects. The financial institutions central to this cascading pattern hold only about one third of the investments in private equity funds, while pension funds, endowments and wealthy individuals that hold a majority of these investments are less subject to severe selling pressure from sudden losses (Chart 4).

Chart 4: Sources of New Funds Raised by PE funds originating in Europe in 2007



Moreover, private equity investors usually cannot exit a fund without giving considerable notice, even when a large loss occurs, thereby reducing the probability of any panic selling.

However, after the US financial crisis in 2007, central banks around the world have become particularly alarmed about the activities of financial institutions. Concerns have been expressed about the interconnectedness between banking institutions and private pools of capital such as private equity and hedge funds and their role in igniting and fuelling a systemic crisis. There is increasing evidence that in the lure of high transaction fees and other revenue earning ancillary services, banks have been competing to provide the debt finance for private equity transactions on cheapest and most flexible terms. The private equity fund manager, in turn, combines debt finance into highly leveraged package, making all or none offer to banks. Because of their ability to distribute debt, banks accept such high leverage levels without regard to the credit terms, credit quality and interest rates. However, there is rising probability that inability to refinance on competitive terms and drying up of the institutional debt market can increase the cost of funds for private equity firms. The appetite for new private equity investment may go down if the participants in the institutional debt market lose on their investments. Hence, there is an emerging consensus that banks should be subject to prudential norms with respect to their exposure to private equity investments. The G-30 Report on 'Financial Reform – A Framework for Financial System', 2009 has observed that systemically important banking institutions should be prohibited from sponsoring and managing commingled private pools of capital. Large proprietary trading in such institutions should be limited by strict capital and liquidity requirements. In the meantime, the political sensitivity towards regulation of private equity has also gone up. Towards this objective, the European Parliament in October 2008 has passed a resolution demanding greater regulation of private equity funds calling for capital requirements, binding disclosure and transparency norms, controls on asset stripping and capital depletion and limits on director's remuneration. The developments in the coming days may enable emerging economies like India where private equity is a relatively new institution to develop their regulation framework for the same. In this context, the following insight into the cross-country experience in regulation of PE in developed and some emerging market economies would be a learning experience for others who are at a formative stage. Given the alarming increase in the demand for regulation of private equity business activity, the following section takes a stock of the existing legislations in different countries with respect to a private equity firm.

III.5.2 Cross-Country Regulatory Experiences

The regulation of private equity in most countries is at an evolving stage. Private equity is a regulated entity in US and UK. Both the countries have standalone rules and regulations for private equity. However, in most other countries, they are regulated within the framework of existing regulations in the state. For example, private equity investment from abroad is considered as foreign direct investment (FDI) which is subject to the regulations on foreign capital such as sectoral caps and lock-in period as in India. Similarly, since private equity firms indulge in mergers and acquisitions, they are bounded by the rules of takeover legislation in respective countries. However, they are not subject to any universal prudential norms like the 'Basel norms for banks'. In some countries, private equity funds are not regulated above and beyond that of any corporate body (Cumming and Johan, 2007). Given the fact that the investors in private equity funds are institutional investors and high net worth individuals and not retail investors, these funds have not received the same degree of scrutiny as other types of retail based funds such as mutual funds. They are only subject to the corporate and taxation laws of limited partnership, if structured so. Further, the industry insists on self regulation where disclosures are made between investors (limited partners) and owners (general partners). In other words, unlike a publicly listed company which has to publish its financial results, annual reports and updates and forecasts of their performance to regulators, private equity faces no equivalent pressures to provide detailed accounts of their activities. The majority of statistical information about private equity ultimately derives from what member firms report to associations voluntarily. However, this leads to moral hazard as there is an incentive on the part of private equity firms to report only successful activities. Hence such a report can only provide skewed image of the impact of the private equity on economy, society and polity at large. However, of late, recognising the positive impact of regulation on future deal flow, as documented in many research studies, several private equity associations like European Venture Capital Association (EVCA), British Venture Capital Association (BVCA) and US Venture Capital Association (UVCA) have framed reporting standards and valuation best practice guidelines to enable investors make informed choices (Box 1).

United States[2]

The regulatory environment for private equity firms in United States has evolved over a period of time gaining from the experience of various transparency lawsuits brought upon by private equity investors on private equity sponsors (State of Connecticut vs Forstmann Little & Co.; CaLpers vs SEC). The primary regulatory requirements for private equity firms consists of registration under the US Securities Act of 1933, Investment Company Act of 1940 and Employee Retirement Income Security Act of 1974 (Erisa). However, each of these laws are provided with several exemptions. For example, under the federal securities laws, a non-US fund may offer and sell interests to US investors without registration, provided that it does not make a public offering in the US, the fund has no more than 100 US investors or that all of its US investors be ‘qualified purchasers’[3]. If a fund makes offers only to sophisticated investors and qualifies for an exception from registration as described above, it is not required to make any specific disclosures to prospective investors.

2 Adapted from www.altassets.net.

3 In general, individuals with investment portfolios of US$ 5m or more and institutions with investment portfolios of US$ 25m or more are ‘qualified purchasers’.

Box 1: International Private Equity and Venture Capital Valuation Guidelines

The increasing importance placed by international accounting authorities on Fair Value reinforced the need for the consistent use of valuation standards in valuing private equity investments. Hence AFIC, EVCA and BVCA developed a set of guidelines to set out the best practice where private equity investments are reported at "Fair value" with a view to promoting best practice and hence helping investors in private equity funds make better economic decisions. The requirements and implications of International Financial Reporting Standards and US GAAP have been considered in the preparation of these guidelines.

1. Principles of Valuation

a. Investments should be valued at Fair Value where fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. In the absence of an active market for a financial instrument, the Valuer must estimate Fair Value utilizing one of the valuation methodologies.

b. In private equity, value is generally crystallized through a sale or floatation of the entire business, rather than sale of an individual stake. Accordingly, the enterprise value will provide a base for estimating the Fair Value of an investment in that business.

2. Valuation Methodologies

a. Price of Recent Investment Methodology: When the investment being valued was itself made recently, the Valuer should use the cost of the investment itself or the price at which a significant amount of new investment into the company was made to estimate the Fair Value of the investment, but only for a limited period following the date of the relevant transaction.

b. Earnings Multiple: This involves application of an earnings multiple to the earnings of the business being valued in order to derive a value for business.

c. Net Assets: This methodology involves deriving the value of a business by reference to the value of its net assets. It is appropriate for a business whose value derives mainly from the underlying value of its assets rather than its earnings.

d. Discounted Cash Flows or Earnings: This involves deriving the value of a business by calculating the present value of expected future cash flows. The cash flows are those of 'underlying business' and not those from the investment itself.

References :

International Private Equity and Venture Capital Valuation Guidelines, www.evca.eu, September 2009.

Fund sponsors, like others who provide securities investment advice, are generally required to register with the Securities and Exchange Commission (SEC). However, a non-US firm is generally exempt from registration as an investment adviser if it furnishes advice to fewer than 15 clients and does not hold itself out as an investment adviser to the public in the US. Performance fee arrangements with clients who are resident outside of the US are no longer covered by the Investment Advisers Act of 1940 and SEC rules give an investment adviser wide latitude to structure fee arrangements with US investors that have a net worth of at least US$1.5m or have at least US$ 750,000 under the management of the investment adviser.

For US investors in private equity funds, domestic and foreign entities are in general equally tax-efficient, provided the fund qualifies as a partnership for US tax purposes. Both foreign and domestic partnerships are ‘pass-through’ entities. No federal income tax is imposed on a partnership at the entry level and US investors are taxed on their shares of the taxable income of the partnership, not on the money or other assets the partnership distributes to them. US institutions, such as pension plans are subject to Unrelated Business Income Taxation (UBIT). UBIT generally applies to investments made by such institutions with borrowed money and may apply when tax-exempt US institutions earn income from ‘leveraged’ (*i.e.* geared) funds.

All US non-governmental employee benefit plans are subject to the Employee Retirement Income Security Act of 1974 (Erisa). Erisa imposes a comprehensive regulatory regime over persons who serve such plans. Among other things, Erisa establishes the standard of fiduciary care that must be shown by a person making investment decisions for such plans. Under Erisa’s plan assets regulations, the assets of a fund with one or more Erisa investors are deemed to be ‘plan assets’. If so, the private equity fund itself becomes subject to the substantive provisions of Erisa, including a comprehensive array of operating restrictions, among which are broad prohibitions on transactions with so called ‘parties in interest’ with respect to any of the Erisa investors. Moreover, the fund manager is held to the standards of an Erisa fiduciary. In order to avoid these burdens, most private equity funds that have a significant proportion of Erisa investors, seek to qualify for the venture capital operating company (VCOC) exception under the plan assets regulation. If the fund qualifies as a VCOC (50 per cent of the assets in venture capital funds), only the Erisa plan's investment (*e.g.* its limited partnership interest) in the fund (and not any interest in the underlying assets of the fund) will be considered to be plan assets. Consequently, neither the fund nor its manager will be subject to the fiduciary requirements, prohibited transaction rules and penalties, and other provisions of Erisa.

Under the US Consumer Privacy legislation, private equity funds organized within US must disclose the firm's policies and practices with respect to disclosure of non-public personal information. Subject to certain exceptions, no non-public personal information may be shared with non-affiliates unless the regulated firm has given the consumer the opportunity to opt out of the proposed sharing of information.

At the state level (Blue Sky laws), most private equity funds were able to raise capital without being subject to any substantive review. The regulations were somewhat tightened after the terrorist attack of September 11, 2001. Now private equity firms are subject to scrutiny at their formation/capital raising stage and regulation of investment advisors and management of portfolio companies is undertaken according to Sarbanes Oxley Act of 2002 (SOA).

United Kingdom

The UK private equity industry is one of the only two regulated private equity and venture capital industries in the world (Speck and Tanega, 2006). The UK regulatory perimeter is set by the Regulated Activities Order (RAO) (FSA; 2006). Although the regulations under RAO define 'venture capital firm', the word 'private equity' does not find mention in the regulations. Hence any private equity firm which undertakes a business which is within the scope of 'venture capital business' mandatorily needs authorisation from the Financial Services Authority. However, private equity firms which engages in activities beyond ‘venture capital business’ have broader permissions. Besides the ROA, the private equity firms have to adhere to the FSA Handbook requirements such as High Level Standards, Prudential Standards and Business Standards. If the activities of a private equity firm bring it under the cover of ‘Investment Services Directive’ (ISD), then it may be subject to prudential regulations. For example, a private equity firm carrying out portfolio management or the reception or transmission of orders is subject to minimum capital adequacy requirements. Private equity firms have to comply with the obligations contained in the Money Laundering Regulations, 2003 and Conduct of Business Requirements. However, each of these regulations provide for a number of exemptions. But with the implementation of the Markets in Financial Instruments Directive (MiFID) which is replacing the ISD, many investment services which were classified as non-core under ISD will be reclassified as core service under MiFID. As a result, more number of private equity firms will be brought under the regulatory purview of FSA. MiFID has more stringent requirements with respect to prudential norms. Apart from the FSA, the British Venture Capital Association (BVCA) has been undertaking periodical review of the self regulatory norms of the industry. The BVCA in collaboration with some private equity firms have set up a committee under David Walker in February 2007 to undertake a review of the transparency and disclosure requirements for the industry (Box 2).

However, post sub-prime crisis, there has been a sudden surge in the demand for regulation of private equity firms. In October 2008, the European Parliament adopted a resolution demanding regulation of private equity funds based on a report prepared by the Party of European Socialists. These demands include: limitations on debt levels in leveraged buyouts; measures to contain asset stripping of portfolio companies by private equity owners; greater transparency and disclosure rules for private equity with far greater scope than the voluntary “Codes of Conduct” which have been promoted as alternatives to regulation; greater capital adequacy

Box 2: Recommendations of the Walker Committee

In order to undertake an independent review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the private equity industry on a voluntary basis, the British Venture Capital Association (BVCA) and a group of major private equity firms constituted a committee under David Walker in February 2007. The report set out guidelines for adoption in six areas *viz.*, (i) appropriate size thresholds for enhanced reporting by portfolio companies; (ii) appropriate ingredients in such reporting; (iii) the extent of public policy and other concerns about the prospective imbalance as between reporting by private equity portfolio companies and other large private companies; (iv) appropriateness of the elements envisaged for inclusion in annual reviews as a key element in greater openness on the part of private equity firms; (v) coverage of the agenda for significantly enhanced data collection and analysis by the BVCA on an industry-wide basis; (vi) an appropriate process for review of the guidelines.

Recommendations of the Committee

1. Thresholds: A portfolio company is a UK company which is acquired by one or more private equity firms in a public to private transaction/secondary or other non-market transaction where the market capitalization together with the premium for acquisition of control was in excess of £ 300 million/ enterprise value at the time of the transaction is in excess of £ 500 million, more than 50 per cent revenues were generated in the UK and UK employees totalled in excess of 1,000 full-time equivalents.

2. Disclosure by portfolio company:

➢ A portfolio company should include in its audited annual report enhanced disclosures such as the report should identify the private equity funds that own the company, details on composition of the Board, business review containing analysis of the main trends and factors likely to affect the future development, performance and position of the company’s business and information about environmental matters, company’s employees and social and community issues, financial review covering risk management objectives and policies in the light of principal financial risks and uncertainties facing the company including those relating to leverage.

➢ The report and accounts should be made available in no more than 6 months after the company year-end. The audited report should be readily accessible on the company website.

➢ Portfolio companies should provide to BVCA data on trading performance, including revenue and operating earnings, employment, capital structure, investment in working and fixed capital and expenditure on R&D and such other data as may be requested by BVCA.

3. Disclosure by Private Equity firm:

- An annual review on its website describing the way in which FSA-authorised entity fits into the firm of which it is a part;
- A commitment to conform to the guidelines on a comply or explain basis and to promote conformity on the part of portfolio companies owned by it;
- Description of UK portfolio companies in PE's portfolio;
- In reporting to limited partners, PE firms have to abide by EVCA guidelines. These guidelines require that PE firms produce semi-annual reports within 60 and 90 days; reporting should include details of commitments, drawdowns and distributions; changes to investment strategy, current and new investments, follow-ons; performance; detailed realization summary by investment; valuation of each investment; and clear statement of benefits, fees and net management fees.
- The PE firm should provide data to an accounting firm appointed by the BVCA informing the amounts raised in funds, acquisitions and disposals of portfolio companies, estimates of aggregate fee payments *etc*.

Adapted from "Guidelines for Disclosure and Transparency in Private Equity", November 2007.

requirements for financial instruments and institutions (including private equity and hedge funds), limitations on the easy securitization of leveraged loans ("originate and distribute") which have fuelled both the buyout boom and the financial crisis generally; and ensuring that employees in private equity-owned companies exercise the same rights to information as other EU private-sector employees. In reaction, EVCA has formed a formal group called as the Brussel's taskforce to respond to European Parliaments' resolutions on this aspect.

Switzerland[4]

Switzerland has been among the top continental European countries with growth rates of more than 100 per cent in 1999 and 2000. Private equity structures in Switzerland can take the form of limited partnership, investment fund or a joint stock company. Swiss

[4] www.altassets.net

investment funds and investment foundations are highly regulated under the Swiss Investment Fund Act. Swiss investment funds may only be set up after the Federal Bank Commission (FBC) has approved the fund regulations established by the fund management and the depository bank. In addition, the Swiss fund manager has to obtain an authorisation from the FBC. Investment foundations are also regulated and supervised by a governmental authority. There are many compulsory investment restrictions, too. In particular, by law, investors in an investment fund must be entitled to make at least quarterly redemptions. For swiss investment funds, there might be high tax on the management's carried interest when compared to a manager's position in an offshore jurisdiction. Swiss joint stock companies have been used in the past for private equity purposes. Ordinarily, a standard Swiss holding company is set up as a two-layer structure with a wholly-owned offshore subsidiary holding company. The Swiss company collects funds by issuing shares to the public and the investments in the targeted private equity investments are then made through the offshore intermediary holding company. Companies structured in this way have been listed on the Swiss Exchange SWX in the investment companies segment. The company is governed by the well established provisions of the Swiss Code of Obligations (SCO) and is therefore in a well known legal environment. In Limited partnership structure, the general partner is required to be an individual under the Swiss law. A foreign limited partnership, on the other hand, is exempted from taxes in its chosen jurisdiction. If a limited partner is not resident in that jurisdiction, any income derived from the partnership's international operations and any interest the limited partner receives is not regarded as arising or accruing from a source in the partnership's jurisdiction. In addition, no inheritance, capital gains, gifts, turnover or sales taxes are levied in the chosen jurisdiction in connection with the acquisition, holding or disposal of interests and no stamp duty or similar taxation is levied on the issue or redemption of partnership interests. However, interests in the partnership are not freely transferable and no secondary market for such interests exists.

China

Private equity activity in China is restricted to venture capital and growth capital areas. The ability of foreign private equity investors to acquire a controlling stake even in unlisted companies is quite limited (Lange et al; 2007). Further the foreign investment policies of Chinese Government are designed to create a protective environment shielded from foreign competition to encourage the development of indigenous industries. And using its extensive powers of approval over foreign investment, Government has easily limited foreign acquisition of control over well known Chinese brands. Given this limited scope, major Western buyout funds have concentrated on acquiring substantial minority stakes in dynamic privately owned companies, hoping to fund a rapid expansion through both capital investment and acquisitions and to lead the company to a successful IPO within two to three years. The preferred strategy in doing this has been the "round trip investment" route. This involves the creation of an offshore holding company in which both the foreign private equity investors and Chinese resident would hold interests. And this offshore company would be used to control a Chinese company by either direct acquisition or captive contractual arrangement.

The Chinese Government overtime became increasingly sceptical about "round trip investments" and since 2005, the State Administration of Foreign Exchange (SAFE) which regulates such investments has made numerous attempts to restrict offshore holding companies. In October 2005, SAFE issued Circular No. 75 which required Chinese residents to register with local SAFE branch before establishing or controlling any offshore special purpose company. Failure to comply with Circular No. 75 prohibits the offshore parent company's Chinese subsidiary from distributing profits outside China. In September 2006, SAFE, Ministry of Commerce, the China Securities Regulatory Commission and State Administration of Taxation jointly issued regulations on mergers and acquisitions of domestic enterprises by foreign investors. According to the newly instituted rules, any acquisition by an offshore company that is controlled by a Chinese resident will require approval of the Central

Government. The M&A rules provide for reporting to Ministry of Commerce in advance of any transaction that would result in the control by foreign investors of a Chinese company that involves a key industry, has an impact on economic security or causes change of control of a Chinese company that owns a well known trademark. In May 2007, SAFE issued Circular No. 106 which contains the guidelines for implementation of Circular No.75. This imposes some extensive new requiements such as 3 year operating history of domestic target company. It also extends the definition of 'round trip investment' by requiring registration of greenfield investments by Chinese residents in offshore companies (Chao and Xu; 2008).

Other restriction on private equity firms include rules such as investors will have to complete their transactions in the local currency renminbi. Additionally, when they sell their stakes back to the public, they will have to list the company on mainland markets, rather than offshore exchanges. Furthermore, the government has made it clear that while it welcomes private equity funds, investors must have a long-term investment approach. However, till now deals often have to go through a plethora of regulators, ministries and councils on a case-by-case basis, with varying degree of success or transparency.

Malaysia

Malaysia has a robust and comprehensive Islamic financial system structured and managed in accordance with the Shariah principles. Hence the emphasis was to develop the Islamic venture capital and private equity where investments are made in businesses that offer Shariah-compliant products and services. The investment model is based on long-term active partnership and risk sharing consistent with the Shariah principles of *mudhurabah, musyarakah and wakaiah.* The venture capital industry of Malaysia is regulated by the Malaysian capital market regulator, the Securities Commission, under the Guidelines and Best Practices of Islamic Venture Capital. Under this, anyone trying to establish a venture capital corporation has to fulfil two fundamental requirements *viz.*, (i) The appointment of a Shariah adviser who provides continuous guidance in ensuring that amongst others, the proposed investment contract and instrument structures are Shariah compliant; (ii) the core activities of the investee company are Shariah compliant. The best practices for Islamic venture capital corporations and management companies are voluntary in nature (MVCA; 2008).

Section IV
Evolution of Private Equity in India

Historical Background

The history of private equity in most of the South Asian regions begins with venture capital firms which later graduated into the indigenous private equity firms by broadening their sphere of activities. The seeds of the Indian private equity industry was laid in the mid 80's. The first generation venture capital funds, which can be looked at as a subset of private equity funds were launched by financial institutions like ICICI and IFCI. In 1984, ICICI decided to launch its venture capital scheme to encourage start-up ventures in the private sector and emerging technology sectors. This was followed by the establishment of 'Technology Development and Information Company Ltd' and IFCI sponsored 'Risk Capital and Technology Finance Corporation of India Ltd'. Commercial banks like Canara Bank also came up with their own venture capital funds. Subsequently, various regional venture capital funds came up in Andhra Pradesh and Gujarat. In late 80's and early 90's, various private sector funds also came into being. Between 1995-2000, several foreign PE firms like Baring PE partners, CDC Capital, Draper International, HSBC Private Equity and Warbug Pincus also started coming in. Firms like Chrys Capital and West Bridge Capital set up by managers of Indian origin with foreign capital also embarked into India with a focus on IT and internet related investments in tune with the technology boom in US during the period (Venture Intelligence, 2005). During the mid 1990's, laws for venture capital funds formally started taking shape. The Securities and Exchange Board of India issued the SEBI (Venture Capital Funds), Regulations, 1996. These regulations were amended in 2000 on the recommendations of K.B. Chandrasekhar Committee.

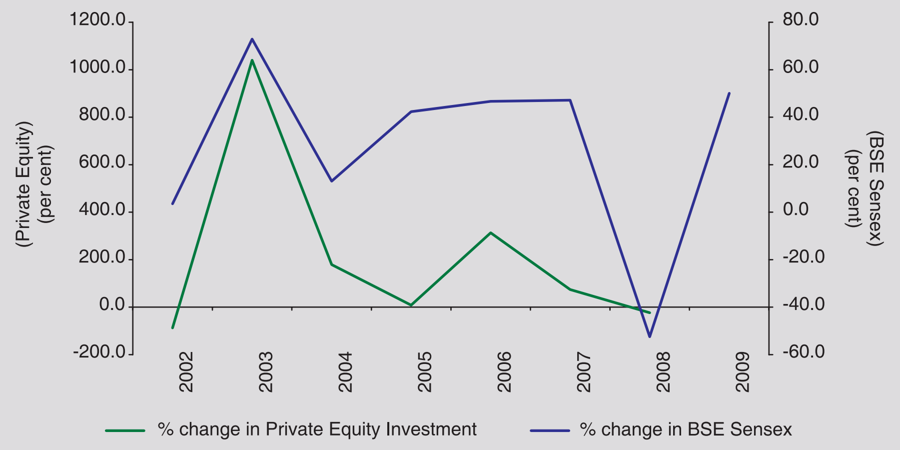
The PE industry slowed down between 2001-03 after the technology boom burst in US in 2000. Many foreign PE investors fled India during that period. Investment activity revived in 2004 with the upward trend in domestic stock market. Six PE-backed companies went public successfully. Investment focus also turned towards non-IT investments like manufacturing, healthcare and those dependent on domestic consumption growth. However, despite a long history, the penetration of PE capital into India remains a miniscule 0.61 per cent of GDP today.

IV.2 Performance of Private Equity in India

In India too, private equity has been emerging as a potential source of corporate finance supplementing the traditional sources of resource mobilization such as public equity issues, private placements, euro issues and external commercial borrowings.

The key driving factors behind the flow of PE capital into India are its strong macro-economic fundamentals characterized by high growth rate, high gross domestic investment and a booming stock market. In fact, private equity interest in India grew from 2003 onwards when the domestic stock markets recorded higher returns (Chart 5). A booming secondary market and regulatory reforms in

Chart 5: BSE Sensex and Private Equity Investments in India



the primary market widened the exit possibilities for private equity firms and hence attracted them to India. Over the last few years, private equity has emerged as a potential source of finance for the cash strapped small and medium enterprises, infrastructure sector, education and environment sensitive sectors too.

The number of private equity deals in India increased from 82 in 2004 to 439 in 2007 with the total investment rising from US$ 1,719 million in 2004 to US$ 13,269 million in 2007 (Table 5).

IV.2.1 Sectoral Analysis

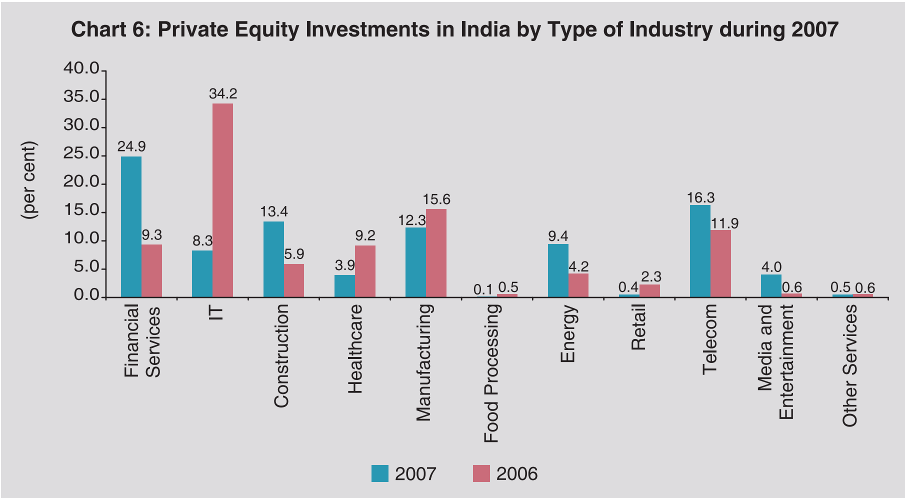
Private equity mainly flowed into banking and financial services, construction and real estate, information technology, media and entertainment and other sectors (Chart 6). During 2007, the financial services sector accounted for around a quarter of the total investments and around 75.0 per cent of the investments in that sector is made by foreign private equity firms. Most of the deals were PIPE deals. The infrastructure sector also accounted for a good chunk of investments. Telecom sector in particular accounted for around 16.0 per cent of the total PE investments in India in 2007 and over 70.0 per cent of the investments were made by joint ventures between Indian and foreign private equity firms. The construction and real estate sector accounted for over 13.0 per cent of the investments, mostly by foreign private equity firms in late stage and PIPE deals (Chart 7). During 2008, private equity investments recorded a decline of 23.0 per cent to US$ 10.8 billion

Table 5: Private Equity Investments in India

(US$ million)

	No. of Deals	Amount
1	2	3
2004	82	1,718.84
2005	158	2,028.73
2006	326	6,631.47
2007	439	13,269.01
2008	399	10,800.00

Source: Private Equity Impact, 2009, Venture Intelligence.



due mainly to the adverse impact of global financial turmoil (Appendix Table 1).

IV.2.2 Performance of PE-backed companies

Between 2000 and 2008, PE-backed companies registered comparatively better performance over non-PE-backed companies in terms of sales, profit after tax, foreign exchange earnings, job creation and growth in research and development (Chart 8).

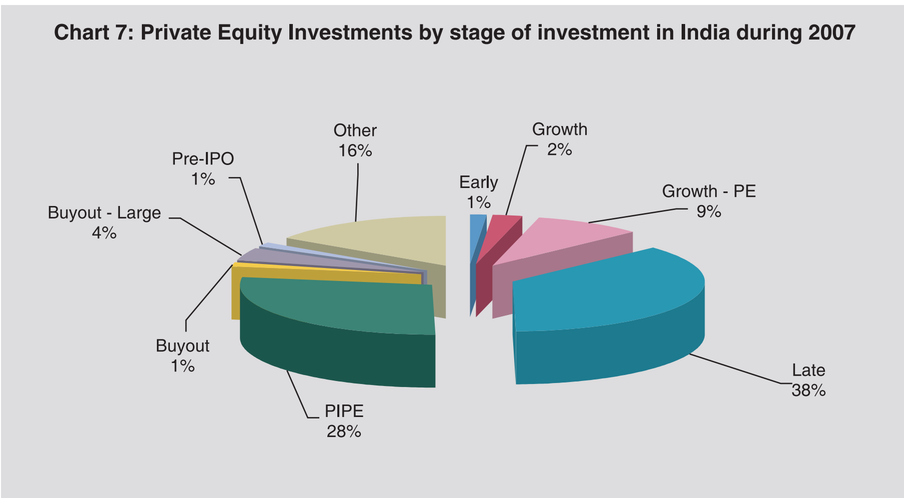
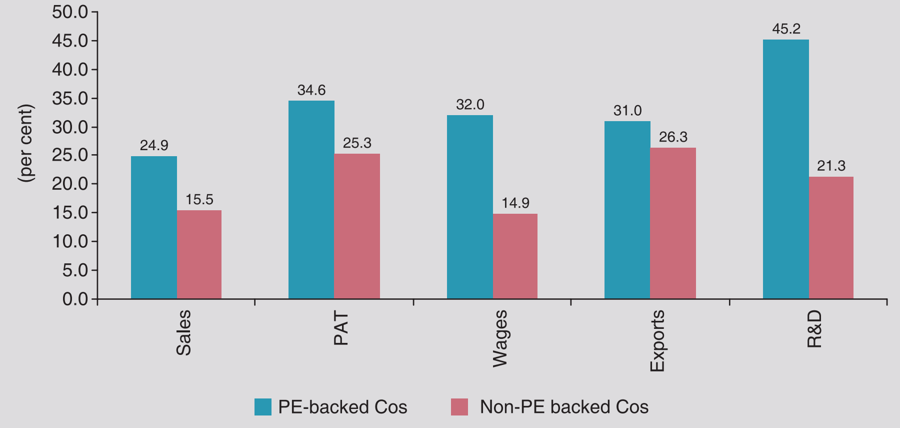


Chart 8: Annual Growth in Different Parameters in PE-backed and non-PE backed Companies during 2000-2008



IV.2.3 Successful Private Equity Deals

One of the early and successful private equity deals in India was Bharti Airtel –Warbug Pincus deal which spurred further private equity activity in India. Bharti Airtel received US$ 292 million from Warbug Pincus over a two year period ending September 2001 (Venture Intelligence, 2005). The fund so raised enabled Bharti to expand its business from just two mobile telecom circles in Delhi and Himachal Pradesh to around 23 circles in 2004. Warbug not only provided capital but strategic inputs and mentored its management team. Warbug Pincus started its process of exiting Bharti Airtel in August 2004 by selling its stake in a piecemeal fashion. Warbug completed its exit in October 2005 by offloading its residual stake of 5.65 per cent to Vodafone for US$ 848 million. Warbug secured total gains of around US$ 1.3 billion in the sell-off.

The leveraged buyout of Infomedia by ICICI Venture in 2003 from Tata Group was another celebrated private equity deal in India. ICICI Venture worked on the company, built a unique business model, made value-added changes and made a successful exit from the company in 2007 by selling its controlling stake in Infomedia to a well known media house, TV 18.

Another notable PE success story lies in the NBFC field. The 'Shriram Transport Finance Corporation', a vehicle finance company opted for private equity capital from ChrysCapital and TPG Newbridge in 2005. It helped the company build a global outlook.

IV.3 Regulation of Private Equity in India

In India, private equity is not a regulated activity, *per se* (Gopinath; 2009). However, indigenous and foreign venture capital funds are regulated by SEBI (Venture Capital Funds) Regulations, 1996 and Foreign Venture Capital Funds Regulations, 2000. Further, private equity/venture capital funds investments from abroad have to adhere to the restrictions on foreign capital inflows. In other words, although there may not be any explicit regulations for private equity fundraising and investment in India like in US and UK, private equity funds are regulated within the ambit of existing regulations.

IV 3.1 SEBI (Venture Capital Funds) Regulations, 1996

Venture capital, which can be looked at as a subset of private equity, has been under regulatory oversight since 1996 when the SEBI (Venture Capital Funds) Regulations, 1996 came into existence. This legislation enumerated the norms for registration of venture capital funds, investment conditions and restrictions, general obligations and responsibilities and investigation and inspection. Under this, venture capital funds are prohibited from inviting subscription from public. They can only obtain funds through private placement of units. Further, no venture capital funds shall be eligible to list on a recognised stock exchange till the expiry of three years from the date of issuance of its units. Restrictions on investment conditions include disclosure of investment strategy at the time of registration of funds, investment in a particular undertaking shall not exceed 25 per cent of the corpus of the fund, *etc.*

IV.3.2 Foreign Venture Capital Funds Regulations, 2000

Subsequently, SEBI introduced Foreign Venture Capital Investors (FVCI) Regulations in 2000 to enable foreign funds to register with SEBI and avail of some benefits which are otherwise not available under FDI route. Some of these benefits include no lock up of shares held by registered investors and exemption from applicability of valuation norms, thereby enabling investors to buy and sell shares in Indian unlisted companies at prices they deem appropriate, upon mutual agreement between buyers/sellers. However, they cannot invest more than 33.3 per cent of the investible funds in shares of listed companies or debt instruments. Further, the provisions of SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 1997 do not apply to shares transferred from an FVCI to the promoters of the company or the company itself. Thus if the promoters intend to buy-back their shares from FVCI, they will not be required to comply with the public offering requirements of the Takeover Code. FVCIs registered with SEBI are 'Qualified Institutional Buyers' under SEBI (Disclosure and Investor Protection) Guidelines, 2000 and hence are eligible to participate in the primary issuance process. They are subject to regular inspection and investigation by SEBI. Further, Indian venture capital funds (VCFs) are entitled to tax benefits under Section 10(23FB) of the Income Tax Act (1961) under which any income earned by SEBI registered VCF, established either as a trust or company, to raise funds for investment in VCF, is exempt from tax. Further, FVCIs particularly benefit from the Section 90(2) of Income Tax Act which provides relief from double taxation to non-resident investors residing in countries with whom India has Double Tax Avoidance Agreement such as Mauritius. Mauritius is now increasingly used by foreign investors to establish offshore entities and invest into Indian VCFs, thus benefiting from the tax avoidance treaty. However, while considering an FVCI application, SEBI reviews the applicants track record, professional competence, financial soundness, experience, general reputation, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer, amongst other factors. However, it is not manadatory for a foreign venture capital fund to register with SEBI. They can still invest in India *via* the foreign direct investment route subject to compliance with applicable securities pricing norms.

IV.3.3 Restrictions on Inflow of Foreign Private Equity

Foreign venture and private equity funds came to invest in India through the FDI route. Foreign investments, either through FII route or FDI route, are subject to sectoral caps. Government of India has imposed investment limits for FIIs of 10 per cent and the maximum FII investment in each publicly listed company may at times be lower than the sectoral cap for foreign investment in that company. Under the FDI route, FIPB approval is required for foreign investments where the proposed shareholding is above the prescribed sector cap or for investments in sectors where FDI is not permitted or where it is mandatory that proposals be routed through the FIPB. Very recently, the Foreign Investment Promotion Board has ruled that foreign investment can flow into private equity funds registered as trusts. The Department of Industrial Policy and Promotion is framing the guidelines for allowing investments in trusts that invest in companies, especially start-ups, with the aim of long-term capital gains.

IV.3.4 Prudential Regulations for private equity

As of now, there are no prudential regulations on private equity unlike Indian banks. However, keeping in view that Indian financial sector is largely bank-intermediated and there have been recent cases of Indian banks engaging in sponsoring and managing private pools of capital such as venture capital funds and infrastructure funds, the Reserve Bank of India had mandated maintenance of certain level of economic capital in some of the cases approved in the recent past (Gopinath, 2009). Further, in the Annual Policy Statement 2009-10, RBI has proposed to issue a paper on prudential issues in banks floating and managing private pools of capital.

However, legal caution still prevails with respect to private equity investment into leveraged buyouts and exit through foreign listing. The laws for leveraged buyout of Indian companies are not conducive. Companies Act 1956, Section 77(2) prohibits a public company (or a private company which is a subsidiary of a public company) from providing any financial assistance whether by means of guarantee, provision of security in connection with purchase of their shares or shares of their holding companies. Further, if a public company is listed, prior to being acquired in a LBO, the company must delist and convert itself to a private company. FIPB's Press Note 9 bars a foreign investment company from borrowing from an Indian bank to buy into a company in India (Chokshi, 2007).

While exit of private equity investment through domestic public listing is under the process of liberalization, laws still hold back exit through foreign listing. SEBI guidelines require mandatory listing of Indian companies on domestic exchange prior to foreign listing. Bulk of the private equity transactions in India are minority transactions. This is because in a large number of Indian companies, management control rests with promoters who may not want to divest their controlling stake for additional capital. In the absence of control, it may be difficult to finance a minority investment using leverage given the control over the cash flows of the target company to service the debt. Further, a minority private equity investor, will be unable to sell it's holding to a strategic buyer, thereby limiting the exit options available for the investment.

Besides, there are restrictions on the use of investment instruments. Funds investing in Indian companies have the option of investing in equity shares, preference shares, debentures and other instruments depending on the status of the portfolio company *i.e.* whether it is a private limited company, public unlisted or public listed company. Usage of innovative customized instruments while investing in private limited companies require the prior approval of Government. Hence, private equity investors mostly subscribe to traditional instruments while investing in private companies. Even within the available instruments, investing in preference shares and debentures raises several regulatory restrictions. For example, proceeds raised by non convertible/ optionally convertible debentures or preference shares cannot be used for general corporate purposes. Also such instruments need to have a minimum maturity period and cap on the coupon payable, if they are to be issued without approval (Gandhi, 2008).

Section V
Private Equity – Implications for India

V.1 Trade off between Private Equity and other Non-bank Sources of Finance

There is no gainsaying that private equity is a boon for capital constrained developing economies as they help to bridge large saving-investment gaps. However, does easy access to private equity funds delay firms' decision to go for public offers? Similarly, does it compete away investments/suck liquidity from the domestic debt market? In other words, does private equity compete with traditional non-bank sources of finance like public issues and private placement or supplement them?

Some traces of trade off between non-bank sources of resource mobilization by corporates was found in the first half of 2008-09 in the Indian equity market. With the Indian equity markets on a downswing, the public issues virtually dried up during the first half of 2008-09. Resource mobilization through public issues market declined by 61.2 per cent to Rs.12,361 crore during April-September 2008-09 in tandem with the subdued conditions in the secondary market. Similarly, resource mobilization through private placement market declined by 31.2 per cent during April-June 2008-09 to Rs.34,719 crore. The number of issues also declined as several companies either withdrew their issues from the market due to lacklustre response from investors or postponed their fund raising indefinitely. Under uncertainty, such firms had been induced to tap alternative investment sources like private equity. 'Worckhardt' is one such example to conjure with. However, it is difficult to establish whether private equity funds delay initial attempts at public issues because PE firms themselves seek exit from an investment 4-5 years down the line by handing over its stake either through public offer or sell-off to another company. Further, after investing in a company, PE firms emphasise organizational changes and encourage the host company to go for raising of debt. In view of that, it is natural to expect a positive relationship between private equity and other non-bank sources of finance such as public/ rights issues and resources raised through private placement of debt. This is an important hypothesis to test because any tendency to compete away or delay public issue by companies may not be a healthy trend as resource mobilization through public offers is more transparent as it involves a number of public disclosures as opposed to private equity. However, testing of this hypothesis requires long period data, which is presently not available in case of India.

In order to test the key hypothesis – whether firms delay public offers due to the availability of private equity finance on easy terms and less paperwork - we analysed the resource mobilization history of those companies that issued private equity during 2004 to 2007 and their resource mobilization through alternative sources. Out of the 78 companies that issued private equity in 2004, five, three and four companies raised debt resources through private placement in 2005, 2006 and 2007, respectively. Out of the 78 companies, four companies were listed in 2005 and one in 2006 (Table 6). In 2007, there was an appreciable rise in the number of companies that raised resources through private equity and also in the number of companies that participated in the private placement and public issues market. Out of 364 companies that raised private equity in 2007, 19 companies raised debt through private placement and 9 companies listed on the stock exchange during 2007 and 2008. From this data, it appears that private equity does not discourage resource mobilization through public issues and private placement market. Rather, it encourages resource mobilization through the traditional sources. Understandably, taking up minority/majority shareholding in a company by a PE firm, induces the parent firm to go for restructuring including mergers and

Table 6: Head Count of Companies availing PE, Public offer and Private Placement Route to raise resources

No. of Cos. that issued PE		Cos. That raised resources through private placement in years subsequent to raising PE					Cos. That raised resources through public issues (IPOs) subsequent to raising PE					Cos. That raised resources Through FPOs/rights subsequent to raising PE				
		2004	2005	2006	2007	2008	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
2004	78	–	5	3	4	0	1	4	1	0	0	–	1	–	–	–
2005	149	–	–	0	0	0	4	4	3	0	0	2	4	–	–	–
2006	285	–	–	1	1	0	1	0	3	0	0	–	–	4	–	–
2007	364	–	–	–	9	10	2	6	5	9	0	1	2	0	3	0

acquisitions which in turn places the need for raising of debt from the market. Further, it is to be noted that private equity may appear as an easy alternative in the short run for unlisted companies, but such companies come back to the public issues market after three to four years to divest their stake and exit the investment to realise their gains. It also needs to be mentioned that during a financial downturn, conditions in the PE market are equally uncertain. Hence, private equity may not be able to crowd out resources from the public issues and private placement market.

V.2 Trade off between PE Regulation and Non-Regulation

Private equity regulation has raised some typical issues in recent times. For example, the activities that private equity firms indulge in, mainly activities like leveraged buyouts may not be compatible with the corporate laws of the state. In European corporate law, for example, leveraged buyouts are perceived as an indirect and fraudulent instance of financial assistance and are as such not immune to the ban imposed by Article 23 of Directive 77/91/EEC under which a company may not provide 'financial assistance' for the purchase of its own shares. In Italy, the legality of LBOs has always been under dispute. Until February 2000, the legitimacy of buyouts were uncertain in Italy. On February 04, 2000, the Italian Supreme Court sentenced LBOs to be illegal (Bottazzi; 2008). Critics have alleged that LBOs fall within the scope of the provisions of Italian Civil Code that prescribes criminal sanctions for directors who damage the integrity of a company's share capital through an acquisition or subscription of shares of the company, or in case of a merger cause harm to the company's creditors. In 2001, the Italian parliament specifically requested to reconsider the buyout regulation and hence in January 2004, a new legislative decree was issued where LBOs were legitimized subject to the fulfillment of additional disclosure requirements and provided they do not violate any financial assistance law. The American law, on the other hand, stresses on the social utility of LBOs. The US legal treatment draws an ex-post distinction between 'illegal' and 'legal' LBOs on the basis of whether or not such transfers are intentionally fraudulent. Such disputes indicate the need for some universal laws for the operation of private equity such as basel norms for banks.

Another issue emerging from this relates to whether regulations should be made applicable uniformly to banks, hedge funds and private equity firms, irrespective of the diversity of their risk behavior. Each of these institutions have different investment objectives, different capacity to bear various sets of risks and hence different risk behaviour. Under similar kinds of transparency, valuation, accounting and risk management rules, these players would behave homogenously in case of eventuality thereby reducing financial market liquidity and enhancing systemic fragility.

VI. Prospects for the Private Equity Market in India

The shift in financial conditions since the US sub-prime crisis in August 2007 has magnified vulnerabilities that extend beyond the mortgage markets. Tangentially related markets like the leveraged buyout market are being affected through second and third order effects as concerns in structured finance markets triggered a broad-based increase in risk premia and induced a reluctance to lend, a reduced distinction between investments and other changes in market psychology (GFSR; 2008). At higher leverage and price multiples, the LBO business of private equity firms are facing high economic risks today. The Global Financial Stability Report of IMF, 2008 has stated that private equity deals are most sensitive to situations of high growth and high interest rates. Rising interest rates have been squeezing the interest coverage ratios (cash flows relative to cash interest payments) and consequently narrowing the gains to private equity holders on LBO targets. The medium term prospects also appear challenging for LBO market because most recent deals are likely to face financing difficulties. Private equity firms may not be able to secure financing on attractive terms and may also have to carry more demanding debt service burden than anticipated in the coming months (GFSR; 2008). Given this gloomy scenario in the rest of the world, what are the prospects for the private equity inflow into India?

The correlation between developed world markets and emerging markets have increased in recent years due to opening up of the trade and financial sector. But due to the gradual pace of opening of the economy, efficient regulatory supervision, strong domestic demand and comparatively limited dependence on foreign trade, economies like India have been able to partially shield themselves from the uncertainties in the rest of the world economy. Thus when the rest of the world has submerged into a recession after the global financial crisis, India has revived relatively faster from the initial contagion of global downturn. India's growth prospects remain robust with the growth forecast for 2009-10 at 6.5 per cent and gross domestic investment expected to be steady at 36.5 per cent of GDP (estimates of PM's Economic Advisory Council). India's industrial and service sector growth remains resilient. Given this congenial investment climate and sound business outlook, India remains a relatively high-return and low risk source of diversifying returns for private equity investments.

However, fresh private equity inflows may witness some re-arrangement in portfolio allocations in the near term. Thus while there may be a trend away from sectors like manufacturing and export oriented IT sectors because of slowdown, banking and financial institutions, media and entertainment and telecom sectors may see more inflows in the coming years given the Government's proposal to infuse more reforms into these sectors (PwC, 2008). Further, capital market reforms may also reinforce growth of private equity finance. SEBI has amended SEBI (Disclosure and Investor Protection) guidelines and listing agreement to reduce the time duration for Rights issue to 43 days from the present 109 days. Efforts are on to squeeze the IPO process to the international best practice of 7 days from the current 21 days. SEBI has also eased SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations, 1997 to extend the creeping acquisitions limit beyond 55 per cent. Under this, SEBI has done away with the requirement of public announcement by non-promoters before acquiring stake in any company. The efforts towards setting up of stock exchange for small and medium enterprises and easing of several public listing norms including reduction of the time period for listing would go a long way in attracting private equity investment into India. Emphasis on infrastructure development and affordable housing will also attract private equity investment into India in a big way. However, tougher trading conditions throughout most economic sectors would shift the way private equity firms create value. Whereas previously private equity firms have achieved high returns through acquisitions, balance sheet restructuring and rising valuations, today they may have to emphasise on growth improvements for which organizational changes and operational improvements would become essential (PwC, 2008).

Section VII
Conclusion

The advent of venture capital and private equity industry has energized the entrepreneurial climate in India. They have been facilitating the productive use of existing assets and resources, usually by identifying companies with untapped potential and reorganizing their operations in ways that increase their value. In fact, the concept of financial inclusion agents may be extended beyond the purview of banks to include enterprises like 'private equity firms' which can commit much needed and timely financial assistance to sectors like small and medium industries, infrastructure sector with long gestation periods and excess capacities in the short run, high value agriculture investments *etc*. With India aiming at more than 9.0 per cent growth and a lot more scope remaining for infrastructure development, private equity investment will have a seminal role to play in the coming years. However, the rapid growth and globalization of the PE industry has raised demands for increased regulation and disclosure within the sector due to concerns regarding anti-competitive behavior, excessive tax benefits and stock manipulation. However, there is a popular discourse as how much restriction is optimum restriction for an evolving industry. This question is particularly important for India. At present the industry is largely self regulated. In India, the quality and end-use of foreign PE capital is well regulated under FDI norms.

The three year lock-in requirement on FDI also restricts the sudden withdrawal of such capital thus limiting the probability of a crisis. As such, the probability of a pure private equity firm interested in long term investments causing a systemic crisis is rather limited. However, one issue that has raised some alarm is banks engaging in sponsoring and managing private pools of capital such as venture capital funds and infrastructure funds. Regarding this, the RBI, in its Annual Policy Statement, 2009-10, has proposed a paper on prudential issue in banks floating and managing private pools of capital. Another issue that has not yet received much attention is diversification of many private equity firms into hedge funds. This may call for some concern in the near future as the activities of hedge funds are rather non-transparent and may lead to information asymmetries. Hence, there is a need to clearly define in our regulations as to what is a private equity firm and the kind of activities they are allowed to indulge in India. At present there is no provision in our existing regulations to report the sources of funds and investments of private equity firms on a regular basis. Hence it is necessary that private equity firms originating in India be asked to file an annual report giving details of the fund raising and investments in a year. At the same time, it is important to create an enabling environment for the development of a vibrant private equity market by relaxing both entry and exit barriers for the industry. To encourage this, there is a need to relax caps on FDI sectors especially infrastructure and technology intensive sectors, easing of norms on repatriation of profits, reform of labour laws and urban land ceiling legislation, rationalisation of tax laws to bring transparency and stability in tax policies and expediting capital market reforms such as developing corporate debt market and shortening of the IPO process to enable smooth flow of capital to more productive sectors.

Appendix Table 1: Major Private Equity Deals during 2008

Private Equity Firm	Parent Firm	Deal Size (in cr)	Per centage stake
January			
Frontline Ventures	Futura Infraprojects	160	10.0
Kubera Cross Border Fund	GSS America	4	10.2
ICICI Venture	Vikram Hospital	95	-
Aditya Birla Group	Core Projects and Technologies	13.5	5.0
Blackstone, Merill Lynch, Deutsche Bank and Galleon Group	Pipavav Shipyard	105	2.3
Goldman Sachs Strategic Investments and Lehmann Brothers India Holdings Mauritius II	Times Innovative Media Limited	200	16.6
Shyam Equiities Private Limited	Independent News Service	100	20.0
Deutsche Asset Management (India) Pvt. Ltd.	Golden Gate Properties	27.4	Undisclosed
February			
ICICI Venture	Arow Webtex	130-140	14.9
BTS Investment Advisors (Swiss)	QAI India Limited	1.6	Undisclosed
DE Shaw	Mack Star Marketing (HDIL)	100	Undisclosed
NYLIM Jacob Ballas Fund III	Saravana Global Energy Limited	10	Undisclosed
IDG Ventures in India	Aujas Networks Pvt. Ltd.	1.2	Undisclosed
Monsoon India Inflection and Jackson Heights Investment (Mauritius)	Acme Telepower	400	3.35
March			
Henderson Equity Partners	Sharda Worldwide Exports	8.6	Undisclosed
Deutsche Bank Developers	Ramprastha Promoters and	32	40.0
Tano Capital	Anil Printers Ltd.	3	Undisclosed
Lehmann Brothers and Deutsche Bank	Unitech SPV	200	Undisclosed
Nalanda India	WNS	13.6	5.3

Merill Lynch	DRS Group SPV	400	Undisclosed
Baring PE	ShareKhan	23.6	12.0
April			
Warbug Pincus	Mannat Group	300	Undisclosed
Blackstone Real Estate Partners	Synergy Property Developemnt Services	7.2	Undisclosed
Dubai Investment Group	Chiranjeevi Wind Energy Ltd.	40	40.0
India Value Fund Advisors	Atria Convergence Technologies	Undisclosed	Majority Stake
Blue River Capital	Wilson Sandhu Logistics	40	Minority Stake
PremjiInvest	Koutons Retail	80	2.0
DE Shaw	ExcelSoft	125	35.0
Firstrand (Ireland) PLC	Lizer Cylinders Limited	4	Undisclosed
May			
Reliance Technology Ventures	Pelago, Inc.	Undisclosed	Undisclosed
Providence Equity Partners	Aditya Birla Telecom	256	Undisclosed
Healthcare Investment	Apollo Health Street	61	8.5
IDFC Project Equity and Lehman Brothers	Konaseema Gas Power	500	16.7
Axis Bank	Harish Chandra India Limited	126	Undisclosed
Blackstone, New Vernon and Reliance	Everron Systems	167.89	Undisclosed
Beacon India PE Fund	New Horizon Media	Undisclosed	Undisclosed
June			
Frontline Strategy (Mauritius)	Shriram SEPL Composites	Undisclosed	26.0
Axis Bank	Lavasa Corporation	250	2.5
Phi Advisors	First Choice	80	Undisclosed
Standard Chartered Bank (Mauritius)	Religare Finvest	100	Undisclosed
GIC Special Investments (Singapore)	Reid and Taylor (S.Kumars)	900	25.4
Actis	Vaishnavi Infrastructure	10	Undisclosed
India Business Excellence Fund	Dixon Technologies	40	Undisclosed

July			
Sun Apollo Ventures	Amrapali Group (SPV)	300	35.0-40.0
TAIB Bank (Bahrain)	Anant Raj Projects	216	26.0
Sequoia Capital and Light Speed Venture Partners	Tutor Vista.com	7.2	Undisclosed
JP Morgan Chase	Alok Infrastructure (SPV)	130	33.0
GE Commercial Finance India	Controls and Switchgear	100	Undisclosed
August			
ECL Finance	Max India	Undisclosed	5.18
Sequoia Capital	Cotton County	120	Undisclosed
Indivision India Partners	Blue Foods	Undisclosed	40.0-50.0
September			
Deutsche Bank	BPL Ltd.	Undisclosed	Undisclosed
IDFC PE	Suzlon Energy	34.4	Undisclosed
International Finance Corporation	Polycab	552	12.0
October			
Nalanda India	Mastek	Undisclosed	5.2
IL&FS	JB Pharma SEZ	75	30.0
Goldman Sachs	ICSA India	35	Undisclosed
November			
Blackstone	CMS Comp	250	Undisclosed
Berrgruen Holdings and Cycladic Capital	Gemini Equipment	7.5	80
Peepul Capital	TeleDNA	5	Undisclosed
State General Reserve Fund of Oman	Ansal API	Undisclosed	24.5
Sierra Ventures	Carwale.com	3.5	Undisclosed
December			
Milestone	The Cerebrum	139	Undisclosed
IDFC PE	Deepak Cables	20	Undisclosed
Blackstone	CMS	Undisclosed	55

Source: India PE

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