THE OPERATING PARADIGM: INDIAN PRIVATE EQUITY CHANGES GEARS

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THE OPERATING PARADIGM

Private equity (PE) funds in India are increasingly focusing on the operations of their portfolio companies to generate better returns.

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As competition for high-quality deals continues to intensify, PE firms have developed stronger operating capabilities to add value to their portfolio companies and to generate better returns on their investments.

India's deal landscape is changing. Today, control transactions make up approximately 30 percent of all deals by value compared to 10 percent three years ago. Deal sizes are also becoming larger, which means that PE firms are now making bigger bets on the business in which they invest. Holding periods are also increasing to ride out negative business cycles. PE firms can no longer rely only on management to deliver the desired results in the underlying businesses over a sustainable period of three to six years.

To understand the change in the operating pattern of PE firms operating in India, Alvarez & Marsal's (A&M) Private Equity Performance Improvement group interviewed 20 active funds in India to learn about their key priorities and focus areas along with the various operating models used by these firms.

CHANGING DEAL LANDSCAPE

Increase in PE investments and growth in average deal size

The overall deal landscape has grown from U.S. $5.8 billion in 2012 to U.S. $8.2 billion in 2016, with average deal sizes increasing from $19 million in 2012 to $31 million in 2016.

In spite of a larger fund pool, the number of deals has decreased slightly in this period, indicating that PE firms continue to experience a shortage of attractive target investments and face intense competition over good deals.

As a result, some deals are fully priced, which makes achieving desired returns more difficult.

Hence, PE firms are looking to increase their operating focus to maximize value creation. Most funds have increased the strength of their operating teams in this period. *From less than 20 five years ago, the number of senior operating professionals has increased to approximately 45 across the 20 funds that we surveyed.*

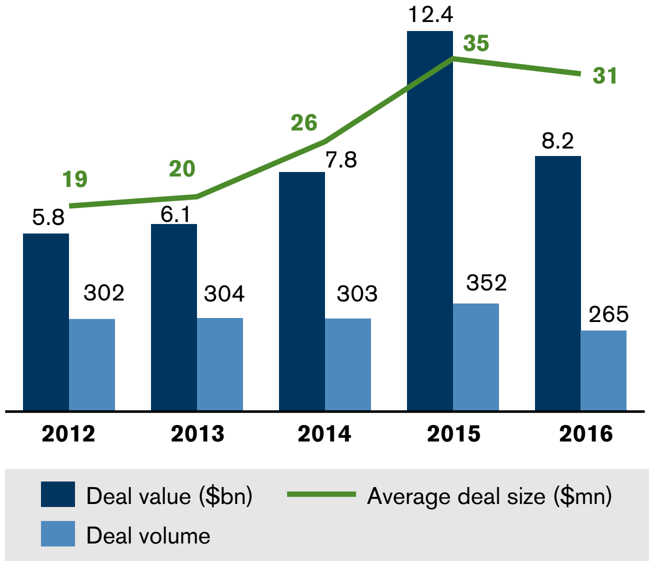
Increasing mix of controlling stake deals

A closer look at the deal characteristics over the last three years shows a significant increase in control deals in India from $640 million in 2014 to $2.3 billion in 2016. *Control deals have increased to 28 percent of overall deal value in 2016 compared to about 8 percent in 2014. At the same time, average control deal size has significantly increased from $53 million to $153 million in the same period.*

Our discussions with PE funds indicated that some firms took a conscious decision to focus on larger stake deals to drive better operational control, while others were led more by market factors, e.g., investing in carve-outs of subsidiary businesses or non-core assets or minimum deal size requirements for global PE funds.

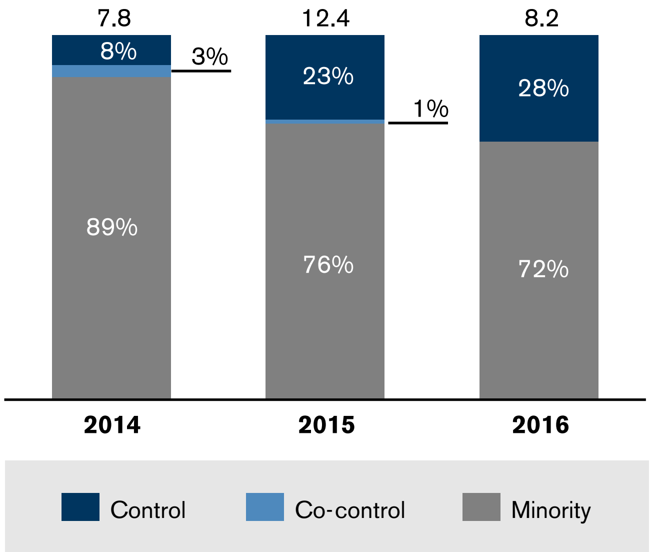
Analysis of control deals over the last five years indicates that PE funds with large operating teams have been front runners in control deal investments.

Further, our analysis of the 30 leading PE funds[1] highlights a growing trend for control deals for both India focused as well as global funds. However, the average deal size (2015) varies from approximately $38 million for India focused funds to approximately $78 million for larger global funds.



Source: APER

EXHIBIT 1: Average deal size in the last five years



Source: APER

EXHIBIT 2: Deal value by stake type in the last 3 years

TOP PRIORITIES FOR PE FUNDS WHEN INVESTING

With increasing stakes and enhanced focus on value creation, PE investors are getting more operationally involved with their portfolio companies. PE funds have now become more familiar with the challenges of working with Indian promoters. Typical challenges include information asymmetry, insufficient middle management talent, limited exposure to best practices, and inadequate reporting and governance structures.

[1] Based on A&M analysis of the top 30 PE funds investing in India in 2015: Source: VCCEdge database

EXHIBIT 3: Key priorities - % Respondents

Based on interviews conducted by A&M India, top priorities for most PE firms are (a) finding the right management, (b) alignment with the promoter / Chief Executive Officer (CEO), (c) value creation and (d) a robust governance process. A majority of funds said that they adopt a similar approach irrespective of their stake, though pushing through these priorities is easier in control deals. In minority growth investment situations, funds rely more on a "positive influence" model, offering support through their "value creation playbook" or providing Indian promoters access to industry / functional expert networks, including inviting eminent industry veterans to join their invested companies. Transparent discussions are held with the promoter pre-deal to ensure alignment on priority areas.

Management Team Capability:
Building the right management team

67 percent of respondents said that finding the right CEO / management was the most critical factor for investing in a deal. Identifying the right Chief Financial Officer (CFO) is the next priority to ensure transparency and establish adequate controls. The funds continuously work with the CEO, their internal operating teams, senior industry advisers and external agencies to fill key gaps in their management teams. Building the right team is considered to be a key element of success by almost all the firms interviewed.

Promoter Alignment:
Agree on investment objectives

PE funds ensure alignment on goals, value creation plans, incentive structures (such as employee stock ownership plans (ESOPS) for key management personnel) and exit planning. Successful firms spend significant time in the early investment period to develop a value creation plan along with the new management. Often large global funds engage functional and industry experts to define the value creation plan along with the deal teams. This is important to set early on so everyone is aligned on the key objectives and expected outcomes.

Performance Improvement:
Execute the value creation plan

The value creation plan agreed upon is worked through in great detail with the management and broken down to the key performance improvement initiatives and focus areas. Typical focus areas include initiatives for revenue enhancement, margin improvement and asset efficiency. As a best practice, firms also clearly identify the right set of resources and capabilities both within and outside the fund to successfully execute and achieve the value creation plan.

Governance and Control:
Monitor and track progress

Almost 70 percent of respondents said that they would not invest in a deal if they did not get a board seat. Further, 60 percent of respondents said that setting up the right governance process was a Day 1 priority for them. Most funds have their own internal requirements and templates for governance and reporting and ensure that these are addressed within the initial 100 days of investment.

	Pre-Deal	Early Holding	Middle Holding	Pre-Exit
Management Team Capability	• Management assessment • Senior talent acquisition	• Identify gaps and key potential hires • Infusion of senior advisers to support management		
Promoter Alignment	• Align on goals and objectives • Define and validate value creation plan	• Fix right incentive structures • Exit planning		
Performance Improvement		• Organic expansion opportunities (new geography, products, etc.) • Inorganic opportunities (acquisitions, joint ventures (JVs), partnerships, etc.) • Develop and execute 100-day plan • Increase connections to industry and customers	• Cost reduction and rationalization • Invest in process improvement, enterprise resource planning (ERP) / technology • Changes in capital structure / allocation / use of leverage • Targeted operational support	• Supplement with non-core capabilities (mergers and acquisitions (M&A), legal) • Drive performance improvement
Governance and Control		• Establish management information systems (MIS) • Get board seat / veto on criticalities • Set review rhythm	• Revisit value creation plan • Identify course corrections • Monitor and track performance	• Prepare for exit

EXHIBIT 4: Operational interventions across deal life cycle

PHASING OF OPERATIONAL SUPPORT TO PORTFOLIO COMPANIES

Key priorities for PE funds through the deal life cycle

To execute key priorities, PE firms support their portfolio companies across the deal life cycle through multiple interventions. About *90 percent of funds highlighted that most of the interventions for value creation are done in the initial 6–12 months.* Types of operational interventions and reasons for engagement varied across the investment life cycle based on requirements of the business and aspirations from the portfolio company.

Pre deal – *Diligence*: Most firms emphasized the need for in-depth diligence of target companies, with a focus on ensuring the presence of a good management team and identification of revenue enhancement opportunities. This includes both organic and inorganic opportunities leveraging the investing PE firms' and portfolio companies' networks.

Early Holding (Initial 6-12 months) – *Setting the direction*: The majority of the respondents rated *"senior talent acquisition"* and *"aligning objectives with management"* as the most frequently exercised interventions in the initial phase. Most funds have a 100-day plan that details the key initiatives for the business. They align with management both on the value drivers and the key gaps that need to be prioritized and addressed.

> “PE FUNDS HAVE NOW BECOME MORE FAMILIAR WITH THE CHALLENGES OF WORKING WITH INDIAN PROMOTERS.”

Middle holding – *Performance execution and monitoring*: Once the value creation initiatives are launched, the focus is largely around monitoring and selectively intervening on key issues and opportunities as they arise. PE firms play a supportive role on new investments, expansion, operational issues and cost optimization on an as-needed basis.

Pre Exit – *Preparing for a successful exit*: About 60 percent of the funds have an initial exit plan at the time of investment and track against their plan through the life cycle. Once the PE firm is looking to exit the investment, ensuring alignment with promoter and company management was highlighted as the top priority during this phase in order to achieve a successful exit.

OPERATING MODELS

Indian PEs are using different models for operational engagement

With an increasing operational focus, PE firms are exploring multiple models of operating support. There are primarily three models that PE firms use: (a) a dedicated operating team, (b) industry / functional experts or (c) engaging external consultants.

	DEDICATED OPERATING TEAM	INDUSTRY EXPERTS	EXTERNAL CONSULTANCY FIRMS
OVERVIEW	▪ **50 percent of funds** surveyed have an internal operating team. ▪ These are full-time, dedicated personnel complementing the investment teams. The team size varies significantly across PE firms and is a function of expectations of the operating professional(s). ▪ The primary role is to support deal teams during diligence and portfolio companies in executing the value creation plan. The extent of involvement varies across funds.	▪ **60 percent of funds** use industry experts. ▪ Industry experts are senior veterans used on a part-time / retainer basis. ▪ Experts are typically engaged pre-deal to provide access to networks and identify opportunities. They also offer light-touch support post-deal as required.	▪ While almost all funds used consultancy firms for diligence, **75 percent of funds** hired them on post-deal support, especially when specific functional expertise or execution resources are required. Top areas where external consultants were used: ▪ Project management office (PMO) value creation plan / 100-day plan ▪ Tactical EBIDTA improvement ▪ Building capability

TEAM SIZE

No Operating Team	Small Team (1-3)	Large Team (>3)
50%	25%	25%

TEAM STRUCTURE

Operating Partner	Operating Partner + Team	Operating Partner + Team + Senior Advisers
36%	27%	36%

Global funds operate with leaner local operating teams in India as they enjoy the benefit of pulling in resources from other regional teams / head office on an as-needed basis. These resources are aligned either by industry or function and are part of a large global operating team.

TYPICAL PROFILES

Consultants	Former CXOs	Hybrid (Consultant + CXO)
11%	45%	44%

OPERATING TEAM - A CONTRAST IN DEVELOPED AND EMERGING MARKETS

While more than two-thirds of PE investments in the U.S. are controlled deals, in India the comparative number is about 30 percent. Based on interactions with 20 leading PE firms operating in India and contrasting them with a survey done for about 30 PE firms in the U.S., this difference in deal characteristics seems to have influenced differences **in operating team size, structure and profile of operating teams in developed and emerging markets:**

- A greater proportion of U.S. PE firms have internal operating groups (70 percent compared to 60 percent in India).
- More than half of U.S. firms have large operating teams (more than three professionals) while only about a third of Indian PE firms do.
- The proportion of operating partners who were former CXOs (C-level executives) is significantly higher in the U.S. when compared to India

With the increasing trend of taking controlling stakes in India, the internal operating teams of Indian PE firms are expected to become larger. A trend is already seen with PE firms hiring a large number of industry veterans in the last few years

* As per a survey conducted by A&M's PEPI practice of ~30 top PE firms with cumulative AUM of $200 Bn. in the US in 2016

LOOKING AHEAD – FOCUS AREAS FOR PE FIRMS

With the trend in increasing deal size and greater share for control deals, we expect PE firms to evolve their operating models to focus on efficiency just as they focus on growth. Specifically, we identified four areas in which PE funds should improve to maximize value creation:

CAPITAL EFFICIENCY

Focus on working capital and capex efficiency needs to complement the growth plan. As funds look to get a better return, capital efficiency will need greater focus.

FLEXIBLE MODELS FOR VALUE CREATION

One operating model size does not fit all investments. Funds are learning to adapt based on the size, industry and management of the portfolio companies.

FUNCTIONAL IMPROVEMENT

Value creation plans will need portfolio companies to drive greater functional improvements across sourcing, manufacturing, sales / distribution and information technology (IT). These improvements strengthen execution but also contribute to EBITDA expansion from efficiency gains.

TRIP WIRES

Not all investments will go as planned. Setting up trip wires will help identify problem areas quickly. In addition to having basic key performance indicators (KPIs), having a set of trip wires will serve as an early warning signal and help initiate timely operating support.

There is clearly a greater focus on operations in the Indian PE landscape. PE firms are changing gears to address the challenges by focusing on the right capabilities, intervention strategies and timing, as well as the right engagement model.

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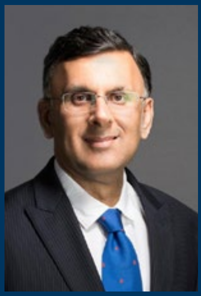

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