BDO KNOWS INTERNATIONAL PRIVATE EQUITY:

SPOTLIGHT ON INDIA

India, one of the fastest-growing nations in a variety of sectors, has attracted sizeable foreign investments over the years. Even during the tumult of the 2008 financial crisis, the nation remained mostly unaffected when it came to foreign investments. As the global economy has bounced back, so too has private equity interest in India—although investors are proceeding with caution. Recently, our own **Lee Duran** sat down with **Pranay Bhatia**, Tax Partner with BDO India, to discuss the latest news and trends in the sector.

Lee Duran

Pranay Bhatia

What is the investment environment for private equity funds in India? Do you predict this environment will change at all in the next 6 to 12 months?

While India has long been an attractive target for foreign investment, 2016 has proved challenging for the PE sector, especially when compared to a booming 2015. Overall PE investments in India in the first half of the year fell 46 percent to $5.86 billion from $10.69 billion a year earlier, and the third quarter's $3.2 billion in activity was half that of the third quarter of 2015. The volume of deals through the first three quarters also slipped 24 percent to 945 from 1,245 deals last year. The sharp decline in investments can be attributed to high valuation expectations, especially in the startup technology sector, and risks surrounding currency conversion. It's also difficult for private equity to maintain the high level of activity that took place this time last year when big-ticket deals reigned supreme, with 25 deals clocking in at over $100 million.

PE investors remain cautious, closing 99 deals through the first three quarters, but India is witnessing a sudden spurt in angel investments, which saw 541 deals over the same period. At a considerably smaller average deal size, this angel interest is largely attributable to the startup-friendly environment in India, especially in technology and e-commerce—sectors where high valuations have kept PE investors choosy.

While PE deal activity remains slow, there are reasons for the PE sector to be optimistic and continue to scout opportunities across several sectors. The Indian economy is expected to grow by 7.6 percent in 2016 and 7.7 percent in 2017, according to the World Bank, making it one of the fastest-growing major economies in the world. In conjunction with this growth, the government is actively pursuing more business-friendly policies, including liberalizing foreign direct investment and rolling out a new indirect tax regime with the Goods and Services Tax (GST). The implementation of new promotion and salary structure recommendations by the Seventh Central Pay Commission will also increase middle class purchasing power, which should help spur growth, as well.

What are PE investors generally nervous or optimistic about at the moment?

Investors are certainly cautious about the expectations of potentially overvalued

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companies, or those where business projections fail to bear fruit. Increasing cost pressures, rapidly changing tax laws, currency depreciation and often-unpredictable local approval processes also challenge PE investors. That being said, the aforementioned implementation of GST, in conjunction with the growth economy and a culture of innovation, all remain encouraging for fund managers.

What do holding periods look like, and what exit trends are you observing?

Like many countries around the world, private equity holding periods usually range from three to five years. Generally, PE funds have historically preferred open market exits, but recently the trend is shifting towards M&A. In the first half of this year, Forbes reports that Indian private equity funds saw 45 M&A exits (representing 47 percent of total exits), versus 28 open market sales (30 percent of total exits). The preference for M&A continued into the third quarter, with 26 M&A exits compared to 17 open market exits, according to a News Corp VCCEdge report.

Which industries are particularly attractive to foreign investors and why?

Foreign direct investment in India grew 29 percent from April 2015 to March 2016, totaling $40 billion. While these investments spanned a wide variety of industries, many occurred in the services, trading, automobile, power, telecom/media/technology and manufacturing industries.

What do you think will be the next hot opportunity for PE investment in India?

The vast majority of general partners expect healthcare, financial technology and financial services will be the most attractive sectors in the next two years.

However, due to urbanization, real estate may also offer compelling investment opportunities, especially in Tier I and II cities. Mumbai and Delhi are likely exceptions to this, though, since high real estate prices are creating surplus inventory.

How has the current lending environment affected private equity activity in India?

Currently, interest rates on debt are incredibly high -- much higher than international norms. Even so, established companies currently prefer debt to private equity so that they can restrict the dilution of ownership. But startups and early-stage companies prefer private equity to debt because they don't have to put up as much collateral and can share the risk if the company misses growth expectations – yet another reason we're seeing a rash of angel investment and increasing caution from PE firms who are scrutinizing high valuations in rapid-growth tech sectors.

In general, PE investment may become increasingly attractive to Indian businesses looking to grow at a quicker pace that debt financing typically allows. PE investors bring sector expertise and business development capabilities to the table that can help a growing company vault ahead of the pack.

How does India handle the taxation of carried interest/management incentive fees, and how has this impacted private equity activity?

There are no specific guidelines for taxation of carried interest or management incentives. In the absence of any specific guidelines, the classification of income is generally driven by the structure. Most general partners have structured their carried interest as investment income and have offered the income as such. However, we are also aware of some instances where attempts have been made to tax the income as business income, liable to the full tax rate. With the introduction of Statutory GAAR (General Anti-Avoidance Rules) provisions, it is likely that the taxation of carried interest will be impacted, and the tax authorities may use the GAAR provisions to levy higher taxes on this type of income.

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