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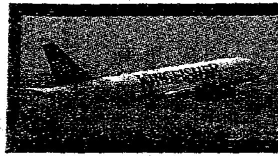

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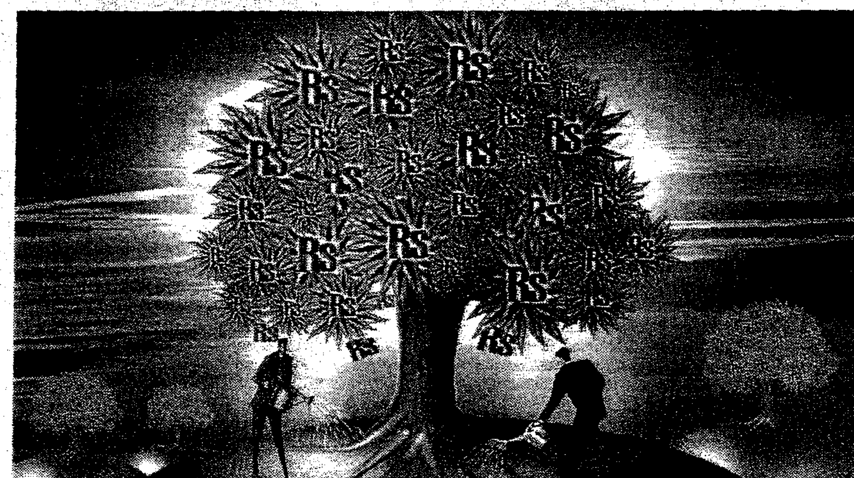
Make the system conducive for PE investment

Sumant Batra

RECENT initiatives by policy makers to promote public-private sector partnership demonstrate a broad consensus that it is the private sector, not the state, which would be the primary catalyst for investment and development. However, for the private sector strategy to succeed, explosive demand for investment capital by a burgeoning number of companies has to be satisfied. As the Indian private sector gears up to undertake huge infrastructure projects, it is on the look out for capital. Large requirements mean they look beyond traditional sources of finance such as friends, family and banks. Due to track record and size, medium-sized companies are not always able to access financial markets.

Private Equity (PE) has emerged as an attractive midpoint along the financial spectrum for Indian companies seeking to raise capital. Cumulatively, from April 2006 to February 2007, $11.89 billion has come in equity, marking a growth of 176% in dollar terms in FDI inflows into India. Average PE ticket size has increased from $16 million to $26 million in a year. FDI inflows in equity in February 2007 alone amounted to $698 million compared to only $127 million in February 2006, a huge increase of 450%.

Conservative estimates suggest PE investment could multiply if long overdue reforms were introduced to create a friendly environment for investment. Today, PE funds face mammoth challenges in making investment decisions. Sectoral caps; uncertain and fragile FDI policy; unsatisfactory quality of information provided by companies to investors for making investment decision; complex and cumbersome regulations; weak legal system for enforcing contracts; lack of timely and predictable dispute resolution by courts and inability to exit due to absence of efficient insolvency system are a few examples. This coupled with high risk profile of the companies targeted for investment act as a serious dampener in the investment plans and decision making of PE funds.



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Though liberalised significantly, FDI policy continues to send mixed signals to PE investors. Investments in key sectors have been made based on representations made at political level that FDI caps would be eventually lifted allowing investors to increase equity base. This does not appear to be happening. Retracting from policy decision, such as seen in SEZ policy, has left the investors confused and scared. In some areas, FDI policy is so ambiguous making it difficult for PE investors to take decisions without going through a plethora of advice from lawyers. In construction area, a number of issues such as acquisition of land, minimum capitalisation norms, repatriation of profits, use of surplus resources, etc remain uncertain. Recent RBI notification to treat non-convertible debentures as ECB and preference shares as equity for determining sectoral cap and capitalisation are not expected to go down well with investors.

Archaic and outdated laws and cumbersome regulatory procedures are the real problem. Land Ceiling Acts, Land Acquisition Act, local and municipal laws pose serious challenges in undertaking infrastructure projects involving real estate. Investors have to spend considerable time and cost dealing with such laws. A comprehensive review of these laws is required, particularly to increase investment in the infrastructure sector. Obtaining approvals continues to be a nightmare. It is difficult imagining a foreign investor trying to deal with state agencies for the clearance of integral township projects, the acquisition of land from multiple owners, obtaining environmental clearance, electricity, water and sewer approvals, dealing with municipal agencies, local police, etc. The much-talked about one-window clearance remains a far-fetched reality.

PE funds cite difficulty in assessing competence and integrity of entrepreneur as their most difficult task in India. Obtaining accurate, timely and transparent information from the companies, in particular the family-owned companies, can be a challenging exercise. In the absence of reliable external sources, the prospective investor is at the mercy of the entrepreneur for information necessary to make critical judgments to evaluate company performance and value. Lawyers and accountants carrying out due diligence find it difficult to gain an accurate picture of company's affairs, legal disputes, concealed assets, hidden subsidiaries, related party transactions, etc.

The corporate governance problem is often compounded due to lack of timely and predictable dispute resolution by the courts and weal enforcement systems. A lot of effort go into constructing enforceable legal contracts between the company and investors, which serve as the bedrock for financial transactions. Regardless of soundness of signed agreements, there is unfortunately minimal legal recourse available to PE investors in the event of differences with management. The problem is often accentuated as owners are exceedingly adept at navigating the ins and outs of the legal system leaving investors at a distinct disadvantage. Funds may also provide a debt to the company. The creditor's rights framework for unsecured creditors remains weak. An unsecured creditor has to file action for debt recovery in ordinary civil court which may take three-seven years to give decision.

There is a clear and definite need for some policy initiatives to create a more favourable environment for PE investors. These investors fill the funding gap and play an important role in improving corporate governance of companies they invest in. They also bring with them international experience, know-how and the best practices. Their role in the country's economy can not be underestimated. At the same time, PE investors too must cultivate the country-specific approach and investment policy, that allow them to make innovative adjustments reflecting the investment realities in India.

(The author is managing partner, KDB & Associates)