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Those looking out for smart capital will turn to private equity rather than stock market

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Clip: 1 of 1

'Those looking out for smart capital will turn to private equity rather than stock market'

Interview with Mr Satish Mandhana, Managing Partner, IDFC Private Equity

N. Ramakrishnan

IDFC Private Equity Co, a 100 per cent subsidiary of Infrastructure Development Finance Co Ltd, is an infrastructure-focussed private-equity (PE) player. It manages a corpus of about Rs 5,700 crore through three funds and has active investments in nearly 20 companies.

Mr Satish Mandhana, Managing Partner, IDFC Private Equity, talks about the private-equity industry and the outlook for the sector. A B.E. in Industrial Engineering from IIT-Roorkee and an MBA from the Faculty of Management Studies, Delhi University, Mr Mandhana has nearly three decades of experience in private equity, corporate finance and business strategy.

"There are three things which are important in private equity — promoter, promoter and promoter. The question is, are you going to back the jockey or the horse? Obviously you would like to see a good horse, but ultimately you are backing the jockey," he says in this recent interview in his Mumbai office.

Excerpts:

Could you give us an update on the private equity industry?

Financial year 2011 was one where the private-equity industry was successful in making exits because the capital markets were in bloom till December. A few investments also took place. It was a good year. We made eight exits in calendar year 2010. The industry was able to remove a stigma that it is difficult to see the money coming back from India. We have returned nearly 60 per cent of the money, which we have raised until now, to the investors.

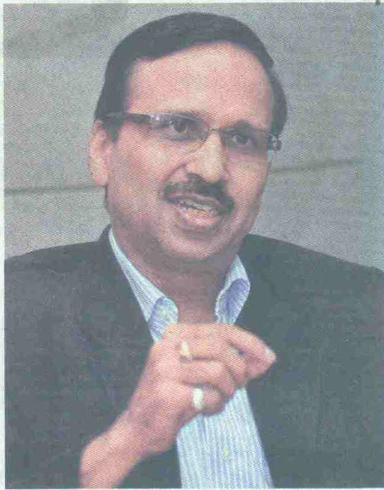
From a PE perspective, 2009 was a dip year where investments fell to about $5 billion and it went up to $9 billion in 2010. This year, we expect it should be $12 billion. If the capital market remains the way it is, we should be able to achieve that number. If the capital market goes up again, people will look at the capital market rather than private equity. Those looking out for smart capital will turn to private equity rather than the stock market.

You said so far this year has been good...

We started on a good wicket where investment opportunities are coming up. A challenge is the valuation expectation on the other side. Recently, we looked at an excellent company. We liked the business, we liked the management team. We gave a valuation which we thought was a rich valuation from our perspective.

The managing director told me his intrinsic value is much higher than what we have assessed. I told him that the intrinsic value of his company was much higher in the long run than what I have put on the table, but that he would realise over the next 15 years. My investment horizon is 5-7 years and I can't take those remaining eight years' value and give it right away. It won't be feasible. You should appreciate that we will be invested in a company for five to seven years only and not for 15 years when it would realise its full potential.

There will always be a disconnect between the entrepreneurs and the investor. Most of the time promoters fall for a better valuation rather than a better quality investor. However, there have been examples. One example from my portfolio, when we were investing in a company called Emergent Ventures India, Goldman Sachs was offering a price 20 per cent higher than what IDFC was offering. He still chose to go ahead with IDFC.



Mr Satish Mandhana, Managing Partner, IDFC PE. - Shashi AshiwalBusiness Line

Why?

Many reasons. Obviously having a private-equity investor in your company whose decision-making is based in India [helps as] you are able to relate to the decision-maker. They are able to see that an Indian private-equity player can understand the local challenges. They feel much more comfortable having a local private-equity company invested in them rather than a situation where they have to relate to somebody far away. This is a relationship-oriented business, but if you are making a relationship with an institution, then the sustainability of that relationship is much longer.

What is the outlook for the PE industry for 2012?

The outlook is good. However, it is a competitive industry and I don't see that competitiveness coming down in 2012. Some of international players who don't have a major presence here will probably make some losses initially before they start realising that they need to do the business in a different fashion altogether.

Wouldn't that also push up valuations, because they are keen to have assets?

That is right and that is why the losses will happen. I don't foresee any reduction in the competitive intensity in 2012.

You made eight exits during 2010-11. How many years were you invested in those companies?

We made exits from our Fund I- and Fund II-companies. Fund I was raised in 2003 and we were investing till 2007. Fund II was raised in 2006 and we were investing till 2009. Then we started from Fund III. The exits that we made had on an average of three and a half to five years.

That is slightly longer than what most PE players look to stay invested in a company, isn't it?

Right you are. But going forward the trend will be that people will have to stay in the company longer to create value. The operational experience that you want to bring to the company doesn't produce results quickly. For many other reasons, the stay of the PE players in the company is going to elongate. Markets have changed whereby you could have gone for an IPO of a small company.

Now you need to have reasonable size before you can do that. Even if there is an IPO, you can't exit it because people realise there is no liquidity in the market. The second reason is that operational experience produces results not in a quantum-jump basis but in an incremental basis. You need to be really patient to see your investments producing results. The third is that the competitive environment makes people invest at a pricing that is aggressive from an investment perspective. If you are invested in a company at a price which has factored in the next two years, obviously you have to wait for another three years to realise returns which you can call reasonable.

> *"Are you going to back the jockey or the horse? Obviously you would like to see a good horse, but ultimately you are backing the jockey".*

Were the returns good from the eight exits you made?

We had decent returns in those exits. These were exits using different mechanisms. We had IPO, we had promoter buyback, we had sale to a strategic or financial investor. We had IPOs for two of our companies — Gujarat Pipavav Port and Ashoka Buildcon — and both were oversubscribed 18-20 times at a healthy multiple. We are still invested in those two companies. We intend to be there to be for next few years before thinking of exiting them. So long as the company is growing at a clip of more than 20 per cent, why should I get out of a train which is moving at that speed and try to board another train?

Infrastructure is a sector where the government intervenes a lot. Does this help entrepreneurs or private-equity players?

I don't think any entrepreneur would ever say that he got great help from the government. The IT industry grew because there was no government intervention. The same holds true everywhere. Interfacing with the government creates challenges of a different kind and it acts as an entry barrier. Government interface cannot be avoided as infrastructure is for the masses and involves public interest.

Is there any impact on the valuation of a company because of this government interface?

The valuation of a company is a factor of what returns you can make. Your entry valuation is a factor of what returns you can make when you exit, assuming that you are entering the company in normal market conditions. I don't think the government interface has any bearing on valuation but if you say that there is a customer-concentration risk, yes it has a bearing.

What has the investment experience with entrepreneurs been like for you?

I have dealt with a large number of entrepreneurs from 1993. The first entrepreneur, where I invested in his company, he was looking out for a small investment into his manufacturing facility for camshafts, castings. I visited the plant and said I will give you double the money you are asking for.

He was surprised. The reason for that was that the capacity which he was planning was not one an international buyer will look at. We increased the capacity by investing more in the company. Within a year Mahle of Germany saw his capacity, his skill set, decided to shut down its Stuttgart facility, bring all its equipment here, took equity stake in the company, I exited. We still remain good friends. He still remains managing director of that company having sold all his stake to the Germans. This is an example where we helped the entrepreneur raise his vision. Obviously the entrepreneur has to have the vision and fire in the belly. Our role has to be [to] hand-hold and raise the vision for the entrepreneur. We become real partners in matters relating to strategy, human capital and fund-raising. That is the role we normally play and we are an active player on the board level.

When people ask me what is important in private equity, I say there are three things — promoter, promoter and promoter. The question is, are you going to back the jockey or the horse?

Obviously you would like to see a good horse, but ultimately you are backing the jockey. You don't know what will happen in the next three to five years, how the environment will change, how the regulation will change, how the competition will behave, you require somebody who can handle those exigencies.

We look forward to somebody who has demonstrated his capability to remain steadfast on the path despite challenges.

We seek absolute transparency and high level of governance. Governance is a big issue in the Indian context. It is not that people don't want to have governance, it is just that our system has not taught them what governance means.