SVCA Singapore Venture Capital & Private Equity Association

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UNDER THE SPOTLIGHT

Private Equity Firms in Asia see Agriculture, Education, Renewable Energy and Services as Hottest Asian Investments for 2010 and Beyond – Results based on a wide ranging one-on-one interviews conducted by Global Intelligence Alliance (GIA) at the end of 2009.

The interviews were conducted with 20 business leaders within Asia's Private Equity industry, including senior executives from GE Capital, Morgan Stanley and CLSA. While these Asian PE leaders may differ in their growth expectations for 2010 and beyond, they all agree that PE investments will shift focus as shown below:

Projected Shift in PE Investment Focus in Asia Pacific

Current	Expected (2010-2012)
Consumer & retail	Agriculture
Healthcare	Education
Financial Services	Renewable Energy
Technology / Media	Business Services
Manufacturing / Industrial	
Infrastructure / Real Estate	

Strong interest in Agriculture, Education and Renewable Energy has been driven by a tidal wave of interest in sustainable development projects across the board, many of which are subsidized by massive government spending. Agriculture is also seen to hold big upside driven by strong secular growth in global demand for agricultural products combined with constrained supply and high commodity prices.

Set out below is an excerpt from the interviews of the co-authors of the white paper, Nicolas Pechet (NP), VP & Head of GIA Group's operation in China and Head of GIA's Global Private Equity Practice and Vishwanath Desai (VD), Senior Consultant

What were the main consequences of the global financial downturn on PE activities in Asia during 2009?

NP: "Firstly, there has been an overall improvement in valuations and deal terms for investors. PE firms with ample cash reserves benefited from the lack of liquidity in the capital markets by being able to negotiate more favourable valuations and deal terms.

Secondly, competition from "me too" deal-makers was moderated during this period as many PE firms with limited cash reserves on hand and difficulty in raising new funds shifted focus to supporting existing portfolio companies rather than seeking new investment targets.

Thirdly, PE firms opted to defer exits and to hold existing portfolio companies until more favourable exit conditions returned. In the meantime, increased focus was placed on improving portfolio company performance.

On the whole, PE firms that are more focused on Asia were less impacted by the economic crisis as compared to many US or Europe focused funds. Our research shows that Asia funds with less exposure to export oriented portfolio companies were least affected during the recent downturn. Moreover, many savvy PE investors used the downturn to generate value as a result of tempered competition for deals and fewer options for companies to obtain funding from illiquid capital markets."

What have been the most popular sources of PE deals in Asia?

VD: "PE firms in Asia source the majority of their deals from investment bankers and brokers, and then also through their own research. Other sources of deals include referrals from their personal and professional networks, industry experts, and companies approaching them directly for funding. Generally speaking, proprietary deal flow, meaning deals sourced through investors' own research and networks, is far more attractive than deals sourced via bankers and brokers for a range of reasons. These could include less competitive deal terms, higher trust factor, etc."

What have been the key success factors for deals in Asia?

NP: "Key success factors for growth capital investments in Asia are quite similar to those in the West. Ultimately, many of the fundamentals are the same. However, there are a few key differences.

In the pre-investment stage, developing strong proprietary deal flow in Asia is essential, perhaps even more so than in the West. It is in many ways the wholly grail of private equity investing in the region. This is because in a country like China, for example, there is far more capital available than attractive investment opportunities. Moreover, many of the best investment opportunities in Asia are available only via informal channels. So unless a private equity investor has developed strong proprietary deal flow, he or she will be competing intensely for the relatively few attractive investment opportunities, or altogether excluded from the very best ones. This ultimately means less attractive returns for the investor.

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UNDER THE SPOTLIGHT (continued)

Post-investment, one of the many key success factors would include the ability to create value in the underlying company. Though there is still a huge gap versus the West, business practices in many parts of the region have come a long way over the past 10 years. This means the investor must increasingly bring to bear specialized expertise and management skills to create substantial value in the underlying company, be in it in improving working capital management, asset restructuring or developing more effective growth strategies."

What has the flow of PE investment into Asia been like, and how is it projected to change?

VD: "Overall investment activity in Asia is set to grow in the next 3 years. China and India are clearly seen as key drivers for regional growth. Senior private equity executives we spoke with consistently mentioned both countries, and both are featured in United Nations Conference on Trade and Development's (UNCTAD) top 5 list of destinations for investment in next 3 years. This does not represent a change in investment trends, as both countries showed the highest growth in FDI inflows in 2008."

Top 6 FDI Destinations, by home region (UNCTAD Survey)

Region	Most Favoured Destinations
North America	China, UK, The Russian Federation, Germany, Brazil, USA
Europe	USA, China, India, Brazil, The Russian Federation, UK
Japan	China, India, USA, Brazil, Vietnam, Germany
Developing Asia	China, USA, Indonesia, Australia, India, Vietnam

What else can we learn from the white paper and why is it imperative reading for anyone interested in the topic?

NP: "What makes the white paper special is that it allows readers to get inside the minds of 20 or so seasoned PE investors in the region. The white paper brings together the key insights we generated from hours of discussions with Managing Directors and other senior fund managers at leading private equity firms. In a sense, it allows the reader to pull a chair up to the table and partake in the valuable insights offered by those investment professionals."

Please visit www.globalintelligence.com for the full white paper on PE industry trends by GIA entitled: "Asia Private Equity Leaders' Outlook".

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IN MY VIEW

India's phenomenal growth potential continues to place it as one of the top investment destinations. However, private equity and venture capital investors must understand some key factors in order to be successful.

After the slump in investments during the most part of 2009, private equity and venture capital in India picked up significantly in the last quarter to US$ 1.4 billion, taking the annual investment figures to US$ 3.82 billion over 232 deals, according to a recent survey[1].

India continues to be one of the top destinations for investment because of its phenomenal growth potential. However, there are some important factors that must be given due consideration by private equity and venture capital investors who decide to invest in India. This article provides an overview of some of these aspects.

Entry into India

Primarily, there are three regimes for foreign investments into India – the Foreign Direct Investor ("**FDI**"), the Foreign Institutional Investor ("**FII**") and the Foreign Venture Capital Investor ("**FVCI**") regimes. While the FDI regime is predominantly used for investments into Indian unlisted companies, the FII regime facilitates portfolio investments in listed companies. The FVCI regime, on the other hand, confers certain benefits for investment in unlisted Indian companies (as discussed below).

Sectoral Limitations

The Indian government has come a long way in opening up the economy to foreign investment, and today most sectors have been opened up for foreign investment. However, certain sectors such as infrastructure (real estate and telecommunications), retail and print media continue to be regulated, while a few sectors such as retail trading (except single brand product retailing), atomic energy etc are prohibited from receiving foreign investment.

Structuring Investments

Structuring becomes critical to ensure that protective provisions customary in other jurisdictions are enforceable in a complex legal environment like that of India. For example, an investor's preference for hybrid instruments such as redeemable, optionally or partially convertible preference shares / debentures is no longer practical because of a notification that characterizes any instrument that is not compulsorily convertible into equity as debt (which entails compliance with numerous conditions)[2]. Issuance of instruments such as warrants and partly paid equity in favour of foreign investors is also not freely permitted under the FDI route and requires regulatory approval.

Therefore, while redemption as an exit option is no longer available to a foreign investor as a consequence of the characterization above, other exit avenues in the form of buy back (by the company) and put options (against management / founders) continue to be available. However, buybacks are subject to various company law provisions (availability of sufficient free reserves etc). Further, for put options to be enforceable, they need to be structured such that they are not construed as a forward contract.

Price it Right

Non-resident investors are required to comply with entry and exit pricing restrictions as prescribed by Indian's apex monetary authority, the Reserve Bank of India ("**RBI**"). However, this restriction is not applicable to investments by registered FVCIs; they can buy or sell at a negotiated price. Hence, complex investments entailing distinctive returns are usually made under the FVCI regime as pricing restrictions do not apply to FVCIs. The RBI has of late become quite strict in granting funds FVCI approval. Conditions with respect to sectors they can invest in and furnishing of minimum commitment letters from their investors need to be complied with.

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[1] According to a study by Venture Intelligence, a research service focused on private equity (PE) and merger and acquisition (M&A) transactions.

[2] The RBI has issued a circular in 2007 that classifies any instrument that is not compulsorily convertible into equity as an "external commercial borrowing", attracting the provisions of the External Commercial Borrowing Regulations.

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IN MY VIEW (continued)

Rights and Enforcement

It is not uncommon to find extensive downside protections in investment documentation in respect of an Indian company; key among these are price protection rights such as pre-emptive rights and anti-dilution rights. However, because of pricing restrictions, an anti-dilution protection cannot be achieved by issuance of shares at nil consideration. It may need to be structured by an adjustment to the conversion ratio of the convertible instruments to allow further shares to be issued upon conversion. Alternatively, a bonus issue (or warrants subject to regulatory approval) may be used to implement ratchet mechanisms.

Restrictions on share transfers are also common in investment documentation; however, these (and all other rights) should be incorporated in the bye-laws of the company to be enforceable. If, however, the investee company is a public company, then transfer restrictions may not be enforceable, as the shares in a public company are required to be freely transferable[3].

How Taxing!

India is a high tax jurisdiction and consequently it is important to structure foreign investments into India through tax friendly jurisdictions to minimise the tax effect, specifically with respect to capital gains tax.

Mauritius and Cyprus have become popular jurisdictions for investing into India. While both Mauritius and Cyprus exempt taxation of capital gains, Mauritius is the more preferred jurisdiction due to the administrative ease of setting up an entity. Cyprus, on the other hand, is the preferred route for debt investments because of the beneficial tax treatment of interest paid to a Cyprus entity. Singapore too has a treaty which grants exemption on payment of capital gains tax, however the benefit of this is restricted as a result of certain limitations of benefits provisions in the India – Singapore treaty.

However, after the Indian tax authorities pulled up Vodafone for not withholding tax on the consideration paid for the acquisition of a Cayman Islands company through its Netherlands entity (a seemingly tax-free transaction so far as India's fiscal shores are concerned), exits involving shares of an Indian company need to be structured carefully to avoid adverse tax consequences under Indian law.

Conclusion

The outlook on investment in India for the coming years continues to be strong although some private equity and venture capital investors remain wary of the uncertain regulatory environment. However, with the mounting international pressure on capital account convertibility, and with gradual reforms, many of the restrictions investors face today may soon be gone.

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[3] In the recent judgment of the High Court of Bombay in Western Maharashtra Development Corporation Ltd. Vs. Bajaj Auto Ltd, it has been held that pre-emptive rights in a public company would impose a fetter on the free transferability of shares, and is therefore, patently illegal.

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