VIVEK KATHPALIA/NISHITH DESAI ASSOCIATES

There's growing appetite for buyout, control deals in India

By Joji Thomas Philip
joji.p@livemint.com

SINGAPORE

While there is a growing interest from private equity (PE) players in the K-12 assets space, the regulatory environment in the country has to change before private investors can take the plunge into the country's education space, Vivek Kathpalia, head of Singapore and Far East, Nishith Desai Associates, said in an interaction. "PE also requires a deep market with quality assets. That is currently missing in the education space. Hopefully along with regulatory reform the market will also deepen," he said. Kathpalia also added that private equity's growing interest in the education space, which is heavily regulated and high risk, was a sign of the bullishness which would apply across sectors.

He further said that for PE/VC sectors, exits had always been a big question mark as far as India was concerned, with respect to the earlier investment cycles, and added that the recent Walmart-Flipkart, was thereby a game-changer. Edited excerpts:

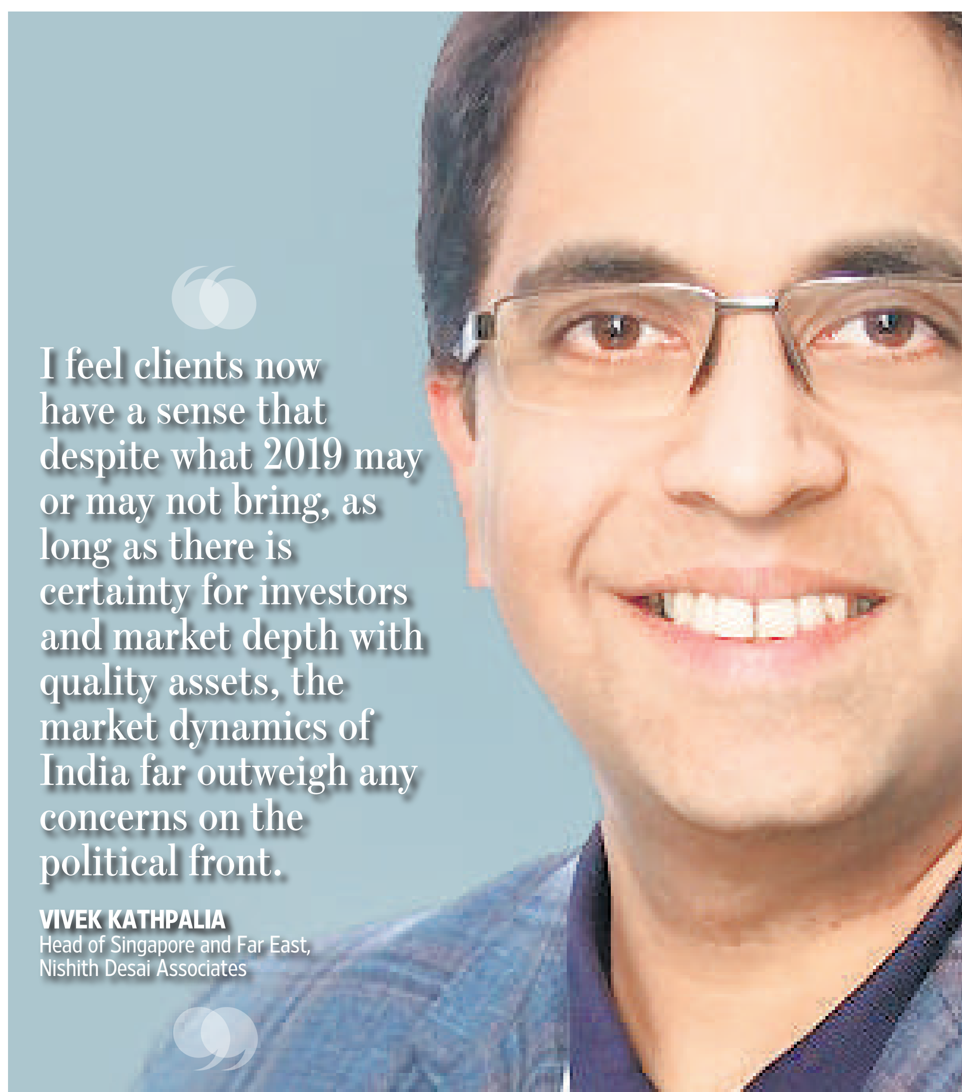
Private equity is pouring back into India's education sector—what has changed to get PE firms so interested over the last 24 months?

I have seen a growing interest in PE investment in K-12 in India. I think the K-12 assets have matured over the years and are ready to meet the higher standards of professionalism and governance that PE investors would demand. From an investors perspective, the biggest stumbling block in K-12 has been the not for profit structure that schools need to be owned and operated under. Robust structures have now evolved which allow such investment in management and services entities which meet all the regulatory requirements as well. We will continue to see growing interest from PE in this space. We need more quality assets to meet the investment appetite. Apart from K-12, the professional and vocational education space is very active as well. We have seen growing PE and strategic interest.

Big picture, what does India need to do to attract major investments into its education space? Do you think that with the Indian government finding it difficult to invest more money in education, can the private sector fill this gap?

The regulatory environment has to change. We are still stuck in a socialist mindset when it comes to private education. The government is unable to fix the broken government school system and is interfering in the functioning of private schools with laws relating to fee regulation and the improper implementation of RTE (right to education). The government should encourage low-cost private schools to adopt and run government schools. A successful PPP model can be created. Some states like Andhra Pradesh have been quite successful. In fact, there is a for profit low-cost private school operator in PPP with the state. As far as private schools which cater to the other segments, the government should ensure maximum autonomy for them to flourish. The new National Education Policy is awaited and hopefully some of these issues will get addressed. Education is in the concurrent list of the Indian Constitution, so states should also compete with each other to make it easier for investment in education. Haryana, for example, allows private limited companies to set up schools.

We have seen some movement in regulatory reform in the higher education space. There is a new regulator being considered to replace the UGC and AICTE. Hopefully this new body will act more like a facilitator than a regulator. There is also an urgent need for an increase in the cross-border collaborations between Indian and foreign institutions in academics and research. The regulatory environment should make these collaborations easier. This could then create another segment for PE to look at. Especially in the for profit space. Education is also a key investment space for impact investors. We have seen the announcement of a billion dollar fund to invest in education from an impact perspective. Innovative investment instruments which track learning outcomes are being stitched together as we speak. Finally, PE also requires a deep market with quality assets. That is currently missing in the education space. Hopefully along with regulatory reform the market will also deepen.



STREET WISDOM

Of late, when you meet clients here, what are their concerns on India? Are any of them concerned about 2019 and whether political stability may remain post next year's general elections?

Overall clients are still bullish on India. If PE interest in education, which is heavily regulated and high risk, is growing, that is a sign of the bullishness which would apply across sectors. The typical issue of uncertainty in various regulatory decisions and their interpretations sometimes continue to cause heartburn to clients. At the same time the government has increased engagement with various stake holders. For example, it's very common now for the DIPP, Sebi and other government departments to get expert views prior to drafting regulation. This has improved the "certainty" outlook as far as India is concerned. Tax, which has been one of the biggest concerns for foreign investors in India, has also been given far more certainty than earlier.

I feel clients now have a sense that despite what 2019 may or may not bring, as long as there is certainty for investors and market depth with quality assets, the market dynamics of India far outweigh any concerns on the political front.

For PE, how big is the stressed assets opportunity in India? Why is that we've not seen global PE majors welcome the Insolvency and Bankruptcy Code, as this regulation creates a slew of new opportunities for them.

Stressed assets are a major opportunity for PE. However the stressed space in India is in a very nascent stage. And at this point it's the strategics that have an advantage as investors. They have the ability to bid higher and have a longer-time horizon. Therefore, if you see the deals in this space, they are all strategic investors. I think the next cycle will see more PE participation. With banks taking bigger haircuts, margins for PE will be better. Some very stressed sectors like power could see more PE involvement.

How do you view the major curbs that were recently introduced by the Reserve Bank of India (RBI) on foreign investment in corporate debt. How do you see the road ahead?

In my view, it's a move that is likely to dissuade foreign investments in listed and unlisted corporate debt. RBI has introduced substantial investment and diversification restrictions with respect to foreign investment in debt. Whilst FPIs (foreign portfolio investors) can now invest in corporate bonds with a minimum residual maturity of one year—as opposed to the erstwhile maturity period of three years —the circular restricts the ability of FPIs to invest in corporate bonds in light of the following —introduction of new concentration limits wherein FPI cannot invest more than 10% of the prevailing investment limits; and diversification limits wherein—one, investments by FPI cannot exceed 50% of the corporate bond issue; and second, investment by FPI cannot exceed 20% of its corporate bond portfolio in respect of a single corporate —including entities 'related to the corporate.

These changes, on a consolidated basis, are likely to result in a change in the investment strategy for foreign investors that are considering investments in corporate debt. It is likely that alternatives such as investment through setting up of non-banking financial company, alternative investment fund, FVCI (foreign venture capital investment) route or the more restrictive ECB (external commercial borrowing) regime maybe considered by such investors.

Again, what is your take on the recent press release by India's ministry of finance regarding the proposed introduction of minimum capital requirements for foreign direct investment into "unregulated" financial services activities?

The press release is likely to have significant implications particularly on asset managers and investment advisors having foreign investment. The press release now imposes dual test of one, registration for the entity, and second, regulation of the activity undertaken by such entity with a financial services regulator, failing which minimum capitalization norms of $20 million—for fund-based activities, such as asset management —and $2 million, for non-fund based activities, such as investment advisers rendering exempt advisory services, may trigger.

There is one significant implication for asset managers of alternative investment funds (AIF). Such asset managers were hitherto considered regulated—by virtue of the AIF being regulated—however, now, in light of the press release, such asset managers would be considered unregulated entities, and be subjected to $20 million minimum capitalization and regulatory approval. Similar implications may also ensue for investment advisers that have hitherto been rendering activities that are exempted under the relevant regulations. We have had interactions with the regulators, where we have been given to understand that asset managers of Sebi-regulated AIFs should continue to be seen as regulated entities and minimum capitalization norms should not be triggered. We have sought clarifications from the ministry of finance. There is also some confusion whether this press release itself has the force of law or whether it needs to specifically notified into law.

Iis the mismatch in valuation expectations between investors and firm owners hindering deal-making? How concerned are investors on valuations?

I think this problem of valuation mismatch is par for the course in a rapidly growing emerging market. A couple of recent deals that I have been involved in have stalled as a result of a big delta in the valuation expectation. Having said that, I have also seen that promoters of Indian companies have also become more pragmatic with respect to their expectations than maybe compared to a few years ago. Investors continue to look for good quality assets and the market has somewhere set a benchmark on the valuations as well. There could always be aberrations as well, with the amount of money trying to find a place to invest and with the increase in bidding wars as well.

If you were to give me the good, bad and ugly of the Indian PE landscape, what would that be?

The overall outlook for India is positive. PE is very engaged and keen to invest. As I said earlier, the key is market depth. That is currently lacking in India for investors. You will see very few big deals. Investors also have to be smart about doing deals. Regulatory issues can create roadblocks down the road. Dealing with them upfront with proper advice is critical.

In 2017, both PE/venture capital (VC) investments and exits recorded new all-time highs at $26.5 billion and $13 billion, respectively. What is your reading from the numbers?

Exits was always a big question mark as far as India was concerned, with respect to the earlier investment cycles. Now we have Walmart-Flipkart. So the proof is in the pudding! The secondary market has developed quite well in India and we are seeing a lot of secondary deals. We are also seeing a growing appetite for buyout and control deals. This also goes to show that the market has matured and promoters and investors have more comfort now in taking calls. We will continue to see a lot of activity in the secondary market and in the buyout space.