



## **Investing in India: The Power, and Potential, of Family-Run Groups**

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### **INTRODUCTION**

Private-equity firms are now playing a pivotal role in financing family-run businesses in India, presenting a new opportunity for U.S. financial firms—including venture capitalists—to profit from India’s fast-growing economy and burgeoning middle class.

India has always been a capital-scarce economy. Historically, large Indian family-run groups like the Tatas and the Ambanis have stepped in to fill this gap, and have moved aggressively to take advantage of newly deregulated markets. But over the last decade, many smaller and regional family groups also have expanded their businesses to achieve national scale in various markets. Many of these companies have done so by partnering with foreign private-equity investors as non-Indian capital has become more widely available—and Indian companies have come to value the guidance private-equity investors can offer.

India today is among the most attractive investment destinations globally, driven by a combination of strong economic growth, an improving regulatory environment and favorable demographics. As India continues on its rapid-growth path, several large investment sectors such as financial services, infrastructure and domestic consumption should offer significant opportunities for savvy investors. We believe India’s family groups will continue to be the entrepreneurial growth engines for these sectors, and partnerships between families and new, outside investors will turbocharge this growth.

### **BACKGROUND**

India always has lacked capital because it is not endowed with traditional resources like oil deposits or mineral reserves that have enriched other nations. India's government also is empowered (and constrained) by the world's largest democracy. As such, it isn't able to unilaterally concentrate massive economic activity on low-cost, export-oriented businesses, depriving it of the foreign-currency growth that has powered other Asian countries like China. In addition, India's democratic government has limited influence over the nation's largest companies. These firms are run largely by professional managers with shareholders as their primary stakeholders. Hence, the government isn't able to, as one example, direct its banks to provide loans to strategic industries that aren't economically viable. Finally, over the last decades, India has attracted very little foreign investment. Over the last 25 years, India has pulled in less than one-fourth the foreign capital China has.

Historically India's large, family-run groups have filled the country's capital voids by serving as the best—and most easily obtainable—source of capital to entrepreneurs. This role became even more important as the Indian government began deregulating the economy in 1991. India's family groups, also called promoter groups, moved aggressively to take advantage of deregulated markets and quickly became the country's economic backbone. Take the legendary Tata Group. It began life in the early 1900s as a steel manufacturer, but has since expanded into businesses as diverse as wireless communications (Tata Wireless), information-technology services (Tata Consulting Services) and automotive manufacturing (Tata Motors). Each of these businesses were started, funded, and grown entirely by capital from within the Tata Group. In fact, when the Tata Group decided to build the world's first Rs. 1 Lakh (\$2,500) car, it funded the entire activity from internal resources.

Each of these Tata businesses now has a multi-billion dollar enterprise value. India's largest family groups, such as the Birlas, Ambanis, Hindujas, Munjals, Bajajs, Godrejs and many others, all have followed a similar pattern, using their own resources to grow and prosper. Looking at the largest and most profitable public companies in India today is a testament of the success of family-run groups and their strategy of self-reliance.

Yet these groups are now increasingly embracing outside private-equity investors to finance the next phase of their growth. Why? The short answer is because private-equity investors are now finally interested in funding these family-promoter groups, lured by India's fast-growing economy and its improving regulatory environment. And the most ambitious family groups have figured out that by tapping outside capital, they can grow their businesses faster. Today, it is a rare family group which isn't considering private equity to accelerate their plans and satisfy their ambitions.

## **THE CASE FOR INDIA**

The rise of family groups is happening against a backdrop of very strong macroeconomic performance and trends in India. In other words, the country is generally ripe for foreign investment, for many reasons. Why?

- ***Strong macroeconomic performance***

After several decades of anemic growth, India has emerged as one of the fastest-growing economies globally. India's GDP growth rate has averaged seven percent over the last decade, resulting in a doubling of real GDP and a two-thirds increase in per-capita real income. Driven by strong domestic demand, an increased pace of investment in the until-now underdeveloped infrastructure sector, increased export competitiveness and favorable demographics, India's growth seems eminently sustainable.

- ***High capital efficiency***

Driven by a historical scarcity of capital, Indian entrepreneurs have learned to be capital efficient. As the chart shows, Indian companies generate better return-on-equity (ROE) than their international peers.

Industry	US	China	India
Basic materials	5.4%	6.0%	16.0%
Healthcare	13.8%	13.3%	11.9%
Information technology	12.8%	10.5%	22.0%
Industrials	8.7%	8.7%	14.6%
Banking and financial services	-3.0%	16.3%	14.7%
Telecom	7.5%	6.0%	14.6%
Utilities	10.5%	6.3%	10.7%
Consumer goods	16.0%	11.6%	9.9%

- ***An improving regulatory environment***

Anyone who has ever done business in India knows the complex regulatory regime can frustrate even the most seasoned international executive. The good news is that things

are improving. Over the past twenty years, Indian governments, led by both major political parties at the federal and state levels, have consistently implemented pro-business reforms in sectors starved for capital. Progressive business leaders are rarely satisfied at the pace of change—but it is happening. India's largest private-sector companies, whether traditional, family conglomerates or first-generation entrepreneurs (e.g. Infosys, Airtel), have executed astonishingly rapid ascents across previously staid, highly regulated industries. These include IT services, telecommunications, power, insurance and real-estate development.

Through progressive legislation such as the Right To Information Act, which has empowered citizens to demand more from government officials, and forward-thinking regulatory reforms such as the Electricity Act of 2003, which substantially liberalized the power sector, politicians and officials are responding to citizens' demands for greater transparency. In the process of evaluating investment opportunities, we identify regulatory risks and work with our portfolio companies to mitigate them. But in most cases, regulatory issues aren't large enough to scuttle a deal.

In addition, India benefits from excellent stewardship of its banking and capital-markets systems by the Reserve Bank of India and the Securities and Exchange Board of India, respectively. These bodies provide further regulatory stability.

## **SECTORS RIPE FOR INVESTMENT/GROWTH**

As it searches the Indian business landscape for potential investments, Bessemer looks for companies that exhibit the following characteristics:

- Large market opportunity
- Capital-efficient environment
- Supportive regulatory structure
- Entrepreneurial management

As India modernizes and deregulates, we believe that financial services, infrastructure, and domestic consumption are the most attractive sectors for investment in India.

## ***FINANCIAL SERVICES***

At a rural bank branch in North India, the smell of decaying paper infuses the branch with an air of stagnation, while the lack of electronic infrastructure all but ensures inefficient transactions. Urban banks looked quite similar only ten years ago. But over the past decade, massive

investment in public and private banking infrastructure, and broader liberalization of the banking sector, has changed the urban retail-banking landscape.

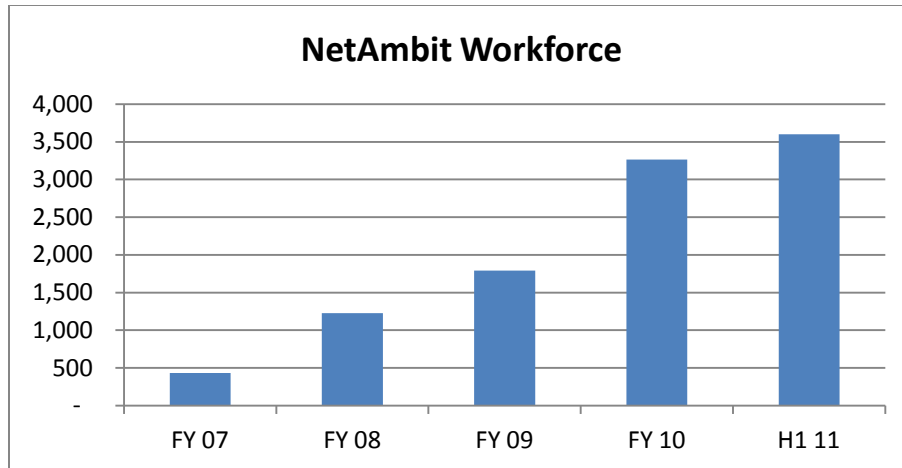
Extending high-quality banking infrastructure beyond Tier 1 cities is the next challenge for traditional banking in India. Mobile technologies, alternative distribution of financial products and stronger, non-banking financial corporations, supported by experienced investors, all will play roles in expanding access to financial products for Indian citizens

India's financial-inclusion metrics, which remain low today despite a decade of strong growth, should also exhibit rapid improvement. Today, fewer than five percent of Indian households have life insurance. Fewer than 10% invest in equity markets, and fewer than 60% have access to the formal banking system. Over the next decade, as India's gross-domestic savings quadruple and the country adds incremental financial savings equivalent to three to four times the total financial savings added since independence, the entire financial sector will see rapid growth.

To date, India's family-run businesses have proven to be effective drivers of this growth.

Consider the case of the Shriram Group of Chennai, India. The group, led by business pioneer R. Thyagarajan, founded Shriram Transport Finance to provide truck loans in 1979. The company was funded entirely by its own resources. The company grew steadily but took nearly 25 years to achieve \$10 million in net income, which it did in fiscal year 2005. That year, Shriram Transport accepted outside equity financing. In the subsequent five years, the company's net income grew 18X to \$180 million. The company's share price reflected this growth – up 20X in this period. With outside capital, the company was able to substantially increase its profit growth. This same example is playing out with other family groups all across India.

In Bessemer's own portfolio, NetAmbit has rapidly grown from a small, call-center based distributor of life-insurance policies to the largest third-party life-insurance distributor in the country. As the chart below shows, taking outside capital, from Bessemer in FY2008, has helped this outstanding management team accelerate growth.



## ***INFRASTRUCTURE***

India needs more roads, railways, power, housing and water if growth is to continue at 7%+ per year. Migration into cities, and the increasing population density that migration brings, make infrastructure improvements even more urgent. The poor state of India's infrastructure is a common complaint among visitors to India and among most Indians as well.

The good news is that state and federal governments have woken up to the need to strengthen India's infrastructure. Recent electoral trends have shown that India's voters are eager to reward good governance, and improving infrastructure is the most visible sign of good governance in India. Consequently, state and federal governments are liberalizing infrastructure sectors to increase foreign-fund inflows and private-sector participation. This has created a virtuous cycle of more rapid infrastructure development, positive investment returns and, thus, more investment. Analysts estimate that over the next decade, India should see infrastructure investments of INR 62 trillion, dominated by investments in power, roads, railways and irrigation.

In addition to building basic infrastructure, creative companies will help sustain India's growth rates by constructing cost-efficient solutions to solve particular infrastructure problems. For example, the Bessemer-backed Applied Solar Technologies saw an opportunity to provide more reliable, cheaper and cleaner power to wireless-communication towers in India, many of which are sprouting beyond the reach of a reliable electric grid. And Bessemer-backed Palogix pioneered the concept of setting up private, third-party railroad terminals to help harried freight consumers bypass the logjams at India's state-owned railroad terminals, which are often choked with passengers.

Several Indian family-run businesses have successfully created substantial businesses in the infrastructure space as well. The list of winners here includes not just the traditional Indian family groups – Reliance, Tata, Jindal, etc.—but some relative newcomers.

One excellent example is the Adani Group, a once-small Indian family group. Just a regional trading house two decades back, the Group today is an infrastructure conglomerate. Adani owns and operates India's largest private port; is developing the country's largest multi-product Special Economic Zone (SEZ); and is working on some of India's largest private-sector power projects. The Group's excellent execution abilities, coupled with the judicious infusion of private equity, has sculpted this Indian infrastructure success story.

In the clean-energy sector, Orient Green Power, a company incubated by Chennai's Shriram Group and Bessemer in 2007, has successfully built and integrated a clean-energy portfolio of 200MW of power generation and a pipeline of 1000MW across bio-mass, wind and mini-hydel (hydro-electric) projects, making it the largest clean-energy producer in India. In September 2010, the company went public in India, raising around US\$200 million. As India continues to encourage renewable-energy usage to help tide over glaring power deficits, we believe that the opportunity for companies like Orient Green Power to succeed and grow will only increase.

### ***DOMESTIC CONSUMPTION***

The Great Indian Middle Class has been a much-discussed and much-pursued entity. After a few false starts in the late 1980s and early 1990s, when Indian and global marketers found the middle class disappointingly elusive, this 400-million strong group is now fueling India's consumption boom. India's domestic private consumption has grown at a 12% CAGR over the last two decades and is expected to more than triple to INR 115 trillion over the next decade. This would make India's domestic-consumption economy, roughly the size of Mexico today, as large as that of France by 2020.

Also, as per-capita domestic consumption grows, the mix of the average Indian's consumption basket will change; bare essentials like food and clothing will comprise a lower proportion of consumption, while the next level of economic essentials (healthcare, education, housing) and discretionary items (communication, recreation, branded foods) will rise in relative importance.

As overall demand increases, and demand patterns change, opportunities will emerge to:

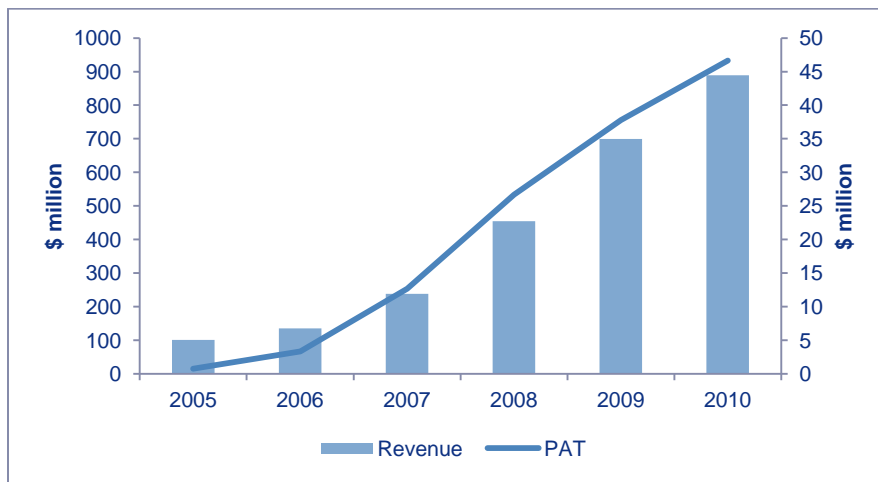
- Sell newer products and services to the Great Indian Middle Class. Examples would be branded, edible oils in place of unbranded ones, or reliable, high-quality healthcare;

- Sell these products and services through newer retail formats, such as big-format/modern retail stores in addition to traditional, neighborhood “kirana” stores;
- Offer products and services through newer and broader channels. Marketers may address the rural and semi-urban markets instead of focusing only on urban customers, and explore Internet-based channels for traditionally offline businesses.

Traditional family-run businesses have made their mark in this area as well.

Future Group’s Pantaloon Retail is a prime example. In less than 15 years, Pantaloon has become India’s largest retailer, with a \$2+ billion market valuation. It has done so by astutely figuring out that the Indian consumer wants the convenience of shopping in an organized format, but is not willing to compromise on low prices or the ability to touch and feel purchases. By designing its highly successful Big Bazaar retail stores around these principles, and creating an efficient supply chain to minimize waste, Pantaloon has successfully converted itself from a regional garment trader into a retailing powerhouse. Pantaloon used private-equity financing to bankroll and scale its Big Bazaar concept– to 132 stores and seven million square feet by June 2010.

Bessemer-funded KS Oils is another company that has successfully driven market growth in the consumer sector. KS led the conversion of the unbranded mustard-oil market to a branded one, while driving expansion of its product into rural and semi-urban markets.



## CONCLUSION

Successful Indian companies deliver some of the highest returns on invested equity in the world today. These superior returns are partly a reward for the increased risks inherent in a less-developed market. But we also believe these excellent returns are a consequence of the

importance family-run groups put on ROE. In a capital-scarce economy, each rupee had to go a long way for these companies, and they have not lost sight of this even as many have grown into industry powerhouses.

At Bessemer, we are firm believers in India's long-term growth story and in the power of India's countless entrepreneurs. Over the last six years, our India investment practice has had the opportunity to work with several family-run businesses, many of which have gone on to become leaders in their respective fields. Going forward, we expect family-run businesses will continue to be important drivers of India's overall growth and valuable partners for Bessemer.

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