TresVista FINANCIAL SERVICES

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Private Investment in Public Equity – India Focus

The study briefly analyzes the global private equity space and the growth prospects of private investments in public equity (PIPE) deals. Given the Indian PE market performance, PIPEs will continue to be an important part of the Indian markets that cannot be ignored. In correlation to the volatility of the market and the subsequent movement in valuations, PIPEs are here to stay.

Executive Summary

With the global private equity investment reaching $180.0bn in 2010, North America recorded deal values up 192.0% and Europe was up 160.0% from the previous year. Consistent with the industry's revival in developed markets in 2010, PE activity in India, China and other leading emerging markets also experienced a quick recovery. By mid-September of 2011, PE investment in China had reached $15.2bn. In India, contrast to 2009, when the country's deal value saw the region's biggest decline, it recorded the largest increase in deal activity among the big Asia-Pacific markets. During 2011, PE firms invested more than $10.1bn over 441 deals in India, compared to $8.2bn across 362 deals during the previous year, taking the total investments by PE firms over the past five years to about $47.0bn across 2,062 transactions.

Private investment in public equities (PIPE) is seen as one of the most attractive markets for qualified individual investors and accredited institutional funds. PIPEs make attractive investments as corporate governance, transparency and accountability of listed firms is perceived to be significantly better than privately held firms. However, PIPE deals, come at a premium of 20.0-30.0%. As of H1 2011, globally, a total of 623 PIPE deals have taken place, of which companies raised $7.6bn from 298 private placements in the second quarter alone. Also Healthcare and Financial sectors remain a favorite among PE investors.

Considering the promising market situation, PIPEs are expected to continue to be a very important part of the PE industry in India. This is because in many segments similar businesses are often said to be valued far more reasonably in public markets than in private situations, especially in sectors where a lot of capital is chasing companies and entrepreneurs. In 2011, PIPEs accounted to 15.0% of the total PE investments made in India. Following the recent takeover code announced by the Securities and Exchange Board of India (SEBI), where the threshold limit for open offer was raised from 15.0% to 25.0%, private investments in public companies are expected to record an increase by 70.0%, especially the small and mid-sized companies.

A common trend over the past few years has been a decrease of PE investments in the shares of public companies in proportion to the increase in public equity market valuations. Despite the current market fall being expected to have an impact on recovery, PE investors remain willing to take long-term bets on the consumption driven India growth story.

Having faced a bad performance of the equity market in the recent past, most promoters are said to have become more realistic about valuations thereby expecting a higher number of PIPE deals in 2012. With 2012 funding estimated to be far more rewarding than the 2008 funding, an increased number of PIPE deals are expected. This is probable of making the equity market cleaner and transparent, and is further expected to trigger shareholder activism which is currently missing in the market. The current market movements are suggesting of a promising future for PIPEs in India.

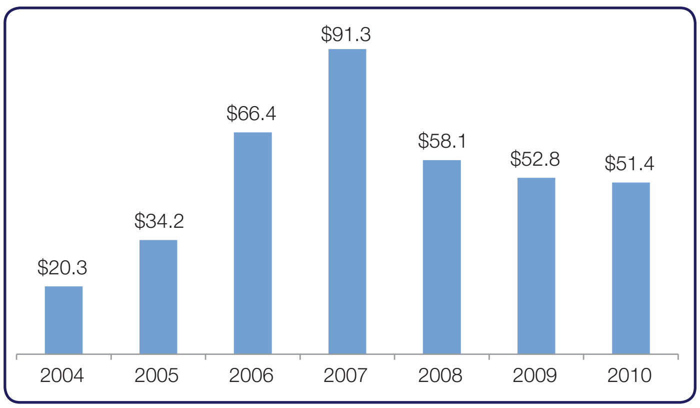
Global PE Market

Current Scenario

Since 2008, the global PE sector has experienced a significant downturn in activity given the economic slowdown. However, 2010 was seen as a year of recovery for PE worldwide, as the industry has been gradually recovering. PE continues to remain an important source of funds for startup and young firms, firms in financial distress and those seeking buyout financing. Nearly $180.0bn of PE was invested globally in 2010, up around 54.0% from the previous year but still down around 74.0% from the peak in 2006. However, activity in the industry has been showing positive signs to build on this recovery and is expected to top $200.0bn in 2011. With bank lending in short supply, the average cost of debt financing is well up on pre-crisis levels while leverage is down and PE firms are contributing a bigger proportion of equity into their deals.

In 2010, the epicenters of the global credit crisis, Europe and North America, recorded deal values up 160.0% and 192.0%, respectively, from the cyclical trough. A large and rapidly growing number of PE funds worldwide are said to be sitting on nearly $1.0tn in committed but un-invested "dry powder", and they are looking across the globe for attractive investment opportunities. In line with the industry's revival in developed markets in 2010, PE activity in India, China and other leading emerging markets also recovered quickly.

Annual Deal Value in Asia-Pacific ($bn)



Source: India Private Equity Report 2011, Bain &Company, Inc.

Annual Deal Value in Asia-Pacific – 2010

Country/Region	CAGR (04 - 09)	Growth (09 - 10)
China	27.0%	56.0%
India	**23.0%**	**111.0%**
Australia/New Zealand	47.0%	50.0%
South East Asia	22.0%	21.0%
Japan	9.0%	14.0%
Hong Kong/Taiwan	15.0%	221.0%
Korea	28.0%	70.0%
Overall	**21.0%**	**3.0%**

PE Market in India

Background and Current Scenario

PE has established strong roots in India over the past decade, owing to the nation's phenomenal growth, dynamic entrepreneurs and hunger for capital to finance opportunities in nearly every business sector. Over the past decade, its role increased in significance and PE began to shape itself to the contours of the Indian economy and unique business culture. Contrast to 2009, when Indian deal value saw the region's biggest decline, India saw the largest increase in deal activity among the big Asia-Pacific markets in 2011. Total deal value more than doubled in

Annual VC/PE Investments in India by Sector

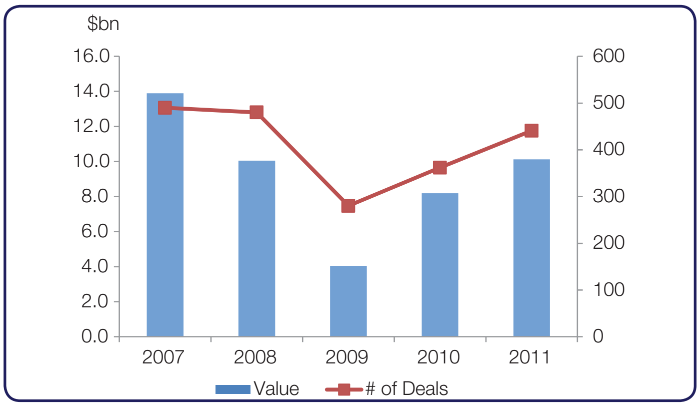
Sector	Growth (09 - 10)
Energy	283.0%
Real Estate	130.0%
BFSI	206.0%
Telecom	164.0%
Engineering &	106.0%
Healthcare	115.0%
IT & ITES	(6.0%)
Manufacturing	207.0%
Media & Entertainment	(46.0)
Other	(48.0%)
Overall	**111.0%**

Source: India Private Equity Report 2011, Bain &Company, Inc.

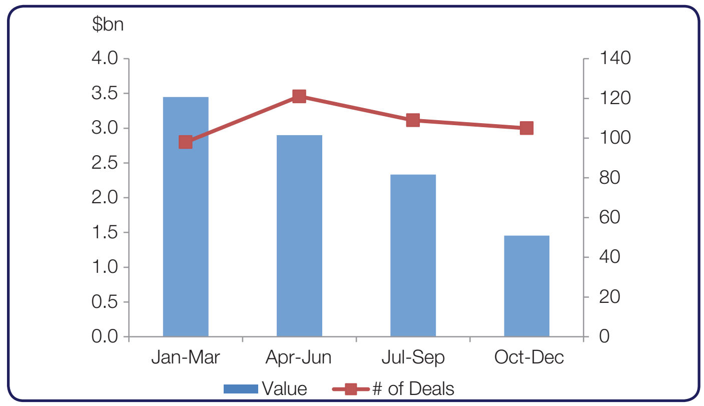
2010 to $8.2bn, and the number of deals rose to 362. Nearly every major sector of the Indian economy participated in the strong deal-making recovery, with the energy sector attracting the most capital.

With financial crisis affecting the global economy and domestic concerns, industry participants have had to tackle with significant new challenges. With that, PE firms are now aware that they need to reassess their strategies and how they can continue to deliver superior returns especially when the traditional drivers of the past such as GDP growth, multiple expansions, and ready availability of capital, no longer provide the lift they once did. As per the analysis by Venture Intelligence, PE firms invested $10,117.0mn over 441 deals in India during 2011, compared to $8,187.0mn across 362 deals during the previous year taking the total investments by PE firms over the past five years to about $47.0bn across 2,062 transactions. However, the PE investments in the Q4 2011 declined to about $1,456.0mn across 105 deals compared to the $1,828.0mn invested across 88 deals in the same period in 2010 and $2,334.0mn invested across 109 deals in the immediate previous quarter. The amount of PE capital deployed is said to have declined for the fourth successive quarter in keeping with the economic uncertainty and the decline in public markets.

PE Investements in India



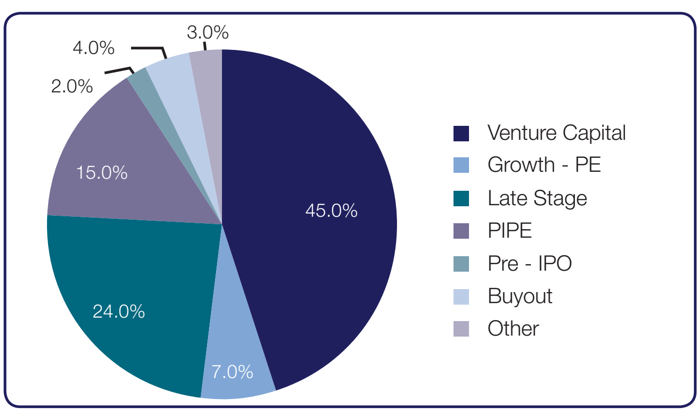
Investments by Quarter – 2011



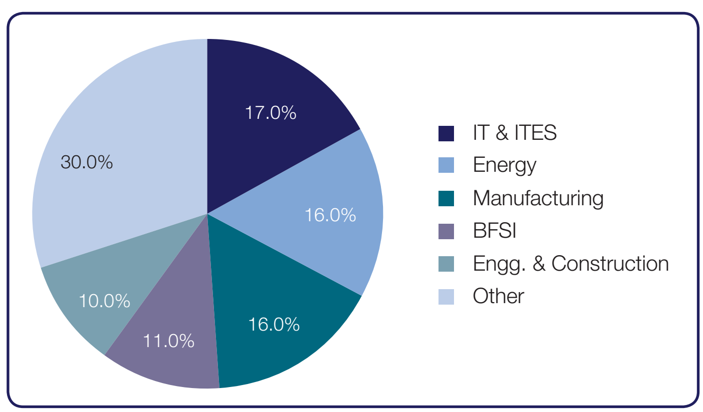
Source: PE Play In 2011: Emerging Trends & Future Impacts

During 2011, with a total of 137 investments and a deal value of about $1,752.0mn, Information Technology and IT-Enabled Services companies topped in terms of both investment value and volume. Engineering & Construction companies and Food & Beverages companies are also said to have attracted special investor attention during 2011. In terms of stage, late stage deals accounted for 24.0% of the investments in volume terms and 36.0% in value terms. Venture capital investments accounted for 45.0% in volume terms and 11.0% in value terms, while buyouts represented less than 5.0% of the total by both parameters. PIPE transactions contributed to 15.0% of the total in terms of both value and volume.

PE Investments by Stage: 2011 Volume - 441



PE Investment by Industry: 2011 Value - $10.1bn



Source: PE Play In 2011: Emerging Trends & Future Impacts

Why PIPEs

PE funds, which mostly invest in private companies, are buying stakes in listed companies trading at attractive prices. The downturn in stock markets in the recent past has brought down valuations of companies offering significant investment opportunities for PE firms to invest in listed companies. Private investment in public equities (PIPE) is seen as one of the most attractive markets for qualified individual investors and accredited institutional funds. A PIPE deal is a directly negotiated transaction between an accredited investor and an issuer, a public listed company. PE firms prefer PIPEs as these allow the funds to sell their investments in just a year or two, compared with the average four-five year wait for exits in privately held firms. Also, PIPE investments are attractive as corporate governance, transparency and accountability of listed firms are perceived to be significantly better than privately held firms. PIPE deals, though, come at a premium of 20.0-30.0%. Since the late 1990s, PIPE transactions have been increasing dramatically, and have successfully raised $105.0bn in equity capital over the past two years. In 2010 alone, there were a total of 1,203 PIPE deals. As per the current trends, top Wall Street executives are increasingly becoming involved in PIPE transactions as placement agents. Also investors tend to consider PIPEs attractive due to the restrictive regulatory challenges in executing control investments like PE or venture capital. In addition to this, since PIPEs do not involve public underwritten offerings, their relative time and cost efficiency make it attractive to public companies. During the credit crisis in September 2008, when the companies could not access equity markets, PIPE transactions have provided quick capital to the companies.

A falling market makes a good time to buy into listed companies. In the current market scenario, companies can't go public and they can't raise debt as interest rates are very high. PE funding turns out to be the better option. There are other advantages in backing listed firms. In unlisted companies, the board seats allow the investor to have more influence, but less flexibility on the timing of the exit. However, in a listed entity with enough float in the market, investors can time their entry and average out their holding price by buying more stock when the market falls. In an unlisted company, it is much harder to do this as investors typically enter at a predetermined price and cannot easily adjust for underperformance or stock market crashes.

Most Active Industries	PIPEs	US $ (mn)
Financial	37	2,630.0
Health Care	89	1,470.0
Industrial	33	838.7
Tech	42	703.4
Energy	30	689.3
Real Estate	9	590.1
Basic Materials	35	270.8
Consumer/Retail	14	230.0

Source: The PIPEs Report, July 2011

As of H1 2011, a total of 623 PIPE deals have taken place globally of which companies raised $7.6bn from 298 private placements in the second quarter alone, compared with $6.1bn from 266 PIPEs in the same period in 2010. Also, the average deal size rose to $20.3mn from $18.2mn.

Globally, Health care companies issued the most number of PIPEs in Q2 2011, with 88 private placements that raised $1.5bn. In terms of dollar volume, financial institutions led the market, raising $2.6bn from 37 PIPEs in the same period. First BanCorp, a San Juan, Puerto Rico-based commercial bank, raised $515.0mn from a private placement of common stock to investors Oaktree Capital Management and Thomas H. Lee Partners. For Oaktree, the deal was priced at a 3.3% discount to the stock's closing the day before the deal was announced. Oaktree, a Los Angeles-based hedge fund manager, and New York-based PE firm Thomas H. Lee each invested $175.0mn.

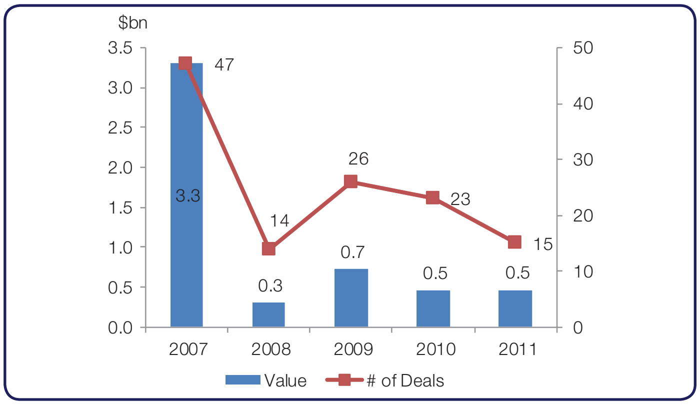
PIPEs India

During the height of the bull-run, one-fifth of the total PE investments made in India were seen to be in listed companies. But due to the financial crisis, the value of these investments was seen to drop lower, exhibiting a steep fall. In 2007, more than $3.0bn or 21.0% of all PE investments were of PIPE nature. Also, given that the markets continued to remain depressed below the highs seen in 2007, it was unlikely that PIPE investments would have recovered their cost. However, the increasing valuation of listed companies is reflected in the number of PIPE deals that took place in the last four years. As a percentage of overall value of PE investments, PIPE deals have fallen to 15.0% in 2011 and even in terms of the number of deals, the figure has fallen to 15.0% in 2011 as investors judged the valuations as excessive.

PIPEs are expected to continue to be a very important part of the PE industry in India as in many segments similar businesses are often said to be valued far more reasonably in public markets than in private situations, especially in sectors where a lot of capital is chasing companies and entrepreneurs. In addition to this, PIPEs in India are expected to rise further after falling for the past 5 years, as lower valuations due to a decline in stocks are expected to present attractive investment opportunities to investors.

In the second largest deal in the past three years after Bain Capital and Singapore sovereign wealth fund GIC invested $850.0mn in 2011 to help buy 26.0% stake in Hero Honda, India's largest two-wheeler manufacturer; US-based Apollo Global Management invested about $500.0mn in three companies of the BK Goenka-promoted Welspun Group. Of this, it invested $290.0mn in Welspun Corp, paying INR 225.00 per share (33.0% premium to Welspun's closing price on June 28, 2011). Shares of Welspun Corp touched an all-time low of INR 68.50 on the Bombay Stock Exchange (BSE) on November 24, 2011. Around May, KKR and IFC, which together acquired 27.8% in Magma FinCorp Ltd for about $100.0mn, paid INR 88.00 per share, a 20.0% premium to the trading price. Magma shares touched an all-time low of INR 48.00 on November 18 on the BSE.

PIPE Investments in India



Source: VCCedge, 2011 is as of July

Top PIPE deals in 2011

Target	Buyer	Value ($mn)
Hero Honda	Bain Capital & GIC	850.0
Welspun Corp Ltd	Apollo Management	290.0
Magma Fin Corp	IFC, KKR	98.0
KPIT Cummins	Chrys Capital	25.0
Aegis Logistics	Infrastructure India	15.0

Source: Public Research, Business Standard

As per industry experts, following the recent takeover code announced by the Securities and Exchange Board of India (SEBI) and implemented from November 2011, where the threshold limit for open offer was raised from 15.0% to 25.0%, private investments in public companies are expected to record an increase by 70.0%, especially the small and mid-sized companies. The open offer limit is said to have kept back a few global PE majors who wished to acquire about 20.0-25.0% stake in listed companies. Although the new rule is expected to improve the flexibility to take larger stakes, it will not be easy in well-managed companies that are doing well and are still undervalued, unless they do primary offering. The dedicated funds investors have raised are expected to make available large pools of PE capital for PIPE deals. Apart from this, industry players also believe the new proposal will increase deal sizes by about 70.0%. Another amendment to Securities Contracts Regulation Act in June 2010 mandated that non-government public companies would be required to achieve 25.0% public float over a prescribed period. Currently, there are 463 companies that have a promoter holding of more than 76.0% and that will need to offload stake to fall in line with the SEBI guideline, indicating increased potential for PE investments.

Returns and Risks Analysis

Strategies Used

PIPE transactions are highly negotiated with widely differing terms of contract. Many a times such deals take place either at a discounted price as compared to the company's market price or at a premium depending on the growth prospects. Most investors, who willingly pay a premium for the stock despite the market volatility, continue to remain bullish on the company's growth potential and the respective sector. Often investors are offered a discounted price to compensate for the expected monitoring, services and expert advice, reduced/lack of liquidity, and/or the cost of due diligence. However, this is unlikely as PIPE investors remain passive and may not increase the firm value through monitoring; they might be facing certain resale restrictions, which may even be an incentive for investors to employ their specialized management and operational skills to increase the issuer's public stock price and even incur expenses to assess the issuer's future prospects. In fact, PIPE investors generally face much shorter resale restrictions and also do not have access to material non-public information.

The issuer's six month stock performance prior to its PIPE transaction is related to the issuer's premium/discount. Positive pre-issue stock price performance may signal the market expected improvements in the Company's financial results. Investors are willing to pay higher premiums to companies whose financial results are expected to improve. Also the presence of hedge fund investors in a PIPE issue is generally associated with smaller premiums. Hedge funds investing in PIPEs tend to use several strategies to hedge their risk. A typical scenario is where a hedge fund invests in a common stock PIPE issue, and after the PIPE transaction has been announced, short the issuer's public shares (incase short-selling is permitted). This may result in the hedge funds playing a role in depressing the issuer's stock prices resulting in contributing to PIPE issuers preferring investors that are restricted from short selling, such as mutual funds. The presence of hedge funds may signal the issuer has fewer interested investors and has to offer larger discounts (or a smaller premium) to entice investors to participate in the financing. This suggests that hedge fund investors may play a negative role in the PIPEs poor long term performance through their hedging activities.

One notable trend over the past few years has been a decrease of PE investments in the shares of public companies in proportion to the increase in public equity market valuations. Also when stocks experience falling prices, PE investors will seldom be willing to pay the previously prevailing higher prices. In such cases, either deals end up not happening or promoters end up waiting for the prices to bounce back. But since most companies have expansion plans, which cannot be put on hold indefinitely, they may be forced to settle for a lower price. A premium in such a market situation indicates confidence in the long-term growth potential of the stock.

PIPE investors making deals in India work on similar principles. Despite the current market fall which is expected to have an impact on recovery, PE investors remain willing to take long-term bets on the consumption driven India growth story, as strategies depend on a particular company and sector rather than performance of the overall market. Also if the investors have managed to identify companies that are expected to survive the present downturn and also have resources to bounce back when the market rebounds, investors can increase the stake in those companies whenever there is a good opportunity.

“One notable trend over the past few years has been a decrease of PE investments in the shares of public companies in proportion to the increase in public equity market valuations.”

Outlook

In the wake of softening valuations, PE fund managers anticipate an increased pace of deal-making in 2012. As per a VCCircle Survey, in 2012-13 consumer products/services is expected to be the most preferred sector (51.4%), followed by healthcare services and manufacturing (14.3% each); financial services (11.4%) and infrastructure (5.7%) in that order. The survey indicated that the strategies to be used by PE fund managers are expected to remain similar to the ones currently pursued. Growth investments are expected to be the most attractive PE segment in the near future, followed by mid-buyouts, given that the Indian private investing market is maturing. PIPEs are expected to be next in preference list, as the market conditions in 2011 presented attractive opportunities for PE funds.

After the bad performance of the equity market in the recent past, promoters are said to have become more realistic about valuations thereby expecting a higher number of PIPE deals in 2012. As per market forces, PIPE investors are expected to stick to the India consumption story and shy away from companies that have significant dependence on the US or the European markets or are export-oriented. Also, the new SEBI proposal is expected to help expand private equity deal universe and effectively increase the potential deal sizes in the listed space by up to 89.0% without triggering the open offer. The change is considered to be good as it would not only lead to increased participation from PE players in terms of size and value of fresh investments, but also in their existing portfolio companies, where they would use the opportunity to increase their stake.

The increasing competition in private space, as far as fundraising is concerned, also compelled the PE companies to change focus into the listed space. Increasing number of PIPE deals are expected to make the equity market cleaner and transparent, and trigger the currently missing shareholder activism. The recent exit of four managing directors of Sequoia Capital to form Westbridge Capital, an independent fund focusing on PIPE deals and raise $500.0mn in a span of three months, indicates a promising future for PIPEs in India. Avendus PE Investment Advisors, a unit of financial services firm Avendus Capital, will also raise up to $200.0mn in a PE fund to invest in mid-sized listed firms. In April, Singapore based Nalanda Capital closed its second fund of $475.0mn. Other PE funds keen on PIPE deals in India include Norwest Venture Partners, Ascent Capital, LotusPool Capital, ChrysCapital and Warburg Pincus. Ascent is yet to make a PIPE transaction from its third fund of $350.0mn. Although the value and number of deals has slowed, PIPE is expected to pick up with several PE players betting on undervalued listed companies.

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- PE Play In 2011: Emerging Trends & Future Impacts
- VCCircle Survey

About TresVista Financial Services

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