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Why Invest in Asian Private Equity? India as a Potential Breakout PE/VC Market

INVESTMENT INSIGHT | MORGAN STANLEY PRIVATE EQUITY SOLUTIONS (MS PES) | September 2024

Demographics, policy, and digitalization are converging at a time of significant change for India's economy. Amid ongoing uncertainty in China, investors have been seeking alternate ways to obtain exposure to Asia with India being a key destination. With Indian public markets having experienced a strong run-up since 2020, global allocators have been turning to Indian private equity (PE). In this paper, we aim to examine the promising performance potential of Indian private equity, address oft-cited concerns, and share with investors how to tap into this potential breakout opportunity.

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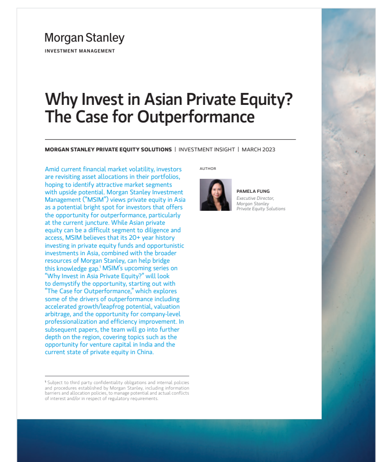
Is India the next China?

THE PARALLELS BETWEEN LAST-CYCLE CHINA AND CURRENT-CYCLE INDIA

China, over the last decade and until recently, had been one of the brightest spots in global private equity. Recalling our prior paper, *"Why Invest in Asian Private Equity? The Case for Outperformance"*, PE investing in China benefitted from accelerated, 'leapfrog' growth, efficiency improvements, and valuation arbitrage. Multiple factors generated excitement in the space: the large homogeneous market, three decades of c. 10% annual Gross Domestic Product (GDP) growth, rapid urbanization and infrastructure build-out, and the accelerated development of technology. The public markets were buoyant and receptive of this rapid growth, spurring major initial public offerings (IPOs) of China-based companies on both the U.S. and Chinese exchanges. Many multi-billion-dollar businesses were created with PE and venture capital (VC) participating commensurately in this growth.

We believe that India currently possesses many of the same characteristics that made China so attractive in the last market cycle. For starters, India's population has just surpassed China's, and annual GDP growth for the next



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Why Invest in Asian Private Equity?
The Case for Outperformance

MORGAN STANLEY PRIVATE EQUITY SOLUTIONS | INVESTMENT INSIGHT | MARCH 2023

Amid current financial market volatility, investors are revisiting asset allocations in their portfolios, hoping to identify attractive market segments with upside potential. Morgan Stanley Investment Management ("MSIM") views private equity in Asia as a potential bright spot for investors that offers the opportunity for outperformance, particularly at the current juncture. While Asian private equity can be a difficult segment to diligence and access, MSIM believes that its 20+ year history investing in private equity funds and opportunistic investments in Asia, combined with the broader resources of Morgan Stanley, can help bridge this knowledge gap.[1] MSIM's upcoming series on "Why Invest in Asia Private Equity?" will look to demystify the opportunity, starting out with "The Case for Outperformance," which explores some of the drivers of outperformance including accelerated growth/leapfrog potential, valuation arbitrage, and the opportunity for company-level professionalization and efficiency improvement. In subsequent papers, the team will go into further depth on the region, covering topics such as the opportunity for venture capital in India and the current state of private equity in China.

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decade is expected to be 6.5%[1] with India replacing China as the world's fastest-growing large economy. India is investing heavily in physical and digital infrastructure, which is expected to contribute significantly to continued GDP growth. Unified GST,[2] introduced in 2017, has India now behaving as one common market with the country moving up ten places in the last five years in terms of ease of doing business.[3] We believe India possesses several structural tailwinds that may provide ample runway for growth—and that India may in fact be even better positioned than China was at a similar point in its growth trajectory.

INDIA MAY BE EVEN BETTER POSITIONED THAN CHINA WAS

Factor #1: More accelerated growth

While Prime Minister Narendra Modi is credited with India's comeback story, many of the building blocks for India's next phase of growth were introduced before he came into power in 2014. The idea for Aadhaar, which requires each Indian citizen to have a digital ID and has integrated millions of previously untracked citizens into the formal system, was born in 2010. The Unified Payments Interface (UPI) was conceived around the same time, providing India with the digital backbone for instantaneous online payments; India now leads the world in digital payments with over 100 billion transactions in 2023. In the ensuing years, the splash made by Jio, India's largest telecom network, enabled India to offer the cheapest and fastest mobile networks in the world with COVID-19 tailwinds rapidly accelerating digital adoption. There are numerous additional initiatives underway, such as India Health ID (initiated 2020) digitizing medical records and Account Aggregator (initiated 2021) digitizing bank account information.

While the development of technology in the U.S. and China has been driven more so by the private sector, in India, it is the government that has laid the groundwork nationwide for multiple facets of society to be digitized, which we believe could potentially lead to even more accelerated growth. As shown in *Display 1*, India's current mobile penetration is already on par with China's and, in the next decade, India may overtake China's mobile banking penetration, distinguishing the country as a clear digital-first economy.

DISPLAY 1

China last decade vs. India this decade

	CHINA LAST DECADE		INDIA THIS DECADE	
Population (mn)[a]	1,349 (2010)	→ 1,427 (2022)	1,422 (2022)	→ 1,538 (2032E)
GDP per capita (USD)[a]	$4,517 (2010)	→ $12,582 (2022)	$2,377 (2022)	→ $5,857 (2032E)
GDP growth (%)[a]	6.6% (2010-22)		6.5% (2022-32E)	
Mobile Penetration (%)[b]	22.0% (2010)	→ 89.2% (2022)	85.1% (2022)	→ 95.8% (2032E)
E-commerce Penetration (%)[c]	0.9% (2010)	→ 31.4% (2022)	6.7% (2022)	→ 9.3% (2027E*)
Mobile Banking Penetration (%)[d]	10.3% (2010)	→ 48.3% (2022)	35.1% (2022)	→ 70.8% (2032E)

[a] Source: Oxford Economics, data as of February 2024; Real GDP CAGR.

[b] Source: EuroMonitor, data as of February 2024.

[c] % ecommerce sales of total retail sales; Source: Euromonitor, National Data Sources, Morgan Stanley Research, data as of 23 April 2023; 2027E is the longest-dated forecast available for e-commerce penetration.

[d] Source: Statista Market Insights, data released May 2023.

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Factor #2: India to global opportunity

While China—given its large, homogeneous market—had historically been mostly focused on domestic solutions, Indian companies in certain sectors have generally been more outward looking. Services make up a relatively high 40-50% of India's exports, and India has a long history of business process outsourcing (BPO), serving a global customer base by leveraging its large and cost-effective talent pool. Today, some of this has transitioned into software-as-a-service (SaaS) with India becoming a potential development hub in this space. With three million developers, 50% more than in the U.S.,[4] and at 50-70% lower salaries compared to U.S.,[5] Indian tech companies can staff large teams, iterate on R&D more quickly, and simultaneously develop multiple products and holistic

[1] Oxford Economics, data as of February 2024.

[2] Unified Goods and Services Tax ("Unified GST") was introduced in India on July 1, 2017, to replace the prior system which involved a complicated system of multiple indirect taxes imposed by the Central Government and each individual State. By introducing a single GST that is applied at uniform rates across the country, the Government of India has greatly enhanced the ease of doing business in India.

[3] Economist Intelligence Unit's Business Environment Ranking.

[4] SaaSBOOMi, "Shaping India's SaaS Landscape Over the Next Decade", July 2021.

[5] Bain & Company, "India SaaS Report 2022"

solutions while maintaining speed-to-market, making for a more compelling customer proposition. With the COVID-19 pandemic opening companies to the idea of enterprise sales originating from anywhere, India's low cost, tech-savvy talent is expected to help grow its share of global SaaS from 5% to 8% over the next five years.[6]

Beyond the tech and software sectors, India has also served as a hub for emerging market solutions for decades. For example, exports in the consumer and healthcare sectors have historically offered strong price-to-quality propositions. With global supply chains diversifying beyond China, India is already proving to be a beneficiary.

Going forward, we believe India will play an increasingly important role in many global markets, from manufacturing to software and tech.

Factor #3: Focus on capital efficiency

For all the buzz around India right now, investment capital has come and gone in waves *(Display 2)*, so for many years, companies could not rely on outside investment capital and were forced to bootstrap operations and grow in a capital-efficient manner. Additionally, until listing requirements changed in 2020, companies had to be profitable in order to go public. Even now, when examining the tech IPOs of the last three years, we observe that the market has rewarded companies with better margin profiles vs. those with high cash burn rates *(Display 3)*. Hence, from both an entrepreneurs' and investors' perspective, in the Indian market, there is an implicit focus on capital efficiency. Companies that can scale profitably with lower cash burn should be generally well-positioned to generate more sustainable returns.

Why do Indian GPs still struggle to fundraise?

Even with all this positive momentum, we observe that many Indian general partners (GPs) with compelling track records struggle to fundraise from international limited partners (LPs). We believe it is important to understand the history behind this and how to think about the perceived risks of investing in Indian private markets going forward.

THE "BAGGAGE" – CURRENCY DEPRECIATION, HIGH VALUATIONS AND LIMITED EXIT OPPORTUNITIES

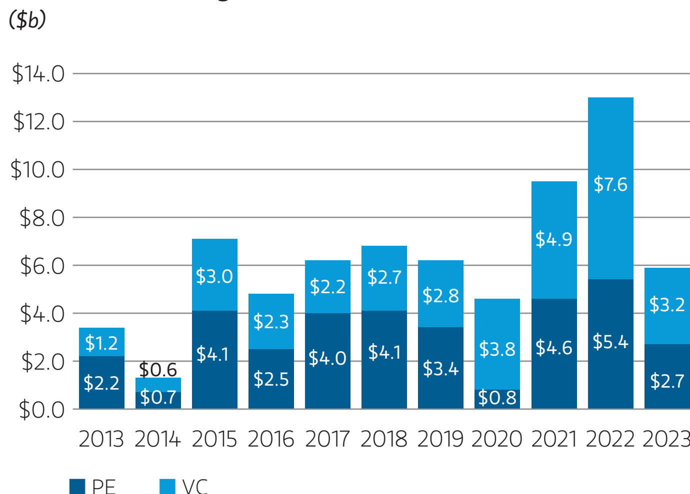
Those who have been investing in India for the last few decades bear a lot of scar tissue. Many investors were burned by disappointing returns in Indian PE/VC. It is not uncommon to see Indian GPs report their returns in Indian Rupee (INR), which, when translated into U.S. dollars, appear underwhelming. Other common gripes included the perceived high entry valuations of underlying target companies and the lack of distributions.

We believe the magnitude of these issues is lower today than in the recent past, but that these considerations must still be proactively managed by GPs.

DISPLAY 2

PE/VC Fundraising in India

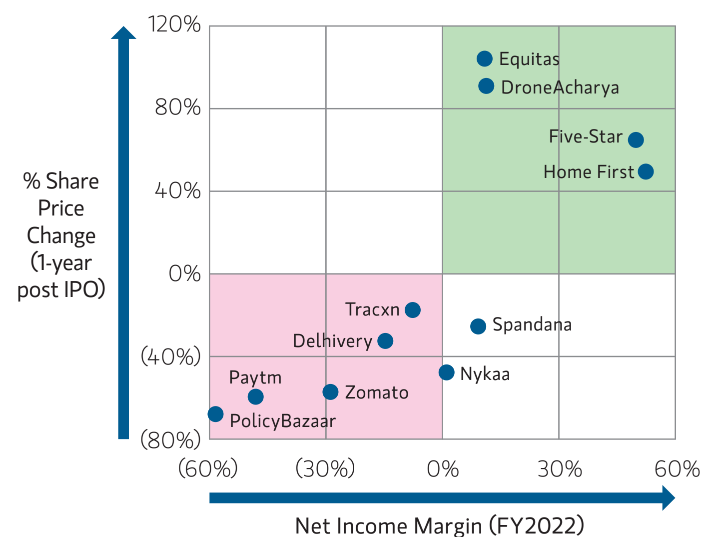
($b)



Source: AVCJ, data as of December 31, 2023.
Data provided is for informational use only

DISPLAY 3

Profitable Indian companies perform better post IPO



Source: Capital IQ, data as of 31 December 2023.
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[6] 2022-27 forecast; Bain & Company, "India SaaS Report 2022".

Issue #1: Depreciation

Steep depreciation and volatility in the Indian Rupee (INR) have been concerns of investors for decades. At its worst, between 2007 and 2013, the INR depreciated over 50% against the dollar.[7] In the last decade, the INR has continued to depreciate, but at a more modest and predictable rate. During this time, given a much more proactive central bank, India's foreign exchange reserves position has significantly strengthened and inflation has moderated to 2.9%,[8] resulting in a more controlled INR depreciation at an average of 4.0% p.a.. Morgan Stanley Research currently expects INR depreciation going forward to be more moderate, at c.2% per annum.[9]

This moderation notwithstanding, due to the prior steep depreciation era, GPs on the ground have generally become much more aware of the effects of depreciation, especially as most Indian PE and VC funds are denominated in U.S. dollars, with GPs' carried interest also tied to dollar-denominated returns. Indian GPs today manage foreign exchange (FX) risk through a combination of diversification within the portfolio,[10] balancing domestically oriented versus export-focused U.S. dollar-revenue-driven companies and/or underwriting to higher returns. The most sophisticated investors include currency as an input in their models to see how the impact of currency flows through the business.

Issue #2: Valuations

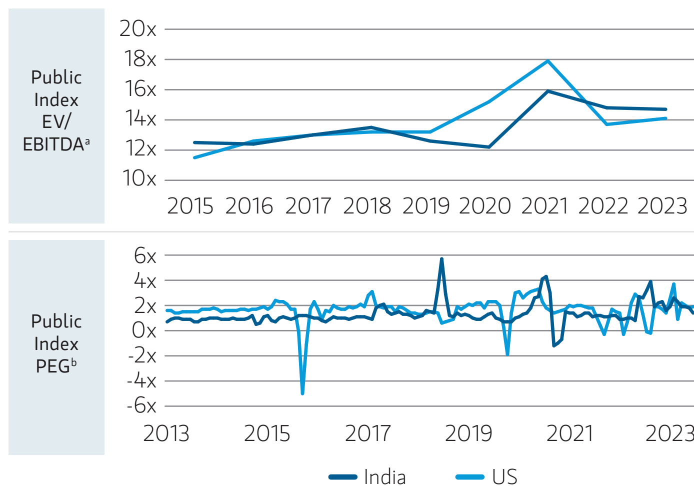
India has been notorious for high valuations, both in the public and private markets. But are valuations really that high?

- Looking at the median in Indian public and private markets, valuations may not, in reality, be considered high. Across several dimensions (i.e. EV/EBITDA, PEG), they appear to be in line with the U.S. We have also observed on the ground that certain market segments still hold a degree of opacity and inefficiency, with some companies—generally small/mid-cap companies that are not part of large auction processes—demonstrating compelling growth and margin profiles and trading at high-single-digit EV/EBITDAs.[11]

DISPLAY 4

Indian Public and Private Valuations

Public Valuations



Source: Bloomberg, data as of 31 December 2023.

[a] Average LTM EV/EBITDA of MSCI India vs MSCI US.

[b] Average 1-year forward PEG of MSCI India vs MSCI US by month.

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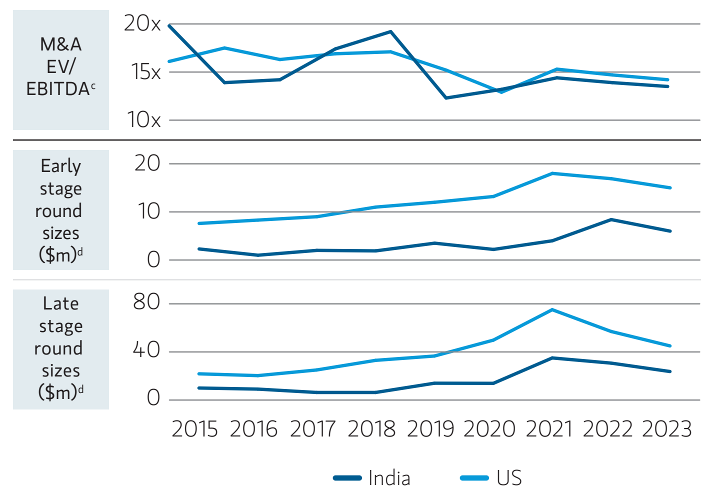
Private Valuations



Source:

[c] Thomson Reuters, data as of 31 December 2023. Median M&A EV/EBITDA Acquisition Multiple.

[d] AVCJ (India), Preqin (US), data as of 31 December 2023. Median round size by year; Early stage: Startup/ Early stage, Series A&B; Late stage: Series C onwards, and Growth/ Expansion.

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[7] Oxford Economics, data as of 31 August 2023.

[8] 2013-2023 average annual CPI inflation differential; Oxford Economics, data as of 31 August 2023.

[9] Based on MS PES discussion with Morgan Stanley India Macroeconomics research analyst on 9 October 2023.

[10] Diversification does not eliminate the risk of loss.

[11] Capital IQ, Bloomberg, data as of 31 December 2023.

- For the last decade, early-stage VC valuations have generally hovered at c.20-50%[12] of the levels of the U.S. This appears reasonable particularly given the strong growth trajectory and capital efficient nature of the businesses. For late-stage VC valuations, where global investors are more likely to participate, the differential is somewhat smaller, but the spread persists. This is in comparison to the China VC market, which at its peak traded close to U.S. VC valuations.
- We do acknowledge that the highest quality companies in India trade at valuations far above global comps. Our Morgan Stanley Global Opportunity Team notes that India is home to a disproportionately high number of high-quality companies as defined as companies with >15% 3-year revenue CAGR (compound annual growth rate) and >15% ROIC (return on invested capital).[13] The highest quality Indian banks and non-bank financial companies (NBFCs) can trade at price-to-book multiples 3-to-7 times the market median.[14] Similarly, the top consumer companies can trade at over 50x P/E, significantly higher than the industry median.[15] These companies attract the most attention and may be what gives India the reputation as a high-valuation market. However, this can also be a boon for PE investors. When entry valuations are controlled, PE investments in India have the potential to generate healthy multiple arbitrage at exit.

Issue #3: Exits

While India has been evolving in the last decade as a market for control-oriented buyout deals, it is still predominantly a minority investing market with the percentage of minority deals hovering around 60% (compared to around 80% a decade ago).[16] Hence, public market activity makes up about 70% of PE/VC exit value.[17] However, we believe that exit markets will continue to evolve on the basis of the following:

- **IPO reforms**
  - Until recently, Indian companies had to meet strict revenue and profitability thresholds to list on domestic stock exchanges, and companies could not IPO on overseas exchanges until they had gone public domestically. This changed in March 2020 when the Securities and Exchange Board of India (SEBI) made it possible for growth-oriented technology companies that had yet to turn a profit to list on domestic exchanges. SEBI also opened the doors to approve direct overseas listings.
  - We have observed that Indian public markets have deepened significantly over time with the development of domestic institutional and retail investors and increased foreign participation. Last year, India's stock market ranked second globally by number of IPOs and sixth by average daily turnover.[18]
- **Foreign investor reforms and M&A activity**
  - Most mergers and acquisitions (M&A) of Indian companies are pure domestic deals. Foreign inbound deals make up only a quarter of all M&A in India.[19] Deal sizes tend to be small—below $100 million— but several changes in recent years are expected to give rise to gradually increasing M&A volumes including relaxed foreign direct investment (FDI) restrictions paving the way for full/higher foreign ownership in a broader range of sectors as well as the rescinding of a 2012 retrospective tax on foreign investments, which scared away would-be foreign buyers.[20]

Nevertheless, even as exit markets in India continue to expand, we would note that exits and distributions need to be actively managed given the ebbs and flows in capital markets and M&A activity. Based on our experience, the best managers plan for multiple exit paths at entry, and the DPI of top-quartile managers in India stacks up well against developed markets.

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[12] Preqin, AVCJ, MS PES Analysis, data as of 31 December 2023.
[13] Morgan Stanley Global Opportunity Team, "The India Opportunity", January 2024.
[14] Morgan Stanley Research, "Investor Presentation – India Banks", November 11, 2022.
[15] Morgan Stanley Research, "India Consumer – Valuations et al", September 1, 2023.
[16] Source: Preqin; MS PES Analysis.
[17] Referring to 2018-23. Source AVCJ; MSIM Analysis.
[18] Dealogic, World Federation of Exchanges, data as of December 31, 2023.
[19] PwC, "Deals in India Annual review 2022", based on number of deals.
[20] As a result of the Finance Amendment Act in 2012, retrospective taxation was introduced in India to impose taxes on deals executed after 1962 which involve transfers of shares in foreign corporations with existing assets in Indian jurisdictions. However, this was rescinded in 2021 with the Taxation Laws (Amendment) Bill 2021, which nullified and voided all tax demand notices based on the 2012 amendment.

OPPORTUNITY SET MISMATCH

Some large allocators have opted to bypass Indian PE funds completely, choosing instead to set up direct teams in-country. Asset owners like Temasek, GIC, CPPIB, OTPP, and KIC are examples of large allocators who have set up dedicated Indian offices and have collectively invested $9 billion in Indian private equity deals in 2023.[21] As shown in *Display 5*, Indian funds may simply be too small for global allocators with the largest dedicated Indian GPs, Kedaara and ChrysCapital, managing funds at $1.5-2.0 billion, and most Indian GPs raising less than $300 million per fund. Several large allocators seeking exposure to India have chosen global or regional funds that are active in India, including Advent, Baring-EQT, KKR, and Warburg Pincus. There may simply not be enough large funds to absorb the potential demand for India PE/VC. It is a situation that is unlikely to correct overnight, as local GPs will need to prove themselves and increase fund sizes gradually to remain commensurate with prior track records. In the meantime, this opportunity set mismatch may prove to be a positive, keeping the overall capital supply at reasonable levels.

The Outlook for India PE/VC

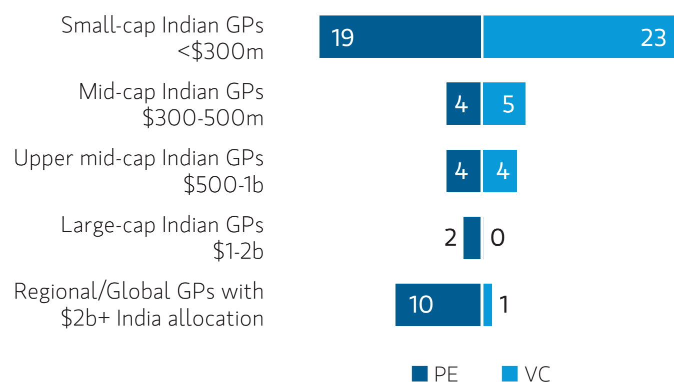
In our view, India PE/VC has the potential to outperform. The turbo-charged yet capital-efficient growth trajectory with multiple tailwinds (domestic growth, India to Emerging Markets, India to Developed Markets) combined with reasonable valuations presents a compelling investment opportunity. Nonetheless, execution is not easy. While exit markets have begun to open, the situation is still evolving, and exits need to be planned early and actively managed.

We remain constructive but selective on India. It is necessary to partner with experienced investors who are well connected, have robust diligence processes, and an active hands-on approach. We have a preference for managers who have seen end-to-end deal cycles and have found ways to deal with some of the baggage from 15-20 years ago. We also look for GPs who are ready to hit the ground running, with tight underwriting and narrow time horizons, strong execution capabilities and several exit avenues identified early, given the need to work against depreciation. But for those who can navigate the nuances in this market, we believe breakout potential exists.

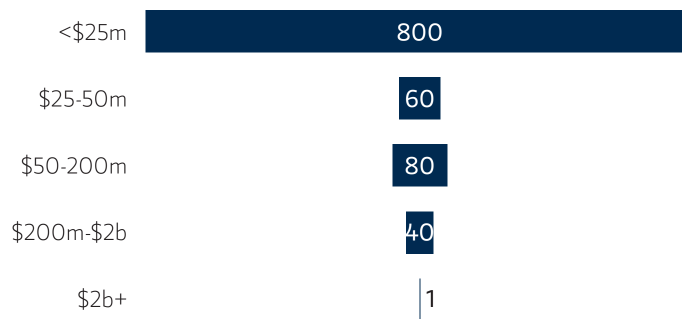
DISPLAY 5

Indian funds and deals skew small-cap

Indian PE/VC GPs by latest fund size



Annual PE & VC deal flow by deal size



Source: MS PES analysis, Preqin, data as of 31 December 2023; No. of GPs: based on GPs' latest fund size based (for regional/global GPs, based on the amount allocated to India for their latest fund). No. of deals annually: calculated as average number of deals per year between 2018-23.

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[21] Pitchbook, data as of 31 December 2023.

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