

PRIVATE INTERESTS

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EVEN IN THE WORLD'S LARGEST RETAIL PLAYGROUND, USA, UNTIL FAIRLY RECENTLY, PRIVATE-EQUITY FIRMS VIEWED THE RETAIL SECTOR AS RISKY TERRITORY. WHILE THAT PERCEPTION HAS CHANGED IN RECENT YEARS IN THE WEST, PRIVATE INVESTOR INTEREST IN INDIAN RETAILING REMAINS RELATIVELY LOW. LACK OF SCALE IS BEING PUT FORTH AS A DRIVING REASON, WHILE IRONICALLY, MANY RETAILERS ARE LOOKING TO EXTERNAL FUNDING TO BUILD EXACTLY THAT. ARE ARTIFICIALLY SHORED UP VALUATIONS ALSO TO BLAME?



→ Private Equity (PE) investment in India is on the rise, commensurate with global interest in the booming Indian economy. However, big ticket PE investments have not really come the retail way. They have largely landed in the courts of IT, banking and financial services and healthcare. Why? In the times to come, do we see a possibility to big time PE investment in the retail sector?

The tentative private investor interest in retail isn't a phenomenon limited to India. Even in the world's largest retail playground, USA, until a few years ago, private-equity firms viewed the retail sector as risky territory. They weren't as sought-after as private-equity mainstays such as industrial parts and manufacturing.

That perception shifted radically a few years ago when encouraged by rising performance and a lower

rate of retail company bankruptcies, private-equity players approached the retail sector with fervour. Among the more prominent investments occurred on July 5, 2006 when Blackstone Group and Bain Capital teamed to buy craft-store chain Michaels for \$6 billion. The group beat back a rival bid from another pair of private-equity giants, Kohlberg Kravis Roberts & Co. (KKR) and Texas Pacific Group (TPG).

The Michaels deal followed several other big transactions in the retail market. KKR and other firms agreed to buy Toys "R" Us in 2005 for \$6.6 billion. Texas Pacific and others agreed in 2005 to buy luxury merchant Neiman Marcus for \$5.1 billion.

Before all this, in 2002, came the Texas Pacific, Goldman Sachs and Bain Capital \$1.5 billion deal for Burger King, which was then struggling, to buy it off Diageo. The PE partners ended up making a handsome profit from an IPO, four years later. (see box: *The Burger King IPO*)

Typically, for private equity firms, the most seductive targets are

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Café Coffee Day's ubiquitous presence owes much to private equity infusion.

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One of the earliest to benefit from PE funding: Shoppers Stop



UTI Ventures' funding of Koutons Retail allowed the apparel chain to build a pan-India retail network.

national franchises, because their higher market share insulates the investor from risk.

However, investment in the retail sector is still widely regarded as a risky proposition. Primarily because of the inability to accurately predict consumer trends – the current rate of spending could be impacted by continuing increases in fuel prices, inflation and changes in the labour market. In the US, certain retail sectors, such as music, toys, textiles and consumer electronics, have been challenged by changes in consumer buying habits.

According to Venture Intelligence, the year 2007 saw PE firms making investments to the tune of \$14.3 billion across 420 deals in India. Of this, about \$65 million went into seven retail companies. There are around 250 funds active in India.

In recent years, private funding instances include the investments of Actis in Nilgiri's, UTI Ventures in Koutons, investments of Sequoia and IFCI in Cafe Coffee Day, Matrix's

investments in Yo! China and Seventymm.com, UTI Ventures in Gitanjali Lifestyle Products, Malaysian investment firm Navis buying out Nirula's, and GEM India picking up 26 per cent in Mark Pi.

One of the largest PE firms in India is ICICI Venture with funds under management in excess of USD 2 billion.

Among the major retailers to benefit from it, specifically under the ICICI Emerging Sectors Fund, is Shoppers Stop, which ICICI Venture entered when it had only four stores and revenues of USD 18 mn. It went to become a 17-store chain with a turnover of USD 136 mn, by the time of ICICI Venture's exit in 2005.

Other retailers, whose early growth phases were buttressed by ICICI Venture include Pantaloon Retail India Ltd., Subhiksha, Trinethra, Crossword and Mars Restaurants.

Among its more recent investments include the firm's funding for Home Solutions Retail India Ltd (October 2006) under the IAF series 2 Fund.

DEFINITIONS

Most analysts agree that in India, as in many other fast-growing markets, the distinctions between Private Equity, Venture Capital (VC), and other forms of financing are often blurred. If a company resists selling majority control outright, private-equity outfits will often settle for a minority stake, usually between 10 and 30 per cent, in exchange for an infusion of "growth capital."

"In developing economies there is indeed a blurring between PE and VC. We treat Venture Capital as a subset of Private Equity, which is focused on earlier stage opportunities," says Arun Natarajan, founder & CEO, Venture Intelligence.

"The boundaries between the different stages of funding often overlap in all markets (whether developing or mature), but the scale of investment, risk profile and typical exits are quite distinct. The first stage typically consists of "friends and family", the second may be seed or angel funding from micro-investors or entrepreneur-turned-

investors, then venture-capital, and then private equity,” says Devangshu Dutta, CEO, Third Eyesight.

“The size of investment and the need for liquidity typically also rises in this progression.”

According to Rohit Luthra, Managing Partner of PVC Partners, the significant overlap of definition is driven by several reasons. The primary reason being the lack of an evolved and organised PE/VC/Angel ecosystem in the country, owing to the relative youth of private investment vehicles. “With less than

10 years of history, it would possibly take another 7-10 years to come to some level of maturity,” he says.

“VC funds tend to be significantly larger (say a median figure of USD 50-60 million) than what can be absorbed by Indian entrepreneurs. Most early/mid stage businesses need less than USD 1-2 million to scale up and this would mean at least 30-40 investments in a fund’s lifecycle (which could be rather challenging and hence the need for larger ticket investments on their part).”

Meanwhile, investors such as Sequoia and Citigroup Venture Capital, which typically finance startups, are plowing money into more established companies.

One of those is Cafe Coffee Day. In July 2006, Sequoia – a Silicon Valley venture fund with \$750 million invested in India – poured \$20 million into Coffee Day’s parent company, Amalgamated Bean Coffee Trading Co. Ltd, and allowed the chain to push ahead on an aggressive expansion schedule.

Despite such instances of private equity interest in Indian



THE BURGER KING IPO

In 2002, a troika of private equity firms led by TPG Capital, L.P with associates Bain Capital and Goldman Sachs Capital Partners agreed to purchase BK from Diageo for \$1.5 billion (USD), with the sale becoming complete in December of that year. The new owners, through several new CEOs, moved to revitalise and reorganise the

company, the first major move being to re-name the BK parent as Burger King Brands. The investment group initially planned to take BK public within the two years of the acquisition, this was delayed until 2006. On February 1, 2006, CEO Greg Brenneman announced TPG’s plans to turn Burger King into a publicly traded

company by issuing an Initial Public Offering (IPO). On February 16, the company announced it had filed its registration for the IPO with the Securities and Exchange Commission. On May 18, 2006, Burger King began trading on the New York Stock Exchange under the ticker symbol BKC and generated \$425 million in

revenue, the largest IPO of a US-based restaurant chain on record.

Over the ten year period starting in 2008, Burger King sees 80 per cent of its market share to be driven by foreign expansion, particularly in the Asia-Pacific and Indian subcontinent regional markets. While the TPG-led group has continued BK’s international expansion by announcing plans to open new franchise locations in Eastern Europe, Africa and the Middle East, and Brazil, the company plans to focus on the three largest markets, India, China and Japan. The company plans to add over 250 stores in these Asian territories, as well as other countries such as Macau, by the end of 2012.

Its expansion

into the Indian market has the company at a competitive disadvantage with other QSR vendors such as KFC because of the country’s large Hindu majority’s aversion to beef. BK will be hoping to use their recent non-beef products, such as their TenderCrisp and TenderGrill sandwiches, as well as other products to help them overcome this hurdle to expand in India.

Burger King is now the second largest chain of hamburger fast food restaurants in the world behind industry leader McDonald’s (31,000 locations) and the fourth largest QSR chain overall after Yum! Brands (34,000 locations), McDonald’s and Subway (28,400 locations).

retailing, by and large, infusion of private capital does not seem commensurate with the much touted transformation in the Indian retail landscape.

“Yes, there is relative low interest in retail, and the reasons for this are many. One major reason is the lack of a viable exit route. If – and when – an investor wants to offload, who does he sell to? The industry has only a handful of large players with enough scale. There is also the IPO route of course for offloading, but an IPO is not something all companies can afford to float,” says Ranjit Shastri, executive director, IVCA (India Venture Capital Association)

“Globally, retail is major sector of interest to private equity investors. Chains such as Burger King owe their growth to tremendous private funding, and have in turn rewarded their investors with significant gains.”

“Private equity investors typically look for a fairly ‘structured’ and ‘predictable’ exit within a relatively shorter time frame, a significantly matured organisation/management,” Luthra points out.

“In India typically their exits are an IPO, a strategic sale, or in many cases the stock market itself for listed companies.”

“Private equity firms in India are currently focussed on backing niche retail opportunities, even as they evaluate the scenario in mass retail segments,” adds Natarajan at Venture Intelligence.

Luthra believes that the organised retail industry in India, which is relatively new, is yet to prove its financial attractiveness (barring the Bull Run, which showered benefits on nearly every industry regardless of shape or size).

“The dominance by players

with deep pockets – Tata, Reliance, Birlas, Bharti – and the stock markets have been rather kind to companies that raised money in the last 2-3 years at very, very attractive Price-Earnings ratios, which the private equity players would have not found viable given the kind of Internal Rate of Return (IRR) expectations they have,” he says.

“Retailing is very money intensive (real estate, scaling, people costs) and purely from a number crunching perspective, it is also an industry with falling EPS (Earnings Per Share), with new equity being needed every 6-18 months.”

What is also denting profitability for retailers in India is the high real estate payout. While the development of the shopping centre industry has certainly expanded availability of quality retail space, it has also been a significant bottleneck with unviable rentals.

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While VCs are willing to work with less-structured business plans and are willing to bet on relatively less mature managements, private equity investors would find that typically challenging, which explains their wait-and-watch approach.

“PEs are faced with issues of maturity, corporate governance (though India rates significantly higher than its peers on Corporate Governance), as well as availability of exits for large tickets and therefore tend to invest in the mid/upper band of a VC’s mandate sometimes,” Luthra states.



VC FUNDS TEND TO BE SIGNIFICANTLY LARGER (A MEDIAN OF USD 50-60 MILLION) THAN WHAT CAN BE ABSORBED BY INDIAN ENTREPRENEURS. MOST EARLY/MID STAGE BUSINESSES NEED LESS THAN USD 1-2 MILLION TO SCALE UP AND THIS WOULD MEAN AT LEAST 30-40 INVESTMENTS IN A FUND'S LIFECYCLE, WHICH COULD BE RATHER CHALLENGING.

INVESTMENT SIZES & EXIT ROUTES

VCs: USD 500,000 to USD 15 million; **Exits:** Strategic Sale, IPO
PEs: USD 10 million-plus; **Exits:** IPO, Stock Market, Strategic Sale

Angel/Seed Funds: USD 50,000 to USD 1 million; **Exits:** VCs, Strategic Sales, Management buyback

Source: PVC Partners

In addition to this, the entrepreneurial ecosystem in India is still evolving. This limits the number of investments a VC could make – even if they had the bandwidth to manage larger no. of investments, this tends to bias the VCs for relatively larger tickets.

Besides, as Luthra points out, large corporates (Tatas, Aditya Birla Group, Reliance etc) themselves act as PEs to their new businesses.

As far as returns are concerned, private investors expect to make about 25 per cent IRR from emerging economies like India and China, says Natarajan.

APPLICATIONS

As regards final destinations and usage of this infusion of external capital, most of that at the moment seems to be headed towards enhancing top line growth, and expanding store footprint.

Agrees Srinath Sridharan, VP& Head, Strategic Alliances, Wadhwan Holdings, “Most investments go into the

glamorous front-end. We are yet to see significant investments coming into the back-end. For instance, we speak about statistics that say USD 200 billion USD is with the food market in India. If you look at investments in back-end operations, it has hardly been USD 1.8 billion. So how do we expect the efficiencies to improve?”

“With big corporates like Reliance and Bharti aggressively integrating the rural supply chain into their retail rollouts and a renewed focus on agriculture by the Indian government, there are several opportunities for startups along the rapidly emerging ‘Farm-to-Plate’ value chain,” Natarajan adds.

“Hence there are several opportunities for investors including in agri-businesses, logistics suppliers, etc.”

“We are likely to see PE investments in warehousing and supply chain management, and I believe manufacturing could also be a candidate for PE investments as the need for scale and sophistication increases,” says Dutta.

Bala Kamallakharan, ED, International Region, Glitnir Bank, Iceland says, “There is a lot of investment coming in, but where is it all going today? One thing that is very clear to us is the lack of consistent proper suppliers to the retailers, who are investing quite a bit in infrastructure.”

“We believe that the investments need to be going on the supply side, so that the farmers, manufacturers and suppliers are linked together and they are working towards consistent quality to supply to the shelves. At least from our side, processing needs tremendous amount of investments.”

“Supply chain Infrastructure and Management is one

area which would make sense for the PEs to bet on some emerging companies needing significant inflow of financial capital and possibly management bandwidth too. The others would include new formats of retail (including online models),” Luthra says.

THE VALUATION GAME

According to Leonard W. Arentsen, a former partner at Arthur Andersen & Co., “A retailer’s overall ROI depends on many factors, including the amount of investment, the method of financing, the total sales, the gross margin, and the operating expenses.”

“One key factor that is often overlooked is the financing method, which determines how much owner’s capital is employed in the business versus other people’s capital. It is the wide use of leverage or other people’s capital which can result in a significant increase in the profitability of the owner’s capital.”

It has been said that Wal-Mart makes money on other people’s money. It reduces



SUPPLY CHAIN INFRASTRUCTURE AND MANAGEMENT IS ONE AREA THAT WOULD MAKE SENSE FOR THE PEs TO BET ON SOME EMERGING COMPANIES NEEDING SIGNIFICANT INFLOW OF FINANCIAL CAPITAL AND POSSIBLY MANAGEMENT BANDWIDTH TOO. THE OTHERS WOULD INCLUDE NEW FORMATS OF RETAIL (INCLUDING ONLINE MODELS).

its inventory investment by pressing suppliers for longer days payable. High turnover items sell long before payment is due. Because of its propensity to use loss leaders as a successful marketing tool, most of the manufacturer brands at Wal-Mart centres are sold long before the retailer is due to pay the suppliers.

D L Narayanan, CEO, River Water Retail believes that the current strategy of Indian mass retailers imitates this practice by channelling revenues into investment for store openings, instead of financing growth through internal accruals.

ICICI Ventures’ PE funding for for Home Solutions Retail began in 2006.



“Suppliers and vendors have many instances of retailers holding back payments much beyond the stipulated 90-day period, even as the retailer continues to add more stores to its portfolio. What this in effect means is that retailers are in many cases, actually rotating distributors’ funds to achieve top line growth.”

The eye is quite firmly on boosting valuation, Narayanan observes. “The strategy is almost always to shore up the topline, not the bottomline. Sometimes, even at the cost of a negative bottomline.”

Dutta believes that in India of today, valuation of everything (real estate, shares etc.) has been rather de-linked from fundamentals. “However, one hopes to see corrections in the coming months. Also, entrepreneurs (and possibly their investment banking advisors, more so) are benchmarking valuations to companies that are already public without discounting for the risk of an illiquid investment. Having said that, markets always work that way – the seller will typically try to get the highest price feasible, while the smart investor will tug the price benchmarks the other way!”

However, it can be pointed out that investors themselves may have been giving out wrong signals to prospective sellers. “Over the last few years investors have been rewarding growth-linked behaviour rather than profit-oriented behaviour; but this is now beginning to change, too.”

“Yes, the game *has* been scale, scale, scale in the last 4-5 years. However, efficiencies and productivities are what we could expect staring the industry in the face in another 12-18 months from now,” Luthra comments.

OVERVIEW: CAPITAL COSTS

- Retail Purchasing Power of Indians - Over 70 mn Indians earn Rs 800,000 a year. This number is all set to rise to 140 mn by 2011.
- Organised retail in India is mere 5%
- The Fashion vertical is the largest contributor to organised retailing at 39%.
- Future Capital Holdings has invested \$5 mn for a minority stake in Biba Apparels Pvt Ltd
- Avigo Capital Partners has invested \$5mn in Spykar Lifestyle
- Citigroup \$8mn + UTI \$4mn in Primus Lifestyle
- Wolfensohn LLC has invested \$11 million in FabIndia for 6% stake
- ADM Capital + Blackstone + New Vernon together have invested \$25 mn in Brandhouse Retails for 10% stake
- Fidelity + Gensis Capital + Artis Capital + Liberty International \$33 mn in Provogue India
- The promoters of textile company Donear Industries are negotiating with potential investors to sell 10-15% stake in the company and raise at least Rs.1,000 million to fund their foray into retail.

Source: Reliance Retail

“Yes, valuations – and it is always relative to the time and context – have been stretched. Rationalisations across different elements of the retail industry would actually be beneficial for the entire retail eco-system.”

SO WHAT'S AHEAD

Luthra at PVC Partners says, “Our analysis shows that the next 12-24 months would possibly see big ticket investments with attractive PE multiples, falling real estate prices, opportunities for consolidation. However, the challenge could be the availability of large capital with PE players themselves.”

“PE investments typically have a shorter exit cycle than VC investments, unless they are a management buy-out or leveraged buy-out. Secondly there is a need for higher scale, such that the company should be able to receive and utilise funding in excess of Rs.50 crore from one source and still leave enough equity on the table for the promoters and future investors,” says Devangshu Dutta.

“For this reason, the companies that have seen PE investments are those that are public (Pantaloon, Kewal



Kiran etc.), that are already liquid, or pre-IPO companies such as Provogue.”

Considering the current scenario – of margins hardening amidst escalating operational payouts – building scale looks set to become tougher, and ironically, more critical to achieve for Indian retailers. Most analysts, however, believe that until valuations draw closer to fundamentals, and retailers focus on building sustainable businesses instead of rushing to score brownie points through store counts, big ticket PE investors may like to play it safe. On the other side of the table, it’s time for PE firms to rethink some of those growth-led evaluation tools. ❌