column

Private Equity and Indian Retail:
Why Does the Relationship Sour?

PRIVATE EQUITY IS AN IMPORTANT SOURCE OF FUNDING FOR MODERN RETAILERS, BUT IN INDIA, MOST SUCH DEALS HAVE ENDED IN DISASTER. SO WHAT GOES WRONG, AND HOW CAN THE INVESTORS AND RETAILERS ENSURE THEY DON'T FALL IN THE SAME TRAP AS OTHERS WHO HAVE BURNT THEIR FINGERS?

By Harminder Sahni

Private equity (PE) should have been an excellent source of funds for the retail sector since it a capital-hungry business. However, the reality on the ground is disappointing. Back in 2005, the potential of modern retail caught the fancy of major PE funds from all over the world. Even the ones that came to India with technology-focussed funds were caught in the frenzy and made large investments into the retail sector. For example, Citibank of India – read ICICI – set up a PE fund to make the best out of restrictive FDI policies and buy large stakes in minor retail companies, supposedly at a bumper discount.

Almost seven years have passed since – certainly not a long period for a sector that is trying to organise itself from the "unorganised" set-up created over the last 5,000 years of Indian civilisation. But in the PE world, seven years is a lifetime because funds have a life of only three to seven years. They are forced to exit or expire within that period and fund managers are supposed to exit their positions, cash out, and move on to the next set of investments. This time-bound exit philosophy of the PE funds contradicts with the nature of business which is an ongoing entity. Anyway, there must be some good reason for that.

In the last seven years, most of the PE investments in the Indian retail sector have led to either premature or distressed exits, or court cases and counter cases between the promoters and the PE funds. It is hard to come up with even a single case where all the involved parties either lived happily or parted happily.

The flow of bad news is not only from the 2005-2006 era. Even PE investments that were consummated in 2010 – such as Lilliput – have beaten all past levels of acrimony between the investors and the investee companies. The memories of Premji Invest suing ICICI for feeling cheated by its investments into Subhiksha are raw in our minds, and the hasty exit of PE funds from Koutons still haunts shareholders.

But all this has not diminished the lure of PE funding in the minds of retail businesses – whether big or small, successful or not-so-successful, professional-promoted or backed by big industry groups. It has also not driven away the PE funds which are not only seeking newer investments but also trying to make the best out of deals gone really bad like in the case of Vishal Megamart.

I seriously hope all the investors and investees probe a bit deeper to understand why things have gone so bad almost every time a PE deal is signed with retailers and why are they hoping that this would not be so in their case. Have they learnt the lessons or figured out some solid means to avoid falling in the same trap as their predecessors?

WHAT GOES WRONG?

I have tried to analyse various scenarios in this context. One of the questions that comes to my mind is: "Is it the nature of the retail business itself that makes it unsuitable for PE funding?" But when I look towards the developed markets, I find that there are enough success stories across formats and markets. In fact, Jerry Gallagher, one of the most successful PE players of all times, made a fortune for his fund OAK Venture and for himself through investing early in many successful retailers in the US. Jerry was vice chairman of the Target Group (erstwhile Dayton Hudson) before he joined the PE world. Maybe this explains his stupendous success as he would have understood the intricacies of the retail world better than most other PE investors. Anyway, the point is that the retail industry is no different from any other in its nature to be either suited or not suited for PE funding. So why do most PE investors lose with their investments in the retail sector?

The next thought that comes to my mind is: "Is it the nature of the promoters of our retail business?" Well, that also cannot be the reason for the failure of PE funding in Indian modern retail because the promoters aren't a homogeneous bunch of people who can be classified as a group on the basis of education, ethnicity or geography. Their most obvious, or may be only common link, is that they all have chosen to build retail businesses.

So, can the reason be the life-cycle stage of modern retail in India? This sector is fairly young and has been built more on the excitement of future potential than the fundamental competence of professionals and promoters. While many other businesses in India have also been built on that basis, modern retail – being the most consumer-dependent and a trading business in nature – hasn't had the benefit of learning from the West that could be used to replicate success.

Indian modern retail also lacks major elements to determine success such as winning a government license (like in the case of telecom or banking) or a technology outsourcing deal breakthrough, like in the case of IBM-Bharti Airtel. The latter deal has been such a success not only because Airtel was willing to outsource but more so because IBM was willing to take up such a contract. Will Reliance not be happy to outsource all its fresh vegetables and fruits sourcing to a Sysco (a $20 bn food aggregator in the US that supplies to major retailers)? It will but – alas! – someone like Sysco doesn't exist in India.

Modern retail is so nascent in India, there are no benchmarks of productivity, profitability, investments, and returns. In such an ambiguous environment, neither the investor nor the investee has any real standards to follow or compare their performance with. Everyone is following their gut. The investors are trying to figure out how can an investment in a consumer business in the world's second-fastest growing economy go wrong, while the investees are wondering how can they fail in organising even 5 or 10 percent of such a huge unorganised market.

All PE deals in the Indian retail sector until now have been done on the basis of potential rather than performance. At least 90 percent of the Indian retail market is unorganised with little competition for modern retail, so it is easy to write business plans predicting a business to grow 10, 20, or even 50 times in a few years. Market potential has never been an issue in India, but capturing that potential is a different story. To maximise valuations, investees tend to exaggerate projections and investors tend to accept these to wrest more control of the business later when its performance is not up to the mark. Raising expectations to get higher valuations and then signing unreasonable term sheets create the ground for a self-fulfilling prophecy.

LACKING IN MATURITY

According to me, it is the lack of maturity of Indian modern retail which is the fundamental reason for so many issues facing it. Retail players need to be clearer about what having a PE investor means beyond the few days of limelight when the deal is signed. Like so many businesses that choose to never go for an IPO or borrow from a bank, there may be a reason for some companies to never seek PE funding as it may not go well with their business philosophy. There is nothing wrong with it, as PE funding is good but not the only or necessary option to build a business.

The investors too need to accept that while there is a huge potential in Indian modern retail, there are very few strong, professionally managed companies with proven formats that can meet their return-expectation in a period of only three to five years. They need to either wait for such companies to emerge and then make investments, or make investments with promising companies now and wait for a fairly long period to hopefully make good returns at the exit. I would prefer the latter option as Indian retail sector needs funding now and can also potentially gain from the global linkages as well as financial expertise that PE funds bring along.

I hope both the parties will consider the past events as a part of the growing-up process and move forward to create an environment for larger and profitable investments in Indian modern retail sector.

ABOUT THE AUTHOR

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