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Impact of Covid-19 on Private Equity in India

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The Covid-19 pandemic, a stern and sensitive public health emergency has brought nearly all the countries around the globe to their knees. India, amidst an ever stretching lockdown and uncertainty surrounding its lifting due to the rising cases of infection along with countries all over the world, have been brutally hit economically, pushing the world towards recession. How individual countries respond to the effects of the virus in the coming weeks will be critical in influencing the trajectory of its economic status.

Covid-19 is most certain to bring challenges for the private equity and M&A. At this time, we may only speculate as to how Covid-19 has and will broadly affect the Private Equity (**PE**) space.

MARKET SENTIMENT

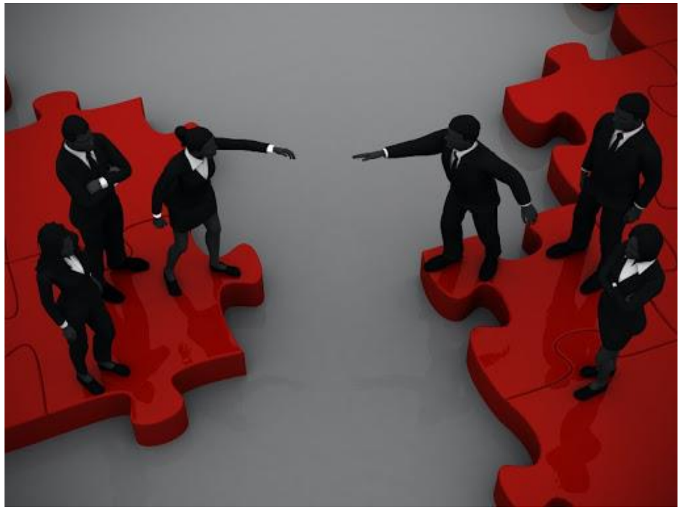
The recent slump in the Indian economy has created uncertainties concerning PE investment in Indian companies. Most investors have used the 'wait and see' approach until they can be certain of some stability in the market while the others are being particularly cautious in their investment decisions. It is too soon to conclusively decide whether this crisis will lead to a buyer's market or a seller's market. However, we believe that with the market being bearish and potential investors holding onto their cash, the investors will eventually look to leverage on the sharp drop in valuations and get their hands on any asset on sale to seek a higher return on capital in the future.

DEAL FLOW

The crisis has significantly slowed down PE and M&A deals. We all know how the financial crisis in 2008 disrupted deal-making and it is now predicted that this crisis should also trigger new deals to a complete standstill, at least for a short period. The fundamental of any deal making is the valuation of a company and the valuation is the ability to project future financials but at this time nobody can entirely project the long term financials or even FY 21 figures in that case. Financial stability of the company and cash in hand with the investor is the biggest determinant for a deal. The investors having turned vigilant are looking to stabilize their portfolios. Whereas, the sellers are hesitant to part with their assets given the steep drop in valuations. Such a mismatch between the expectations of the buyer and the seller will create a hindrance in deal making. It remains to be seen how quickly the PE space will recover from such market conditions.

CHANGE IN LAW

In order to contain the spread of the Covid-19 pandemic the Government of India is continuously taking laudable measures.



The Chinese investors have been on a buying spree and are beefing up their positions in the markets all over the world, including India. However, the Government of India in a bold decision vide its Press Note No. 3 dated April 17, 2020 issued by the Department for Promotion of Industry and Internal Trade and a subsequent amendment to the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 dated April 22, 2020 issued by the Department of Economic Affairs, notified changes to the foreign direct investment policy which aims to curb opportunistic acquisition/takeover due to the pandemic, especially from China. The restriction was implemented soon after the People's Bank of China (PBC) raised its stake in Housing Development Finance Corporation (HDFC) from 0.8% to 1.01%.

The restriction now puts all fresh funding from new investors as well as additional funding from a beneficial owner from India's land border-sharing countries (China, Bangladesh, Pakistan, Bhutan, Nepal, Myanmar, and Afghanistan) under the approval route which will certainly barricade or at the very least impede any Indo-China deals.

While such a restriction protects the Indian companies from opportunistic takeovers, it may be noted that this policy change requiring blanket approval may not be reasonable as it may hamper the confidence of the Chinese investors in Indian companies which may affect the ease of doing business in India.

IMPACT ON ONGOING TRANSACTIONS

Any transaction in the final stage of execution or negotiations is expected to continue but at a much slower pace and some postponed to a later date, to be activated once the crisis subsides. The parties to the transaction will now look to amend their contract(s) to address the new risks in light of the present crisis leading to changes in various clauses, for instance force majeure, indemnity, material adverse change, long stop date, etc.

EXIT OPTIONS

An exit option is the plan that is provided for in the investment document by an investor to liquidate its investment. Usually, the idea for an exit plan is to optimize a good position, rather than get out of a bad one. Exit Options come in various forms, for instance, IPOs, third party sale, merger, secondary sale, etc, depending on the investment, the general climate and the business.

The Exits will inevitably drop and the investors will look to extend the holding period on some of their investments, as they would wait for the markets to recover. The investors won't exit unless they can square off on the right price but there is reason to expect that as soon as the anxious market stabilizes, exits could bounce back quicker than the exits coming out of the 2008 financial meltdown.

RETURNS

The returns will take a hit in the short term as the investor's portfolio value is likely to drop considerably. Industry and trade dynamics are going to change and Indian companies are likely to undergo structural adjustments. PE players will need to reassess their portfolio and investment decisions to minimize risks and maximize returns. Having said that, the market volatility can be troublesome for a while, but the investors need not worry bearing in mind the long-term growth.

POSITIVE PERSPECTIVE

Not all is negative about the outbreak as Covid-19 will change the way people look at how people do business. For instance, India's largest IT firm - Tata Consultancy Services (TCS) has planned to get rid of its 20-year-old operating model and consider a new model of work. TCS now plans to ask a majority of 75% of its employees globally to work from home by 2025. The paradigm shift in mindset of certain employers will drastically change the way people work.

People who weren't acquainted with the concept of video conferencing before the Covid-19 outbreak, now most certainly are. Silicon Valley based Zoom Video Communications is one such company that has soared as corporate offices, schools, universities, organizations, and millions across the world working from home have started using their product, ballooning to more than 200 million users from 10 million users in just 3 months.

Considering the long-term growth opportunity, PE investors will now look to invest in Remote Management Companies, Software, and IT companies that provide improved technological infrastructure for efficient work from home services.

Streaming apps like Netflix, Amazon Prime Video, and Hotstar have also seen a surge in the number of paid subscribers. It is expected that with the high rate of usage in the lockdown coupled with improved services with personalized content, the video streaming industry is likely to be ingrained into the culture of the majority of people. Such companies may come out as winners after the crisis.

Other sectors like Healthcare, Pharmaceuticals, E-Commerce, Logistics, FMCG, and ed-tech will also become attractive to the PE investors.

CONCLUSION

In addition to the severe health implications on people, Covid-19 has had a significant impact on businesses and the economy as a whole. The implications of Covid-19 are changing by every passing day. The PE market though, is not all shot to hell. Many investors are preparing to make investments at a lower valuation or seeking to invest in industries that have changed consumer preferences, whilst others may focus on securing their existing investments in Indian companies.

After taking initial steps to recoup and stabilize, PE players can prepare for growth once the crisis is abated.

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