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Investor defaults stump PEs

Many Limited Partners Hold Back Their Promised Fund Infusion

Sugata Ghosh & Rajesh Unnikrishnan MUMBAI

THERE are rumblings in the world of private equity (PE). The investors in the funds, known as limited partners (LPs) in trade parlance, have defaulted on their commitments to several PEs.

At least four PE funds in India have been told by some of their major LPs that they would not chip in with the promised money. These PEs — which include big Indian VCs and offshore funds — are exploring legal recourse under terms laid down in the subscription agreement.

It's easier for an LP to back out if it has not yet invested in the fund pool. However, if it holds back investments after contributing a few tranches, the fund manager may freeze the money already invested. Indeed, a few funds ET spoke to did not rule out this possibility. One of the funds floated by an Indian financial services firm, which recently announced the completion of fund raising and even indicated a 25% return, has been told by two big US pension funds not to go ahead with the 'draw down'.

Draw down refers to fund managers accessing the money that has been committed. The pension funds, the LPs in the Indian fund, have said they would not invest at this point, said sources in the financial services industry. When contacted, some of the advisors to the PE funds confirmed that LP defaults, which venture capital and PE firms are grappling with in other markets, are also happening in India, albeit on a smaller scale.

Some managers brace for long legal challenge

ACCORDING to Nishchal Joshipura, a funds lawyer at leading law firm, Nishith Desai Associates: "While we have seen defaults in contributions by investors, in both domestic and offshore funds, considering the global downturn which might continue for the next few quarters, some investment managers are following a more prudent approach of returning the initial contributions to the investors and winding up the fund."

Mr Joshipura, who refused to name the funds due to client confidentiality, indicated that some funds could take a tougher stand. "In extreme situations, the investment managers may also explore the option of forfeiture of earlier capital contributions by defaulting investors," he said.

Another reason why LPs are defaulting on commitments is the percentage increase in PE or VC exposure in their portfolios. Since many PE investments are in unlisted firms, where valuation dip has been comparatively lesser than investment in listed stocks, the ratio between public and private companies in LPs' portfolios are well over the agreed limit. The India head of a wellknown PE firm said that in many cases, an existing LP is buying out the stake of another LP (which has defaulted) at a discount.

Some fund managers may go slow on defaults to preserve relationship with big LPs, but those planning to move court or an arbitration panel could see protracted feuds. "Since many investors/funds are based overseas, the legal battle usually takes place in the respective countries. Even if the foreign courts favour them, they have to fight another case in the Indian courts," said Akil Hirani, partner of law firm Majmudar & Co. According to Punit Shah, leader, financial service tax practice, PwC, certain LPs could be adopting a cautious approach in choosing right opportunities for making right investments. "The environment is tough," said Mr Shah, who is an advisor to many funds.

The number of PE deals between January and November had an announced value of $10.11 billion against $15.73 billion in the year-ago period, according to Grant Thornton. In majority of these deals, PE firms have stepped in as significant minorities in what are called growth and late-stage companies rather than buyout deals that are more common in developed markets. The numbers for December and January are likely to be lower. Even in cases where LPs have contributed, they are asking fund managers to slow down the investment, said Rashesh Shah, chairman & CEO of Edelweiss Capital.

sugata . ghosh @ timesgroup . com