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Lower growth projections cast shadow on PE deals

Performance slump has put a question mark on earnings, the basis for deciding the size of investment

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Mumbai: The uncertainty in corporate earnings growth and projections following the economic slowdown, and the multi-crore fraud at Satyam Computer Services Ltd have made it tougher for private equity (PE) firms to arrive at valuations.

In a falling market as in 2008, the trouble was getting a fix on the multiple on earnings—or the price-earnings ratio, a measure of how much an investor should pay for an assumed rate of growth.

But the current slump in performance has put a question mark on earnings, the basis on which the multiple is arrived at, say PE investors.

Valuation concerns: Balaji Telefilms creative head Ekta Kapoor / HT City

A PE firm typically evaluates a company's potential based on its earnings growth forecast and pays a multiple of this when it invests.

For instance, some investors in Sony Entertainment Television have been trying for months to divest their stake in the company in favour of PE investors but haven't been able to convince them of the company's growth forecasts.

"Whatever benchmarks PE investors are using to evaluate a company have become as conservative as they can get," said Kunal Dasgupta, chief executive of Sony Entertainment.

Star India Pvt. Ltd, too, has been trying to divest stake in Balaji Telefilms Ltd.

Mint had reported in August that a consortium of PE investors led by Balaji had agreed to buy back Star India's 25.99% stake in the firm, but the deal hasn't materialized because of valuation concerns.

A spokesman for Star India said no one was immediately available to comment on the deal or the extent of scrutiny the company's projections were subject to by potential PE investors.

Almost every company looking at PE is being probed deeper on its growth projections. In the aftermath of the accounting fraud at Satyam, some investors are even sceptical of past numbers, say investment bankers.

"Given this transitionary phase, the numbers projected by most companies are to be re-looked at and updated to reflect the current line of thinking on the future performance," said Bhavesh Shah, executive director, investment banking, **JM Financial Consultants Pvt. Ltd**.

"All companies got used to forecasting high growth on paper based on their short history," said Pranav Parikh, managing director of **Q-India Investment Advisors Pvt. Ltd**, the Indian arm of US investment firm **Q Investments Lp.** "With enough funds availability in the market till about a few months ago, a lot of companies got away without really needing to justify their ability to attain such growth over...time."

Though multiples have contracted, Parikh said he has not yet seen earnings-based projections from companies contract in many instances. "But that will happen," he said.

Till that happens, investment bankers such as Mehul Savla, who runs his own transaction advisory firm, **Ripple Wave Equity Pvt. Ltd**, have shifted focus from PE to mergers and acquisitions (M&A) advisory. "In a falling market, investors and companies were trying to get a fix on the P (price), there are now doubts being cast on the E (earnings) as well," said Savla, who was earlier executive director of investment banking at **JPMorgan India Pvt. Ltd**. "So deals are not getting done, and we see more opportunities these days in the M&A space."

According to JM Financial, PE and venture capital deals dropped to $11.5 billion (Rs56,005 crore now) in 2008 from $15.9 billion in 2007.

"The basic cost of operation has gone down, but volumes have also gone down. That also means it's difficult to project revenue and profit growth," said Biswajit Choudhury, group vice-president of marketing at auto parts maker **Endurance Technologies Ltd**, which has put on hold its plans for an initial public offering. Endurance Technologies is a portfolio company of **Standard Chartered Private Equity Advisory (India) Pvt. Ltd**.

Citi Investment Research, a division of **Citigroup Global Markets Inc.**, said in a report dated 7 January that it expects earnings of the 136 Indian firms it tracks to fall by 9.8% year-on-year for the quarter ended 31 December. That's a "de-growth for the first time after 20-plus successive quarters", the firm said.

To tide over this problem of unrealistic earnings forecasts, PE firms may now increasingly resort to structured deals. "We are more interested in looking at structured deals, where funding happens in stages and is contingent to the company meeting its growth projections or has other ways to protect our downside," said Parikh.

"The earnings build-up is being scrutinized more microscopically. I think there will be more use of convertible instruments," added Bharat Banka, managing director and chief executive of **Aditya Birla Capital Advisors Pvt. Ltd**, which is raising a $250 million PE fund.