PRIVATE DEBT INVESTOR

India: Capitalising on the trend to lend
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India has a growing population of young entrepreneurs for whom banks are no longer the only providers of finance. Vik Mehrotra of Venus Capital discusses the rise of alternative lenders.

Mehrotra: no need to take equity risk

In 1994, it was all about equities. That was when Vik Mehrotra, who had spent the previous three years with UBS, launched Venus Capital in Boston, Massachusetts.

The firm, which also has offices in London and New Delhi, started life as an India-focused equity firm and launched what it claims was the first-ever US-based, India-dedicated hedge fund two years later, in 1996. The long-only fund (going short was not permitted in India at the time) did well during a boom period for the Indian market from 1995 to 1999.

On the back of financial market reform, including the ability to trade short on a derivatives market, Venus went on to raise the $440 million market-neutral Venus Arbitrage Fund and the $150 million Venus Special Situations Fund. "The idea was to generate alpha and control volatility," says Mehrotra, "and we made a good risk-adjusted return."

Equity remained the focus until 2013 when, according to Mehrotra, "we went to our long-term investors [mainly US pension plans] and said that we thought debt looked very interesting". Mehrotra explains that the inflation rate at the time was 7.5 percent, borrowers were taking out loans at 15 percent, loan-to-values (LTVs) were on average a conservative 40 percent with borrowers providing 2.5 times the amount they were borrowing in collateral. "There was no need for investors to accept equity volatility anymore," reflects Mehrotra.

The firm's direct lending push was seeded by a group of investors, and it has since gone on to complete 106 loans, of which 52 have been paid back, with an average duration of approximately two years, ticket size of up to $2 million and an average LTV of 40 percent. The loans take the form of senior debt secured on collateral.

Since the effort was launched, it has been assisted by important regulatory change in India which saw the passing of the Insolvency and Bankruptcy Code. The Code, based on the existing UK model, "has been working very well," in Mehrotra's view. "If a borrower defaults, they can be taken to a specialist court under the Code and quickly placed in liquidation."

Since the Code came into being, more than 200 cases have been registered with the courts and – contrary to India's reputation for red tape and stifling bureaucracy – they are being processed relatively smoothly. "It used to take years to recover your money," says Mehrotra, "but now it will normally take 15 to 18 months, or you could reach a settlement before that."

Aiming for $500m

Today, Venus has around $60 million of lending capacity but Mehrotra says he thinks this will grow to around $500 million in a few years' time. As well as the US pension plans mentioned earlier, support also comes from a Scandinavian sovereign wealth fund and European family offices. While the capital commitments go into a fund – the Venus India Structured Finance Fund – the loans are made by operating company Venus India Asset Finance, a non-banking finance company (NBFC) regulated by the Reserve Bank of India.

The NBFC is headed by chief executive officer Saket Misra, formerly the head of structured credit for India at RBS in Singapore. He oversees a team of five analysts working on origination. Once a suitable deal is identified, it goes to the investment committee – from which unanimous approval is needed for the deal to be taken further.

Mehrotra says Venus does about 20 percent of the deals which come through the pipeline, with 106 completed so far out of around 650 possible ones. Since inception, these loans have delivered a return on equity of around 19 percent according to Mehrotra, which he expects to grow to 22-23 percent with the use of additional leverage.

As yet, the Indian SME direct lending opportunity remains very much a niche strategy (see chart). Much private debt capital is targeted at hard assets such as plant and machinery. But there is no doubt that, overall, private funds are in favour due to the increasing regulatory constraints on Indian banks. NBFCs have grown to account for around a third of total lending in India, compared with two-thirds for the banks – but there is no reason for the trend to change, and therefore NBFC market share is expected to continue rising at the expense of the banks in the years ahead.

Although NBFCs are regulated by the Reserve Bank of India, meaning they are subject to much the same regulatory scrutiny as the banks, Mehrotra does not view this as problematic. In Europe and North America, direct lenders are not regulated by central banks and arguably therefore have greater flexibility to operate in the way they wish. However, Mehrotra believes that the Indian government has fully recognised the importance of alternative sources of debt to a growing economy given the constraints on bank lending. Regulation is, therefore, unlikely to be too restrictive.

Young thinking big

What's clear is that there is no lack of potential entrepreneurs in India, a country where half the population is under 25 years of age and where many young people are drawn to establish their own businesses by successful precedents. Many Indian companies have demonstrated an ability to achieve top line growth of between 20-25 percent, and therefore "the need for growth capital is immense" says Mehrotra.

He adds that many entrepreneurs will seek both equity and debt, frequently choosing to borrow from the likes of Venus in the form of debt at the personal level before investing into the business as equity. Loan requests will typically be evaluated in around three weeks, Mehrotra claims, compared with typically 60-90 days for the banks. "We're nimbler and we can provide bespoke solutions. For that, we can charge a few hundred basis points extra," he says.

As an example of how non-banks can outmanoeuvre banks, Mehrotra cites a British brewing company, a growing business with UK roots that has opened 15 restaurants in India. "They lease equipment and premises and have no hard assets," says Mehrotra. "A bank will never lend in that

kind of situation as there is no collateral. We lent to them on a cashflow basis, escrowing their weekly sales into an account controlled by us from which we took interest and principal and released working capital to them. It's why entrepreneurs come to us."

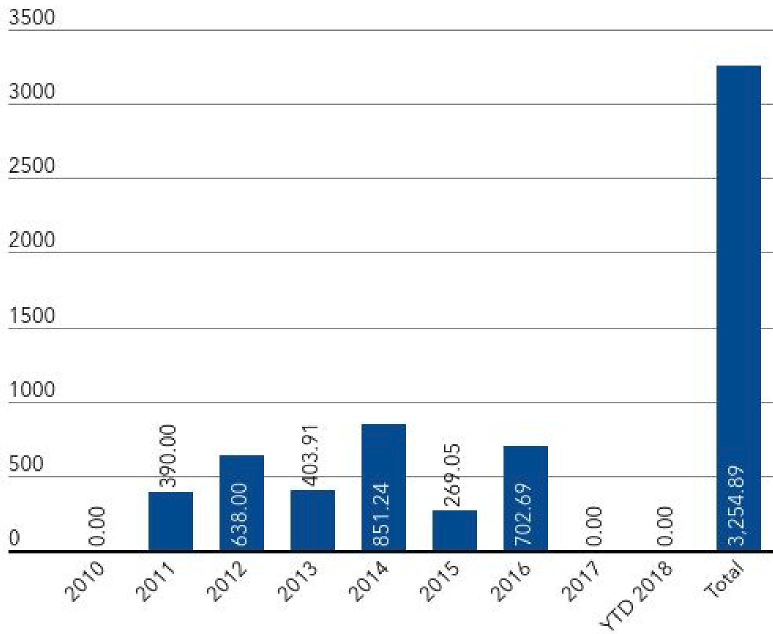
Mehrotra says he sees opportunities in Indian debt spanning beyond the SME space, partly as a result of the new Bankruptcy Code. Given the $200 billion of non-performing loans on the balance sheets of public sector Indian banks, he is looking closely at the Indian distressed space – to which end, Venus has obtained a licence to set up an Asset Reconstruction Company (ARC) to enable it to buy bad loans from the banks.

Asked whether Venus might one day broaden its activities beyond India to other emerging markets, Mehrotra's response is emphatic. "We have been in India since 1994. We have a focus on India, there is so much to do there. There are 1.3 billion people. Why go anywhere else?"

SLIM PICKINGS

Little capital has so far been committed to India-focused private debt funds

Capital raised ($m)



Number of funds closed