How Strategic Design Can Transform The Private Equity Industry … In India

X36 Falcon
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1. Challenges Facing Private Equity In India :

Since the year 2000, global private equity firms have brought in approx. US $ **132** billion into India. Of this just US $ **36** billion or so has been able to exit with a decent return.

Essentially then, in excess of US $ **90** Billion remains trapped mainly because "DESIGN ISSUES" concerning the investee company and its unique ecosystem were ignored during the original due diligence process.

Secondly even after the investment was made and mistakes were identified, investors have relied on conventional methods and management techniques to get that much hoped for exit … at an attractive multiple.

This note talks about deploying un-conventional Strategic design concepts that could potentially recover some of this US $ **90** Billion + for Private Equity investors.

We will, at the end of the note also share FOUR different examples from around the world where strategic re-design has helped return an " Under Water " part of a PE firms investment portfolio to productive use.

Readers who would like to see the Examples are requested to go to No 7 directly.

2. Background

The Private Equity industry initially did well in the 2000 – 2007 period when it achieved a 21 % return according to Mckinsey & Co.

Then after the economic crisis of 2008, returns on exit dropped to 7 %, well below capital market benchmarks and a dark age for private equity began which lasted for the next 5 years.

By March 2014 things had started looking better and 2015 turned out to be a very good year wherein a total of US $ 17.3 Billion were invested in 775 PE / VC deals.

The year 2016 was not as good as 2015 but still with 620 PE / VC deals and $ 16.2 Billion invested … it was still robust.

3. The Exit Problem

As far as Exits are concerned however the performance has been rather sad. The truth is that between 2000 – 2008 only a quarter of the US $ 51 Billion invested had been returned to investors by 2014 … on a cost basis.

PE / VC Exit performance started getting better after 2013 and in 2014, US $ 4.2 Billion was returned to investors through 178 deals.

Exit performance was more encouraging in 2015 and 2016 with US $ 9.4 and US $ 10 Billion returned to investors respectively.

This Exit activity has been across very diverse sectors … IT / ITes, Healthcare, Education, Consumer Tech, Manufacturing etc , with exits taking the form of strategic sales, secondary deals to other PE players and IPOs.

This is not all. To quote Mckinsey & Co, the average holding period for investments has also increased from an average of 3.1 years between 2001 and 2007 to 4.4 years during 2008 to 2013.

Overall … if you add up the Macro numbers, a total of just US $ 36.35 Billion of the US $ 132 Billion + that has been invested, has been able to exit with decent returns.

Is that OK ? Maybe not.

4. Solving The Exit Problem … Learning from Henry Kissinger

Henry A Kissinger, former US Secretary of State, has a few words of advice that urge us to think beyond the ordinary :

Kissinger says …

1. "If you are going to do something ultimately you might as well do it immediately."

And …

2. "In crises, the most daring course , is often safest ."

Some PE portfolios are indeed facing a crisis and in such cases it might be better to aggressively act and re-design the project , rather than passively wait for the rising tide of markets to make an exit.

Kissinger also urges leaders to <u>go beyond</u> what the experts advise them to do :

"It is, after all, the responsibility of the expert to operate the familiar and that of the leader to transcend it." – Henry A Kissinger

5. Strategic Design … breaking through the familiar

Strategic designers thrive under constraints. They look at constraints as lines to be Negotiated … not as boundaries.

This is because, designers know that they cannot arrive at a truly innovative design unless they battle with constraints.

A Strategic designer uses a combination of methods to work his magic. At certain times he will need to think like a Surgeon … to cut out stuff and restructure deals and at other times he will need to think like an architect … to look at possibilities both within and outside the problem and its immediate ecosystem.

Architects, think very differently from Engineers and Finance people and therefore bringing in the " possibilities" angle, helps achieve solutions that were hitherto not possible.

The prize will then reveal itself in the form of a new set of value creating options by executing which an Exit at an attractive multiple can be achieved for investors.

6. Can all " Under Water " Private Equity Investments be Rescued ?

Each investment is unique. Every Industry is different with its own ecosystem and the solution also therefore … has to be unique.

The strategic designer cuts through all this variety and complexity by focusing on possibilities … not problems.

There are enough experts in this world, who focus on problems and they can be brought in to educate the designer … so that constraints can be defined.

Once the constraints and the Red Lines are identified … the creative work of re-design begins.

Not all PE investments can be rescued and at such times the surgeons view predominates … with investors having to take not just a haircut … but a crew cut. In such cases it might be possible to get back maybe 30 % of the original capital … maybe 40 %.

However … given the enormous potential within the Indian economy, it may actually make sense to re-deploy money coming out of a “ haircut “ after Executing a Stop Loss … in new kind of structures that today allow quick exits at attractive multiples, thereby possibly achieving initial promises.

Most private equity firms are not thinking in terms of possibilities within the Indian economy today. Neither are they looking at the new structures that are possible for instance … within areas such as Infrastructure or Healthcare or Education where faster exits are possible at very attractive multiples. They are instead sticking to tried and tested areas … where they have … lost money in the past.

India is without doubt one of the most exciting places to invest today. The Narendra Modi Government has in April 2017 announced a plan to triple the size of the Indian economy from US $ 2.2 Trillion currently to US $ 7.25 Trillion by 2030. Given this , things will only get better. We may, in the interim, have security related tensions in Asia with the North Korean situation developing into a Trade war that could affect markets in the near term, but the long term India picture looks extremely promising.

7. Four Re-Design Examples

We had in the beginning of this note said that we would share a few examples to demonstrate how Strategic design could add enormous value.

In the four examples below Strategic Design has helped return “ almost drowned ” investments to profitability.

These are partly hypothetical examples built around real world cases. We have masked certain details so that they illustrate the concept while retaining confidentiality.

The examples are from diverse sectors … Biotech, Real Estate & Entertainment, Infrastructure and Information Technology … which illustrates that Strategic Design works across sectors and the designer does not necessarily have to have any domain experience.

Indeed as we first discovered … domain experience is a liability … not an asset when looking for un-conventional solutions.

It is for this reason that in our design team we prefer to have at least 2 people in a group of 10, who do not know anything about the problem or the industry in question. These are the people who ask the questions no one else thought about !!!

i. Biotech Investment Example

A group of private investors had pumped in over US $ 200 Million into a biotech project. This involved growing a photosynthetic organism that produced a diesel like fuel when grown in open ponds. Fuel was produced by harvesting and processing the organism.

The problem was that fuel yields were very low due to low energy density in the organism. Secondly when the oil market collapsed by over US $ 40/bbl in Aug 2014, the project's economics were no longer viable. This was causing deep anxiety to investors.

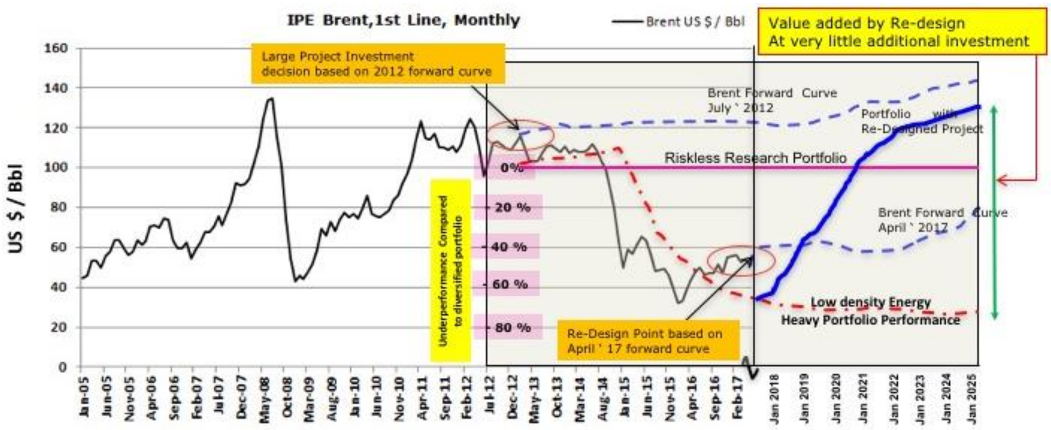
It was at this time that X36 Falcon was brought in by the lead investor to attend a review meeting of the company's top executives and investors.

Unique insight

One of the presentation slides displayed the material while it was being processed. A closer examination by X36 Falcon's design team revealed that the material could acquire an unusually high tensile strength and crystallinity if it was processed differently.

In short the new process would produce a super material.

We summed up the situation, to the company's management in the graph (below). The dark blue line is the Turnaround plan.



Conceptual Re-design can unlock large value

Further market studies revealed that the super material, if produced in larger quantities could possibly bring in US 6000 / tonne and global demand was 5,000 tonnes each year.

This resulted in the company re-deploying a team of 12 scientists to further develop this super strong material.

Additional Mandate

Based on this experience the company gave us a further mandate to redeploy another 50 scientists from their biotech team to higher value projects.

We did not have any prior biotech experience but having re-imagined one biotech project we took on the challenge and did extensive studies on the possibilities in biotechnology and related disciplines.

Six weeks later after studying 64 different companies in the biotech space globally,   X36 Falcon's designers understood the strategic lay of the land in biotech.We knew what kind of research was receiving funding and what mistakes companies had made.

Finally we came up with three new, high value, product ideas which the company's leadership supported and 40 scientists were re-deployed to these projects.

A comprehensive study by the clients marketing team found that the four new products would yield an additional US $ 45 Million EBITDA / year starting in 2023. We were thus able to turn around the investment from a US $ 200 loss situation.

ii. Investment in an Entertainment Venture

XYZ Inc had an excellent operating track record in the Real Estate business with good margins. The firm then decided to set up a theme park at one of its waterfront sites in a European city.

A Private investor Club committed US $ 150 Million to the project of which US $ 100 Million was consumed within 2 years and 70 % of the park was commissioned in phase I.

It soon became apparent that the project was not going to make even its cost of capital as people were just not showing up despite the city being an International centre of trade and commerce and had a large population.

One of the lead investors was a very close friend of our team leader from Engineering college and he called us to look at the project and suggest changes.

It immediately became apparent to us that they had totally neglected the waterfront part of the project and had concentrated on Rides and other stuff.

We suggested that they Re-design the project to include a waterfront Sound and Light (i.e Laser Show) that featured the city's awesome history and a small Marina that maximized the value of the seafront. We also advised them to seek extra building rights and sell part of the waterfront to a hotel chain.

This resulted in increased valuation for XYZ inc and the investor club could make an exit within 3 years though at a respectable multiple.

iii. PE Investment of US $ 20 Million in a Port Project

A Private equity investor had financed a private sector port project to the extent of US $ 20 million in return for a small stake.

Later a group of national banks had made loans to the extent of US $ 450 Million to the port company for the construction of a few jetties and container cargo facilities. Some dredging capex was also involved.

The promoter group however had made a mistake in planning the ports logistics as they had not foreseen opposition from the local community through which port traffic would be required to pass.

They were therefore unable to bring in any cargoes after the third month of operations as rural communities stopped vehicles carrying cargo to and from the port.

The desperate port management then asked the state government for help but to no avail.

Therefore, four years after start of construction and a year after the first cargo had come in, it was decided to convert the port from a container cargo / dry bulk facility into a liquids handing facility targeting petroleum products and gases such as LPG and LNG.

By the time the decision was taken, silting of the port entrance had taken place. Bringing in industrial gases also required a breakwater. All of this required another US $ 250 million in financing and neither the banks nor private equity financiers were keen to put in more capital.

X36 Falcon's design team got involved when a prospective buyer (brought in by the PE investor) asked us to take a look at the facility and to suggest changes that would see a return to profitability.

Critical Insight

As it happened our designers were also working on a Naval project and after three visits to the site we were convinced that it was best to recommend the takeover of the facility by the Indian Navy.

Meanwhile the port was referred to the NCLT for resolution and has been handed over to a new owner after a Govt. mandated process. However the logistics & linkages problem remains. Therefore, the strategic design solution, may now take the form of a Negotiation design involving the Ministry of Defence on one side and New owner and his bankers on the other.

A second option has also been developed to allow all parties to actually make a profit on the deal. The matter is still being discussed with the Ministry of Defence and a decision is expected within the next few months.

iv. US $ 15 Million investment In a Software company

A mid sized textile manufacturer in 2010 had invested US $ 15 million is a 150 head software company.

By 2014, the writing was on the wall. A majority of the firms customers wanted them to move beyond plain vanilla services and add value instead by helping them acquire customers. Some customers also moved to Israeli companies who were offering AI and other automation software that would in due course totally do away with the need for hiring companies that did plain vanilla work.

Ultimately a strategic designer was called in. After studying the company he recommended something very unique that no one was able to see. We will give you a hint … The solution involved a major shift in the business plan by switching industries.

8. Strategic Design Helps Ensure that Investors get their targeted returns

All of this goes to show how a Strategic designer can dramatically alter the Risk / Return profile of a business, just by looking at the company and studying existing constraints within its unique ecosystem.

It is the constraints make innovative design possible as they challenge the designer to come up with truly out of the box solutions.

To maximize returns and minimize risk, it is best to bring in a Strategic Designer right at the beginning when the Private Equity or Venture Capital firm is considering investing in a particular company.

As can be seen from the above 4 examples, the designer does not need to have any prior experience in any of the above sectors as he / she is looking at possibilities and not so visible risks.

Strategic designers therefore bring in unique value which no one else can. He sees things that no one else can.

This reminds one of a conversation between Sherlock Holmes and the police inspector in the story Silver Blaze.

The inspector had missed a critical clue which Holmes found almost immediately.

“ I cannot think how I came to overlook it,” said the inspector with an expression of annoyance.

Holmes quietly said “ It was invisible, buried in the mud. I only saw it, because I was looking for it. ”

– Concluded –