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Q&A: Jupiter Capital's Indika Hettiarachchi

Author: Mirzaan Jamwal

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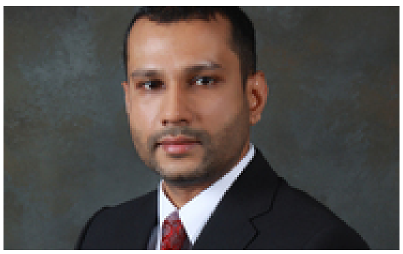

Indika Hettiarachchi, director at Sri Lanka-based Jupiter Capital Partners, outlines why India's economic troubles could help other South Asian countries get a bigger share of investment in the region

Q: In 2009 Leopard Capital and Calamander Capital failed to raise a Sri Lanka fund. Is there more LP interest now?

A: I think there is good level of LP interest. It's being driven by LPs experiencing low returns in South Asia regional funds and realizing there are vast differences between each country in the region. So they are now looking at taking direct country exposure. Also, many investors who already have large Asia allocations are finding it tough to increase their investments in traditional favorites like China or India because these markets are slowing down. So they are looking at smaller growth markets like Sri Lanka. We have a lot of interest from large global funds-of-funds as well as from a couple of development finance institutions (DFIs). Many of them are looking at the country for the first time.

Q: How does Sri Lanka compare with other emerging markets?

A: Sri Lanka offers good opportunities but due to the small size of the economy these are not $100 million deals - they are in the $5-10 million range. I think when selling Sri Lanka opportunities, it is important to distinguish them from India. Sri Lanka has never achieved its fair share of attention or investment due to the India factor - it is considered an extension of India or part of a South Asian regional allocation, which India ends up absorbing disproportionately large chunks of. Sri Lanka cannot be evaluated using same criteria used for India. It is important that investors they look at South Asian countries individually because they have different growth drivers and different business environments. The Sri Lankan economy is not linked to the domestic market, but includes exports and services such as tourism. Also, compared to other emerging markets, PE is an excellent way to get broader equity market exposure here. The small size of the stock market means that often transactions for around $1 million have to be negotiated off market - like a PE deal. So Sri Lanka is a good market for secondary PIPE deals.

Q: What is the outlook for the Sri Lankan economy?

A: Last year growth slowed to 6.4% from two years of 8%. This year I think we will hit 6-7%. In terms of contributors to GDP growth, for the next few years, the bulk will come from infrastructure development and the reconstruction of former war zones. The construction sector will contribute significantly, partly driven by large property projects which are underway, and also transport, especially port-related activities, and industrial ventures. In addition, steady growth in export and tourism is expected.

Q: Why have you chosen to focus on small and medium-sized enterprises (SMEs) for Jupiter Capital's debut fund?

A: That's where the growth is going to come from. During the last 30 years the level of entrepreneurship has been low so the larger companies have become too big and too diversified. As a result, some have lost their competitiveness or core expertise. SMEs are more flexible and able to achieve higher growth, plus exiting them is not as challenging as exiting large businesses. The domestic market is not big enough to give high returns so we're looking at companies whose growth is linked to exports or overseas expansion. We are targeting companies that have a unique product or service which can compete in the international market. We will also focus on companies which are targeting local market, but will be very selective. The typical deal size will be $2-8 million and we plan to do about 15 deals.

Q: But according to the Sri Lanka Chamber of Small and Medium Industries, around 25% of local SMEs have gone bankrupt over the last 2-3 years...

A: The debt level of Sri Lankan companies is much higher than elsewhere in the region. When a company is in the growth phase it needs quick money and banks have been very aggressive in their lending practices. As a result, companies are over-leveraged and all their cash flows are used to pay off debts. We expect defaults to grow in the coming quarters. A lot of mid-sized companies lack capital for expansion and modernization, so they open to equity deals but they don't have many options for equity funding. There are some equity investors, but they are linked to other business groups or family investment firms. Companies don't like to get funds from such parties due to perceived conflicts of interest.

Q: What is the competition for deals like?

A: In smaller markets like Sri Lanka developing proprietary deal flow is a challenge. There are no local independent PE fund managers, but there are many investment firms that are actually linked to financial institutions, diversified business groups or family offices. There were two foreign PE firms here - LR Global and Aureos Capital [now part of The Abraaj Group] but they have closed down. Other than those, Actis and DFIs such as International Finance Corporation (IFC), German Investment Corporation (DEG) and the Netherlands' FMO are active here.

Q: What kind of returns can investors expect?

A: We are targeting a minimum 100% return in three years, or about 23% IRR. We've increased the target size of the fund from $50 million to $100 million - with the option of closing at $75 million - after investors said $50 million was too small for them to consider. We've also broadened the fund strategy to include secondary and PIPE deals.

Q: What is the exit strategy?

A: We have seen both public market exits as well as trade sales. I personally prefer IPOs because it helps to develop the capital markets, but usually trade sales give much higher returns as large companies buy into emerging companies or SMEs to find growth.

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