By Narinder Kapur and Ankit Doshi | 04 November, 2020

Harsha Raghavan on Convergent's strategy, how Indian PE industry is different and more

In 2018, Harsha Raghavan left the position of managing director and chief executive officer at Fairbridge Capital Pvt. Ltd – an advisor to Fairfax India Holdings Corporation – to build a new investment firm. Since then, Convergent Finance LLP has made at least six bets, with Raghavan leading a team that includes other Fairbridge alumni as well.

In an article published last week, Raghavan detailed the strategy the new firm is using for making investments, as well as how it is differentiating itself from other homegrown investment outfits.

In this conversation with VCCircle, the Convergent Finance managing partner talks about the relationship between private equity investors and promoters, whether the firm prefers making investments in listed companies, and how the Indian PE industry compares to ones in developed markets. Edited excerpts:

How did you transition out of Fairfax and set up Convergent Finance?

I've spent around 24 years in the PE industry, and started in the 1990s with a fund that was associated with JPMorgan Chase. Then I was at Goldman Sachs and started a PE team in India. Around ten years ago, [HDFC's] Deepak Parekh introduced me to [Fairfax's] Prem Watsa and we hit it off very well. We agreed for me to set up Fairfax investment activities in India, which I did in 2010. We invested over $2 billion over almost a decade. We generated a very healthy multiple of money on that capital and approximately tripled value over a period of time.

In 2018, I had a heart-to-heart with Prem Watsa saying it is my dream to set up something I can build for 30 or 40 years. Prem is a people person and he understood those dreams of mine. He and Fairfax have supported us to spin out as a team. Fairfax also supported us through investor introductions and other things and hence we set up a fund.

How does Convergent Finance's fundraising take place? Who are the investors?

A long-term, long-standing Fairfax shareholder is our anchor investor. It is a blue-chip global foundation. We have many other investors. We have a combination of investors from three continents.

When investing in potential or portfolio companies, what differentiates an Indian entrepreneur with some of their global counterparts, and what is there to learn for the Indian entrepreneurs in terms of opportunities available?

India has always had a very strong entrepreneurial base, and I think it's quite clear – CEOs of some of the world's biggest corporations are Indians. The management bench and the entrepreneurial bench in India has always been very strong. We've had shackles, we've had constraints… regarding sub-scale and inefficient economies. [But] a lot of those are gone now that our entrepreneurial juices are flowing. So, I'd say it is our moment to shine.

How do you distinguish your investment approach compared with that of other long-term investors?

As you will recall, Fairfax was not investing in India prior to us setting up Fairbridge. So, in great part, I would say what you've seen in terms of the investment strategy there is very much who I am. And my temperament has really not changed much. So we will be opportunistic and we will be delighted to buy controlling stakes and make outright acquisitions if the deals merit it. But no, we're not opposed to buying 5% or 10% positions either.

Considering your engineering and technical background, how do you device your investment strategies?

We are very data-oriented, but not trying to do quant-type heavy-duty math. What we're trying to do is make a judgement call based on numbers and based on people. When I say numbers I'm talking about the fundamental numbers of the company.

You talked about your experiences in the PE industry. Could you give us an idea about the Indian market scenario, and specifically when it comes to the cash flows, generation and preservation by a business?

India has this tendency to obsess over just GDP growth. While I don't dismiss the importance of that, I think there needs to be a bit more focus on earnings growth. Even if a sector is seeing earnings growth of, say, 15% the real winner in that sector may be seeing earnings growth of 50%. So, you may have a situation where GDP will grow by 5%, but earnings in one sector are growing at 15%, and the winner in that sector is growing at 50%.

When we look at our bottom-up analysis – industry, company, and management – we're looking to see, is this a good sector or is this the winning horse within that sector. And is there an alignment in terms of the philosophies between the ways they want to build for the long term we do.

If all of those parameters are met, that's when we make our investments. As it relates to my macro outlook, this is a great time to be building because of the availability of inexpensive labour, land, etc. So I would say that we're going to see some real winners getting built going forward.

I'd like to point out that Google was founded in 1999. They were not the first search engine. They were not even the hundredth search engine. One may have concluded that the search engine industry was crowded, unprofitable. But if the VC who looked at Google looked at the industry, the company and management, they would have realized that this one is the winner. That thought process also applies in my world, which is investing behind proven companies.

Regarding the current market scenario (after COVID-19), do you see any similarities to previous financial crises such as those in 2008 and 2001? If not, how is it different?

The best time to build a business is when competition is subdued. When others are distracted or afraid, when labour resources are plenty and fully available, when land resources are plenty and economically available, and so on and so forth. That's the time to build a business.

At a different point in time where everything is frothy and heated up and overvalued that's the time to be very cautious. If you look at those cycles, they ebb and flow with surprising frequency and regularity, not just in India but globally. As a result, I think one needs to be rather judicious in terms of selecting the time in which to be aggressive and build, versus being conservative and conserved capital.

Today is a point in time where the opportunity [in India] is very much there to build. We have all seen negative press about economic and other concerns. Having said that, there have been so many fundamental structural changes that will allow India to leapfrog and become a highly efficient economy. I'm very excited for those things.

What incentives can PE investors offer to promoters to ensure long-term value generation?

Investing involves a healthy dose of judging people and applying common sense. It's also a "batting average game" where it is almost impossible to get it right every single time. Of course, one hopes to be more right than wrong. It is greatly beneficial when you have big successes and make small mistakes – but it's easier said than done.

When it comes to judging people, one needs to look for three key attributes – intelligence, integrity and energy. If you pick someone who doesn't have the first, the other two will kill you… I think that is absolutely true!

Once we find a company with the right leadership, it becomes critical to ensure that incentive systems are aligned, both individually and collectively. It is obviously not ideal when individuals have different incentives from one another – this can lead to a win/lose situation or else a dysfunctional one.

Aside from financial incentives, individuals invariably have career aspirations and this can become a stress point even when people have money at stake. This is where it becomes critical to have a good leader at the helm – who all the individuals on the team look up to and view as being their guiding light. They need to trust this leader to protect their career aspirations as well as their financial ones.

What is your strategy with respect to a listed or an unlisted firm when investing in a specific sector? Do unlisted companies in certain sectors have an advantage over their listed peers? Or vice versa?

We are indifferent between investing in listed versus unlisted companies. In both cases, we look for the same qualities – industry, company and management. In all cases, we do our best to work alongside management to build the business, applying ethical and governance processes to build a robust institution.

In India, we have not seen any distinct advantage or drawback to being listed versus unlisted. Amongst the smaller-cap listed companies, raising fresh equity capital can be a real challenge since there are regulatory issues to contend with such as the takeover offer, promoter ownership caps, SEBI pricing formula and foreign institutional investors' ownership caps. So sometimes, small-cap listed companies are constrained for equity capital compared with their unlisted counterparts in the same industry. But on other occasions, the opposite applies where listed companies can go for qualified institutional placements or offer for sales in periods when the capital markets are hot.

How would you compare the Indian PE industry to other developed markets?

The Indian PE industry functions very differently from developed markets – this is true as compared with the US, Canada, Europe as well as Japan and Australia.

In India, we are constrained on the use of leverage. This has some benefits but also results in returns being depressed – a challenge that has resulted in fundraising challenges for the industry as a whole.

Further, the delisting guidelines in India work very differently from mature markets and hence there is no opportunity to undertake "public to privates" or "leveraged buyouts", which are standard strategies in other markets.

As a result of these differences, I would say that many PE funds have felt tempted to merely offer "growth capital". This can sometimes turn a "value-addition strategy" into a mere "valuation strategy" involving buying low and selling high as quickly as possible.

However, as our market matures, I can already see an evolution with a lot of smart investors realizing that building businesses is the most enduring, timeless and sustainable strategy of all.