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Motilal Oswal Financial Services Ltd.: An IPO in India

This country was a capital desert—it had everything, land, labor, intelligence—but no capital.

— Raamdeo Agrawal, Joint Managing Director, Motilal Oswal Financial Services

Motilal Oswal and Raamdeo Agrawal, founders of Motilal Oswal Financial Services, Ltd. (MOFSL), one of India's leading equity brokerages, watched the cars carrying members of their board of directors thread their way through Mumbai's (Bombay's) notoriously deranged traffic after the December 2006 meeting. "So now 20 years after we stuck our necks out and founded this organization, we may finally go public," mused Oswal, chairman of the company.

The two founders had established MOFSL in 1987, after meeting as students in a hostel in suburban Bombay. Both chartered accountants by training, they had built the operation to a position as one of the three leading brokerages in India, with more than 1,100 outlets in almost 360 cities, an investment banking business, and a private equity operation. Between 2000 and 2006, the company's profits had grown 45% annually, and in the most recent two years, the return on equity came close to 70%.[1]

MOFSL's mission was "to be a well respected and preferred global financial services organization enabling wealth creation for all our customers." Recently, the founders had focused on expanding the business, in part to match the growth of the Indian market. Indian consumers, whose per capita income was expected to double by 2014, had a savings rate of roughly 29% of gross domestic product.[1] This promised increasing demand for equities, as stocks and mutual funds accounted for only 4.5% of India's retail financial assets.[2] The growing presence of foreign institutional investors (FIIs) in India, however, threatened cut-throat competition and the founders knew that MOFSL needed to increase its balance sheet and international credibility. To address this, Oswal and Agrawal had sold 9.3% of the company (fully diluted) to private equity investors. Employees owned a further 13.27% (fully diluted) through an Employee Stock Option Plan (ESOP).

[1] As is common with Indian companies, the fiscal year ended March 31 of the year in question. Thus the 2006 fiscal year ended March 31, 2006.

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The results to December 2006 had been encouraging. Buoyed by the market, the company's revenues in the nine-month period ending December 2006 were $62.3 million compared to $59.4 for the year ending March 2006. Similarly, profits were $11.3 million for the nine months to December 2006, versus $13.7 million for the prior full year. The founders felt that the time was promising for an Initial Public Offering (IPO), not only to increase the company's balance sheet and raise its profile but also to facilitate exits for the shareholders, both private equity firms and employees. "We have to provide incentives to our workforce or, even as dedicated as they are, we'll lose them," said Agrawal. Further, in the fragmented but consolidating Indian brokerage landscape, a publicly traded stock would give the company additional currency to make acquisitions. Lastly, going public in India usually resulted in a significant increase in a company's market valuation.

But was now the right time, they wondered. "If we hold off for another year or so," Agrawal said, "and continue making acquisitions and growing organically, we'll go public from a larger base and attain a higher multiple." Would the process of an IPO take their attention from guiding the company through the challenges of growth?

Both men also knew that the market might take one of its roller-coaster swoons prior to the IPO. The current anticipated listing date of mid-May would get the company on the market just after the traditional end-of-fiscal-year softening, in the light of corporate earnings announcements and the publication of the government's budget. This timing, however, posed a problem for the private equity investors. Recently enacted laws allowed inside investors to sell their positions immediately if they held shares in a private company for more than a year before it filed to go public, but the proposed timetable had MOFSL filing its papers 11.5 months after the firms had invested. This would require the private equity firms to hold their positions for a further 12 months. One of the firms, Bessemer Venture Partners, was a U.S.-based venture capital investor with a history of taking long-term positions in its companies. The other, though, was a hedge fund, a type of investor typically pressured to show short-term gains. Would they agree, or would the year's lock-up represent an awkward compromise that satisfied no one?

India[3]

With a population of 1.1 billion in 2006, India ranked as the world's second most populous country and its largest democracy. At 3.3 million square kilometers (1 million square miles), it stretched from the Himalayas to the Indian Ocean, making it the seventh-largest country in the world in terms of land mass. It bordered Nepal, Pakistan, Bhutan, Bangladesh, and China (see **Exhibit 1** for map, including MOFSL's offices).

India was a country of great disparities. India's 2006 estimated Gross Domestic Product of INR 39.8 trillion (Indian rupees, $876 billion) ranked it 10th in the world, but in terms of purchasing power parity, at $2.7 trillion, it was fourth. Since 2003, real GDP had grown in excess of 8% each year.[4] Yet as many as 230 million people still lived on less than $1 per day, below the international poverty level.[5] This absolute number had remained flat since 2000, though, and 2005's poverty rate of 22% reflected a huge improvement from 26% in 2000 and from levels in excess of 50% found in the 1950s.[6] The situation in the 29 states and six territories also differed dramatically, with three states serving as home to almost half of the country's poor. Similarly, levels of education and literacy varied greatly throughout the nation.[7]

India had made great progress since 1991, though. Not only had poverty fallen, but mortality rates had improved, school enrollment increased,[8] life expectancy at birth had risen to 65 for women and 62 for men, and literacy rates reached 73% for adult males and 48% for adult females.[9]

The year 1991 marked a watershed in India's economic development. After 180 years of British rule, the country gained its independence in 1947 after a non-violent resistance movement led by Mahatma Gandhi. India's first elected government established a policy of economic self-reliance, aiming to build strong local industry by protecting local producers and state enterprises from competition. The strategy was implemented through extensive regulation of international trade and foreign investment, central control of domestic investment, and a complex set of government regulations on all aspects of business that became known as the License Raj.[10] Starting and running a company required treading a difficult path through a thicket of government regulations and licensures.

In 1991, Dr. Manmohan Singh, an economist trained at Oxford University, became India's Finance Minister in the wake of an economic crisis, and started to deregulate the economy. Since 1992, despite four changes of government, India had continued the process of deregulation, reducing tariff barriers, slicing income and capital gains tax rates, and creating a much more hospitable business climate. Over the 1990s, the issue of attracting foreign investment was specifically addressed by several regulatory changes: automatic approval of foreign investment in non-restricted industries; permission for foreign institutional investors to hold up to 49% of the issued capital in any Indian company; simplification of the divestment process of institutionally-owned shares, including the automatic approval of sales of listed company shares at prevailing market prices; expansion of automatic approval to cover any investments by Indians living abroad and by firms where they controlled at least 60%; and the establishment of disclosure and investment protection guidelines for IPOs.[11]

Because of its colonial past, India had a number of qualities that made it attractive to international firms. With its polyglot domestic languages (18 major languages and more than 1,000 minor languages and dialects), English was widely understood as a common language and especially as the language of business.[12] Thus, even if a western visitor could not hold a conversation with a taxi driver, the driver could understand a request to go to the train station. In addition, India also had Western legal institutions, a modern stock market, and private banks and corporations.[13]

Oddly enough, the years of regulation and scarcity had benefited the economy. Indian companies and entrepreneurs (known as promoters) had become accustomed to improvising. This talent could be observed even in 2006 when driving Indian highways. Despite the common occurrence of a passenger car overtaking a heavily laden bus that was passing a camel, a cow, a cyclist, and a pedestrian, all on a two-lane road in the face of oncoming traffic, the visitor saw surprisingly few accidents. "Indians *adjust*," was the comment.

This capacity for adjustment manifested itself in an ability to adapt to scarcity, whether in capital, capital goods, or energy. Indian firms used capital more efficiently than did those in its frequent comparison, China, due in part to the legacy of government capital control. Many companies had gone public to raise money unobtainable through bank loans and thus were accustomed to pressure from private investors to produce adequate returns on invested capital.[14]

India also had the advantage of a large, young (roughly 50% were less than 19 years old), growing, and increasingly educated work force. The number of young professionals in the engineering, life sciences, and finance and accounting professions was projected to exceed that in the U.S. by 2008.[15] Private consumption spending per capita was forecast to double between 2004 and 2014, with growth in real GDP per capita averaging close to 6%.[16] India was expected to become the world's most populous nation by the middle of the 21st century, with 1.6 billion people.[17]

Yet for all its advantages, India faced significant challenges. The legacy of the License Raj still persisted in the form of stifling bureaucratic regulations, and rigid labor laws and a Byzantine set of land ownership restrictions complicated the ability of business to respond to changing opportunities.

The infrastructure was breath-takingly inadequate.[18] One glaring example: according to one hotelier, Manhattan had more hotel rooms than did all of India. A series of coalition governments had slowed the pace of reforms and hindered the country's ability to reduce government spending and thus its budget deficit, which was expected to exceed 4% of GDP by 2008.[19] Moreover, the country still faced issues of water, energy, pollution, ethnic and religious strife, various insurgent movements, and the possibility of war with its neighbor, Pakistan. Yet the dynamism, creativity, and sheer number of its citizenry had made it an opportunity that no one could ignore.

Indian Private Equity[20]

India had already experienced one tidal wave of VC money in 1999 and 2000, with investments peaking at INR 1.16 billion (roughly $26 million).[21] Riding the tech wave of the U.S., much of this was invested in start-ups, especially software companies and dotcoms, where a marketing operation in the U.S. would be backed by low-cost technological support based in India. The later rise of business process outsourcing operations and call centers also followed this model of labor cost arbitrage.[22] Commenting on the early boom, one reporter observed, "There were some success stories, but a lot of money was burnt as well."[23]

By late 2006, India was again buzzing with private equity investment activity. One widely quoted study announced that U.S.-based VC firms had raised roughly $4.4 billion for early-stage investments in India.[24] The term venture capital, however, was often defined loosely—even by the venture capitalists themselves. Rather than focusing on early stage investment, private equity groups, whether domestic or foreign, were targeting later-stage companies for growth or expansion financing. In 2005, 72% of the new capital raised for private equity investment in India was earmarked for growth or expansion deals.[25] Even India-based Chrys Capital, which had started as an early-stage investor, had moved toward larger deals in more established companies. Said Ashish Dhawan, senior managing director at the firm, "Theoretically, early stage investments should generate more returns. But private equity firms [i.e. firms investing in later stage companies] have generated more returns in India."[26]

"Larger companies are less risky; listed companies are less risky," commented Dalip Pathak, a partner at long-time India player, Warburg Pincus.[27] In addition, India's larger domestic companies were increasingly seeking to move abroad, leading them to welcome the advice and networks of globally oriented firms with a history of active investing.[28]

Regardless of the company's stage, a lot of money was being raised and invested. In 2004, $1.1 billion was invested in 66 companies in India;[29] and $1.4 billion was invested in 104 in 2005. During the first half of 2006, $2.36 billion had gone into 68 deals, putting the industry on track to double the previous year's performance.[30] The country had been home to 2005's second-largest Asian private equity deal: KKR's $900 million purchase of Flextronics Software Systems, India's largest leveraged buyout.[31] Average deal sizes had risen from $13.4 million in 2005 to $21.8 million in the first half of 2006, even excluding the massive KKR deal.[32]

KKR was not alone in its attention to India; a number of top venture and private equity groups—such as Carlyle, Blackstone, 3i, and Bessemer Venture Partners—had recently established offices on the ground or raised funds targeted for India, joining investors such as Chrys Capital, Actis, ICICI, Morgan Stanley, and Warburg Pincus. In fact, Carlyle and Blackstone had each announced plans to invest $1 billion in Indian companies.[33] Hedge funds also had entered the Indian market, with roughly 45 directly targeting the country and an addition 200 including it as part of a pan-Asian strategy. Hedge funds liked the short settlement time (T+2, or the day of the trade plus two) that had been adopted, with one investor commenting, "Mumbai's efficiency is ahead of Tokyo's."[34]

Due to regulatory constraints that prevented them from deploying complex hedging strategies, many offshore hedge funds had adopted strategies often associated with other classes of investors. New Vernon, with $1.2 billion under management, had set up offices in Mumbai and invested in a variety of sectors, including property, autos, textiles, engineering, and corporate bonds.[35]

A partner at a private equity fund targeting India assessed the opportunity as follows:

> We took a bottom-up view. Indian GDP has been growing between 6% and 8% over the past seven years. The inflation rate has been roughly 4%. So that makes 11% nominal growth. By choosing good sectors, we avoid such under-performing areas as agriculture and the public sector—which are still terribly inefficient and subsidized— and the chaotic states, and we can add 4%, which takes you to 15% annual growth. If we pick well within these sectors, we should be able to get 5% over the market, which gives you a 20% return.

Picking well within sectors meant that investors had expanded their focus beyond the historically favored Information Technology (IT) sector. In particular, investors realized that India possessed a vibrant domestic market fueled by a thriving middle class of 300 million people[36] that wanted, in the words of one U.S. venture capitalist, "well, what every other middle class consumer wants." This included mobile services, financial services, education, health care, hospitality, entertainment, and clean energy.[37]

Part of the appetite for investing stemmed from the ability of private equity firms to exit their investments. India had a tradition of a stock market dating back to the 19th century and its activity had been picking up speed. The combined value of stocks on its largest exchange, the National Stock Exchange (NSE) rose 50% between 2004 and 2006.[38] In early February 2006, the Bombay Stock Exchange's Sensex (Sensitive Index; India's Dow Jones Industrials) had broken 10,000 (see **Exhibit 2** for movements since 2000). The bellwether exit story, though, occurred in 2005, when Warburg Pincus exited its investment in Bharti Televentures via a block trade on the Bombay Stock Exchange. Warburg's total realizations over the six year life of the investment were estimated at $1.6 billion.[39]

On the cautionary side, investors had started to voice concern that valuations were becoming excessive. Average deal sizes had risen as firms had more money at their disposal. Despite the euphoria as the Sensex blasted through 10,000, by the end of December, some whispered about bubbles, as India's stocks traded at an average of 16.8 times 2007 earnings, compared to 20 for China[40] and essentially even with the 16 times 2007 earnings estimated for the S&P 500.[41] None could deny that money from FIIs, which had invested $10.7 billion in India during 2005, had played a role in the stock market's climb. This foreign investment was coupled with domestic activity, as government regulations barred foreigners from owning more than 25% of domestic firms. "It's as if Christopher Columbus had discovered India," said one banker.[42]

In May 2006, the Securities and Exchange Board of India (SEBI, the stock exchange regulatory authority) revised its Disclosure and Investor Production (DIP) guidelines relating to IPOs. The DIP guidelines previously in force had specified that all shares of a company prior to the IPO would be locked up for a year following the IPO's completion except for those shares owned by employees through an ESOP and those held by Foreign Venture Capital Investors (FVCIs) and Indian VC firms registered with SEBI. This was changed to stipulate that FVCIs and Indian VC firms would only be exempt for the one-year lock-up if they had held shares of the company for at least a year prior to filing the paperwork for the IPO.[43]

India's Financial Services Sector

Although India had Asia's oldest stock exchange, its market capitalization to GDP level was much lower than that of developed Asian economies: using 2004 data, Hong Kong's was 5.97, Singapore's 2.36, and India's 0.64.[44] This stemmed from a number of factors. For much of the country's history, the government had controlled the financial sector, including the amount of money companies could borrow and, until 1992, the amount, type and price of IPOs. This corresponded to low liquidity and scanty trading volumes and in a negative spiral, lack of interest among analysts. "In a way," observed a long-time investor in India, "buying the stock of most public companies in India was akin to buying a private company only worse. You had illiquidity and no control rights."

After 1992, however, the government controls over IPOs began to be relaxed. Companies could go public if they fell in one of three categories: tangible assets of at least INR 30 million (roughly $75,000), an equity book value of a least INR 10 million ($25,000) in each of the three prior years, and positive distributable profits; or through a book-building route in which at least half was allocated to qualified institutional buyers (organizations expected to possess the expertise and financial wherewithal to participate in equity markets).[45]

Until 1999, though, companies could only go public through a fixed price offering, in which the company and its investment bank set a price and investors bid for the number of shares they wanted, with allocations on a pro-rata basis. The "book building" approach used in the U.S. was not allowed, and shares were usually substantially under-priced, often at the legally set face value of INR 10 (22 U.S. cents).[46] After 1999, issuers could still use the fixed price method, but they could choose to use a variation of the U.S. book-building approach. As in the U.S., the issuer set a base price and a band around it, but the final offer price had to fall within the initial pricing band, rather than the free float allowed in the United States. Investors then bid for a fixed number of shares at a price equal to the final offer price set by the investment bank, but in contrast to the U.S., the bidding was firm. Investors who were allocated shares at their bids were required to accept that allocation. Different investor categories were required to be allocated different proportions of the total offering; in the case of under-subscription by any one type of investor, these proportions were fungible between categories.[47]

Book-building rapidly gained popularity in India, to the point that this method was used for more than 60% of the IPOs in 2005.[48] In 2004 and the first 11 months of 2005, public stock issues in India raised as much money as was raised in the previous 14 years.[49] Average deal size for companies going public trebled between 2002 and 2005.

Part of the new activity in the stock markets reflected not just increased interest in equity investing among the Indian population, but a decline in the interest rate on domestic passbook savings accounts. Until 2000, government guaranteed passbook savings accounts paid rates between 12% and 15%, compared to an historic return of 17% to equities. Starting in 2000, however, interest rates started to slide into the single digits, and by 2005, they stood near 6%.[50] Said Oswal, "With no return to illiquidity, how could equities compete? Now our challenge is that the public still believes that interest rates are around 15%. As they start to internalize the recent drop, they will turn to equities in greater numbers."

Indians historically had high household savings rates, in the vicinity of 29% of GDP, and the 300 million people in the middle class were moving into their prime saving years, but most of those funds were in banks. Mutual funds, the common way in which American retail investors participated in the market, only held INR 1.5 trillion ($34 billion) in assets under management at the end of 2004, with 10 times that amount, INR 16.2 trillion ($368 billion), in banks. In the U.S., for instance, mutual funds held nearly three times the assets of bank deposits.[51] Figures from 2000 showed that only 8% of Indian households owned equities, and that overall, Indian households had only 4.5% of their wealth in the equity markets,[52] compared to U.S. figures for the same year that showed 27% of households owning equities, and 15% of household wealth in equity markets.[53]

Retail investors had been more active in 2005 and 2006, opening 1 million new depository accounts in the first seven months of 2005, which raised the total to 8 million by mid-year.[54] Portfolio management services (PMS) had gained favor with those Indians holding equities, as capital gains taxes fell and the stock market rose. India's "higher income population" – households with incomes above INR 200,000—was expected to almost double, to 32.3 million households between 2005 and 2009. These consumers were expected to increase the scope of product they demanded, moving from purely Indian financial products to globally oriented products.

As FIIs recovered from their fright at the crash of 2000, they had joined retail investors in Indian equity markets starting in 2003. In 2004, FIIs' trading volume rose 105% from the year before, to $70.5 billion.[55] Along with their faith in the vitality of India's economy, FIIs also benefited from reduced capital gains tax rates.

The fragmented Indian broking industry was consolidating dramatically. The volume of the top five brokers had doubled between 2001 and 2005, but still was only 15% of the market. The top 50 brokers only had a 50% share (see **Exhibit 3** for concentration). Small players were being acquired by larger domestic operators. At the same time, the industry's efficiency had significantly improved. The number of registered brokers on the NSE, India's largest exchange, had fallen by 3% between 1997 and 2005, while the number of trades had risen by 1,630% in the same period.

Competition was intense, as all the major foreign investment banks had entered the country, either independently or in joint ventures. By 2005, though, many of the joint ventures were dissolving, as the foreign partners, thought to want complete control of the operation, either bought or sold their stakes in the joint venture. December 2005 had seen Merrill Lynch buy out its partner DSP for $500 million to increase its 40% stake in DSP Merrill Lynch to 90%. This effectively valued the operation, which focused on institutional broking, investment banking, and asset management, at $1 billion. In March 2006, Goldman Sachs and Kotak Mahindra Bank had severed their 10-year partnership for a nominal valuation. General sentiment held that Goldman had wanted the split to pave the way for setting up a proprietary operation.[56] Even online broker E-Trade was staking a claim in India through a 27% share in brokerage IL&FS Investsmart. E-Trade was thought to be in the process of adding to that stake. Throughout this time, rumors swirled that Morgan Stanley and JM Financial, partners since 1999, would buy out their shares of the joint operation.[2]

Much of this activity stemmed from the wild ride in the Indian markets. Total investment banking revenue had risen to $637 million by the end of 2006, almost 10 times 2002 levels. In addition, the benchmark BSE Sensex had doubled in value since 2003 and proven surprisingly resilient, as it recovered from a 29% drop in May 2006 only to rebound to new highs in October of that year.

Motilal Oswal Financial Services, Ltd.

MOFSL had deep experience of the ups and downs of India's equity market. Its founders, Oswal and Agrawal, met in the early 1980s when they shared a student hostel in suburban Bombay as they studied for degrees in chartered accounting. In 1987, they started a sub-broking firm distinguished by its emphasis on research-based investing even though sub-brokers could play only a limited role,

[2] This finally did occur in February 2007, when Morgan Stanley paid $445 million for the venture's institutional brokerage business and JM Financial bought the capital markets and wealth management business of the venture for $20 million.

introducing clients to brokers or settling the trades of clients introduced to them by brokers, akin to the role of wholesale brokers in the United States. Three years later, the firm Motilal Oswal[3] was founded when Oswal acquired a membership on the Bombay Stock Exchange (BSE).

Over the next five years, to 1995, the company acquired a membership on the NSE, entered the institutional broking business, and formally established a separate research office, to which it had dedicated nearly 20% of annual revenues ever since. The firm was famous for its emphasis on value investing and research, in addition to an annual Wealth Creation Study that detailed the fastest, largest, and most consistent wealth creators over the previous five years. Since 2003, the firm had routinely placed among the top three in Asiamoney's annual brokers' poll for Best Local Brokerage in India and Most Independent Research Brokerage. "We're passionate about research," said Agrawal:

> We really stick our necks out. We're unique in that we do independent and unbiased research—we write without motives. We're also unique in our conviction. All research is completely available from anyone, so it's our conviction that sets us apart. As a portfolio manager, I have a '10% buy' recommendation—put 10% of your holdings in that stock. It's terrible when I'm wrong!

By 2006, the company had grown both organically and through acquisition to a position as one of the top three brokerage houses in India. Through its subsidiary Motilal Oswal Securities Ltd., the company served both retail and institutional clients. The group also offered depository services, with over 190,000 accounts, PMS with over $118 million in *corpus*, and margin financing to its broking and other customers. Recognizing India's commodity-rich economy, MOFSL had recently established a commodity broking group. In 2006, MOFSL added several new lines of businesses, including an investment banking operation and a private equity fund (see **Exhibit 4** for MOFSL business lines).

The brokerage service generated by far the largest amount of revenue. MOFSL held a 4.99% share of the equities cash market, and 3.87% of the equity derivatives market. To institutional clients, of which it had more than 240, MOFSL offered research on more than 200 small-, mid- and large-capitalization companies trading on India's exchanges. It also advised clients on hedging and arbitrage strategy in institutional derivatives, and provided "soft dollar" services.[4] (See **Exhibit 5** for details of MOFSL's business sectors.) Previously, international firms such as CLSA, UBS, and joint ventures established by Merrill Lynch, Morgan Stanley, and Goldman Sachs were estimated to handle 60% of the institutional market, as most FII clients preferred to deal with familiar brands that were known to have strong balance sheets. Patterns had been shifting recently, however, and domestic firms like MOFSL now serviced a variety of institutions, including hedge and mega-funds

MOFSL's network of retail brokerages served almost 200,000 customers across 1,160 business locations, addressing different client groups through different channels. The Equity Advisory Group served high-net-worth individuals (HNIs) and small-to-medium enterprises (SMEs) through branch offices, offering equity, commodities, portfolio management, and mutual funds along with equity research. Branch offices and franchisees served retail clients, and an online brokerage (www.MotilalOswal.com) allowed self-directed investors to trade electronically. The MOFSL brand,

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[3] Oswal and Agrawal were partners from the beginning, but Indian law at that time prohibited any business partnership between people not related by blood. Regulations also required a brokerage to be founded by a person with a three-year history in trading. Oswal happened to be the person who took out the trading license initially, four years before the partners filed for incorporation, and his unusual name made a unique corporate name. "Now," said Agrawal, "he's become a brand!"

[4] "Soft Dollars" were a way of paying for goods or services without writing a check. In this situation, the client, usually a FII, would pay for MOFSL's research or advice not in hard dollars but by adding a small surcharge to the fees it paid a third-party to execute trades, with that excess going to compensate MOFSL.

with its slogan of "Solid Research, Solid Advice," was well known. Agrawal appeared frequently on Indian television, recommending stocks and giving an overview of the market.

MOFSL had been a pioneer in using the franchise model in retail brokerage. The company and the franchisee split the revenue from the client according to an agreed-upon ratio, and MOFSL provided the brand name, marketing, training, back-office support, and research ideas, which came from a special department in the head office. Remissiers were another sort of franchisee, operating out of MOFSL branches. With no infrastructure investment, they received a smaller portion of the client's fees. An even lower-overhead way for an individual to become a broker was through MOFSL's E-franchisee program, in which an individual with a computer and an internet connection could qualify to become a MOFSL broker. By mid-2006, MOFSL had 51 E-franchisees.

MOFSL's revenues for fiscal year 2006 (ending March 31, 2006) were $62.3 million, and the $13.7 million in profits represented 45% annual growth between 2000 and 2006. Even as the BSE's Sensex had tripled between 2000 and 2006, MOFSL's market share had grown by five times, a compound average growth rate of 53%, and its average daily turnover by 33 times, a compound average growth rate of 155%. The company's revenues in the nine-month period ending December 2006 were $59.4 million with profits of $11.25 million.

Growing the Company

In 2004, a big institutional foreign bank had approached the founders about buying 76% of the company. "That focused our thinking on growth," said Oswal. "We realized we didn't want to sell a majority share. It's fun to build the company and run it. But we thought that we might sell a minority share, take a private equity infusion, and eventually go public."

During the following year, Oswal and Agrawal began expanding the business. "We'd had four years of great performance," said Agrawal. "The market was growing across the board. A lot of things came together at the same time."

MOFSL added several new lines of business in 2006, including an investment banking operation and a private equity fund. Said Oswal:

> I wanted to create a machine to raise capital within and outside of India to fund Indian companies. Starting in 2003, we'd been looking for a business manager for an investment banking group. We needed someone who was very smart and experienced because we'd never done investment banking; all we'd be able to do was make introductions. We talked with the guy who led the effort at Rabobank, and he came to us and brought his whole team with him. We created a company around them (Motilal Oswal Investment Advisors Private Limited) and gave them 25% equity in it.

Both the investment banking division and the private equity fund reflected the desire to reduce the company's dependence on cyclical transaction-based brokerage fees. MOFSL already offered two PMS options for high-net-worth clients as a way to increase its fee stream. Said Oswal, "The private equity fund was another way we could build the fee-based business. Rabo's senior relationship manager—this was a different part of Rabo, you understand—joined us to run our private equity operations. He's a chartered accountant and very good at building and maintaining relationships." As of December 2006, MOFSL had raised $40 million toward its $100 million goal and was hoping to complete six deals before the final close.

The company had also acquired three smaller brokerages in the south and one in the north of India, extending its market reach and brand recognition and increasing its share of the retail market. These acquisitions, and the arrival of international financial institutions, had made the executives aware of the need for some powerful friends.

Selling a Bit

"We started looking at taking private equity for a couple of reasons," said Agrawal. "Certainly we wanted the cash to enhance our balance sheet and to make acquisitions. But it was actually an intermediate step toward going public."

Oswal agreed:

> We anticipated that the market would rise, so there was less risk in delaying an IPO to do the private equity investment first. We expect the market to be more active in the next 15 years and we want to create something that outlasts us. The ongoing market perception of stability and endurance is very important to the longevity of a firm like ours. And we're aware that the best way to change generations of leadership smoothly is through the stock market—the best arbiter of value is the market. Otherwise, it's very difficult to determine your value. Getting the PE investment allowed us to get an outside valuation.

"Moreover," said Agrawal, "with international investors, we attained a global character. It showed that someone had done due diligence on us. We had access to their expertise and their network, and it increased our own confidence."

Five private equity firms were interested in the deal, in which the company offered 9.3% of its equity at a premoney valuation of $277 million (see **Exhibits 6a** and **6b** for MOFSL's financials, and **Exhibit 7** for projections). The eventual investors were Bessemer Venture Partners, a global investment group with a top tier U.S.-based VC practice that had recently begun investing in India, and New Vernon Capital, a hedge fund with $1.2 billion under management targeted for India. Bessemer purchased 2.6% of the company; New Vernon held 6.7%.[57] A New Vernon investor went on the MOFSL board.

Oswal said:

> We chose New Vernon and Bessemer for a couple of reasons. They knew our business well and one of the New Vernon team members is someone we've known well for a long time. We knew they would critically appraise our business and help us improve. Some of the New Vernon partners had experience with Merrill Lynch and broad international knowledge of the markets. And lastly—but maybe most importantly—they were looking at the Indian market for the long term. We've been here for the long term and we intend to be here long-term, and it was important that our time frame lined up with that of our investors.

Bessemer also accessed the expertise of Managing Partner Rob Stavis, whose 15-year career at Salomon Brothers had included experience as co-head of global arbitrage, along with membership on the firm's operating and risk management committees. Observed Bessemer Managing Partner Rob Chandra, "Rob's experience assured us of the underlying fundamentals, and his network meant we would be able to make important introductions for MOFSL. As an operation, MOFSL fits into our India roadmap of backing profitable industry leaders with proven execution skills, aligned with a major growth driver, which in this case was the growing consumer class." Bessemer had done extensive due diligence on the company, Chandra explained:

> We met with the entire management team, visited their branches and franchisees, reviewed their internal processes, accessed their research and met several of their customers, in addition to commissioning auditors and lawyers to go through their books. Our findings confirmed the view that MOFSL is a clean, well-run operation with an extremely strong management team and research product.

To reconcile the different investing styles of the two private equity firms, the deal had one unusual term. If MOFSL did not go public within five years, the investors could put their stock back to the company at a stated minimum internal rate of return. Chandra noted, "Our biggest concern is investing in a cyclical market at full-price. This company is very sensitive to any slowdown in India's growth, and market conditions will definitely affect our exit valuation and timing. We're a venture firm and we look for venture returns. The return on the put is definitely not something we want. We look to maximize our upside, not minimize the losses."

Selling a Bit More

Part of the challenge of an IPO, everyone agreed, was the timing, in terms of both the market and the company's growth. Chandra explained:

> Smaller public companies in India are undervalued. There are a huge number of companies on the Indian markets with capitalization under $100 million, and their multiple is roughly eight times earnings. Companies with capitalizations above $100 million trade at a significantly higher multiple. There can be a real benefit to going public with a larger revenue base, in terms of research attention. The FIIs are another part of this—larger companies have larger floats and can absorb the minimum efficient purchase from FIIs. (See **Exhibit 8** for market caps and multiples.)

"For us to compete for business from the FIIs and especially the big mutual funds, we need the visibility of going public," said Agrawal. "They choose brokers based on research – at which we lead the field – but also on the strength of their balance sheets, and going public would be terrific for that. In addition, the deals in India are getting bigger, and if we want to be part of them, we need a stronger balance sheet."

Oswal agreed. "Not only that, but it's a big signal to the employees. Some have been with us for a long time and it's great to be an employee owner but when is it really worth anything? Going public will make us more visible to current and prospective employees and allow us to reward our long-term staff." MOFSL's staff turnover fell in the range for financial services in India, between 25% and 30% per year.

A number of MOFSL's competitors had gone public in the past several years, including IndiaBulls in later 2004 and Investmart in mid-2005. While IndiaBulls' share price had risen steadily since its debut, Investsmart's stock price had followed a rollercoaster path and in November 2006, still lagged its peak although it was trading above its opening price (see **Exhibit 9** for share prices and **Exhibit 10** for financials).

They also knew that publicly traded stock would serve as a currency for acquisitions, allowing MOFSL to continue to roll up small brokerages throughout the country. Oswal and Agrawal did not consider listing anywhere but in India. "We're known in India. We have no presence anywhere else. We're an Indian institution," said Oswal. "And the compliance costs of listing in the U.S. are prohibitive."

Timing the market was another challenge, but Oswal and Agrawal were sanguine about the Indian market's long term prospects. "People are getting nervous because they remember the booms and busts of the past," said Agrawal:

> But this is different. The economy is really doing well. Corporate profits are real. The underlying ground for investment in India is solid. It's ironic, though, because we are worried even though corporate profits are 5% of GDP and the price multiple is 20x. During the dot-com boom, it was 35x. But Indian corporates are competing with the best in the world. It's not just a local guy who can make a lucky bet and win. Indian firms have to compete with international operations, and they're doing so successfully. It's more secular growth than cyclical – and of course we say that, and then people get irrational. Basically what's happened is that the earlier IT boom created a bridge for capital to enter the country in terms of global companies investing in their own operations. But now bankers want to give money to India. It's become broad-based.

Oswal and Agrawal expected to sell about 10% of the company's equity, the minimum allowed by the government. BVP's Chandra said, "We have to wonder what sort of float this will allow. The investors have 9% and the employees have 13%—that's a lot of supply trying to sell into a fairly shallow float."

Bessemer and New Vernon faced another challenge. The May 2006 changes to the DIP guidelines would lock up the two investors' positions for the coming year if they had held the stock for less than a year before the paperwork was filed (note that this was not the company's actual IPO date but often preceded it by several months). The investment into MOFSL had closed in April 2006 and the company was not sure when it would file the paperwork. "Maybe the market will keep going up," said Chandra. "And maybe it won't. It would be great to have the position liquid, though."

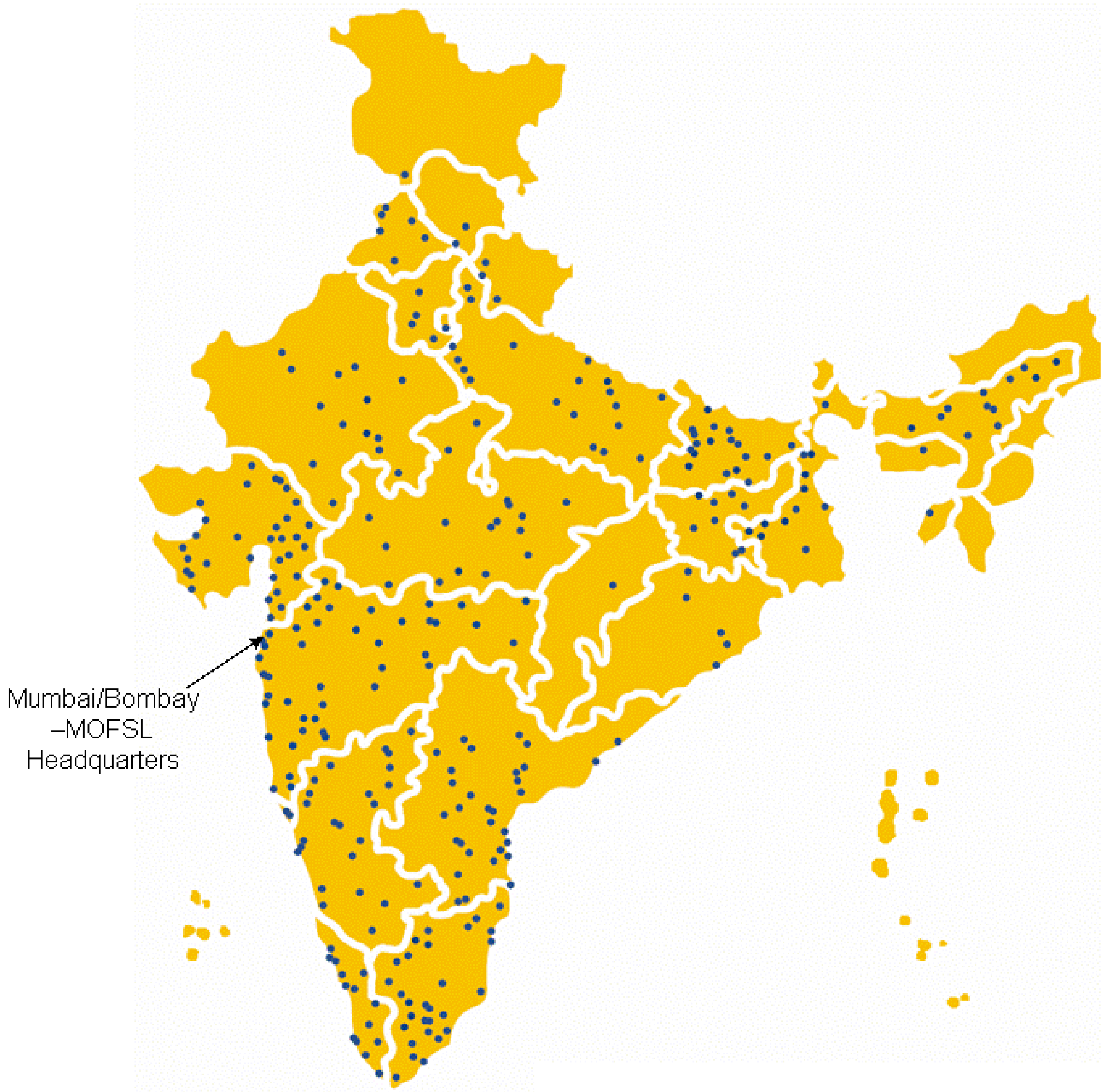
Getting Ready

As Oswal and Agrawal waited for the leisurely elevator at the end of the day, they shared a recollection. Oswal said, "Do you remember back when we started, and it took 28 days to clear trades? We did it all on paper—100 trades per day."

"The stock market is the only piece of infrastructure in India that really works," said Agrawal. "Now we do 250,000 trades a day at T+1. And the back office is still 200 people. India's markets are as safe as anywhere else in the world."

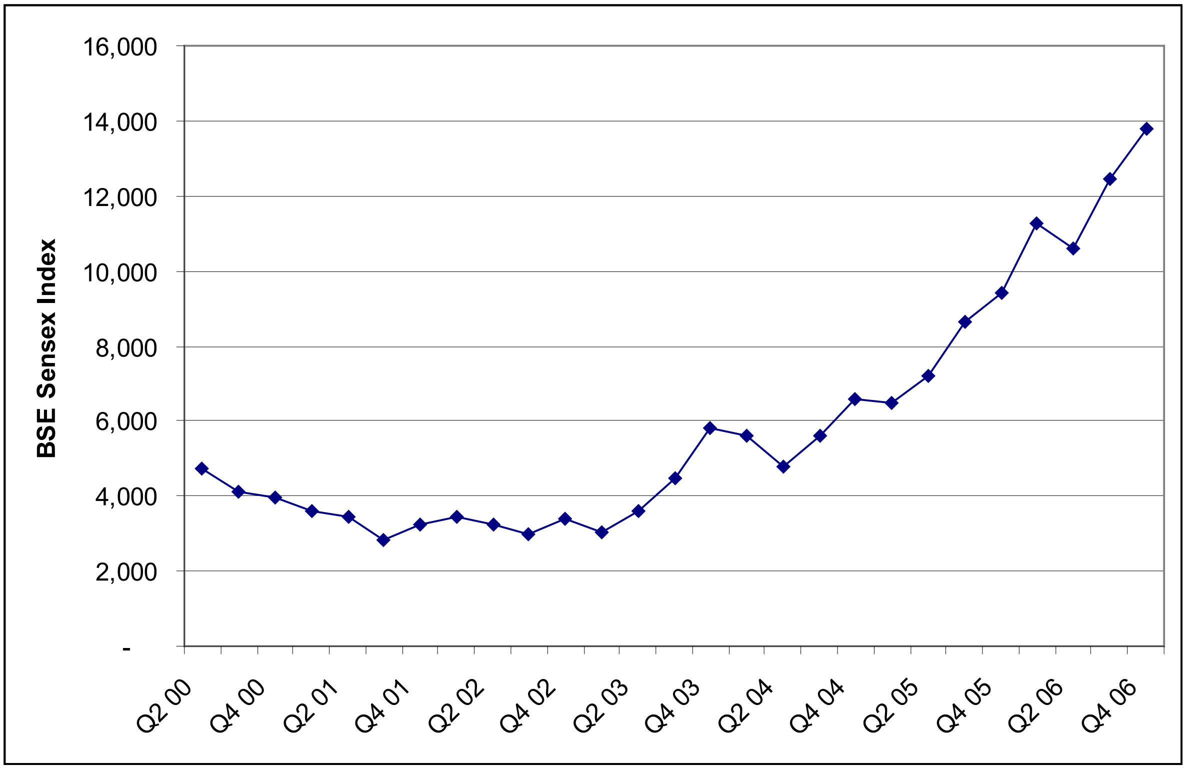
They wondered whether the markets would welcome the debut of their company, and whether they ought to wait until a few more acquisitions had been completed and the rising market had lifted their valuation a bit higher. The founders of the firm whose tagline was "Solid Research – Solid Advice" hoped that their research was pointing them in the right direction.

Exhibit 1 Map of India with MOFSL Offices



Source: Company information.

Exhibit 2 Bombay Stock Exchange Sensex Index: Quarterly Close Since 2000



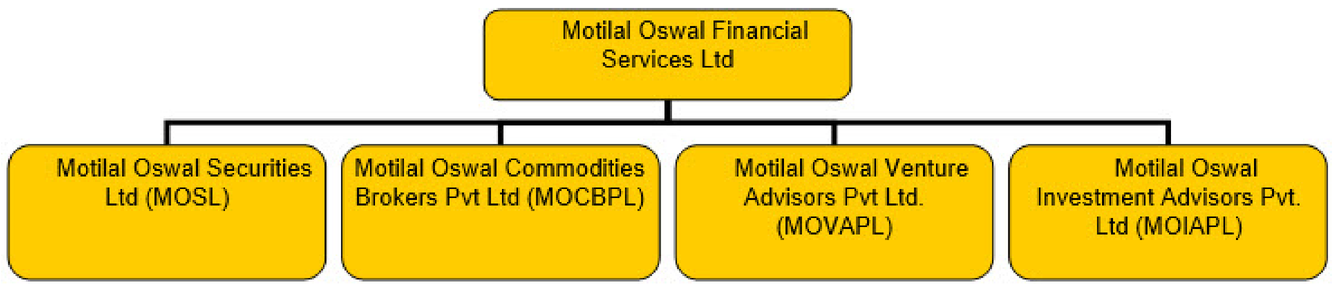
Source: Thomson Datastream.

Exhibit 3 Shares of Top Brokers, 2001 – 2005 (in percent)

Year	Share of top:	5	10	25	50	100
2001-02		7	12	24	36	53
2002-03		10	16	29	42	59
2003-04		12	17	30	44	61
2004-05		15	22	37	50	66
2005-06		15	23	38	53	68
December 2006		16	26	44	58	72

Source: NSEIndia.com, in company information.

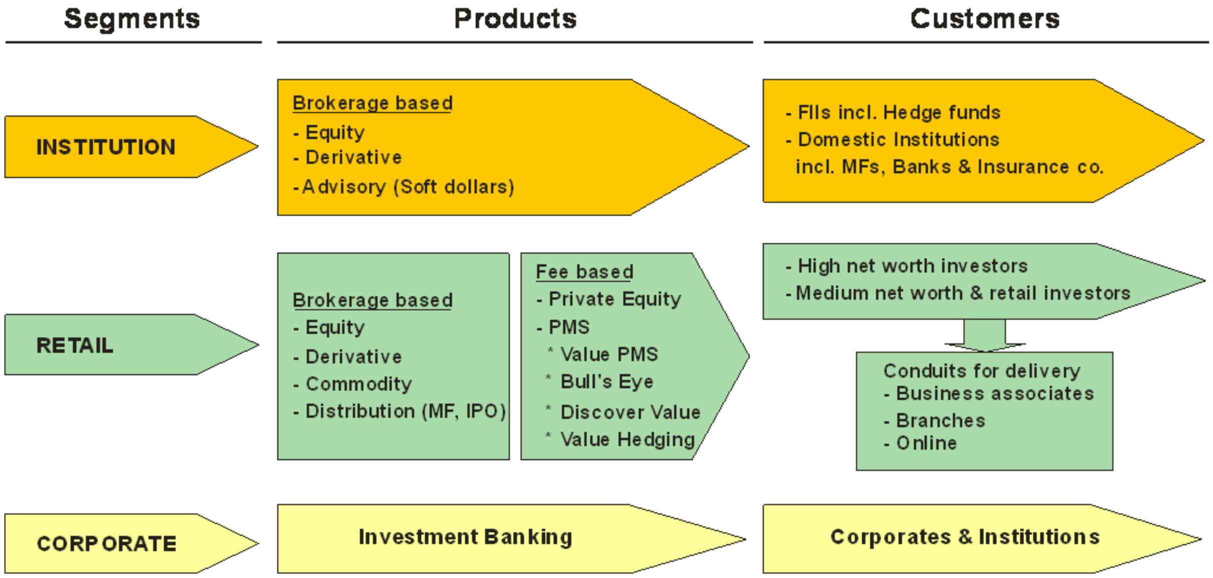
Exhibit 4 MOFSL Structure and Business Lines



Shareholding Pattern	MOFSL-99.95%, Promoters-0.05%	MOFSL- 97.55%, Mr. Oswal & Family-2.45%	MOFSL- 100 %	MOFSL-75%, Employees -25%
Date of Inc.	July 1994	March 1991	April 2006	March 2006
Business Line	Stock Broking (Institutional & Retail)	Commodity Broking	Private Equity Investments management and advisory	Investment & Merchant Banking
Gross Revenues (FY- 06) in $ million	61.77	0.52	N.A	N.A
Gross Revenues (9 mon. FY-07) in $ million	56.17	0.84	N.A	2.44

Source: Company information.

Exhibit 5 MOFSL Business Offerings, Details



Source: Company information.

Exhibit 6a MOFSL Operational Metrics

For the year ended	**9 months ended Dec 31 2006**	**31 March 2006**	**31 March 2005**	**31 March 2004**	**31 March 2003**	**CAGR (FY03 - 9 mons. to Dec 31, '06)**
Trading volumes – cash equities ($ million)	23,315	22,768	11,393	6,869	2,228	84%
Market share - cash equities	4.99%	4.21%	3.13%	1.97%	1.15%	48%
Trading volumes – derivatives equities ($ million)	48,721	34,526	10,777	4880	456	242%
Market share - derivatives equities	3.87%	3.16%	1.89%	1.05%	0.50%	73%
Number of depository clients	196,713	156,289	84,059	42,610	11,168	115%
PMS assets under management ($ million)	114	118	41	11	-	131%
Exchange rate (US $, to Indian rupee, average over period)	0.02199	0.02266	0.02233	0.02180	0.0207	

Source: Compiled from company information and exchange rate data from www.oanda.com.

Exhibit 6b MOFSL Operational Metrics through December 2006

in $ million	9M FY07	FY06	FY05	FY04
Total Income	$59.4	$62.3	$28.7	$14.7
Profit after Tax	$11.3	$13.8	$6.4	$3.6

Source: Company information.

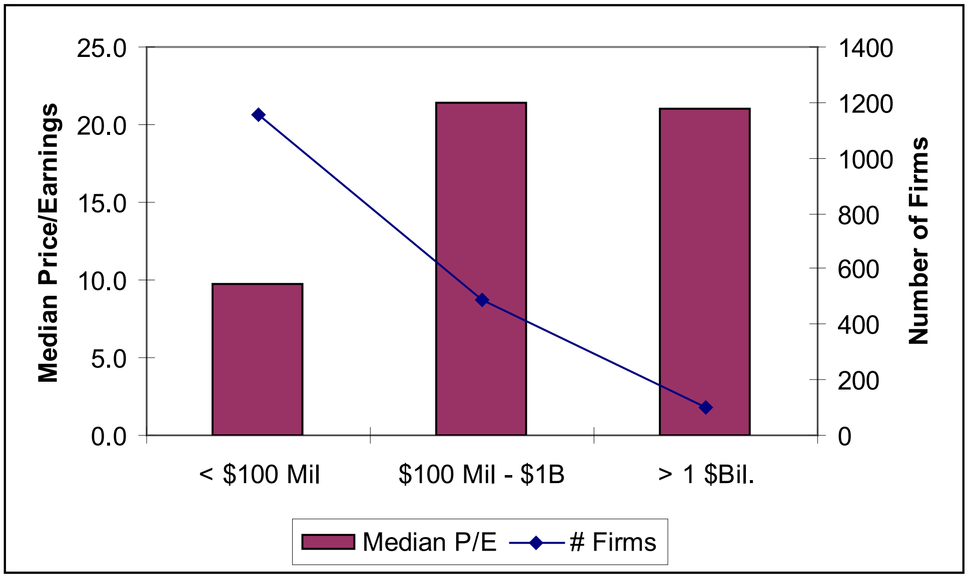
Exhibit 7 MOFSL Projections

	In INR Millions			*In USD Millions*		
year to March 31	**2008 (Est.)**	**2007 (Proj)**	**2006**	**2008 (Est.)**	**2007(Proj)**	**2006**
Revenues	5,325	3,791	2,725	$ 132.27	$ 84.01	$ 61.53
Profit After Tax	1,172	684	610	$ 29.11	$ 15.16	$ 13.77
P/E	19	27	4			
Balance Sheet						
Liabilities						
Equity Capital	142	127	56	$ 3.53	$ 2.81	$ 1.26
Reserves	6,820	3,205	1,052	$ 169.41	$ 71.02	$ 23.75
Net Worth	6,962	3,332	1,108	$ 172.94	$ 73.84	$ 25.02
Loan Funds & Minority Interest	37	30	23	$ 0.92	$ 0.66	$ 0.52
Total	**6,999**	**3,362**	**1,131**	**$ 173.86**	**$ 74.50**	**$ 25.54**
Assets						
Fixed Assets	725	685	519	$ 18.01	$ 15.18	$ 11.72
Investments	1,262	856	79	$ 31.35	$ 18.97	$ 1.78
Current Assets						
- Sundry Debtors	3,743	2,808	1,344	$ 92.98	$ 62.23	$ 30.35
- Cash and Bank Balances	6,511	2,165	1,238	$ 161.73	$ 47.98	$ 27.95
- Loans and Advances	1,742	2,410	1,214	$ 43.27	$ 53.41	$ 27.41
- Others	96	81	30	$ 2.38	$ 1.79	$ 0.68
Current Liabilities						
- Trade Creditors	5,660	4,498	2,611	$ 140.59	$ 99.68	$ 58.96
- Provisions	1,420	1,130	668	$ 35.27	$ 25.04	$ 15.08
Net Current Assets	5,012	1,821	533	$ 124.50	$ 40.35	$ 12.04
Total	**6,999**	**3,362**	**1,131**	**$ 173.86**	**$ 74.50**	**$ 25.54**
Capital Expenditures- income/(expense)	(316)	(305)	(376)	(7.85)	(6.76)	(8.49)
Change in Working Capital – increase/ (decrease)	(1,444)	(864)	197	(35.87)	(19.15)	4.45
Long-term Debt	1,489	5,672	3,316	36.99	125.69	74.88
10-year Gov't Bond Rate	8.011	8.5449	7.8856			
Exchange Rates (USD:INR)	0.02484	0.02216	0.02258			

Source: Adapted from Kunal Shah & Vishal Goyal, "Motilal Oswal Fin. Srvs: Right Time, Right Place," *Edelweis Equity Research*, August 20, 2007, p. 16; exchange rates are annual averages from OANDA.com; additional data from OneSource Business Browser, accessed January 19, 2009.

Please note: Exhibit 7's 2007 data is **projected for the full year**; Exhibit 6b shows actual data for the first nine months of the year.

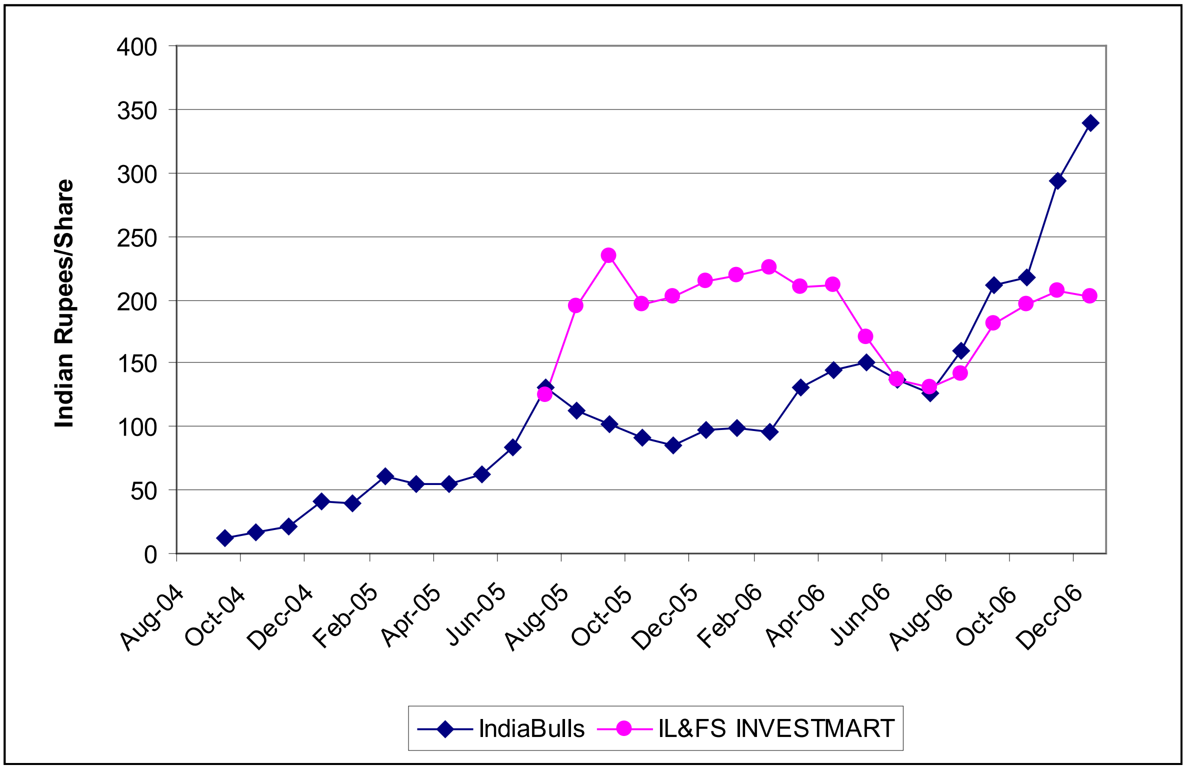
Exhibit 8 Publicly Traded Indian Companies by Market Capitalization, with Median Price-Earnings Multiple, as of 2005



Note: Includes only profitable companies.

Source: Datastream.

Exhibit 9 IndiaBulls and Investsmart Share Price since IPO



Source: Thomson Datastream and casewriter.

Exhibit 10 Financials for IndiaBulls and Investsmart

in $ millions	IndiaBulls				Investsmart		
Fiscal year ending	**First Half - 30-Sept.'06**	**31-Mar-2006**	**31-Mar-2005**	**31-Mar-2004**	**First Half - 30-Sept.'06**	**31-Mar-2006**	**31-Mar-2005**
Total Revenue	**106.9**	**138.7**	**37.5**	**15.7**	**25.6**	**50.7**	**27.6**
Cost of Revenue, Total	8.2	12.4	4.9	2.6	2.6	5.5	2.2
Gross Profit	**98.7**	**126.3**	**32.6**	**13.1**	**23.0**	**43.4**	**23.9**
Selling/General/Administrative Expenses, Total	37.7	33.1	9.1	5.1	12.7	21.1	12.9
Depreciation/Amortization	1.5	1.6	0.5	0.2	0.8	1.1	0.8
Interest Expense (Income), Net Operating	5.5	7.1	3.0	1.0	0.1	0.4	0.8
Total Operating Expense	44.7	54.2	17.5	8.9	13.6	28.1	16.7
Operating Income	**54.1**	**84.4**	**20.1**	**6.7**	**9.4**	**22.6**	**10.9**
Income Before Tax	54.1	84.4	20.1	6.7	9.4	22.6	10.9
Income Tax - Total	16.7	27.1	7.4	2.5	3.3	7.1	3.5
Income After Tax	37.4	57.3	12.6	4.2	6.1	15.5	7.4
Minority Interest	0.0	(3.6)	(0.2)	0.0	0.0	0.0	0.0
Net Income Before Extra. Items	37.4	53.7	12.5	4.2	6.1	15.5	7.4
Preferred Dividends		(0.1)	(1.4)	(0.2)			
Net Income	**37.4**	**53.6**	**11.1**	**4.0**	**6.1**	**15.5**	**7.4**
Capital Expenditures-income/(expense)		(9.8)	(2.1)	(0.8)		(2.2)	(1.1)
Change in Working Capital – increase/ (decrease)		(50.7)	(122.5)	(22.9)		(30.0)	(8.2)
Long-term Debt		68.0	113.5	28.0		0.3	5.2
Market Cap as of Sept. 30, 2006	1,446.6				279.3		
Shares Outstanding (millions)		160.2	133.2	81.6		66.9	35.0
Beta (as of Sept. 30, 2006)	1.7				0.72		

Source: Data provided by OneSource® Business Browser℠, an online business information product of OneSource Information Services, Inc. ("OneSource"). Market capitalization and Beta from Datastream.

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