Z3Partners founder Gautam Patel on tapping dometic LPs, fintech 2.0, and exits

Mumbai based Z3Partners, a venture capital firm focused on digital and technology investments, marked its first close of its debut fund at $14 million (about Rs 103 crore) earlier this month. The vehicle seeks to raise a total of $100 million (around Rs 730 crore) by September this year.

Z3Partners was founded last year by Gautam Patel, who previously co-founded early stage technology investment firm Zodius Capital, which was acquired by Mumbai based financial services firm Avendus Capital in 2017. Prior to Zodius, Patel spent several years at Battery Ventures.

In an interview with VCCircle, Patel said that the debut fund will continue to raise capital from Indian investors or limited partners, an experience that he is carrying forward from his experience with fundraising at Zodius, which had backed startups such as Bigbasket and Pepperfry. He also spoke about the firm's exit strategy and broad investment thesis.

Edited excerpts:

What was your experience raising the fund in the midst of the pandemic?

I strongly believe that India is a great investment destination. And thanks to what happened in the pandemic with leading technology companies and large US funds investing in Reliance Jio, that defines both commerce and content. With legitimate global money coming into the digital and technology sector, this kind of puts India on the map next to China.

Effectively, with this and the $150 billion market in ecommerce in the next five years, 600 million smartphone users including the 100 million from Bharat, this is a destination that is booming with opportunities.

India is all about the 95:5 rule. At Z3Partners, we focus on the top 5% LPs (limited partners), 5% entrepreneurs, top 5% market leading companies and so on.

The reality is that fundraising does happen when you get on a plane. Fortunately for us, because of our prior track record and relationships with family offices as well as making investments in sectors like cybersecurity, Cyfirma, prior to the pandemic, and the tailwinds around cybersecurity, all that came together to give us a good first close of the fund. If you get into the right investment opportunities then capital starts flowing into your hands regardless of market situations.

So, the experience with Zodius and Battery Ventures eased the fundraising for Z3Partners?

It was relatively easier, but more importantly we were positively surprised that we were getting access to proprietary deal flow during the pandemic.

For example, DealShare was a company highly vouched for and with an established player like Westbridge Capital coming in and with existing marquee investors like Falcon Edge and Matrix Partners, it was a difficult deal to get into. But because of my prior relationships with Westbridge, Falcon Edge and Matrix, Z3Partners got an entry into it. Two of the three investors in DealShare are co-investors in my Zodius portfolio.

You get good deals on the basis of your reputation, investment track record and who is on the cap table. Similarly, with Cyfirma there was Goldman and Zodius as investors. Despite having two to three term sheets and an all cash offer Cyfirma still selected Z3Partners.

Give us a sense of the domestic and global LPs in the fund.

When I was fundraising for Zodius, some of the family offices in the US used to tell me that they were hearing about all the wealth creation happening in India. They would ask me -- “so why are you coming to the US to raise capital?” I went back to our Zodius partnership and shared this and that is when we partnered with Kotak Wealth and raised almost half of our fund at Zodius in rupee capital.

For Z3Partners too, we are going to continue to raise more money from Indian HNIs and family offices. We are also getting very good interest from Indian institutions. On the other hand, global institutions begin to show interest only once you are an AUM of $150 million or higher. Now, Indian government institutions, banks and insurance companies are waking up and saying that we need to back this team because of its previous track record. Similar to the US where local private equity fund managers get money from local institutions.

Do you expect to raise the entire corpus from Indian investors?

We won't go to global institutions but we will go to global family offices because we have an aggressive co-investment opportunity for family offices. We've had co-investment through Zodius and we are offering it through Z3Partners.

.**What investment themes will you chase actively this year?**

We have been an investment thesis led investor and we will continue to do that with Z3Partners. What we do is we carve out an investment thesis around sectors and then we go out and find the top 10 companies that fit around those thesis. After we meet the top 10 companies in the sector, we zone in on the top two market leaders. For instance, when we invested in OfBusiness from Zodius, there were IndustryBuying and Power2SME. What we liked about OfBusiness is that they did B2B commerce and lending. When we invested in Bigbasket, there was Grofers and Peppertap but we went after Bigbasket because our investment thesis said that you can build a marketplace, but you also need to build private labels because the margins in the marketplace in grocery are not high enough over the long term for this business to break-even.

And when we had looked at the furniture space, we thought the market was too small in 2015 to take a private label approach like UrbanLadder. We believed you had to take a marketplace approach plus a private label approach and that is why we chose Pepperfry. Effectively that is how we have chosen these sectors. They have to be large addressable markets, high margin businesses and entrepreneurs who have prior execution experience. I have nothing against a 22-year old coming out of IIT, but to navigate a business to scale in India it is important to have prior execution experience. We invest in early growth which means we invest in companies that have been around for three to five years and a company that does Rs 3-5 crore revenue per month.

What stage will you focus on mainly?

We don't get pedantic about the Series but we usually end up investing at later Series A or early Series B. We write an initial cheque of $3-5 million and it goes up to $10-12 million with our co-investment.

Fintech has been attracting a slew of investments in the past years? What areas do you think are yet to be tapped in this sector?

Our investment thesis around fintech is that most of the companies we see around in India are not fintech but techfin. They understand technology but they don't understand financial services and lending. For example, lending in our country is very challenging because it is under-penetrated and we have not as a country gotten our head around credit scoring across segments. How do you credit score a 25 year-old differently from a 30 year-old or a 45-year old, and how do you correctly credit score a SME.

But in the 2.0 of fintech, we are seeing companies that understand financial services, wealth management, lending and risk assessment/analytics. So we are very bullish on fintech infrastructure meaning digital EMI, electronic payments, etc. Also, thanks to our highly dependable and scalable Indian technology infrastructure like UPI, the adoption is massive. With this government technology infrastructure we have the ability to build good fintech companies in India. The opportunity for fintech is to take all the balance sheet strength of the large banks and provide digital infra and UI/UX to bring it to the consumer.

Agritech has also shot to the limelight with reforms initiated by the government, although it has seen some backlash from farmers. What's your view on the sector?

I think there is a progression towards getting rid of the middlemen and gaining more transparency so money goes directly in the hands of the farmers. So effectively we are getting an opportunity for creating digital infrastructure for agritech. This is important because it creates transparency and efficiency. We kind of pioneered this at BigBasket because we started going directly to farmers to procure their produce. We believe agritech, given where it stands today, is going to be a huge opportunity. The sector is getting strong government support from institutions like SIDBI and NABARD, which is very encouraging.

VCs are said to think about exits at the time of their investment. What's Z3Partners' exit strategy?

We have a fiduciary duty to maximise returns for our LPs. Our view is good companies in India are not bought, they are sold. This means that from day one of investing in our companies, every time I go abroad I spend half my time fundraising and the balance half meeting potential buyers showcasing our investee companies; we subsequently continue to update them on a quarterly basis. For example, in the last five years I have met Wayfair (an online furniture company in the US) three to four times. The idea was to give Wayfair an idea about a company in India as they could be a natural eventual buyer. However, having said that Pepperfry is on a strong footing to IPO (initial public offering).

Do you see the scope of potential domestic buyers, mainly in the form of Indian corporates, increasing?

Our thesis is to invest in companies with post money valuations of less than $50 million. If you invest in companies at $150-$200 million valuations then to get to a 5X or a $1 billion exit we believe there are 5-10 potential buyers globally for Indian technology and digital companies valued at $1 billion or higher. These buyers include Amazon, Google, Microsoft, Facebook and financial buyout firms. You can't bank a fund on these high exit outcomes consistently. But if you come in at sub-$50 million you have a significantly higher probability of achieving a 10X exit opportunity for the fund.

In addition, typically, Indian corporations are willing to buy technology and digital assets at $250 million up to $500 million, but if valuations run up to $1 billion they will say, "we will build it ourselves".

So it is very important to come in at sub $50 million and build it to $500 million to $1 billion so you will have more options to get an exit at 10X. But yes, Indian corporates are warming up to buying assets in India but they are not buying at north of $1 billion.

Several early stage VCs have started talking confidently about exits via IPO. What is your view?

The gestation for early stages businesses to IPO is much longer than the tenure of most funds. That is why we focus on early growth investing. If you are coming into a business early you have to be pretty lucky to get an IPO in 10 years because the Indian market is fairly inefficient -- it takes a while to build scale and get to profitability. However, today compared to 20 years ago, the opportunity to exit at an IPO is significantly higher. Over the next 10 years you will see more digital and technology companies going for IPOs. However, building on the 95:5 rule, in India, only the top one or two technology and digital companies in each sector will go public, while in the US you see the top 25 companies, say in SaaS or ecommerce, going IPO.

In financial services, however, in India, you will see a bunch of IPOs because of the RBI’s stringent regulation and good monitoring that has led to the emergence of high quality financial services and fintech assets.

Are you also bullish on secondary exits?

Yes, there are three to four types of exits -- IPO, foreign strategic sale, domestic strategic sale and the fourth category is sale to buyout shops i.e. the large local and global PE/VC firms. I do think that they are warming up to buying/investing in good quality sustainable digital companies in India.

What is your take on valuations in the market today?

You get in high and you are going to be on the back foot for the rest of the five years. But if you have a disciplined approach in terms of investment thesis led investing and have the ability to say no, then there is money to be made in India. Having said that, venture investing is a cyclical business. If you got into a company in 2015, you had to overpay, but if you got into a company in 2016, then you got a significantly better valuation. So my advice to the industry is to stay patient and wait for the right valuation cycles and then invest.