Private Equity Investment: Growth and Performance

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Private equity investments witnessed a dramatic growth over the last two decades, as investors are increasingly thriving on the growth and potential of funded firms. This paper aims at examining the growth trends in the private equity industry and determining the emerging themes in private equity literature. The study finds that there are gaps in the existing literature with respect to selection determinants and value drivers of private equity investment, and emphasis has been given to investment performance in the private equity space.

Keywords: Private Equity Investment, Venture Capital, Performance, Mergers and Acquisition, Firm Performance

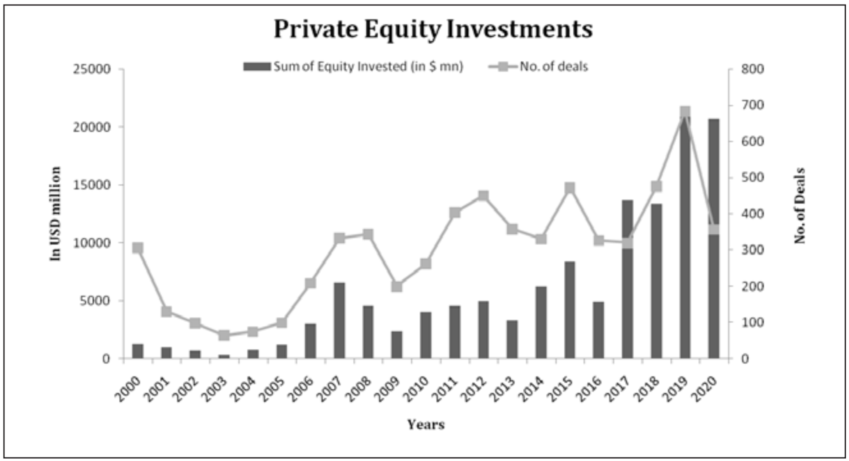
Overview

For decades, private equity firms have provided operational and strategic guidance to their portfolio companies in addition to the financial capital they require. Previous studies document positive effects of private equity on portfolio firms' access to financing (Ivashina and Kovner, 2011), governance (Cumming *et al.*, 2007), and operations (Boucly *et al.*, 2011). The private equity market is imperative in financing start-ups firms, private firms, public firms seeking buyouts and firms in financial distress. Private equity has gradually developed as a source of corporate finance and become the fastest growing market over public equity and public and private bond markets. The private equity market has grown enormously in the last two decades making India an attractive destination of deploying funds for private equity investors. Over the last 20 years, private equity firms have invested more than $127 billion in India. There has been a dramatic growth in the private equity investments over the last two decades, in terms of both the sum of equity invested and the sum of deal value (Figure 1)[1]. The recent investment growth is strong as private equity investments in 2019 recorded the highest level at $22 billion, typically due to increasing number of large deals as well as increase in average deal size. The investment value is about 63 per cent higher than the level recorded in 2018[2].

The growing market paved the way towards improving regulations and enabling pooled investment funds to fall under the ambit of law. In 2012, Securities and Exchange Board of India (Alternative Investment Funds) Regulations were introduced to regulate pooled investment funds in India, such as real estate, private equity and hedge funds. Prior to its introduction, many funds were operating in India that could not be classified as domestic venture capital funds (VCF), foreign

FIGURE 1

SUM OF EQUITY INVESTED AND NO. OF DEALS



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venture capital investors (FVCI) or foreign institutional investors (FII). According to SEBI, Alternative Investment Fund or AIF means any fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors. The Alternative Investment Funds (AIFs) have been categorized into three classes - Category I: These funds receive incentives from the government. These include social venture funds, infrastructure funds, venture capital funds and SME funds; Category II: These include private equity funds, debt funds and fund of funds; Category III: These include funds that make short-term investments and then sell, like hedge funds.

Private equity investments in India primarily fall under Alternate Investment Funds (AIFs) Category II introduced by Security and Exchange Board of India (SEBI). In the last three years, the AIF Category II (consisting real estate funds, private equity funds, funds for distressed assets) investments have witnessed more than five-hold increase. The value of Category II alternative investment funds rose from \$2.5 billion in December 2016 to \$12.9 billion in December 2019, according to the SEBI's quarterly data.

Private Equity Investment Trends

The private equity in India has gained inordinate momentum in the past few years as investors are thriving on the potential of Indian firms to provide substantial returns at the time of exit. The P.E. investments as seen in Figure 2, depicts the quarter-wise increase in the P.E. investments and the subsequent increase in the number of deals for a period starting from January 2018 to June 2020. The scale of investment is rising, as high growth can be seen from 2018 to 2019, while investments till June 2020 have already reached a level almost as high as that 2019.

The total private equity investment analyzed through quarter-on-quarter (QOQ) growth rate shows an upward drift with 64 and 68 per cent increase in Q2 and Q3 of 2018 respectively, and a high growth of 105 per cent in Q1 2019. The last quarter of 2019 however, did witness a drop in the investment by 60 per cent, possibly due to the outbreak of novel coronavirus in China. The investments picked up in Q1 2020 (32%) and took a steep jump in Q2 2020 (320%) as a result of hefty foreign investments in Jio Platforms Ltd. (a subsidiary of Reliance Industries Ltd.). The number of deals have increased significantly over the period of time, adding to the growth in the equity investments (Table 1).

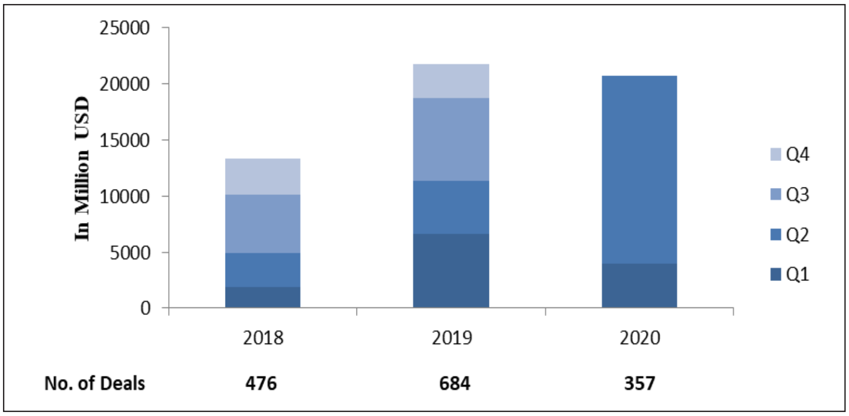
Among the industries which attracted larger investments during 2018-2020, internet specific, computer software, financial services and communications (owing to a huge chunk of investment by Jio Platforms in 2020) gained the maximum equity. Internet specific investments have remained popular throughout, indicative of the surge in the tech industry of India. The financial service is another industry that has been gaining large amounts of investments.

The proportion of equity investments in different industries during 2018-2020, gives a fair view of sectors which have been emphasized on by the investors quarter-wise. This also takes into consideration the period when Covid-19 hit India, i.e., Q1 2020 and

$$\textit{QOQ growth} = \frac{\textit{(Current Quarter's investments – Previous quarter's investment}}{\textit{Previous quarter's investment}}$$

FIGURE 2

QUARTER-WISE PRIVATE EQUITY INVESTMENTS FOR 2018-2020



Q2 2020. In Q2 2020, the communications industry gained most of the market share due to large numbers and volumes of deals made by Jio Platforms Ltd (Figure 3). However there are other industries that have also fetched investments even during the Covid-19 crisis, but the behemoth of Jio investments overshadowed them all. Therefore, let's look at the industry-wise investments excluding investments in communications from the dataset. In Figure 4, we observe that apart from Internet specific and financial service sectors, medical/ health and consumer related companies have also attracted P.E. investments, especially in Q2 2020. The Covid-19 crisis has surged the number of investments in the medical and health companies, as the sector becomes the controlling center of the crisis. The consumer

TABLE 1

QUARTER WISE DISTRIBUTION OF P.E. INVESTMENT AND NUMBER OF DEALS

Year, Quarter	Sum of Equity Invested (US$ mn)	QOQ Growth Rate	No. of Deals
Q1 2018	1885		104
Q2 2018	3071	0.63	122
Q3 2018	5175	0.68	140
Q4 2018	3209	-0.38	110
2018 (4)	**13340**		**476**
Q1 2019	6588	1.05	150
Q2 2019	4708	-0.28	188
Q3 2019	7458	0.58	155
Q4 2019	3004	-0.60	191
2019 (4)	**21759**		**684**
Q1 2020	3978	0.32	189
Q2 2020	16724	3.20	168
2020 (2)	**20702**		**357**
Totals (10)	**55,800**		**1,517**

FIGURE 3

PROPORTIONATE DISTRIBUTION OF QUARTERLY INVESTMENTS AMONG INDUSTRIES

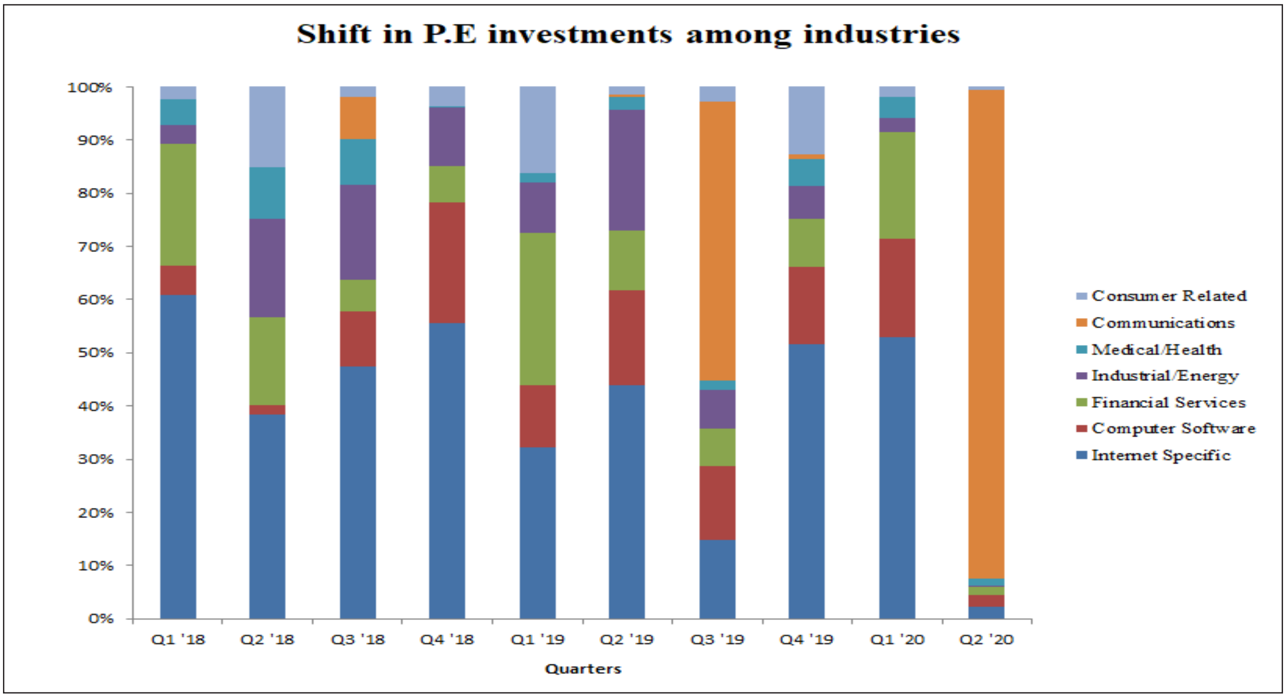
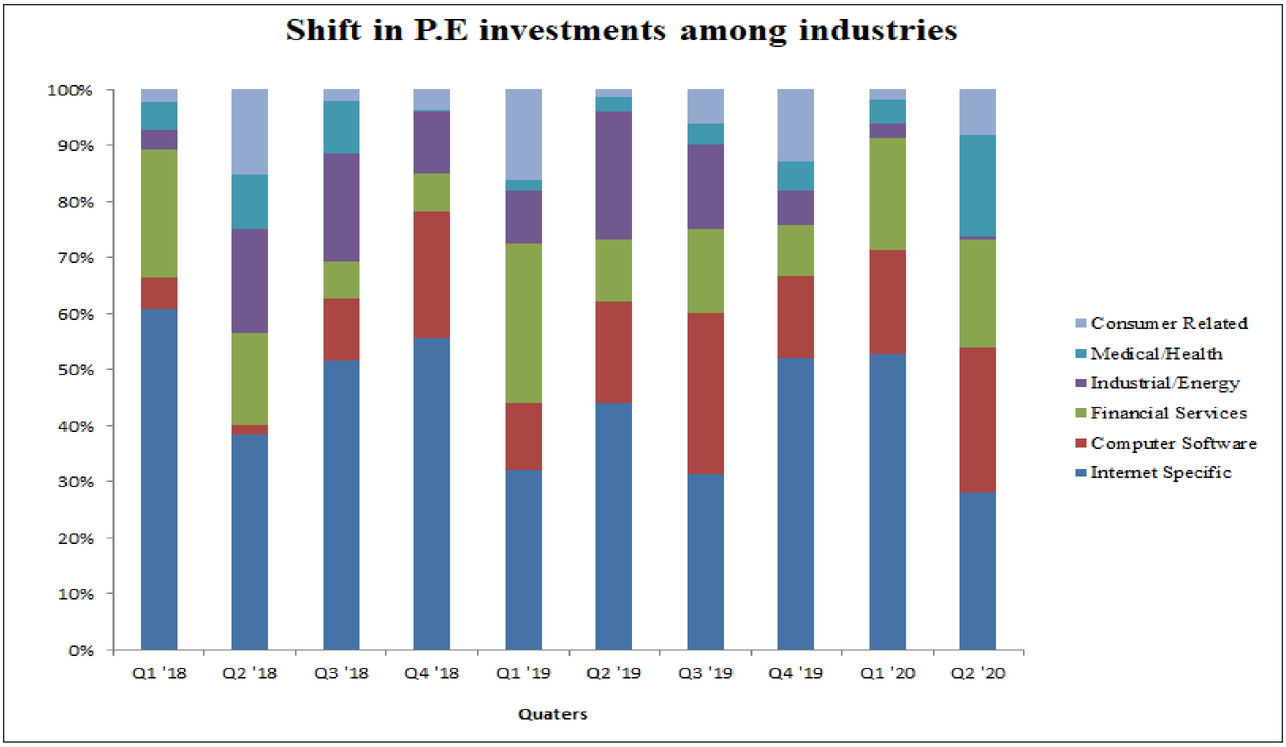


FIGURE 4

PROPORTIONATE DISTRIBUTION OF QUARTERLY INVESTMENTS AMONG INDUSTRIES (EXCL. COMMUNICATION)



related companies also attracted a handful of investments, with a noticeable increase in grocery focused companies amid the Covid-19 situation.

India's position in the private equity investment market has jumped from being the fifth highest in 2018 to second highest in 2020, after the United States. India's share of the private equity deal market increased in 2019, while China's PE market retracted over the last year. Despite its dramatic growth and increased significance in corporate finance, the private equity market has gained little attention. The role of private equity investments in stimulating innovative business models and entrepreneurial spirit cannot be undermined. The steep growth in Indian private equity market in recent years has unraveled the potential of private equity investments.

Private Equity Investment

Private equity is an asset class classified as equity investments in private companies with medium to long-run investment horizons. The theoretical and empirical contributions suggest superiority of private equity as an owner and an asset class (Engel, 2002; Bertoni, 2011), showing enhanced performance (Kalan, 1989; Smith, 1990; Davis, 2008). The ownership changes can shift resources to more efûcient uses and more active managers (Harris et al. 2005) and bring active monitoring and close follow-up actions in the post-PE investment period (Lerner, 1995; and Kaplan and Stromberg, 2004).

Apart from the simple provision of financial resources, private equity firms additionally support the portfolio firms by integrating them with their professional environment. The private equity firms' high reputation, well connected networks and superior access to information influence the IPO rate (Chang, S.J., 2004), financing decisions (Hsu, D.H., 2004; Shane, S. and Cable, D., 2002), and performance of funded firms (Nahata, R., 2008). In India, the private equity market has also been pivotal to the development of the startup ecosystem in India with 80 per cent of all PE investments in India between 2001 and 2013 being in early-stage to mid-size corporations (Pandit, Tamhane, and Kapur, 2015).

The private equity investments have been studied through the lens of various themes largely containing the growth of PE industry (Annamalai and Deshmukh; 2011; Dugar and Pandit, 2017), effect of PE investments on growth, performance and successful exits of PE-backed firms (Peneder M., 2010; Chemmanur *et al.,* 2011; Rosenbusch *et al.,* 2013; Dhankar, R.S., and Malik, K., 2016; Smith T.D., 2018; Bernstein *et al.,* 2019), selection superiority of PE firms (Gompers and Lerner, 2001; Baum and Silverman, 2004; Colombo and Grilli, 2010; Bertoni, D'Adda and Grilli, 2019), value creation ability (Croce, Martí, and Murtinu, 2013; Humphery Jenner *et al*., 2017), and drivers of PE investments (Achleitner *et al.,* 2010; Kelly, 2012; Valkama *et al*,. 2013; Oberli, 2014; Ndlwana and Botha, 2018; Neerza, N. and Tripathi, V., 2019).

Under the purview of these themes, a large focus has been made on the performance of PE investments and their successful exit providing an assessment post investment. However, it is also imperative to understand what drives the PE investments with regards to firm performance and which characteristics influence their choice of investment.

Determinants of PE Investments

The related literature on determinants of PE investments is broadly divided by macro-level and firm-level determinants, with high inclination towards macroeconomic drivers and its impact. There is expanding body of literature which focuses on evaluating the macroeconomic determinants of PE investments globally. Initially, Black and Gilson (1998) observed the relation between active stock market and presence of strong VC industry in the US. They concluded that a developed stock market provides a potential IPO exit strategy for VC investors. Gompers and Lerner (1998) studied the market-wide and firm-specific determinants of fundraising for the VC industry in the US during 1972–1994 and claimed VC-backed IPOs to be insignificant supply-side factor in affecting commitments to VC funds. They also found that VC activity increases with higher GDP growth and lower capital gains tax rates. Schertler (2003) examined VC activity across 14 Western European countries during 1988-2000 and reported stock market capitalization, number of listed companies, number of employees in R&D field, number of patents and labour market rigidities as significant drivers of VC investment.

Bernoth and Colavecchio (2010) conducted a comparative study on the macroeconomic determinants of PE investments for 14 Western countries and three CEE countries spanning from 2001 to 2008. They examined that the size of commercial bank lending relative to GDP and the size of equity market capitalization has a positive impact on PE investments with a stronger effect in CEE countries. The short-term interest rate does not significantly affect PE investment, while lower the corporate tax rate is, more will be the flow of PE particularly for the Eastern countries. Kelly (2012) assessed various drivers of PE activity across 17 European countries and compared them with those of VC activities over a span of five years. Controlling for cyclical factors like GDP, inflation, stock market, unemployment and so on, the study examined the impact of structural drivers on PE activity. He concluded that depth and liquidity of capital market, entrepreneurial environment, labor market conditions and tax and legal environment determine the total investment activity.

The macroeconomic determinants are the external variants influencing the private equity investment activity such as GDP growth, industry growth, legal environment, inflation and unemployment. These determinants largely depends on factors neither in control of private equity firms nor the investee companies, and vary distinctively from one country to another. The firm-specific determinants, conversely are not external to the operations of private equity firms and their investee companies. These are characteristics that a target company need to possess in order to get acquired by a private equity investor. Therefore, the study focuses on firm-specific determinants of private equity investment.

Most existing literature address the closely related question of value drivers, that is, the driving factors that create value in the PE investee firms. These value drivers can also be characterized as important selection determinants for PE investors, as the ultimate aim remains value creation through the selected investee firms. Pindur (2007) concludes the growth of earnings before interest, tax, depreciation, and amortization (EBITDA) as the main driver of value for PE investments over the life of the investment, this suggests that a low EBITDA might be considered a selection determinant. Loos (2004) shows that deleveraging and multiple effects contributes to over 80 per cent of the internal rate of return generated. Haarmeyer (2008) observes operational performance, leverage increase, and interest coverage as the main contributors to the success of private equity funds, where companies with relatively low ratios might be suitable targets for PE companies.

Acharya *et al*. (2009) identifies the selection pattern for PE targets in Western Europe, and provides evidence for stable operating performance and nonlinear profitability (EBITDA margin) in companies acquired by PE firms. Chapple *et al*. (2010) and Osborne *et al*. (2012) conduct relative studies for determining firm-specific factors in selecting among PE targets and corporate targets. Chapple *et al*. (2010) emphasizes that private equity targets have relatively greater financial slack and financial stability along with greater free cash flow, and a lower measurable growth prospects. While Osborne *et al*. (2012) examines higher market to book ratio, greater abnormal operating income, firm size and lower stock volatility as significant internal drivers for attracting PE investment relative to tender/merger targets. They iterate that firm-specific factors are more important in selecting targets than country-specific factors. While Rath and Rashid (2016) analyses PE targets against public mergers and finds market undervaluation as a dominant factor in private equity takeovers.

Private Equity and Firm Performance

It has been frequently proposed in the literature that private equity and venture capital firms have played a significant role in increasing the performance of funded firms (Rosenbusch, N., Brinckmann, J., and Müller, V., 2013; Bertoni, Colombo and Grilli, 2011). The profitability of a firm is influenced by the capability of private equity investors to capitalize on the management and reduce hazardous behavior and agency costs between multiple entrepreneurs (Arthurs & Busenitz, 2003). The involvement of PE can also increase the earning quality of the portfolio firms as suggested in Beuselinck C. *et al*. (2009) PE involvement increases a firm's willingness to recognize losses more timely as compared to industry, size and life-cycle matched non-PE backed firms.

For young and innovative start-up firms thriving for growth, financial performance measures should not be considered for measuring the performance. The positive performance effects of PE and VC investment are associated with firm growth, leaving profitability unaffected (Rosenbusch *et al.* 2013). Research argues that growth and productivity can also be seen as organizational performance measures for start-ups funded by private equity (Chemmanur *et al*., 2011 and Croce, Martí, and Murtinu, 2013). Through monitoring and consulting aimed at early detection of need for managerial support, and operational and strategic weakness, private equity thereby provides resources to eliminate them. Selecting startups with a potential for high growth are preferred as firms with higher sales are more likely to go public than being acquired. In this context, Chemmanur *et al.* (2011) find that a VC increases growth by 18.5 per cent compared to similar firms that had not received VC financing, and Puri and Zarutskie (2012) observe that VC-funded firms are able to achieve higher and faster growth in revenue compared to their non-VC-funded counterparts. However, Belden, Keeley, and Knapp (2001) pose that these higher growth rates of VC-funded firms vanish after an IPO. Lohwasser, T.S. (2020) suggests a broader view observing that venture capitalists are able to add value by increasing the profitability, productivity, and growth of their portfolio firms through active on-site involvement and monitoring.

The existing literature debates to determine whether private equity investors only possess superior scouting capabilities or whether they can also provide additional value beyond the simple endowment of financial resources. One section of research claims PE investors possess selection superiority which therefore results in outperformance of PE backed firms (Gompers and Lerner, 2001; Baum and Silverman, 2004; Colombo and Grilli, 2010; Bertoni, D'Adda and Grilli, 2019). While the other section argue that it is the monitoring and value creation ability of PE investors that PE backed firms perform significantly better than their matched peers (Peneder, 2010; Rosenbusch *et al*., 2013; Croce, Martí and Murtinu, 2013; Humphery Jenner *et al.,* 2017; Lohwasser, 2020). Some studies have also observed that the positive performance effect of PE investors is compromised or vanished when controlled for industry selection effects, suggesting a selectivity bias for specific industries (Rosenbusch *et al*., 2013; Lohwasser, 2020). The relationship between private equity involvement and backed firm's performance is at a nascent stage with inconclusive results, indicating the need for extensive research on PE- performance effect. It also observes that the performance effects are reduced when the funded firms are very young or very mature. The literature has widely focused on the performance of funded firms, taking into consideration the selection and monitoring ability of private equity investor.

Conclusion

The private equity industry in India has been showing great signs of growth, 2019 was a record year for the highest PE investments with investment value over 63 per cent higher than that recorded in 2018. In 2020, it is expected to increase even further, despite the adversities of the Covid-19 pandemic. The PE industry has relatively developed in India over the last 5 years and demands the attention of academic research towards its presence and performance. There is limited literature which studies PE investments and its determinants specifically the internal factors, the determinants at firm level. Due to limitation of data availability and information asymmetry, research has focused on the firm specific determinants of private equity investment inadequately. Most of the related studies have taken place in western countries which have highly developed markets and formal institutions. Considering that a country's financial market and formal institutions largely affects both investment and firm performance, studying the PE investments and firm performance in an emerging country will provide a fresh perspective to this domain.

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