Venture Capital and Private Equity Funds – Prospects & Challenges

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Banks and corporations have for a long time invested in the equity of private companies in order to gain financial and strategic benefits for their businesses. Over the last few decades; endowment, foundations, and pension funds have allocated a proportion of their assets to private equity, primarily through fund managers managing venture capital, leveraged buyout and distressed asset funds.

Returns enjoyed by the early players have encouraged large inflows of capital, and subsequent growth in the size and depth of the funds management industry specializing in private equity investments.

Private markets comprise an important part of the financial system, acting as a redeeming bridge between the sources of funds, and the private companies seeking risk capital. Private equity is a growing proportion of private capital markets, although its relative size is most noticeable in the developed Western economies.

The sources of capital for private equity can be classified into 3 basic entities, and which can be described as driven by the motivation and investment behaviour of the funding institution. Some institutions seek to invest in private equity in order to improve absolute returns of their investment portfolios. These investors tend to be relatively sophisticated, long term, and committed to their investment programs. However, private equity is also sourced from nonfinancial institutions, which can have broader motivations associated with strategic (banks, corporations) and public policy (government) goals.

The key motivations to invest into private equity for three types of investors – institutional investors, banks and governments; are as follows:

1. **Institutional investors** are professionally operated organizations with the mandate to invest capital on behalf of beneficiaries. Their primary motivation to invest in private equity is to improve the absolute returns to their asset portfolios. These investors are typically pension funds, endowments, life insurance companies, and specialist intermediaries such as fund-of-funds. Institutional investors prefer investing through private equity partnerships with specialist private equity firms and often tend to build private equity programs over multiple years. The amount of capital allocated to private equity is determined with reference to asset allocation and portfolio liability modelling.

   Over time, Institutional investors have been a major source of capital for private equity.

2. **Banks, nonbank financial institutions (e.g., securities firms), and corporations** are motivated to invest in private equity due to their strategic goals to cross-sell products, gain insights on new technologies and/ or limit competitive threats. Banks supply capital to in-house private equity groups with the intention of developing a broader financing relationship with portfolio companies or for generating fee income from third-party private equity funds.

   Financial institutions such as securities firms also invest in private equity in order to access potential customers and cross-sell products.

   Non-financial motivations for private equity can lead these investors to behave differently to institutional and expect different outcomes from private equity. For example, banks are more likely to invest domestically than internationally and construct more diversified portfolios than professional fund managers. Securities firms can be faced with conflicts of interest between financial returns from investment, and ensuring an initial public offering is successful.

3. **Government (at both the national and local/ regional levels)** supported private equity investment has been popular around the world for the purpose of promoting economic development goals (economic growth; employment). Motivation for investment in this case is often due to perceived market failure in the supply of risk capital. These programs are funded through taxation revenue.

Private equity has evolved into a more transparent investment vehicle. Firstly, institutional investors, demanding better risk management, are encouraging equity funds to adopt better valuation techniques and controls. Secondly, buyout groups improve their reputation and image by joining respectable industry bodies, like the 'Private Equity and Venture Capital Associations' (VCAs) in their respective countries. The Purpose of these groups (VCAs) is to conduct research, and more importantly, to provide information about the industry to policymakers, investors, and other interested parties. Last, in search for more stable capital, private equity funds are increasingly raising or plan to raise money by listing funds on public markets. By floating shares or units of a fund, advisors voluntarily subject themselves to regulatory supervision.

The contractual nature of private equity funds in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity are themselves capable of disciplining opportunistic behaviour by fund managers and advisors. This strategy ensures that possible rules and regulations are in line with both best practices and standards applied in the world of private equity.

The Private Equity in emerging markets is still in its infancy compared to the more-developed regions. However, the interesting growth prospects increasingly attract international investors, in combination with a growing number of local PE firms. PE investors are especially welcome in the emerging markets where capital shortages keep the valuations low as compared to long term value creation.

Over the years, the role of PE funds, have been well documented, in fostering innovative and competitive firms, and there now exists a broad consensus that a strong PE market is a cornerstone for commercialization and innovation in modern economies. What is valid for industrial countries should be even more important for emerging markets. The growth potential is enormous and deserves capital to be exploited. Hence, policymakers should focus on the creation of an adequate setting for a prospering PE market to support investments, growth, competitiveness and entrepreneurial activities.

In a list of emerging markets; India leads the ranking of emerging market investment activity, closely followed by China.

Private Equity in India offers huge opportunities. The increasing impact of private equity on Indian business is a dual effect of indigenous factors such as an expanding domestic market and globalization which would further scale up the PE Segment.

The Small and Medium Enterprises (SMEs) in India is an emerging segment and is looking at various avenues for raising funds. For SMEs, PE investment could be an alternative and viable source of financing. Apart from financial support, SMEs would also get exposure to global management practices in operations, human resources management, financial planning, reporting and investor relations. Such involvement would bring more accountability, transparency and corporate governance. Sectors like back-end retail, logistics, infrastructure, power, renewable energy, hospitality, transportation and telecommunication have gained favour among the private equity firms. Even the Research and Development sector has caught momentum. Initially, lack of capital to invest in R&D held back corporate India. Private Equity capital is helping address this issue. Growth in R&D investments at PE-backed companies is over twice that at their non PE backed counterparts.

Other new investment avenues with huge potential for PE investments are education and agriculture sector in India. With an estimated US$40bn market for private institutions and a CAGR of 8.6%, it is no surprise that PE & VC investors are looking to ramp up the investments they have already made in Education-related companies. Even Microfinance and Clean Technology are some emerging sectors for PE players.

Whilst the Private Equity opportunities in India are huge, so are some of the challenges that Private Equity faces in the Indian landscape, including, lack of well established domestic network of entrepreneurs, financiers, firms and research institutions; poor operating environment including poor corporate governance at the smaller firms and an inefficient legal system; tax environment and a costly process to create a tax-efficient structure for international investors.

Ideally, VCs are expected to be more involved with companies compared to PEs since they invest in the entrepreneurial stage of the companies whereas, PEs invest during the growth phase. However, very often in India, PE firms have to do a lot of handholding for companies. This is because most of the companies in India are lacking professional management. Hence, in order to protect their own self interests and investments, PEs step in to handhold them.

Before the slowdown in 2008, funding was based primarily on market growth factors backed by stock price and sensible business plans. However, As a result of the downturn, there would be several investee companies that may not be able to achieve their business plans, which would be the basis of the PE investment. PE firms have realized that to overcome the situation, they need to provide adequate support to firms so that returns are in line with projections. The general approach towards business is mostly a “me too” approach. Hence, VCs too are wary of investing in companies in the beginning. In the $10 million space, mostly VCs and PEs compete against each other.

Deal sizes are smaller in India because companies are smaller. Average deal size is around $25 million, i.e. around 125 crores. Though core sectors like infrastructure may need this kind of investment, PE firms are wary of investing in this space because of inherent Greenfield project risk in India. For example a typical road project may require 25 licenses before any work can start on the project. Procuring these licenses may not be within the control of PE firms at all. Besides, with minority stake, the investment becomes even more risky. Hence, from the risk-reward and faster liquidity perspectives, it makes sense not to invest in the same.

Indian firms are mostly promoter controlled. Promoters don’t want to let go off their stake. Hence, PE firms are given minority stake only. As they say, it is more of “buy-in” than “buyout”. Besides, buyout market hasn’t really picked up in India, as yet.

Deal valuation, is still a challenge in India, owing to factors like:

- Ineffectiveness of stock markets: Our stock markets are not too deep since most of the companies are controlled by promoters. If promoters start selling their large stakes, stock prices of the particular company would collapse. Hence stock prices are not really reflective of the true value of the firm.

- Lack of usage of international accounting standards: Accounting standards followed in India are quite different from international standards. So the financial statements of Indian companies need to be interpreted in terms of international accounting standards adding to the increased cost of due-diligence. This situation would improve once International Financial Reporting Standards (IFRS) is adopted in India from 2011.
- Payment of minority premium: India may be the only country in the world where minority premium is paid instead of availing minority discount. This is because promoters are loath to let go off their shares.
- Lack of data about private company deals: Most of the data available with Indian investment bankers are from public companies. Hence, they use the inappropriate basis of public company multiples to value private companies.
- Quality of projections in business plans: Earlier, financing was done based on predicted growth of the market for the product or service and projections made in the business plans. However, the slowdown in the past year has forced PE firms to challenge the projections made in the business plans. Increasingly, there is a perceived shift in arguments for funding businesses – they are moving from arguments about multiples used in valuation to challenging the estimated figures in the business plans.

The main barriers to entry for PE's in India are complex regulatory issues relating to sector investment and ambiguities in the Indian interpretation of the tax codes as well as the regulatory costs. Moreover, what aggravates the problem is that there are multiple regulations and little harmonization of guidelines across government agencies (SEBI, RBI, CBDT, Ministry of Company affairs). As on date, there are no clear cut guidelines for Private Equity investment.

Presently, PE firms are viewed generally as financial investors and are not expected to provide much of strategic insight on various aspects of the business. Unlike PE firms abroad, PE firms here are not expected to come up with best practices and tighten operational aspects. In contrast most PE firms believe that the future lies in providing appropriate guidance to management teams so that the targets could be achieved and the returns could be enhanced. To get strategic insights into the business, PE firms need industry veterans within their ranks.

The PE industry is a relatively new concept in India having just a decade long history in India. Even though NRIs with prior experience in PE firms abroad are coming back to India, most PE firm's feel that they have to re-skill themselves to take up challenges in Indian business scenario. They hope to overcome the challenge as the industry takes off in future.

Some PE firms feel that privatization is yet to take off in India owing to the fact that PIPE financing still contributes almost 30% of PE investment in India. Ideally, partners do not expect PE firms to invest in public equity.

The exit period in India has also increased because of slowdown in last couple of years. The exit period, which typically was 2-3 years, has now increased to 4-5 years. Extended periods have also led to PE firms providing a second round of financing in companies in which they have already invested. Furthermore, the legal and equity protection rights are still not strong enough in India, enhancing the concerns of PE firms about the inherent risks involved in investment projects.

Competition owing to 'qualified institutional placements (QIPs)' is another challenge for Private Equity in India. Merchant bankers who advise companies on fund-raising options say companies prefer QIPs over PE investment for various reasons. These include the need for giving board representation to a representative of the PE firm if it is picking up a significant stake, which is not mandatory in case of QIPs. Besides scrutiny of management decisions, PE investors also tend to take a much longer time to invest through stringent due diligence compared with QIPs which usually take place within a few weeks. Besides giving listed companies the option to raise funds, QIPs also enable them to raise money from foreign investors in the domestic market rather than going abroad and issuing shares in international markets through depository receipts.

To sum it up, private equity has entered the economic mainstream and has gained a lot of momentum over the past few years. Venture Capital/ Private Equity funding is a significant percentage of our FDI inflow, and such funding should be nurtured and encouraged further as it creates new ventures and new employment with the investment being made with a long time horizon. VC/PE investments can significantly contribute to Forex reserves, reduce rupee volatility and be one of the important factors contributing to financial stability. A simple, well-defined and unambiguous regulatory regime can help the private equity industry to grow further.

Everything said and done, to make the above happen; PE firms, in coordination with IVCA, will have to come together along with the regulators to create specific regulatory provisions for the PE industry. A right form of regulation will not only benefit the existing PE firms but also lead to the growth of the PE industry by routing more PE firms to India.