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PRIVATE EQUITY CAPITAL: SOME CONCEPTUAL ISSUES

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ABSTRACT

Private equity (PE) fund has now become a crucial source of finance for corporate world and has earned the status of a specialised asset class. Continuous improvement in savings, abundant liquidity propelled by petrodollars, sovereign wealth funds as well as hedge funds and an accommodative monetary policy that enabled a low interest rate environment accelerated the growth of private equity investment in the world as well as in Asia-pacific countries including India. Soon after World war II the PE industry have grown up simultaneously in US and Europe mainly as a conduit to finance young entrepreneurial firms which require substantial capital to drive growth and innovation. Just like in developed countries, the import and indigenous development of private equity in Asia-pacific countries like Malaysia, Singapore, India and China was aided by the PE support policies of the State as well as inflow of money from public sources. This paper is an attempt to explore various conceptual issues related with private equity and uses secondary data for investigation purpose.

Keywords: Asia-Pacific Countries, Growth & Innovation, Hedge Fund, Private Equity, Specialised Asset Class

INTRODUCTION

Today, Private Equity (PE) funds have become a crucial source of finance for corporate and has earned the status of an important asset class. It is the provision of capital and management expertise to companies in order to create value and subsequently, with a clear view to an exit, generate capital gains after a medium to long holding period. Since 2000 various regulatory changes such as pension fund reforms and numerous financial innovations like securitization motivated the growth of alternative asset classes like private equity and more particularly, the leveraged buyout industry. Growth in savings, abundant liquidity propelled by petrodollars, sovereign wealth funds as well as hedge funds and an accommodative monetary policy that enabled a low interest rate environment accelerated the growth of private equity investment in the world. They have been facilitating the productive use of existing assets and resources, usually by identifying companies with untapped potential and reorganizing their operations in ways that improve their value. While venture capital firms invest in early stage, low profitable firms and rarely use bank debt, PE sponsors

usually buy mature, profitable businesses *via* leveraged/management buyout transactions finance the transactions with large portion of bank debt and assume control of board of directors but are less likely to assume operational control. They protect the value of their equity investments by conducting careful and extensive due diligence before making an investment regarding business, financial, regulatory and environmental issues relevant for the company in question. Private equity investors draw capital from a defined pool; and invest predominantly in unquoted companies on the basis of a medium to long-term strategy and holding period with a focus on financial gain through exit by sale, buy back or flotation. They have a dedicated professional team, negotiated contractual relationship with qualified / professional investors and involve active ownership driving value creation.

OBJECTIVES AND METHODOLOGY OF THE STUDY

The present study is basically exploratory in nature and depends exclusively on secondary data. Secondary data are collected from various reports on private equity published by Price Water House Cooper (PWC), Bain and Company, Indian Venture Capital Association (IVCA), Malaysia Venture Capital Association (MVCA), Emerging Market Private Equity Association (EMPEA) and Reserve Bank of India (RBI). To be specific, main objectives of the study are:

- To explain the meaning of private equity capital or fund.
- To describe the major participants in private equity capital market.
- Point out the differences between private equity capital, venture capital and hedge fund.
- To highlight on the major activities of a private equity firm.
- To elucidate the benefits of private equity finance.
- To explore the history of private equity capital.

Accordingly, the reminder of the paper is organised as under. Section three explains the meaning of private equity while section four describes the major participants in private equity capital market. Section five point out the differences between private equity, venture capital and hedge fund. Section six narrates the major activities of private equity firm. Section seven underlines the benefits of private equity capital in today's globalised economy. Section eight investigates the history of private equity; the last section is devoted for concluding observations.

Meaning of Private Equity Capital

Venture capital and private equity (VC/PE) industry has originally evolved as a conduit to finance young entrepreneurial firms which require substantial capital to drive growth and innovation. These enterprises are characterized by major intangible but limited tangible assets, expect a period of negative earnings and have uncertain prospects which makes debt financing difficult (Povaly; 2007). A private equity is a collective investment scheme or reserve capital used for making investments in various equity (and to a lesser extent debt) securities according to one of the investment strategies associated with private equity firm. However, there is no universally agreed definition of private equity. Various academic

studies and private equity associations in various countries have defined private equity differently depending upon the role they play in those countries. Lerner (1999) broadly defines private equity organization as partnerships specializing in venture capital, leveraged buyouts (LBOs), mezzanine investments, build-ups, distressed debt and other related investments. Fenn, Liang and Prowse (1995) have identified them as 'financial sponsors' acquiring large ownership stakes and taking an active role in monitoring and advising portfolio companies. Ljungqvist and Richardson (2003) describes private equity as an illiquid investment since there is no active secondary market for such investments, investors have little control over investment pattern and investment profile covers a long horizon. The European Venture Capital Association defines private equity as the provision of equity capital by financial investors – over the medium or long-term – to non-quoted companies with high growth potential. It is also called 'patient capital' as it seeks long term capital gains rather than short term regular reimbursements. Similarly, the International Financial Services, London discussed private equity as any type of equity investment in an asset in which the equity itself is not freely tradable on a public stock market. Private equities are generally less liquid than publicly traded stocks and are thought of as a long-term investment.

All private equity firms are organized as limited partnerships with a fixed term of 10 years (often with annual extensions) where private equity firms serve as general partners and large institutional investors and high net worth individuals providing bulk of the capital serve as limited partners (Metrick & Yasuda; 2008). There are also other types of structures which are controlled and managed by the specific private equity firm acting as the general partner (GP). A limited partnership is sometimes known as a "fund". In this case the general managers of the limited partnership are known as the "management company". Many times there will be a separate and unique company that is associated with the general partner. Equity funds get their capital commitments from investors who are qualified. This includes funds from financial institutions, pension funds, as well as money from individuals who have invested a certain amount of their funds. The investors who have provided this capital become a "passive" partner within the hierarchy of the partnership. The investor is permitted to "call" the equity capital when an investment opportunity is announced by the general partner. At this time the limited partner will fund a portion, or pro rata, of its share of the required commitment.

The general partner makes all of the decisions about the private equity fund and is also in charge of managing the fund's portfolio. The portfolio contains all of the fund's investments. During the span of a fund, which can be as long as ten years, the equity fund will make anywhere from 15 - 25 different types of investments. In most cases one particular investment won't exceed more than 10% of the total commitments of the fund. The general partner of a private equity fund will be compensated, or paid, with a management fee. This management fee is a certain percentage of the total amount of the fund's capital. Usually the management fee will be 1% to 2 % annually of the total amount of capital that has been committed. As well, the general partner will earn what is called "carried interest". Carried interest is essentially a fee that is based on the total amount of profits that have been earned by the fund. Carried interest is also known as a performance fee. General partners will earn about 20% of the performance fee over and above the hurdle rate, otherwise known as the target rate of return. The general partner makes all of the decisions about the private equity

fund and is also in charge of managing the fund's portfolio. The portfolio contains all of the fund's investments. During the span of a fund, which can be as long as ten years, the equity fund will make anywhere from 15 - 25 different types of investments. In most cases one particular investment won't exceed more than 10% of the total commitments of the fund. A private equity fund will earn gross returns of over 20% annually. If a firm has buyout leverage this return will be mostly a result of the leverage. A portion of the 20% will be accounted for by the high level of risk that often comes along with any investment that is in its early stages. Limited partnership interests are usually part of a very limited market. Keep in mind that the interests from a limited partnership, unlike mutual funds, are not free to trade on the open market.

Major Participants in Private Equity Market

There are three major participants in private equity market (povaly, 2007)-

1. Issuers or firms who were seeking private equity. These issuers are usually firms that do not have recourse to an alternative source of financing such as a bank loan, private placement or the public equity market (IFSL Research, 2008). Firms seeking venture capital include young firms that are expected to show high growth rates, early stage capital for companies that have commenced trading but have not moved into profitability as well as later stage investments where capital is required for further growth of widely accepted product or service.
2. Financial intermediaries which are private equity funds themselves. These are mostly organized as limited partnerships where investors who contribute to the fund’s capital are limited partners, while the professional managers running the fund serve as the general partners.
3. Investors who are contributing capital to private equity firms. These may include public and corporate pension funds, endowments, foundations, bank holding companies, investment banks, insurance companies and wealthy families and high net worth individuals (HNI).

Differences between Private Equity, Venture Capital and Hedge Fund

Presently there is lot of ambiguity surrounding the concepts of private equity and alternative investment channels like venture capital and hedge funds. Venture capital is a subset of private equity which is guided as equity investments for the commencement, early development or expansion of a business. It emphasised on entrepreneurial undertakings rather than on mature businesses. The concept of private equity and venture capital were used interchangeably in most of the literature. Hedge Funds differ from private equity firms in terms of their time-to-hold, liquidity, leverage and strategic direction of investments which in turn guided the differences in their exit strategy, risk tolerance and desired rate of return of the two types of funds. Hedge funds seek a quick return of their investments with the average length of their investments being 6-18 months, whereas the time horizon of private equity investment is around 3-5 years. Hedge funds are also inclined towards volatile withdrawal of investments as opposed to private equity firms which are focussed on long term returns. However, of late, it has been observed that the arena of activities of such institutional investors is not mutually exclusive. Many private equity firms own hedge funds and make long term investments in hedge funds. Further, attracted by the significant returns

in leverage buyout deals, many hedge funds have joined hands with private equity players to make large buyout deals. Given the differences in activities and risk tolerance of the two players coupled with the absence of any reliable public reporting norms of their activities, the synergy between the two players has raised regulatory concerns, of recent.

Major Activities of Private Equity Firms

According to Pratt (1981), the major activities of a private equity firm can be categorised under nine heads depending upon the stages of corporate development where private equity financing is seeking –

1. **Seed Financing***:* Providing small amount of capital necessary to develop an innovative business idea.
2. **Start-up financing***:* Providing capital needed for product innovation and development and initial marketing activities.
3. **First-stage***:* Financing the production and commercialization of products.
4. **Second-stage***:* Providing working capital funding and required financing for young firms during growth period.
5. **Third-stage***:* Financing for the expansion of growth companies.
6. **Bridge financing***:* Last financing round prior to an initial public offering of a company.
7. **PIPE deals:** A private investment in public equity (PIPE) deal is the selling of publicly traded common shares or some form of preferred stock or convertible security to private investors. In the U.S., a PIPE offering may be registered with the Securities and Exchange Commission on a Registration Statement or may be completed as an unregistered private placement.
8. **Leveraged Buyout (LBO):** It means the acquiring of a company by a small group of investors, especially buyout specialists, largely financed by debt.
9. **Management Buyout (MBO):** It is a subset of LBO whereby incumbent management is included in the buying group and key executives perform an important role in the LBO transactions.

Benefits of Private Equity Finance

In recent times, private equity finance has become very much popular in developed as well as in developing countries because it not only serve to the concerned company but also provide numerous benefits to the industry, country and the society at a large. A survey on 119 PE-sponsored firms in Asia conducted by KPMG has establish that most private equity firms conceptualise ‘provision of capital’ as their most important contribution towards growth of business followed by optimizing company’s financing structure, general management guidance at the board level, aptitude to recruit the best managers to run the business, improve corporate governance and development of business processes. Host companies also benefit from international network of contracts like inoculation of international know-how, *etc.* Several studies have also documented that private equity/venture capitalists speed up product commercialization (Hellman and Puri; 2000),

adoption of human resource development policies and strengthen commercialization strategies of the companies (Gans, Hsu, Stern; 2002; Hsu, 2006).

Private equity firms are also known as natural system stabilizers (Persaud: 2008). During a systemic crisis, while those with short term funding may indulge in brisk trading; being a risk trader private equity firms can balance the system because of their long term funding requirements.

Private equity fund also looked upon as a 'company builders' as they provide 'venture capital'. They outline portfolio companies innovative strategies by investing at the right time and making them public at the right moment (Rin and Penas; 2007) and thus freeing of capital to reinvest it in new ventures (Michelacci and Suarez; 2004). They inspire management for add-on acquisitions or for launch of new higher margin products or markets. A study on post-buyout operating performance of 48 LBOs completed during 1980 to 1986 (Kaplan, 1989) shows that in comparison with the year before the buyout, operating profit has increased by 42 per cent over a 3-year period after the buyout. Most of the research studies have indicated that the pressure of servicing a debt load coupled with changes in incentive, monitoring and governance structure of firm lead towards improved performance. It has also been found that post-IPO, majority ownership by a PE-sponsor is result in a better long-term stock performance. A survey of PE-firms in Asia-Pacific by KPMG has shown that in India, the average share price of PE-sponsored companies trading for 501-616 days rose by 195 per cent, while non-PE sponsored companies' stock gained only 99 per cent.

PE-firms are also extending several social benefits such as improving environment, building infrastructure, encouraging R&D and upgrading human capital. The survey of Australian PE firms has shown that investee companies help in productivity improvements and ongoing Australian R&D. IFSL Research study find that private equity backing companies in UK accounted for the employment of approximately 3 million people in 2007. This is equivalent to 16 per cent of UK's private sector employees. A survey of Indian PE firms has also shown that PE-backed firms have shown higher annual wage growth of around 32 per cent as compared with 6 per cent growth in non-PE backed firms. Annual sales grew by over 22 per cent in PE-backed firms as compared with 10 per cent in non-PE backed firms. Private equity foster innovation in the economy as is evident from the comparatively higher growth in research and development in PE-backed firms than non-PE backed firms. Private equity also benefits the economy at large by incentivising capital formation, optimizing allocation of resources, encouraging competition and thereby raising social welfare of the economy as a whole.

The position of private equity in developing economy like India may broadly be described as arranging capital for the capital starved sectors such as SMEs and infrastructure, emerging sectors like realty, telecom, IT, *etc*., restructuring of loss making companies as well as the high value agriculture sector. With better policy support, private equity can revolutionise the disinvestment process in India.

History of Private Equity Capital

Soon after World War II the PE industry have grown up simultaneously in US and Europe. However, the degree and pace of development of the PE market varied significantly on the two continents since then (Povaly; 2007). The first formal PE firm, ARD was established

after World War II in 1946 in the US. But the PE industry started a rapid growth after the 1970s due to post amendment to the so-called 'prudent man' rule governing the pension fund investments and lowering of capital gains tax rates in 1978. Between 1979 and 1988, the US private buyout market expanded from less than US$ 1 billion to a peak of more than US$ 60 billion as a result of creation of high yield junk bonds market. The industry used this high yield debt to finance huge corporate takeovers including that of RJR Nabisco, Inc by Kohlberg Kravis Roberts & Co. (KKR) for US$ 31.4 billion in 1988 (McKinsey, 2006). Together with the growing capital inflows, the number of private equity firms propagated dramatically and firms began to specialize in the various aspects of private equity such as early stage venture capital, leveraged buyouts or mezzanine financing. However, the zenith of the Leveraged Buyout (LBO) wave was associated with many bankruptcies and fierce public and political resistance (anti-takeover legislation) such that PE activity slowed down abruptly to US$ 4 billion in late 80s (Renneboog, Simons and Wright, 2007). However, the market recovered by mid 90s due to strong public equity market environment and exit of many inexperienced venture capitalists. The revival was aided by cut in capital gains tax in 1994 on investments in smaller firms and opening of NASDAQ stock exchange which expanded exit perspectives for portfolio firms. The US market is today the biggest and most developed private equity market in the world. The number and value of US private buyout-related deals rose from 12 transactions in 1970 involving less than US$ 13 million in direct capital raised and invested to 4,821 deals involving US$ 110 billion in 2012. The private equity investments in US amounted to US$ 212.7 billion or 0.8 per cent of GDP in 2012 (PwC, 2013).

In Latin America, private equity industry flourished in Brazil. The private equity industry in Brazil which developed in the early 90's did not receive much direct support from the Government at its preamble. Between 1992-94, there was only one player in the market. The focus of the industry was exclusively on buyouts and no venture capital was raised. The industry largely gained from deregulation of previously protected sectors like telecom, energy and utilities. Subsequently, many large regional funds came up and fund raising recorded a 512 per cent rise to US$ 5.2 billion. The industry troughed between 2000 and 2002 after Brazilian currency devaluation, crisis in Argentina, international macro-economic uncertainties and extended regulatory transition of local pension funds industry (Holman et al, 2006).

The private equity industry in Mexico originated in the early 1990's through foreign direct investment rather than as a result of organic growth (Holman et al., 2006). Between 1992 to 1996, many US-based funds made a foray into Mexico and initial investments were made in manufacturing, telecom and entertainment sector by firms like Chase Capital Partners, Blackstone Group and Banc of America Equity Partners. In the second wave of PE investment during 1997-98, several new sectors witnessed interest namely, retail, food, power and utilities. Between 1999 to 2001, private equity in Mexico was negatively impacted by Brazilian devaluation of 1999, Russian default in 1998 and the burst of the telecom bubble in 2000 and Argentine economic collapse of 2001. This led to withdrawal of investments from telecom and IT sector. The industry recovered in 2002 with a structural shift away from foreign investors to emergence of local funds. The latter arranged bulk of their capital from foreign institutional investors as well as indigenous high net worth individuals. The Mexican Government was also directly involved in financing private equity.

Since early 1990's, Nacional Financiera (NAFIN), a branch of the Mexican Development Bank, has adopted an institutional strategy of direct and indirect financing. Under direct investment, NAFIN makes equity contributions, monitors and advises specific firms. Indirect investment refers to matching-fund equity investments in venture capital funds known as SINCAS and private equity funds. PE investment has been attracted by Mexico's relative economic and political stability, abundant workforce and economic integration brought about by North American Free Trade Agreement. The current fund size averages to US$ 132 million. Today, Mexico is the second largest private equity destination after Brazil in Latin America.

Till 1980's, the growth of the United Kingdom (UK) PE industry was constrained by a multitude of factors, including political environment where mainly socialist governments had created harsh entrepreneurial climate, cultural impediments such as higher risk averseness and lack of liquid stock exchange for small and mid-sized businesses (Povaly; 2007). Discouraging fiscal and legal rules of game added muscle to the stagnation of the industry. It was only in the mid 80's that the State took progressive steps towards promoting venture capital industry including development of missing markets, rationalization of marginal tax rates, *etc*. The establishment of the Unlisted Securities Market (USM) in early 80's proved advantageous for the exit of small firms because of relatively easier listing requirements. Private Equity investments in UK increased to US$ 76.8 billion or 1.9 per cent of GDP in 2007 (PwC, 2013).

Just like in developed countries, the import and indigenous development of private equity in Asia-pacific region like Malaysia and Singapore was aided by the PE support policies of the State as well as inflow of money from public sources. The growth of the private equity industry in Singapore, for example, was facilitated by institutional support from the Government of Singapore. In 1985, the Economic Development Board (EDB), an institution established to act as a facilitator to develop self-sustaining enterprises, created its own venture capital fund. The inflow of private equity got further boost and thrust after the exit possibilities were enhanced on the establishment of the Stock Exchange of Singapore Dealing and Automated Quotation System (SESDAQ) with less stringent norms for listing, which became useful for small and new companies. The private equity industry in Malaysia developed under the guidance of the Malaysian Government and support from the more advanced venture capital firms in Singapore. The first venture capital company, 'Malaysian Ventures' was established in 1984 by Singapore- based South East Asian Venture Investment (SEAVI). The Malaysian Government earmarked resources during the five yearly plans for developing the indigenous venture capital industry. The Government granted several tax incentives in addition to liberalizing equity ownership for venture capital corporations and venture capital management corporations. The Malaysian Venture Capital Development Council (MVCDC) was established in January 2005 to facilitate the development of the venture capital industry by coordinating Government initiatives and incentives towards charting the industry's strategic direction. Further, the Government also established its own venture capital companies to infuse resources into certain strategic sectors of the economy. As at end-2012, Malaysia had 145 venture capital companies and venture capital management companies registered with Securities Commission with total of RM 5.1 billion committed funds under management (MVCA, 2013).

The seed of the Indian private equity (PE) and venture capital (VC) was laid in the mid 1980's. and it scaled new heights in 2000 primarily because of the success demonstrated by India in assisting with Y2K related issues as well as the overall boom in the Information Technology (IT), Telecom and the Internet sectors, which allowed global business interactions to become much easier. In fact, the total value of such deals done in India in 2000 was $1.2 billion and the average deal size was approximately US $4.14 million. The first generation venture capital funds, which treated as a subset of private equity funds were launched by financial institutions like ICICI and IFCI. Commercial banks like Canara Bank also came up with their own venture capital funds - CanBank Venture Capital Fund Limited. Subsequently, various regional venture capital funds started their activities in Andhra Pradesh, Kerala and Gujarat e.g. Andhra Pradesh Industrial Development Corporation (APIDC), Kerala Ventuer Capital Fund Private Limited, Gujrat Venture Fund Limited. In late 80's and early 90's, various private sector funds also came into being like IL&FS Investments Managers Limited, Kotak Mahindra Finance Ltd, Punjab Venture Capital Limited etc. Between 1995-2000, several foreign PE firms like Baring PE partners, CDC Capital, Draper International, HSBC Private Equity, Merlion India Fund (Standard Chartered Private Equity) and Warbug Pincus also started their function in India. During the mid 1990's, laws for venture capital funds formally started taking shape. The Securities and Exchange Board of India issued the SEBI (Venture Capital Funds), Regulations, 1996. These regulations were amended in 2000 on the recommendations of K.B. Chandrasekhar Committee. According to Euromonitor, VC/PE investment in India reached at 0.5 % of GDP in 2012 which is higher than those of China (0.26%) and Brazil (0.26%).

CONCLUSION

Private equity helps in the productive use of existing assets and resources, usually by identifying companies with untapped potential and reorganizing their operations in ways that will increase their value. In fact, the concept of 'financial inclusion agents' may be extended beyond the purview of banks to include enterprises like 'private equity firms' which can supply much needed and timely financial assistance to sectors like small and medium industries, infrastructure sector with long gestation periods and excess capacities in the short run, high value agriculture investments *etc.* However, the rapid growth and globalization of the PE industry has raised demands for increased regulation and disclosure within the sector due to concerns regarding anti-competitive behaviour, excessive tax benefits and stock manipulation.

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