



A study on private equity mechanism

Sachin¹, Dr Shakti Singh²

¹ Ph.D. Research Scholar, Department of Commerce, Maharshi Dayanand University, Rohtak, Haryana, India

² Assistant Professor, Department of Commerce, Maharshi Dayanand University, Rohtak, Haryana, India

Abstract

Private Equity funds invest in start-ups or technical projects. Private equity firms provide financial and managerial assistance to their portfolios. The investment made by private equity has been continuously increasing in India, which helps to boost the Indian economy. Hence it becomes vital to study the mechanism of private equity firms and the status of private equity investment in India. The current study revealed that private equity selects their portfolio firms after in-depth due diligence that helps to take suitable action to the prevention of potential threats. Diligence also helps to know the strength and weaknesses of the portfolio, which is vital before making an investment decision. The value of the investment has been continuously increasing from 120 US Million \$ in 2001 to 77000US Million \$ and it is also found that the global economic shocks directly affect the PE investment value such as the Dec 2007- June 2009 US recession, covid 19 etc.

Keywords: venture capital, private equity, start-ups, diligence

Introduction

Private Equity is defined under 2 (1) (r) of Securities and Exchange Board of India (alternative investment funds) regulations, 2012, as follows:

"Private equity fund means an Alternative Investment Fund which invests primarily in Equity or Equity-linked instruments or partnership interests of investee companies according to the fund."

Private equity refers to those funds that inject funds into start-ups and risky projects. These funds do not only provide financial assistance but also provide managerial assistance. These firms earn profits by transforming a small company into a high-net-worth company. High net-worth individuals, government institutions, and different pension fund park their investments in private equity funds for high returns. After World War 2, this concept was developed in the USA. In 1901 the first deal took place between J.P Morgan and Carnegie Steel company; J.P Morgan acquired Carnegie Steel Company for \$480 million, the first buyout made at that time. Being the developer country of private equity finance USA has the highest number of private equity finance. In India, this concept developed in 1975; IFCI constituted a Risky Capital and Technology Financial Corporation of India (Now known as IFCI venture capital Fund Limited). After that, different financial institution formulated their venture capital funds. In today's era, India has become the hot country receiving private equity funds value of an investment in India has increased from \$120 Million to \$ 77000 million in 2021. Different study findings revealed that the growth of those sectors in which private equity has invested is higher than the average growth rate of that industry. It also came to know that the performance of the companies funded by private equity was better than that of non-private equity-funded companies. Hence it becomes vital to study the mechanism of private equity.

Objective: to study the mechanism of private equity

There are mainly three parties involved in the Private Equity Market

1. Limited Partners
2. General Partners
3. Portfolio Companies

Limited partner

Limited partner refers to third-party investors such as pension funds, endowment, high net worth individuals etc. These are the passive investor who invests for a long period, generally for 7 to 10 yrs. In return, they get a high amount of profit. Fund Managers or general partners manage their funds. Their liability is limited only to the amount to be contributed by them.

General Partner

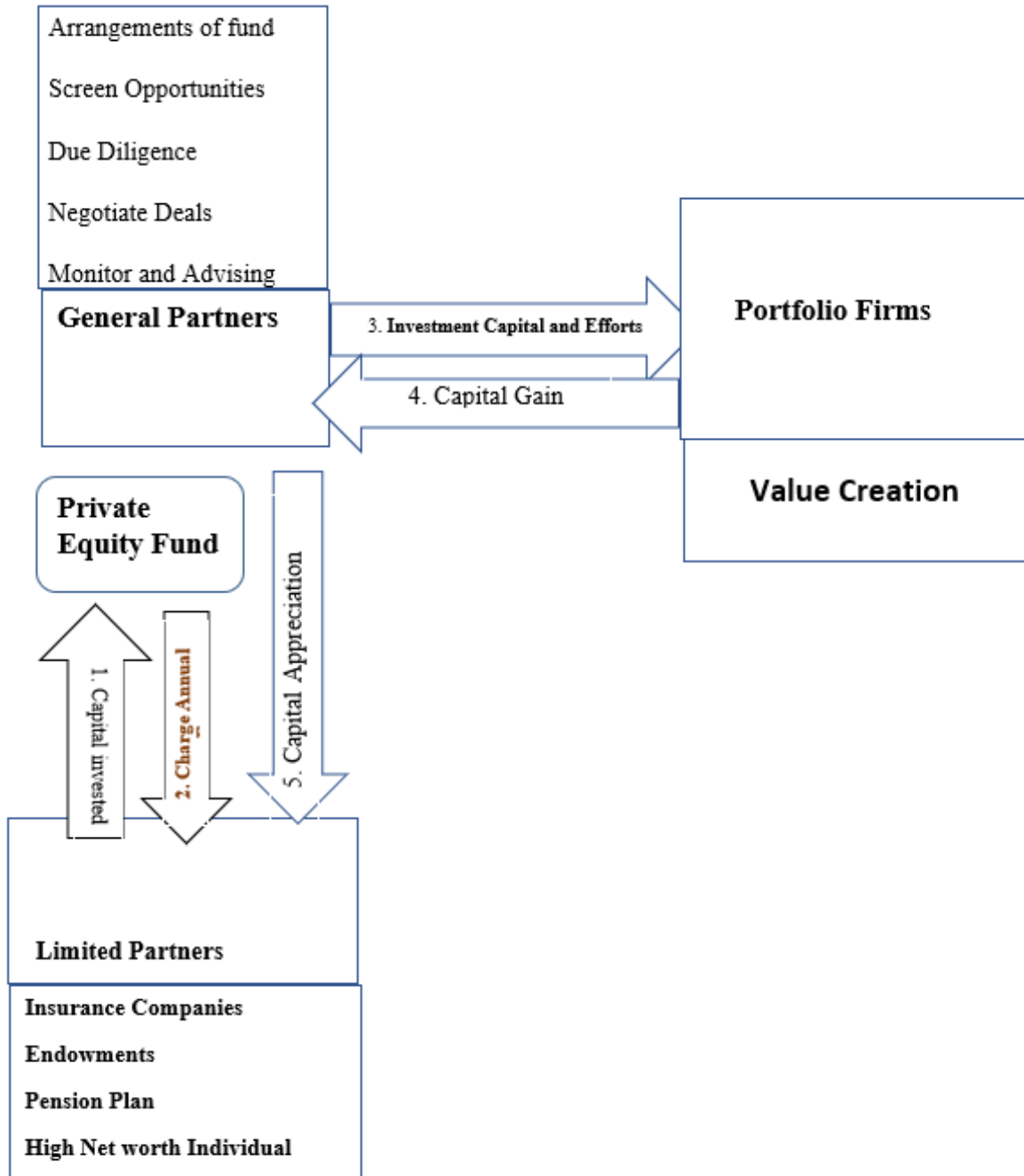
These are also known as fund managers, which have better experience in a particular sector and which are experts in that field. These managers decide on the selection of a portfolio firm. The general manager may invest in 10-12 different portfolios, including investments in private firms as well as public firms. They perform the function of due diligence based on which they investigate potential growth, profitability, and legal matters of their portfolio. After due diligence, these managers decide whether to invest in a particular firm or not.

In lieu of their service, they get a fixed fee for asset management, like 2% in general. After exiting from the portfolio, they get a performance return such as 20% of capital appreciation. The rate of return is subject to variability. These managers help the transformation of a small company into a highly net-worth company by increasing its value.

Portfolio companies

Portfolio refers to those firms which are investment seekers and which are backed by private equity companies. These firms may be private or may be public. These firms have the potential to grow rapidly. These firms need to frame a project based on which it may attract potential private equity firms to fund it. These are the investee firms.

Mechanism of private equity structure of private equity market



Source: Researcher Collaboration

Fig 1

The main investees of Private equity firms are the following.

1. These firms generally invest in start-ups, growth funds or companies for whom it is not easy to raise funds from traditional sources and have the potential to grow rapidly.
2. These also invest in those firms which are underutilising their resources due to a lack of management expertise but have the potential to grow.
3. Even those companies which are earning profits but have a low operating cash flow also approach private equity firms to make investments.
4. Private equity firms may also help those firms which want to expand their business in different geographical

areas. Private equity firms generally have a worldwide network which may help their portfolio to expand their business.

5. Private equity firms may invest in the sick company, which has the potential to revitalise and make a profit after making significant strategic decisions. (Singh, 2015) ^[2]

A portfolio selection decision is a long-term and irreversible decision to be made by private equity firms. So, while making the investment decision, all factors should be analysed properly (Kulkarni & Prusty, 200).

Steps of private equity investment

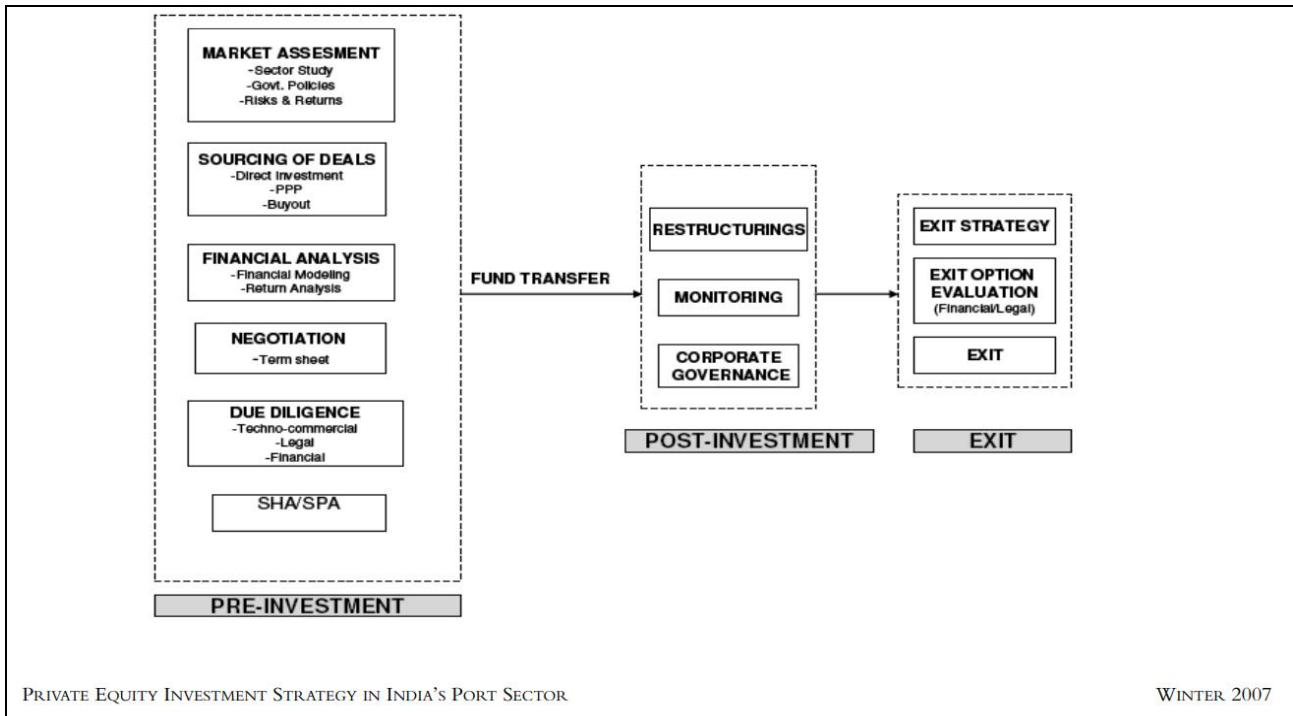


Fig 2

It mainly consists of three stages

1. Pre-investment stage
2. Post-investment stage
3. Exit

Pre-investment stage

This stage includes all the possible factors which affect the investment decision. On basis of these factors, it is analysed whether to invest in a particular portfolio or not. It consists of decisions related to finding the sector in which opportunities are available.

Market assessment

Market assessment help to identify lucrative opportunity available in different sector of the market. Here investors must try to assess the demand and supply factors related to each segment such as the product or service with which the portfolio is dealing. Government policies of domestic and host nations should also be analysed while making an investment decision. there may be various sectors in which incentives are given by the government while in other sectors there may be some hindrances. Competitors should also be analysed properly before making an investment decision.

Sourcing of deals

PE investors should also analyse the various sources of investment such as funds from limited partners, leverage buyouts, mezzanine debt etc. Fund managers have to assess the pros and cons of each source.

Financial analysis

In financial analysis, an investor must analyse the cost parameter, revenue and growth drivers. There are different methods of financial analysis. Such as net present value, internal rate of return, etc. to measure the value of the project.

Negotiation

Firstly, there is a controversy in the valuation of the project between the investor and the owner but after some time they will be agreed on a particular price and that price is known as a reservation and their agreement is known as negotiation. Both parties enter into a term sheet agreement that includes the offer price, reservation price and milestones of the transaction and terms and conditions.

Due diligence

Before making the final selection of its portfolio firm PE performs due diligence to identify the possible risk and to ensure the information provided is correct. this comprises financial, legal and corporate matters. It helps to bring transparency to transactions.

Different agreement

There is a legal contract between the two parties so there should be a legal document stating the rights and duties of both parties.

Post investment

Post investment stage involves restructuring monitoring and corporate decision. Private equity investors should be experts and have a better experience operating in that sector. They must have sufficient operation knowledge on basis of which they can make strategic decisions such as restoring the capital structure innovative cheap sources of capital, monitoring the operational function and making the decision to cut down unnecessary costs. PE investors should focus on the mission and vision stated in SRA with corporate governance

Exit strategy

The exit strategy is as must important as the investment strategy. In developing countries, it is difficult to exit. So, PE investors should analyse the most favourable exit strategy on basis of the pros and cons of each strategy i.e., IPO, trade sale, secondary purchase dual track recapitalisation.

Different types of exit strategies are there

Initial public offer (IPO)

An initial public offer is an exit strategy where the company offer its securities for sale to the general public. It is the most common strategy followed by Private Equity companies. The advantage to exit with an IPO is its higher return possibility. But it also has the problem of a lock-in period it is not possible for the promoters to fully exit at the same time as the IPO.

Trade sale

Trade sale refers to that exit strategy in which sales are made to a third party and mostly to that party which is already operating in the same industry. Buyer has a strategic advantage with this deal while private equity may completely exit from its portfolio through this strategy.

Secondary purchase

It refers to that exit strategy in which private equity sells its portfolio to another private equity. There may be different

reasons such as existing private equity has no more interest in that business or it may invest in some other portfolio where it may get better returns. The secondary purchase gives an easy way to exit.

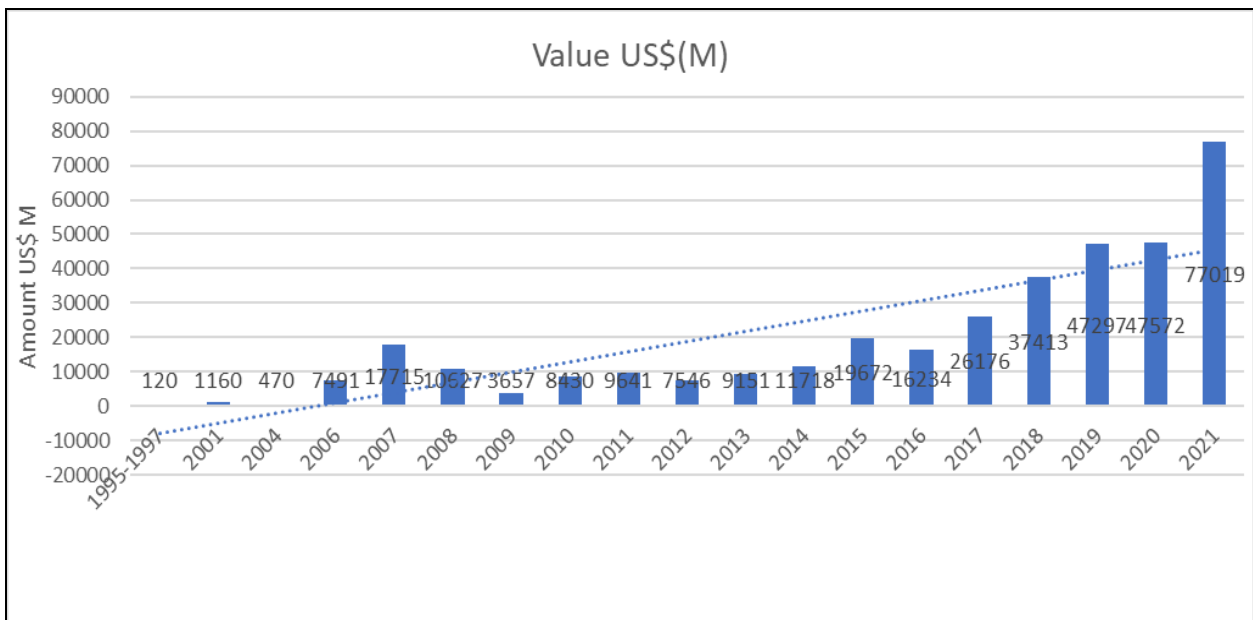
Dual track process

It refers to the exit mode where private equity firms use trade sales as well as fill on initial public offers at the same time. This strategy helps private equity to test its possible return through IPO and it also looks for a third party for a trade sale.

Leveraged recapitalisation

This is a partial exit through which a private equity sponsor generates cash from the business without selling its portfolio company. This strategy helps the firm to borrow from other sources such as bank loan.

Private equity investment in India



Sources: Annual Investment value from 1995-2021 retrieved from IVCA database

Fig 3: Investment value

As shown in figure 1, there is a tremendous increase in the value of private equity investment in India. India has become an attractive country for private equity investors due to consistency in GDP growth with high consumer demand and liberalised policies.

Discussion and conclusion

Private equity investment is a tool of economic growth that helps infant firms to operate smoothly and to rapid growth. The expertise assistance and financial support help to improve the performance of their portfolio firms. One of the major reasons for the better performance of the companies backed by private equity may be their diligence process through which private equity firms came to know the strength and weaknesses of their portfolio that help to prevent the possible threat and make suitable action for the betterment of performance. Private equity funds adopt different investment strategies for the selection of their portfolio firms. There are different criteria such as economic

growth, the profitability of portfolios, creditworthiness, cash flow generation etc. Hence it can be concluded that investment seeking companies should design a catchy and informative proposal which can attract the investors.

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