Importance of Domestic Investment in Private Equity

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The Indian Private Equity market has grown by leaps and bounds in the last decade. Annual PE investments in India have increased from $ 14.8 billion in 2011 to $ 62.2 billion in 2020[1]. 2021 was a watershed moment for the Indian VC space, with 16 startups entering the unicorn club, taking India's total tally to 50 (as of 22nd June 2021)[2]. The Indian PE/VC industry received a vote of confidence from international investors, as India has consistently ranked among the top three most attractive emerging market destinations for LPs globally to make GP investments[3].

Private Equity plays a transformational role in emerging markets such as India. The long term nature of private equity investments allows for nurturing of growing firms. A mature private equity ecosystem encourages entrepreneurship and gives enterprising founders the capital they need to create productive assets for the economy. Private Equity investors also bring with them, technical expertise and fiscal discipline helping their portfolio companies become efficient and more profitable.

In addition to benefits for individual entrepreneurs and companies, PE/VC investments also support entire industries that are conventionally viewed as investment heavy or capital intensive. While renewable energy has recently gained a lot of traction, the sector owes its current investment viability to a lot of capital committed by PE/VC funds in its early years. There has been a similar story in many high growth sectors such as e-commerce, fintech, health-tech, and edtech, online streaming and logistics platforms[4]. These industries have driven change in customer behavior, created new categories and employed millions of new jobs on the back of PE/VC investment. PE/VC investment has also acted as a catalyst for change in the cultural mindset of entrepreneurs and professionals. Access to PE/VC funding has given a lot of prospective entrepreneurs comfort in making the jump from working professionals to founders. The importance of such a shift in the risk appetite and mindset of Indian society cannot be overstated.

In addition to the impact on certain industries, the broader Indian economy has also benefitted from increased funding to entrepreneurs, with an estimated 2.6 million jobs being created by PE/VC in 2019. This represented a 27% and 57% increase over 2018 and 2017[5] respectively. PE/VC is also an important source of foreign capital in India, being the single largest contributor to FDI in the country, dwarfing all other sources put together[6].

Despite what reports of record valuations, fundraising and PE/VC investments would have you believe, the PE/VC industry in India is just starting out. PE/VC investments in India is equal to ~1.7% of the Indian GDP. This just meets the global average and significantly trails the investment in mature economies such as the US, UK and other European nations. Given the aspirations for a $ 10 trillion Indian economy by 2032, a 3% PE/VC investment to GDP ratio signifies a $ 300 billion market opportunity for PE/VC funds in India. This is a 5x increase from the current investment of ~$ 60 billion.

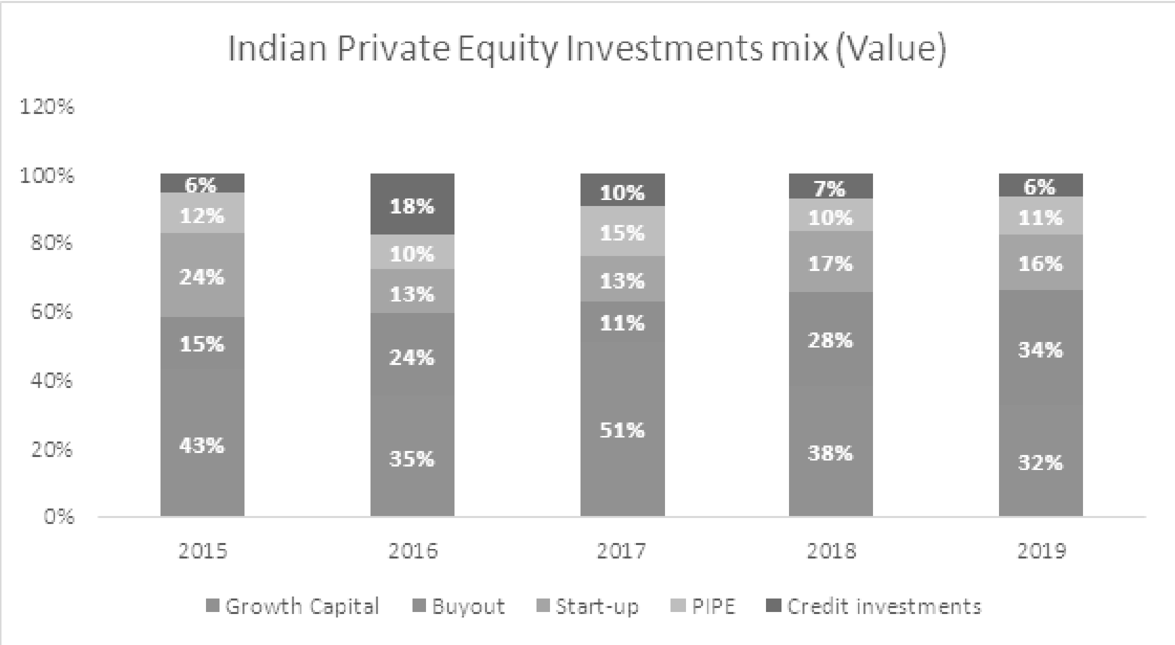
	2016	2017	2018	2019*
Global	**1.7%**	**1.7%**	**1.8%**	**1.7%**
United States	3.3%	3.2%	3.6%	3.2%
China	2.0%	1.5%	1.7%	0.7%
Europe	1.8%	2.1%	2.2%	2.2%
UK and Ireland	3.5%	5.5%	4.1%	4.5%
DACH (Germany, Austria, Switzerland)	1.2%	0.9%	0.8%	1.7%
France and Benelux	2.7%	2.3%	2.4%	2.6%
India	0.7%	1.0%	1.4%	1.7%

Source: EY PE/VC Agenda India trend book 2020

While the value creation in PE/VC funding has been immense, equitable access to this value creation can be improved. On this front, we would like to focus on two aspects: the significance of growth capital and the importance of domestic investors in the Indian PE/VC landscape.

As the PE/VC landscape in India has grown, there has been a noticeable shift in strategies employed by PE/VC funds. As most PE funds have grown larger, they have transitioned from minority style growth capital investment to buyout investments. Simultaneously, the popularity of VC funding has exploded in India.

The chart below shows the increasing popularity of buyout funding has largely come at the expense of growth capital funding. Growth capital investments are generally made in sectors that are an important part of the Indian economy such as manufacturing, consumer goods, financial services and life sciences. The importance of growth capital in such sectors cannot be overstated.



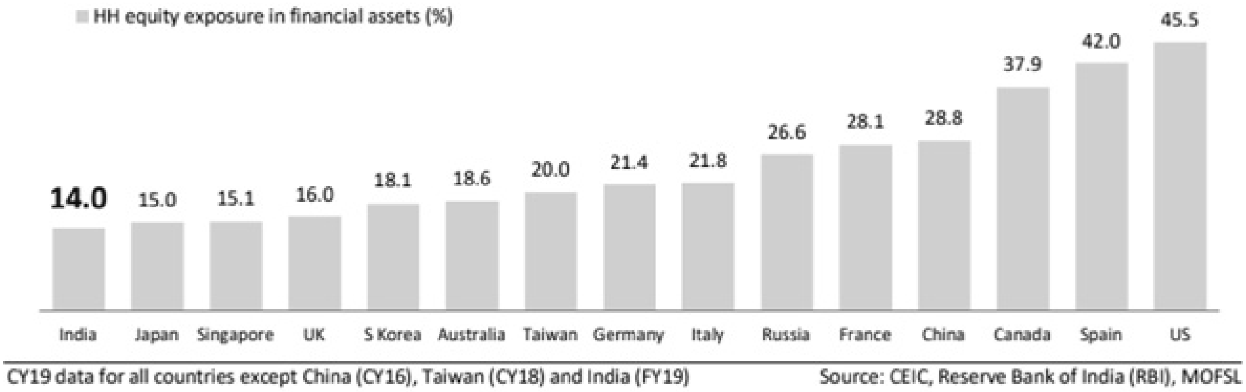
Source: EY: PE/VC agenda India trend book 2020.

Growth Capital funding combines the best characteristics of VC and buyout funding. It involves backing young companies who have a long runway of growth in front of them, who are led by proven entrepreneurs but with a history of financial excellence and reduced uncertainty around the business model. Growth Capital is also essential for entrepreneurs since it often comes at a time when the company is at an inflexion point, looking to make the jump of moving from a small regional player to that of a national or an international player. This expansion entails significant capital expenditure, which would typically be out of reach for the company. Growth Capital provides an attractive value proposition, equipping the business with substantial long term funding and allowing the entrepreneurs to join hands with partners who have a similar vision for the company. Given its dual benefits to investors (better risk-adjusted returns) and entrepreneurs (patient funding) alike, growth capital will take a center stage in the PE/VC landscape for the benefit of the broader economy.

Further, one would like to see more broad-based participation from domestic investors in PE/VC funds. Currently, the PE/VC investments being made in India are funded (>80%) primarily by foreign origin capital, coming from foreign LPs or global funds of international GPs. While it is admirable that India is vetted by marquee global investors as an attractive investment destination, we must realize that foreign capital at times can be fickle as for them India will be just one of many options that they would have as they would be looking for the best investment return across the globe. As per various reports, PE/VC industry in China would raise over 2/3rd of funds locally.

India cannot just rely on foreign investment to fund nation building, especially when the total Indian individual wealth is more than sufficient to bridge any investment gap currently in India. Like China, domestic fund raising (either direct or pooled) will have to play a pivotal role for growth of PE/VC industry in India. The wealth in India is heavily skewed towards real assets (such as property, gold etc.), with only 56.5% of individual wealth in India being invested in financial assets. Currently, the total Indian individual wealth is $ 6.2 trillion, of which $ 3.5 trillion is invested in financial assets (largely consists of deposits, insurance schemes and cash which form close to ~65%) and $ 2.7 trillion is invested in real assets[78] . A mere 3-4% shift from real assets to financial assets will help the Indian private sector bridge its investment gap.

This shift must be in the form of long term risk capital i.e. equity capital. However, the Indian investor's exposure to direct equity is the lowest amongst global peers, at 14% of household financial assets, compared to 45.5% in the US and 28.8% in China.



Source: MOFSL, RBI

Not only does the Indian investor need to increase allocation to the equity asset class, domestic investors also need to diversify beyond mutual funds and listed equities, to alternative investments. Currently, asset allocation to such sophisticated investment products is abysmally low with unlisted equities and alternative investments at 5% and 0.76% of household financial assets respectively[9]. Transition to PE/VC investments would allow domestic investors to participate in wealth creation that is currently happening in private markets. PE/VC funds generally target IRRs of 25%+ on their investments. These returns are also largely uncorrelated with other asset classes such as bonds, gold and real estate. Additionally, growth capital investment would allow HNIs to back a company throughout its life cycle. Currently, HNIs selectively have opportunities to invest in early-stage companies through angel investing as well as pre-IPO stage companies through wealth management solutions. However, the large ticket sizes in the growth stage fundraising exclude HNI investments. Investing in mid-market PE funds will give HNIs the desired exposure to exceptional companies at the inflexion point in their life cycle.

The importance of domestic investors in Private Equity cannot be overstated, as they bring with them an inherent understanding of Indian sensibilities, exposure to ground realities and expertise in investing in Indian markets. Similarly, as India progresses on its journey to becoming a $10 trillion economy, PE investments in middle-market growth capital will be invaluable to domestic investors and entrepreneurs alike.

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1 Bain: Indian Private Equity Report 2021
2 https://www.business-standard.com/article/companies/indian-startup-ecosystem-crosses-the-threshold-of-50-unicorns-121061601323_1.html
3 Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets 2019
4 EY: PE/VC Agenda India trend book 2020
5 https://www.business-standard.com/article/pti-stories/pe-vc-backed-startups-created-over-26-lakh-jobs-in-2019-report-120021800713_1.html
6 EY: PE/VC Agenda India trend Book 2020
7 Karvy India Wealth Report 2020
8 1 USD = 75 INR
9 Karvy: India Wealth Report 2020