Creating a larger role for domestic investors in PE/VC firms

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Private equity (PE) and venture capital (VC) are vital components of the financial ecosystem. PE typically involves investing in more mature companies through various strategies, with the goal of improving their profitability before exiting the investment. In contrast, VC is primarily concerned with funding early-stage startups with high growth potential, often in exchange for equity stakes. Both forms of investment aim to generate significant returns for their investors, but they operate at various stages of a company's lifecycle and involve varying levels of risk and management involvement. In India $39Bn was invested by PE/VC firms in the year 2023 alone. India's share of PE-VC investments in Asia-Pacific has grown over the past 5 years from 15% to 20%, driven by China + 1 tailwinds and India's robust macro fundamentals. We have made our way into the fifth largest economy and are in a trajectory to become the third largest economy by 2030. Our domestic consumption has grown on the back of a growing middle class (~330Mn in 2016 to ~430Mn in 2021) and growing working age population (~810Mn in 2016 to ~875Mn in 2021) and on scale adoption of digital rails (e.g., UPI, OCEN) and effective fiscal and monetary policy discipline.

In India, the landscape of domestic versus foreign investments in PE/VC has been shifting. While foreign capital has historically dominated the sector—accounting for over 80% of total investments—there is a growing trend of increased domestic participation. In recent years, domestic investors have started to play a more prominent role, with their share of total PE/VC investments rising to approximately 20% in 2023, up from 15% in 2018. This shift is indicative of a maturing investment ecosystem where local funds are becoming more confident in supporting homegrown companies. With public markets at all-time high, investing in PE/VC provides an alternative diversified exposure. Even international pension houses like the Ontario Pension Fund, CPPIB etc are investing in Indian homegrown PE/VC as LP's.

Increasing domestic investment in PE/VC is crucial for India's economic growth and development. By bolstering local investment, the country can foster a more resilient and self-sustaining startup ecosystem, reduce reliance on foreign capital, and enhance the ability to address unique market challenges. Furthermore, domestic investors bring valuable insights and a deeper understanding of local dynamics, which can lead to better investment decisions and outcomes and more efficient allocation of capital. As the Indian economy continues to evolve, encouraging domestic pension firms, endowment funds, insurance companies to invest in PE and VC will be essential for driving innovation, creating jobs, and sustaining long-term economic growth.

Domestic investments are also essential for job creation, technology development, and overall GDP growth. By investing in local startups and established businesses, domestic investors help stimulate economic activity, which in turn creates employment opportunities across various sectors. This has become even more important in present times when India stares upon a 9.2% unemployment rate. The infusion of capital enables companies to innovate, adopt modern technologies, and expand their operations, contributing significantly to the country's economic landscape. In 2023, despite a decline in overall FII investments the Indian public markets remained resilient because of the high DII participation. We need to create similar level of resilience even in our private markets by bringing in more domestic capital in the PE/VC space.

Moreover, increasing domestic investments expands investment opportunities for local investors, promoting financial inclusion. In India less than 10% of our population owns a stock while it is 61% in the USA. As more domestic funds enter the PE/VC space, retail and institutional investors gain access to diverse investment options, allowing them to participate in the growth of emerging sectors. This democratization of investment opportunities not only enhances individual wealth but also strengthens the overall economy by mobilizing domestic savings for productive use.

Reducing reliance on foreign capital is another critical aspect of fostering a robust PE/VC ecosystem. By increasing domestic participation, India can mitigate risks associated with global economic fluctuations, such as geopolitical tensions and financial crises. A strong domestic investment base provides a buffer against external shocks, ensuring that local businesses have the necessary support to weather economic downturns or any geopolitical shocks.

Also, domestic investments facilitate knowledge transfer and leverage local market expertise, which are vital for fostering innovation and entrepreneurship. Local investors possess a deeper understanding of regional challenges and opportunities, enabling them to provide tailored support to startups and established firms alike. This localized approach not only enhances the chances of success for these businesses but also contributes to a vibrant entrepreneurial ecosystem that drives economic progress.

In India 54% of the wealth is controlled by millionaires. The top 1% control 40.1% of the wealth while the top 0.1% control 29%. This was around 7% in 1980s and has risen sharply. This has given rise to an upper-class eager to explore alternative ways of growing capital providing a boost to the domestic investor ecosystem. A similar trend was seen in China too which grew on the back of local domestic investors with local city funds accounting to 63%

of the total PE deal volume in China between 2016 to 2022. This has allowed China's PEVC ecosystem to stay resilient despite the pullback of funds by the US on the back of the ongoing trade war.

The current state of domestic investments in Indian markets reflect a dynamic and evolving landscape. Domestic investors, including family offices, high-net-worth individuals (HNIs), and institutional investors, are increasingly participating in the PE/VC ecosystem. Family offices and HNIs are leveraging their capital to invest in promising startups and established businesses, contributing to the growth of the domestic investment scene. Institutional investors, such as mutual funds and pension funds, are also playing a significant role, with domestic mutual funds' share in listed companies reaching an all-time high of 8.64% in June 2023. This growing participation underscores the increasing confidence in India's economic potential and the opportunities within the local market. Firms have come up in the shape of family offices of large businesses like Reliance Retail Ventures, Tata Healthcare Fund or in the form of Angel investors like Kunal Shah of Cred, Kunal Bahl of Snapdeal, Family offices of Kris Gopalakrishnan, Pratiti, that of Narayan Murthy, Catamaran or independent PE raising capital from LPs like Kedaara, Multiples, Gaja Capital etc. These firms have created tremendous values both in taking companies from 0 to 1 as well as from 1 to 10.

However, domestic investors face several challenges when investing in private markets. One significant hurdle is risk aversion, as many pension funds, insurance companies prefer safer, short-term investments over the long-term commitment of 5-7 years typically required in PE/VC. Additionally, a lack of expertise in evaluating high-growth startups and emerging sectors can deter investors from making substantial commitments. These challenges are compounded by the need for more robust support systems and educational resources to equip them with the necessary skills and knowledge to navigate the complexities of the investment landscape.

The role of government policies and regulations in private equity (PE) and venture capital (VC) in India is pivotal. Supportive policies, such as tax incentives, regulatory ease, and infrastructure development, have positively impacted the investment landscape. For instance, initiatives like the 'Make in India' campaign and Production-Linked Incentive (PLI) schemes have encouraged domestic firms to enhance production capacities and attract investments. Additionally, the introduction of a streamlined Goods and Services Tax (GST) and the Business Reforms Action Plan have made it easier for businesses to operate, thus fostering a more favourable environment for domestic investors. Also, along with the policies, India's vibrant Digital Public infrastructure has provided a boon to homegrown startups to build over. It is the cornerstone of India's digital transformation. It is a collection of open APIs that allow governments, businesses, and developers to build digital services. Aadhar, UPI, Digi locker, eKYC has helped in financial inclusion, efficiency, transparency, innovation and allowed Indian startups to attract funding and build stable businesses.

However, restrictive policies can hinder investment growth. Bureaucratic hurdles and excessive regulations can create barriers for domestic investors, discouraging them from engaging in the PE/VC space. The complexity of compliance can lead to delays and increased costs, deterring potential investments. For example, the need for numerous approvals and licenses from numerous government organisations can slow down the process of capital deployment.

Looking globally, best practices from countries like the United States and Israel highlight the importance of a supportive regulatory framework that encourages innovation and investment. These countries have successfully implemented policies that reduce bureaucratic red tape, provide tax incentives for startups, and foster collaboration between the public and private sectors.

In the USA, pension funds and insurance companies are allowed to invest in PE/VC but imposes fiduciary duties on plan managers to ensure prudent investments. Insurance companies are regulated at the state level. Most states allow insurance companies to invest in PE/VC, subject to limits based on the company's capital and surplus. Almost all of the capital invested in PE VC ecosystem in the USA comes from local retail and institutions like pension firms and insurance companies.

In India, although the domestic pension and insurance companies are allowed to invest in the PE VC space, they have limits on the amount of allocation and stringent criterions on risk exposure.

In conclusion, the Indian PE/VC landscape has witnessed a transformative shift with the increasing prominence of domestic investors. From insurance giants to family offices and corporate venture arms, the spectrum of domestic capital infusion has broadened significantly. This evolution has been driven by a confluence of factors including economic growth, regulatory reforms, and a burgeoning startup ecosystem. Domestic investments have been instrumental in nurturing homegrown champions, creating employment opportunities, and stimulating innovation. As India continues its journey towards becoming a global economic powerhouse, the role of domestic capital in the PE/VC space is set to expand further. However, challenges such as a relatively shorter investment horizon compared to global counterparts and a need for deeper financial literacy persist. To fully unlock the potential of domestic investments, a conducive ecosystem is essential. This includes policies that encourage long-term investments, robust investor protection frameworks, and a thriving secondary market. With concerted efforts from policymakers, industry stakeholders, and investors, India can solidify its position as a global investment destination, driven by the strength of its domestic capital.