DOI: 10.7763/IPEDR. 2012. V55. 26

Indian Private Equity Industry – The Challenges Ahead

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Abstract. The objective of the current study is to examine the challenges faced by the private equity industry in India. Sixty-four private equity professionals were conveniently approached for the purpose of data collection. Analysis of the collected data revealed that there exist six significant challenges facing the Indian private equity industry: deteriorating economic climate, ethical/regulatory concerns, poor performance, competition, illiquidity and lack of professional expertise. In the wake of these challenges there is a need to proceed with caution. The challenges facing this industry must be meaningfully combatted before this industry can take the desired shape.

Keywords: Private Equity, Challenges, Investors, Factor Analysis

1. Introduction and Review of Literature

Over the last decade, private equity has been instrumental in transforming the world economies. Its presence, in not only the developed economies, but also in the emerging economies can no longer be ignored. Today, it has become a crucial source of finance for companies and has earned the status of an important asset class.

However, experts believe that while the prospects of this industry are bright, its future is likely to be bleak[1]. They opine that the there exist many challenges which may prove a hurdle in the success of this industry.

A review of the existing literature shows that the lack of available credit is the most significant challenge faced by the private equity industry. This lack of credit has stemmed from many reasons, some of which include destabilization of world economies, poor investor confidence and unpromising growth prospects[2].

Another significant challenge holding back the growth of this industry is the ethical concern of the stakeholders[3]. One of the respondents who preferred to remain anonymous expressed his concern thus: “As if operating in a harsh fundraising setting is not a challenge enough, private equity companies are also expected to adhere to the most rigorous ethical and governance standards, duly accompanied by adequate transparency.” Meaningfully combatting this challenge has become more significant in the wake of latest criticism by experts wherein private equity firms have been accused of asset striping[4] and non-transparent practices[5].

Further, there also exist a host of other challenges “facing the private equity industry including regulation, competition, limited partner sentiment and performance”[6]. While acquirers are ready to pay a premium for businesses with a strong potential for revenue growth, the future of the businesses lacking this feature is in jeopardy.

There thus exist “investment challenges for actual and prospective private equity investors in terms of the legal, regulatory, cultural and macroeconomic environment”[7].

2. Objective of the Study

Experts in the field of private equity believe that the private equity industry today is facing many significant challenges (refer to section 1), which are retarding the growth of this industry. The opinion of the experts and the lack of research in this area in the Indian context provided the necessary impetus for current study. The current study is thus an attempt to explore the challenges faced by the private equity industry in India.

3. Research Methodology

3.1. Construction of the Questionnaire

The questionnaire consisted of an inventory of statements describing the probable challenges faced by the private equity industry. An attempt was made to draft these statements on the basis of review of literature. Also for the same, 10 private equity executives were interviewed. In order to ensure rationality of responses, only executives with at least 5 years of relevant experience were approached. The responses of these interviewees significantly helped in the construction of the questionnaire. The responses to these statements used in the questionnaire were anchored on a five point Likert scale with one indicating a 'strong agreement' and 5 indicating a 'strong disagreement' with the statement. Apart from the inventory of statements, the questionnaire also contained questions on the profile of the respondents.

The final questionnaire was pretested for validity and clarity on respondents conveniently selected from the relevant population.

3.2. Data Collection

Data for the study was collected over a six-month period (February 2012 to July 2012) from 16 different Indian states. In all 70 questionnaires were conveniently administered to private equity professionals. At the end of the survey however, only 64 usable questionnaires were obtained. The final analysis was therefore conducted with the data obtained from these 64 questionnaires.

3.3. Reliability of the data

Before subjecting the data to analysis, its reliability was established with the help of Cronbach's coefficient Alpha. Its value worked out to .710 (refer to table 1). This clearly establishes the reliability of the data[8, 9].

Table 1: Reliability of the data

Cronbach's Alpha	Number of items
710	15

3.4. Data Analysis Technique

After verifying the reliability of the data, the data reduction technique of factor analysis was used to analyze the responses of the respondents. The extraction method used was Principle Component Analysis. It was followed by Varimax with Kaiser Normalization[10, 11].

3.5. Profile of the Respondents

Table 2 presents the profile of the 64 respondents.

Table 2: Profile of the Respondents

Variable	Categories of variable	Frequency	Percentage
Type of private equity professional	Entrepreneurs seeking private equity funds	14	21.9
	Professionals employed in the private equity industry	36	56.3
	Investment managers	3	4.7
	Advisors/Consultants	7	10.9
	Fund managers	4	6.2
Gender	Male	61	95.3
	Female	3	4.7
Age	Less than 20 years	0	0
	20 – 35 years	46	71.9
	35 – 50 years	16	25.0
	50 – 60 years	2	3.1
	Older than 60 years	0	0

As can be seen from table 2, 21.9 percent of the respondents were entrepreneurs seeking private equity funds, 56.3 percent were professionals employed in the private equity industry, 4.7 percent of the respondents were investment managers and 10.9 and 6.2 percent respondents were advisors/consultants and fund managers respectively. As far as the gender of the respondents was concerned, 95.3 percent were male and only 4.7 percent were female. Lastly, 71.9 percent respondents were in the age group of 20 to 35 years, 25 percent in the age group of 35 to 50 years and only 3.1 percent respondents were in the age bracket of 50 to 60 years.

4. Data Analysis and Discussion

After establishing the reliability of the data, it was reduced by applying factor analysis. The results are shown and discussed in this section.

On reduction of the data, a six-factor solution emerged (refer to table 4). The Kaiser-Meyer-Oklin measure of sampling adequacy was .812 (refer to table 3). The total variance of the solution was 68.16 percent. Further, only those factors were retained which had an Eigen value of greater than 1.0. Also, only those variables, which loaded clearly on one factor with a loading of greater than 0.5[11] (15 out of the initial 16 variables contained in the questionnaire) were retained (for variables refer to annexure 1). These constructs establish the reliability of the model[12]. The results of factor analysis are shown in table 4.

Table 3: KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.812
Bartlett's Test of Sphericity	Approx. Chi-Square	960.212
	Df	126
	Sig.	.000

Table 4: Results of Factor Analysis

Factor Number and Name	Eigen Value of Factor	Scale Items		
		Item Number	**Item Name**	**Loading**
Factor I Deteriorating economic climate	5.001	4	The deteriorating economic and financial activities have led to a decline in private equity investment activity.	.814
		3	Uncertainty in the world markets has led to postponement of new deals by acquirers.	.719
		7	On account of the current financial crisis, the rate at which deals are settled is likely to go up/ already on the rise.	.702
Factor II Ethical and regulatory concerns	3.224	9	Governance concerns have led to slow down of activity in the private equity industry.	.810
		1	In the wake of numerous scandals, it has become difficult to attract private equity.	.753
		14	The legal and regulatory framework of the private equity industry is not in place.	.688
Factor III Poor performance	2.516	8	Lack of lengthy track records is a major hurdle in the way of private equity fund raising.	.836
		15	Dearth of promising target companies in a slowly growing economy has led to higher prices for acquisitions.	.777
		11	Institutional investors are getting disillusioned because the returns of the private equity industry are insufficient to justify the asset class.	.689
Factor IV Competition	1.648	10	Since large and small firms compete in the same market, it is more difficult for the small firms to raise private equity.	.914
		12	Inability of the private equity companies to differentiate themselves poses a major challenge for these companies.	.618
Factor V Illiquidity	1.416	5	The private equity market is illiquid because secondary players have held back.	.678
		6	Achieving liquidity for investors via IPOs is a major challenge for the private equity industry.	.515
Factor VI Lack of professional expertise	1.008	2	It is difficult for the private equity managers to make the investors believe that they know what they are doing.	.714
		16	Lack of trained professionals is holding back the growth of the private equity industry.	.501

Factor 1: Deteriorating economic climate

Destabilization of the world economies is proving to be a major hurdle in the success of the private equity industry. In the wake of the ever-worsening macroeconomic scenario, private equity investment has seen a decline. Keeping the investors satisfied has become a difficult feat.

The impact of the current situation is manifesting itself in two different ways: either acquirers are postponing new deals or asking for a higher rate to settle the deal.

Factor 2: Ethical and regulatory concerns

Ethics has become a matter of concern for all industries worldwide and the private equity industry is no different. Concerns pertaining to ethics, governance, legal and regulatory issues have adversely influenced the Indian private equity industry.

Factor 3: Poor performance

This factor indicates that the poor performance of private equity firms is one of the major challenges facing the private equity industry. On account of this poor performance investors have lost faith and hence the performance of the firms in this sector must be considerably improved to once again regain the faith of the investors.

Factor 4: Competition

In the face of the stiff competition in the private equity industry, small firms competing with large firms are finding it difficult to carve a niche for themselves. Also, competition has made it imperative for firms to distinguish themselves from the other firms in the industry.

Factor 5: Illiquidity

The private equity markets are illiquid on account of primarily two reasons: secondary players have held back and poor liquidity via IPOs. The call of the hour is to infuse liquidity into the private equity markets. This requires improving both the primary as well as the secondary markets.

Factor 6: Lack of professional expertise

The last challenge that has emerged after the analysis of data is the lack of professional expertise in this industry. The private equity industry is a relatively new industry and lacks trained professionals. It thus becomes imperative for the fruitful survival of this industry to impart the necessary training to its professionals. This shall also be helpful in winning the faith of the investors.

5. Conclusion and Implications

To conclude it can be said that there exist six significant challenges facing the Indian private equity industry: deteriorating economic climate, ethical/regulatory concerns, poor performance, competition, illiquidity and lack of professional expertise. In the wake of these challenges there is a need to proceed with caution.

Past data on the private equity industry in India has divulged that although private equity activity has considerably accelerated in the last decade, much is still desired[1]. This becomes especially conspicuous when the Indian private equity industry is compared with the private equity industry of the developed countries. The extreme lack of credit in the Indian industry viz-a-viz the foreign industries may be on account of the many challenges faced by the Indian private equity industry. Therefore, the challenges facing this industry must be meaningfully combatted before this industry can take the desired shape.

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1. In the wake of numerous scandals, it has become difficult to attract private equity.
2. It is difficult for the private equity managers to make the investors believe that they know what they are doing.
3. Uncertainty in the world markets has led to postponement of new deals by acquirers.
4. The deteriorating economic and financial activities have led to a decline in private equity investment activity.
5. The private equity market is illiquid because secondary players have held back.
6. Achieving liquidity for investors via IPOs is a major challenge for the private equity industry.
7. On account of the current financial crisis, the rate at which deals are settled is likely to go up/ already on the rise.
8. Lack of lengthy track records is a major hurdle in the way of private equity fund raising.
9. Governance concerns have led to slow down of activity in the private equity industry.
10. Since large and small firms compete in the same market, it is more difficult for the small forms to raise private equity.
11. Institutional investors are getting disillusioned because the returns of the private equity industry are insufficient to justify the asset class.
12. Inability of the private equity companies to differentiate themselves poses a major challenge for these companies.
13. Heavy reliance on leverage is a significant challenge facing the private equity industry.
14. The legal and regulatory framework of the private equity industry is not in place.
15. Dearth of promising target companies in a slowly growing economy has led to higher prices for acquisitions.
16. Lack of trained professionals is holding back the growth of the private equity industry.

Annexure 1: Statements Used in the Questionnaire