McKinsey&Company

Rohit Kapur, Vivek Pandit,
and Toshan Tamhane

Private equity and India's economic development

McKinsey Digital August 2015

Our new survey determines if India's emerging private-equity sector has helped or hurt the country and its companies.

Private equity has injected more than $100 billion of capital into India in the past 13 years, providing scores of companies with a vital new funding source. Yet the sector continues to be considered a mixed success. Has private-equity capital helped bring new skills and capabilities to investee companies? Or has it simply pushed companies to sweat assets, take on excessive leverage, and strip nonessential components to benefit a few?

The much bigger and more useful question is whether India has benefited from the contribution of private equity. We examined data and surveyed dozens of stakeholders, including key regulators, and found that it has played a pivotal role in the development of small and medium-size enterprises and critical industries, spurred job growth, and facilitated the development of strategic capabilities. And while it has shortcomings, we are optimistic about the role it can continue to play in India's economic development.

What we found

Private equity's contribution to fund-raising in India has increased over the past 15 years: from 20 percent of total capital raised in 2001–05 to 31 percent in 2006–10 to 46 percent in 2011–14. With a standard deviation of 76 percent, private-equity capital has proved to be a more stable source of equity funding than foreign institutional investment (a standard deviation of 100 percent) and initial public offerings (103 percent). The standard deviation of capital is important: the lower the percentage, the more stable and reliable the asset class is with regard to the availability of financing.

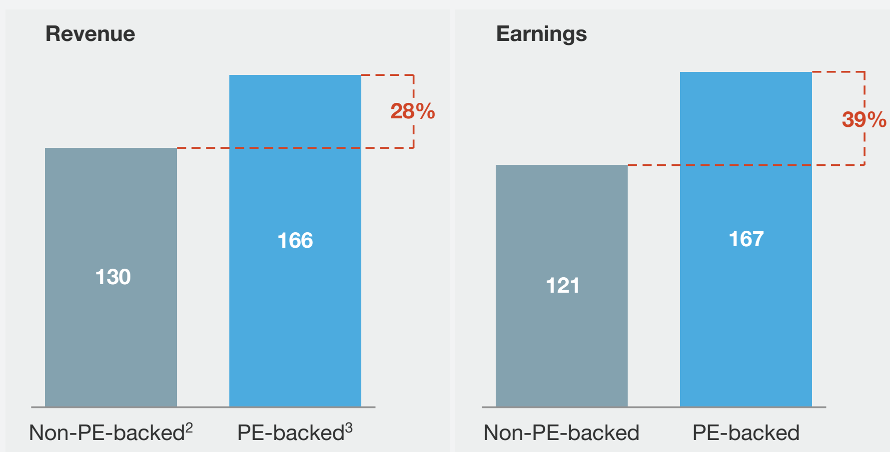
Over this period, approximately 3,100 companies received infusions of private-equity capital: roughly half were companies with annual revenue of less than $2 million, and another 30 percent were companies with revenue of $2 million to $125 million a year. This highlights its critical role in the development of early-stage ventures and small and medium-size enterprises, and the risk appetite of private-equity investors has undoubtedly helped shape the development of some critical industries. The most well-known and oft-cited example is mobile telecommunications: 4 of the top 10 Indian telecom companies and 7 of the top 9 tower operators were funded by private-equity capital. It's similar in information-technology services, where 6 of the top 15 companies were funded by private equity.

One clear impact of private equity in portfolio companies is accelerated job growth. In the five years following initial investment, companies backed by private-equity firms grew direct employment 6 percent faster than those not backed by the sector. Private-equity-backed companies also grew faster than the non-private-equity backed ones, both in revenue and profits (Exhibit 1).

Exhibit 1

Revenue and earnings grow faster at companies backed by private equity (PE).

Comparison of PE-backed and non-PE-backed companies,[1]
year of PE investment indexed to 100 compared with 2 years after investment



[1]Analysis compares growth in PE-backed companies 2 years after PE investment to growth in non-PE-backed companies over a comparable period. The weighted average was calculated based on the performance of PE-backed and non-PE-backed companies over FY 2007–15.
[2]Sample of non-PE-backed companies consists of 1,075 comparable listed companies for FY 2007–15.
[3]PE-backed company sample is based on 200 PE investments in listed companies between FY 2007–15.

McKinsey&Company | Source: AVCJ Research; S&P Capital IQ; VCCEdge; McKinsey analysis

Our study also found a deeper, structural impact of private-equity involvement: private equity has often facilitated and encouraged investee companies to build strategic capabilities. Exports at private-equity-backed companies grew about 60 percent faster than those at companies not backed by the sector; in addition, more than 80 percent of private-equity-backed companies made their first cross-border merger or acquisition after receiving private-equity funding. This correlation holds at an overall level and by industry, suggesting that private-equity investors helped investee companies by bringing to bear their global experience, foreign-market access, deal-making expertise, and networks (Exhibit 2).

Exhibit 2

Cross-border M&A occurs more quickly and more often with companies backed by private equity (PE).

Companies involved in cross-border M&A, 2001–13, %

Sector	Non-PE-backed[2]	PE-backed[3]	First time after PE investment, %
Automobiles and components	2.8	11.3	**83**
Pharmaceuticals and biotechnology	6.2	10.0	**80**
Metals, mining, and materials	2.2	8.8	**88**
Engineering and construction	3.2	7.8	**75**
Machinery and industrial goods	1.9	6.1	**90**
Consumer goods	1.5	5.8	**77**
IT and IT-enabled services	14.1	5.7	**78**
Other[1]	1.2	1.8	**76**

[1]Includes business services, energy and utilities, financial services, media and entertainment, real estate, telecommunications, and other miscellaneous sectors.
[2]Sample of 584 non-PE-backed companies that did cross-border M&A between 2001 and 2013.
[3]Sample of 126 PE-backed companies that did cross-border M&A between 2001 and 2013.

McKinsey&Company | Source: AVCJ; CMIE Prowess; McKinsey analysis

A big advantage of private-equity investment that's not highlighted often enough is its "governance dividend." Private-equity investors have been able to influence investee companies to enhance their corporate governance standards through measures such as the appointment of independent directors, better functioning of the audit and compensation committees, and increased board oversight. When we asked portfolio companies to name the most significant contribution by private-equity board members within six months of investment, 65 percent of the executives surveyed pointed to material changes in compliance and governance measures, including appointment of new auditors.

Of course, private equity has its shortcomings. In the years prior to 2008–09, private-equity investors often took minority positions in companies—in more than 62 percent of transactions, they took less than a 25 percent stake, often without major governance rights. This made it difficult to influence the company in any meaningful manner and, not surprisingly, there were more than a few disputes over strategy, operational value creation, and the timing of capital events.

In addition, private equity's record is checkered when viewed from the perspective of providers of capital. Of the $51 billion invested up to 2008, only $16 billion was able to be extracted by January 2014—and the multiple of 1.7x is far below expectations. One could argue it's because of a host of underlying causes, ranging from the global financial downturn to the devaluation of Indian rupee. Yet the impact on investors is undeniable: they paid high entry prices to make investments and found exit routes restricted.

Overall, though, our study gave us optimism. It's clear that private equity as an asset class has had a significant impact on investee companies in India as well as the underlying economy. And while we know there's room to improve eventual returns, private equity could play a big role in powering the Indian economy in the months and years to come. □

For the full report on which this article is based, see *Indian Private Equity: Route to Resurgence*, on mckinsey.com.

Rohit Kapur is a director in McKinsey's Mumbai office, where **Vivek Pandit** is a director and **Toshan Tamhane** is a principal.