

# Indian private equity: Coming of age

Private Equity & Principal Investors Practice, November 2018



**Authored by**  
Peeyush Dalmia  
Vivek Pandit  
Gaurav Sharma  
Dushyant Singh



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# Preface

As more capital becomes available, competition increases, and lessons from past excess and inexperience result in better performance, private-equity firms are reevaluating their strategies and internal capabilities.

In McKinsey's 2015 report, *Indian private equity: Route to resurgence*, the authors analyzed the performance of the private-equity industry in India and its impact on the Indian economy.<sup>1</sup> At that time, the industry was at a crossroads, and we highlighted the challenges it faced and identified some green shoots that indicated a possible revival. In the aftermath of the global financial crisis, fund managers were forced to reevaluate their playbooks and tool kits; the changes they made prepared them for the next phase of growth.

Since then, the volume of private-equity activity—fund-raising, investment, and exits—has indeed grown, helped by global liquidity and the inability of other domestic sources of capital to keep pace with a growing economy. In another good sign, the industry has seen a greater range of participants and a wider spectrum of deal types and investment strategies. Other indicators are more mixed. Growth has been strong but heavily concentrated. Deals greater than \$100 million are the only category that grew in the past three years. And these larger deals have, up until now, earned lower returns than smaller deals.

Firms are learning from experience and shifting into buyouts, where they have more influence over their investments. They are also choosing to focus on sectors with sound macroeconomics and more liquidity. But with the influx of new participants, the industry has become more crowded. The number of investors and new funds grew, while deal count fell, in 2015 and 2016 (before rebounding in 2017).

Now a rebounding industry enters a new phase. Five emerging discontinuities have the potential to alter competition and behavior:

- A flood of capital, as global limited partners (LPs) increase allocation to private equity and local sources of capital are accessed
- Heightened competition, including from direct-investment teams of LPs
- A new pool of restructuring opportunities, as banks unwind stressed loan portfolios
- A new generation of business owners and professional managers that are more open to alternative investments and partnership models with private-equity funds
- The emergence and adoption of impact investing strategies

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<sup>1</sup> Vivek Pandit, Toshan Tamhane, and Rohit Kapur, *Indian private equity: Route to resurgence*, June 2015, McKinsey.com.



How private-equity firms adapt to these discontinuities could differentiate winners from also-rans. In this evolving environment marked by more capital, a wider range of opportunity and deal types, heightened competition, and a redefinition of traditional relationships and alignments, private-equity firms that can deliver consistent performance at scale could capitalize on an outsized opportunity. While shifting gears may be difficult, we see an expanding role for private equity as India strives for greater globalization, efficiency, and economic development.

**Peeyush Dalmia**

Partner

**Vivek Pandit**

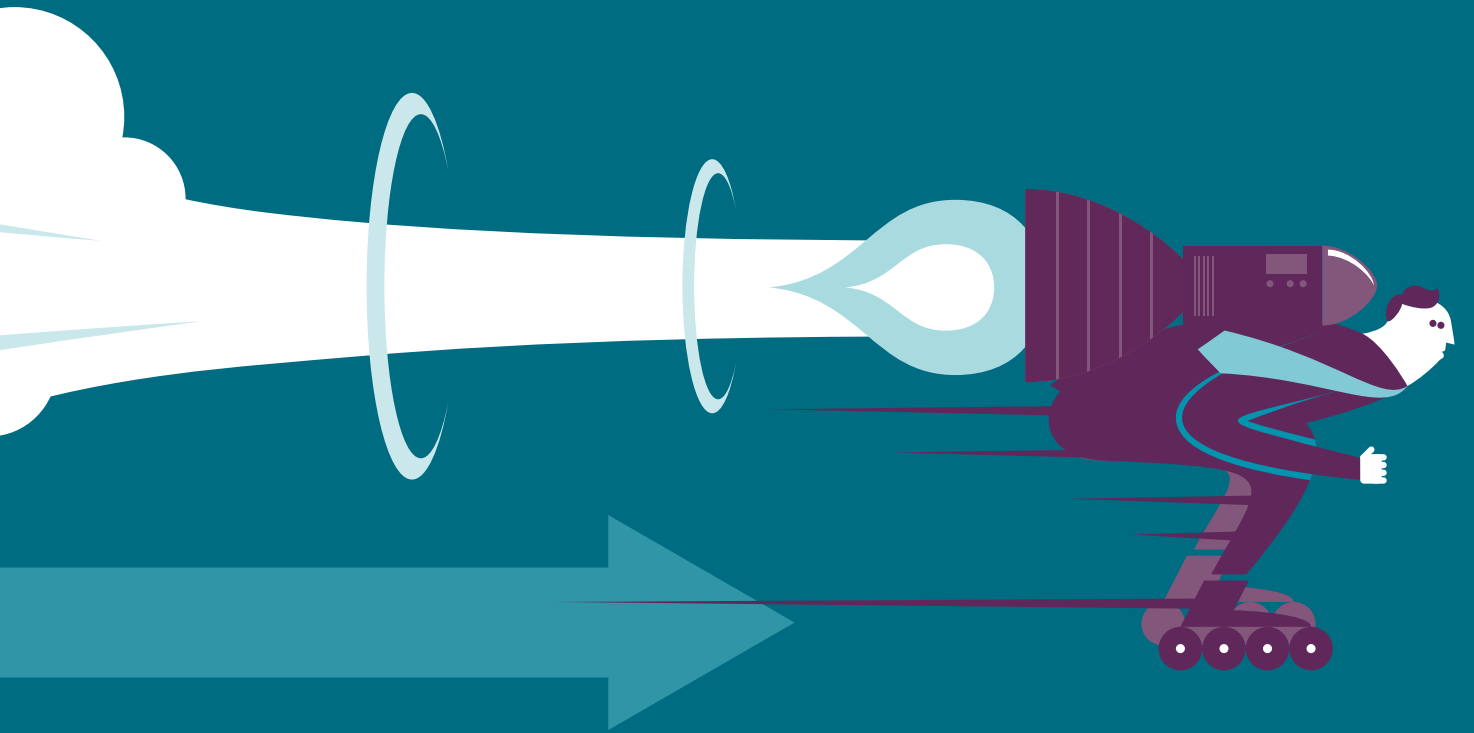
Senior Partner

**Gaurav Sharma**

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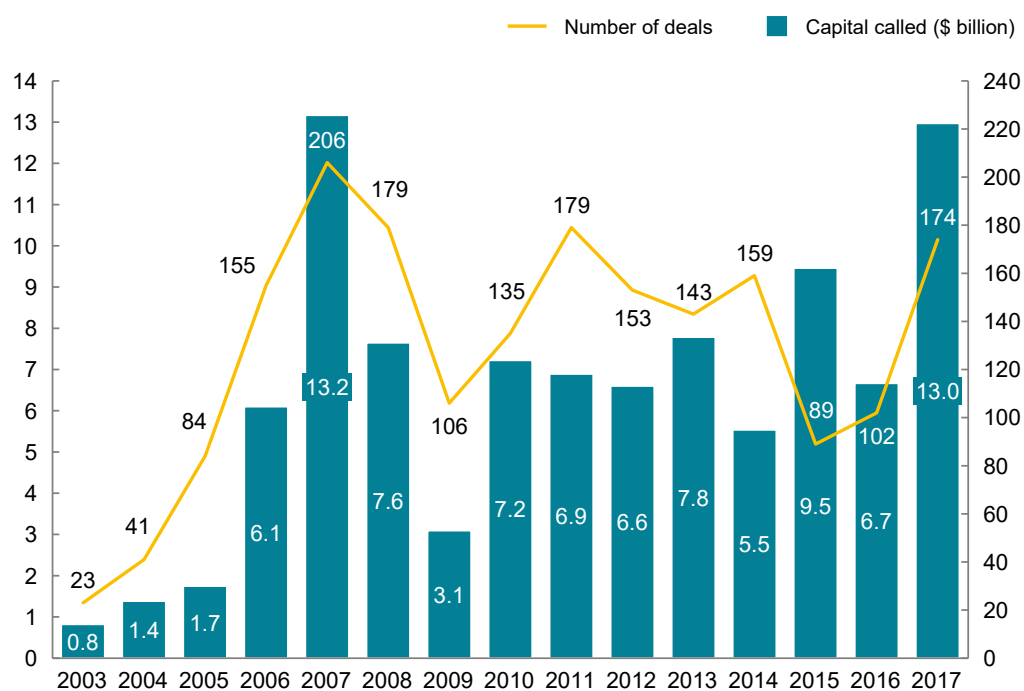
# Deployment: Riding a wave

Since 2003, private-equity firms have invested more than \$97 billion in India; this amount excludes funds invested in real estate assets and venture capital. Recent investment growth is strong: more capital was deployed in 2017 than in any year since the global financial crisis (Exhibit 1). Deal count picked up as well in 2017, after a two-year lull.

Exhibit 1

## Private equity has invested more than \$97 billion in India since 2003.

### Capital deployed and deal count<sup>1</sup>



<sup>1</sup> Excludes venture capital and real estate investments.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

Is this growth sustainable or will the industry overheat at these activity levels? Our assessment shows that recent growth is underpinned by several long-term forces and that there is considerable opportunity for advancement.

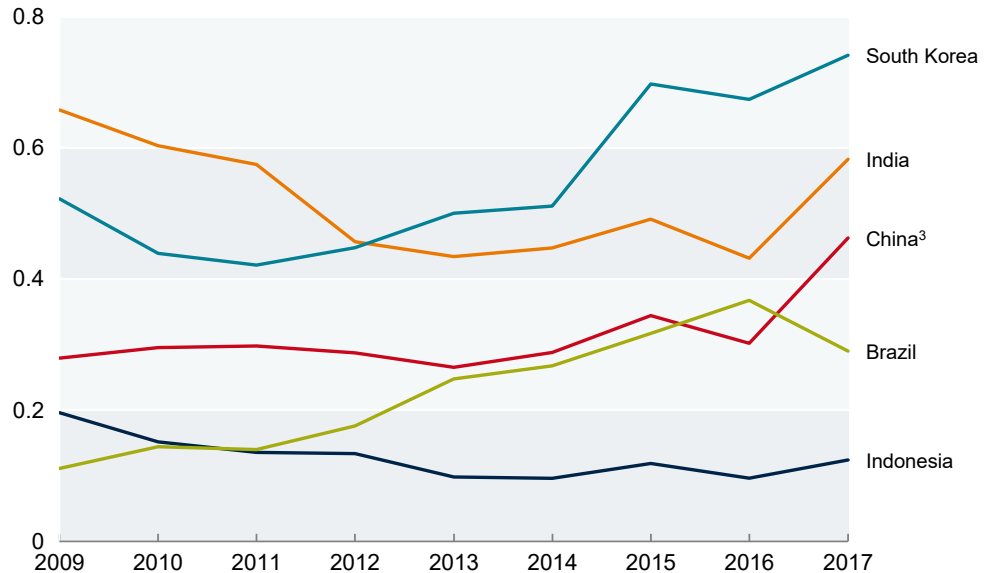
### Investment supported by a buoyant global investment climate for private markets

Investment intensity—measured as a ratio of private-market investment to GDP—has long been higher in India than most other emerging markets (Exhibit 2). Recent investment growth, in the context of a growing economy, is simply a reversion to earlier levels of intensity.

Exhibit 2

**Investment intensity in India continues to be strong relative to most emerging markets.**

**Private-market investment<sup>1</sup> intensity (% of GDP)<sup>2</sup>**



1 Includes private-equity, venture capital, and real estate investments. Private equity includes buyouts, private investment in public equity (PIPE), expansion, turnaround, mezzanine/pre-IPO, and bridge loans. Venture capital includes seed/R&D, start-up/early-stage, and small and medium enterprises (SMEs).

2 Ratio of average annual private-market investment over the past five years and the most recent year's GDP.

3 China includes Hong Kong, the People's Republic of China, and Taiwan.

SOURCE: AVCJ Research; Capital IQ; HIS; Pitchbook; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

A key factor affecting investment growth is a buoyant global investment climate for private market investments. As McKinsey's recent report *The rise and rise of private markets* points out, growth in private investments is influenced by a combination of factors, including investors' needs for higher returns as well as declining returns in other asset classes.<sup>2</sup> India's share of global private investments, at 2.2 percent during the period from 2015 to 2017, is roughly equal to that during the period from 2009 to 2011 (Exhibit 3). As investor allocations to emerging markets grow and GDP growth remains robust, there is potential for India's share to rise.

**Rise of local and regional fund managers as regional specialists**

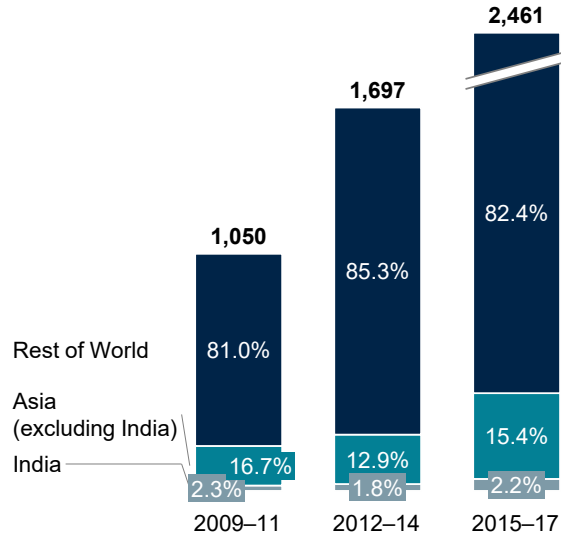
India-based managers raised \$6 billion from 2015 to 2017, 50 percent more than from 2012 to 2014. Yet their share of fund-raising focused on Asia-Pacific has remained essentially flat since the period from 2009 to 2011 (Exhibit 4). The share of local managers in private-equity investment remains lower in India than in China. Local managers participated (including through club deals with other firms) in 42 percent of Indian private-equity investment; in China, the figure was 83 percent. A quarter (by value) of India-focused funds are pooled and managed outside India. An increase in allocation to private equity by India-based investors, and regulatory actions to incentivize pooling of funds in India, could result in a significant increase in fund-raising by locally domiciled fund managers.

<sup>2</sup> *The rise and rise of private markets*, February 2018, McKinsey.com.

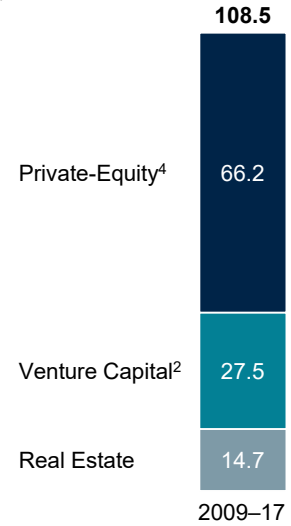
Exhibit 3

**India attracts more than 2 percent of global private-market investment, two-thirds of which goes to private equity.**

Private-market investment<sup>1</sup>—India vs Rest of World, \$ billion<sup>2</sup>



Private-market investment—India, \$ billion<sup>3</sup>



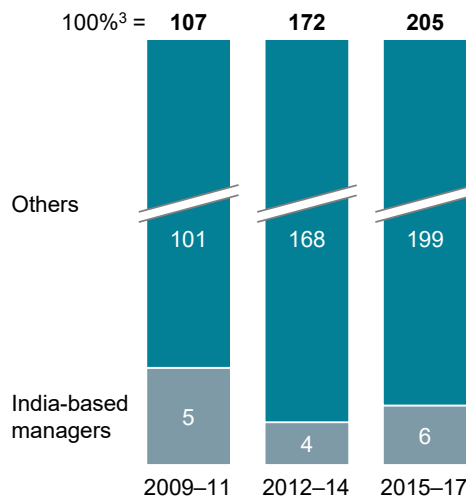
- 1 Includes private-equity, venture capital, and real estate investments.
- 2 Includes seed/R&D, start-up/early stage, and SMEs.
- 3 Figures do not sum to total, because of rounding.
- 4 Includes buyouts, PIPE, expansion, turnaround, mezzanine/pre-IPO, and bridge loans.

SOURCE: AVCJ Research; Capital IQ; Pitchbook; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

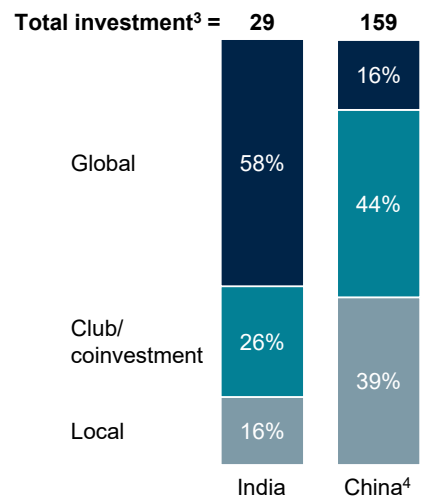
Exhibit 4

**India-based managers have raised more than \$6 billion since 2015.**

Private-equity fund-raising focused on Asia-Pacific<sup>1</sup> by location of fund manager, \$ billion



Share of private-equity investment<sup>2</sup> by investor location 2015–17, \$ billion



- 1 Includes growth/expansion, buyout, PIPE, coinvestment, hybrid, secondaries, special situations, balanced, turnaround, mezzanine, direct secondaries, and coinvestment multimanager funds; includes only fully closed funds focused on Asia-Pacific. Excludes venture capital and real estate investments.
- 2 Includes buyouts, PIPE, expansion, turnaround, mezzanine/pre-IPO, bridge loans. Excludes venture capital and real estate loans.
- 3 Figures may not sum to totals, because of rounding.
- 4 China includes the People's Republic of China, Hong Kong, and Taiwan.

SOURCE: AVCJ Research; Preqin; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

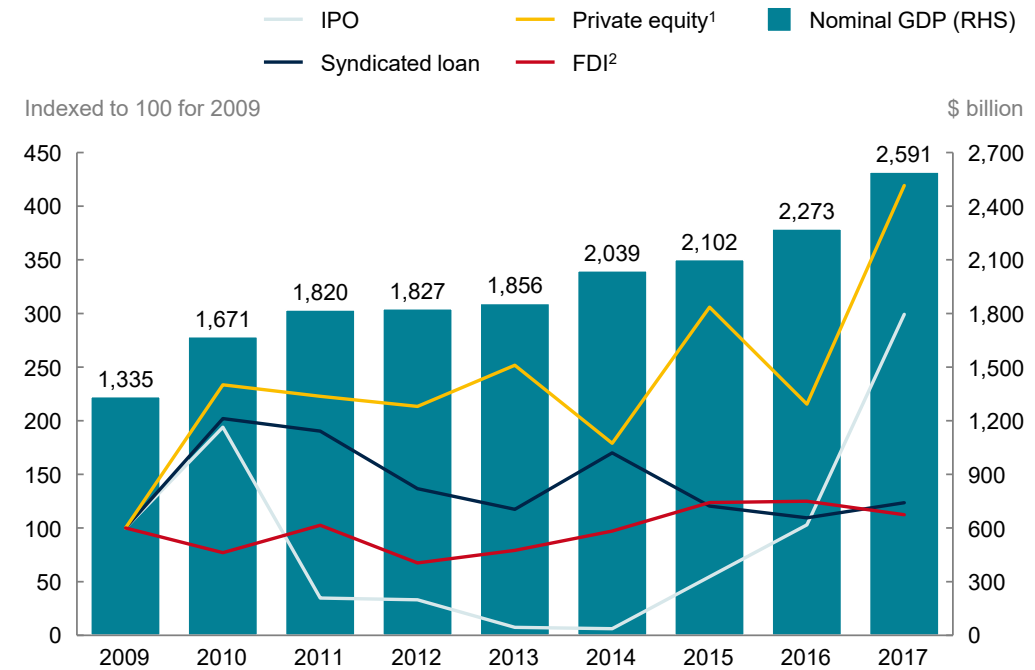
### Alternative capital not keeping pace as consistently

Since 2009, India's economy (in nominal terms) has doubled in size. During this period, private equity has increased fourfold, the syndicated loan market and (non-private-equity) foreign direct investment (FDI) have remained mostly flat, and IPOs have been a volatile source of capital at best (Exhibit 5).

#### Exhibit 5

### Private equity grows with the economy.

#### Growth of select sources of capital vs GDP



1 Excludes venture capital and real estate investments.

2 Foreign direct investment.

SOURCE: AVCJ Research; Capital IQ; DealLogic; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

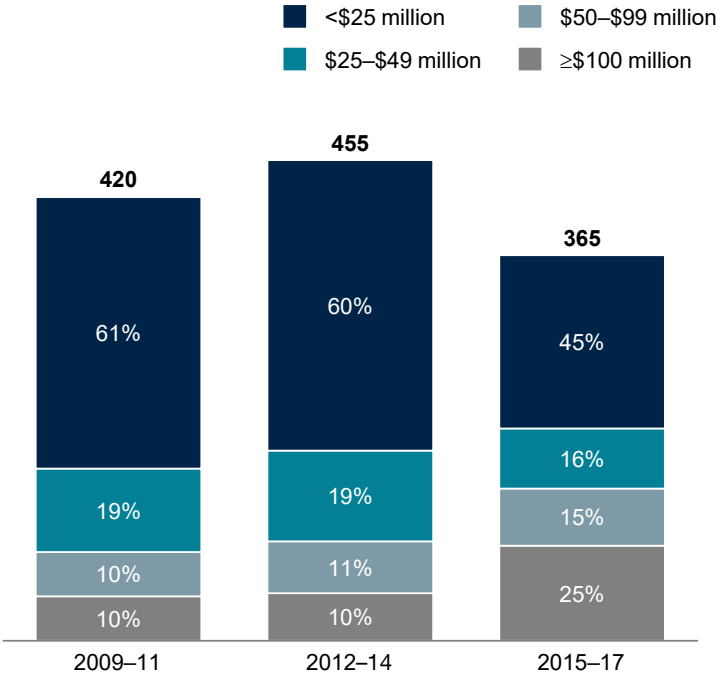
### Private equity deploying more capital in larger deals and companies

In keeping with the global trend of larger funds and bigger deals, private-equity growth in India has been fueled by an expansion in deal size, as general partners (GPs) seek larger deals. While deal count fell approximately 20 percent during the period from 2015 to 2017 compared with 2012 to 2014, the number of deals greater than \$100 million more than doubled (Exhibit 6). At the same time, the number of deals of less than \$25 million fell by 40 percent.

Exhibit 6

Investment growth is driven by deals greater than \$100 million.

Number of deals by size<sup>1</sup>



<b>Number of deals &gt;\$500 million</b>	<b>1</b>	<b>3</b>	<b>8</b>
<b>Average size of deals ≥\$100 million</b>	<b>191</b>	<b>233</b>	<b>245</b>
<b>Largest deal size in period (\$ million)</b>	<b>~851</b>	<b>~1,250</b>	<b>~1,800</b>

<sup>1</sup> Excludes venture capital and real estate investments. Figures may not sum to 100% because of rounding.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis



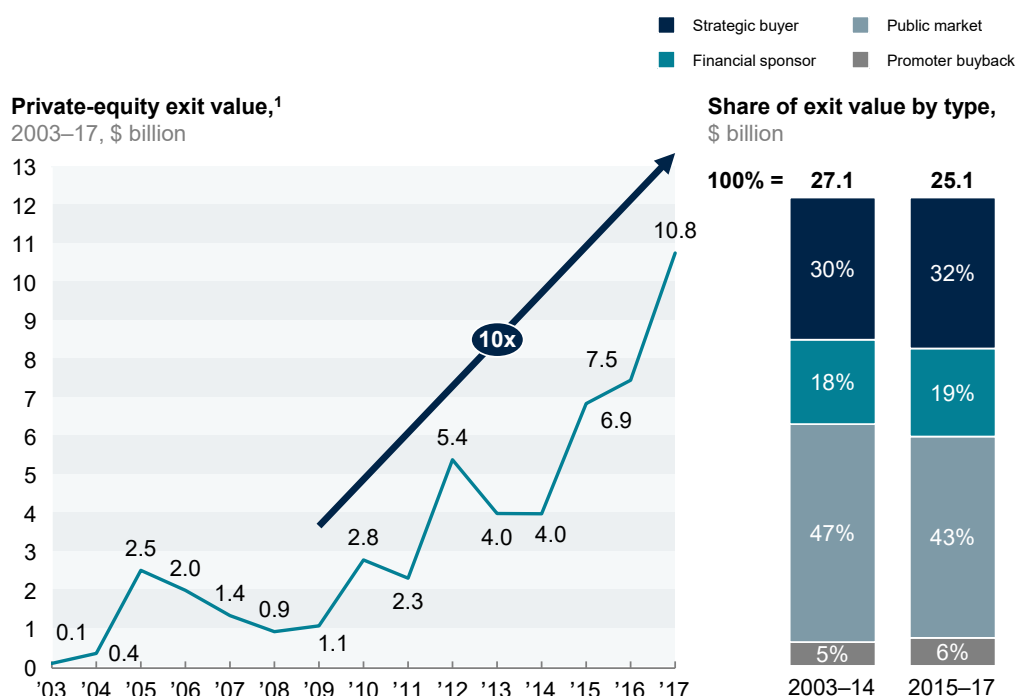


# Exit: Gaining momentum

In 2015, private equity had an overhang of unexited investment.<sup>3</sup> Since then, the pace of exits has grown significantly, to \$10.8 billion in 2017—a tenfold growth since 2009. In fact, 48 percent of all exits since 2003 (by value) took place in the past three years (Exhibit 7).

Exhibit 7

## Exits are growing; sale to public markets and strategic buyers account for three-quarters of exits.



<sup>1</sup> Based on exits 2003–17 where transaction amounts were disclosed; includes full and partial exits. Excludes venture capital and real estate investments.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

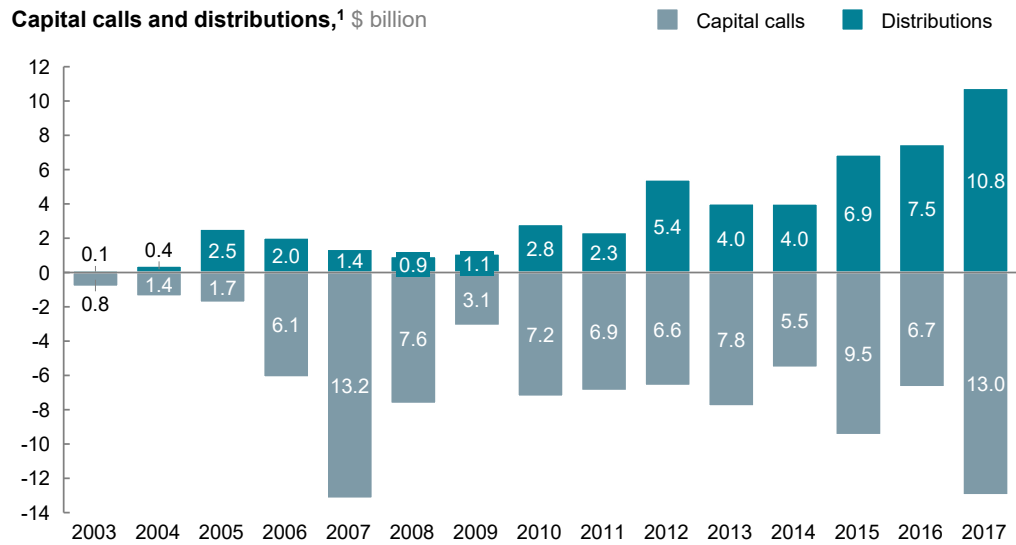
Sales to strategic buyers account for almost a third of exits (measured by value) from 2015 to 2017. This finding underscores the influence private-equity investors wield over exit approaches and timing to capture value, reposition portfolio companies as attractive acquisition targets, and steer other owners and investors through an exit process. Buoyant markets have recently facilitated sales to the public. These sales grew 1.5 times from 2015 to 2017 compared with 2011 to 2014, although such exits claimed a slightly lower share than they did over the longer period of 2003 to 2014.

Since 2014, the industry has focused efforts on exits and returned more capital to investors than in previous years (Exhibit 8). Capital calls exceeded distributions in 2017, although distributions have grown over the past five years (Exhibit 8).

<sup>3</sup> Vivek Pandit, Toshan Tamhane, and Rohit Kapur, *Indian private equity: Route to resurgence*, June 2015, McKinsey.com.

Exhibit 8

**Capital calls have nearly doubled and distributions have increased fourfold since 2011.**



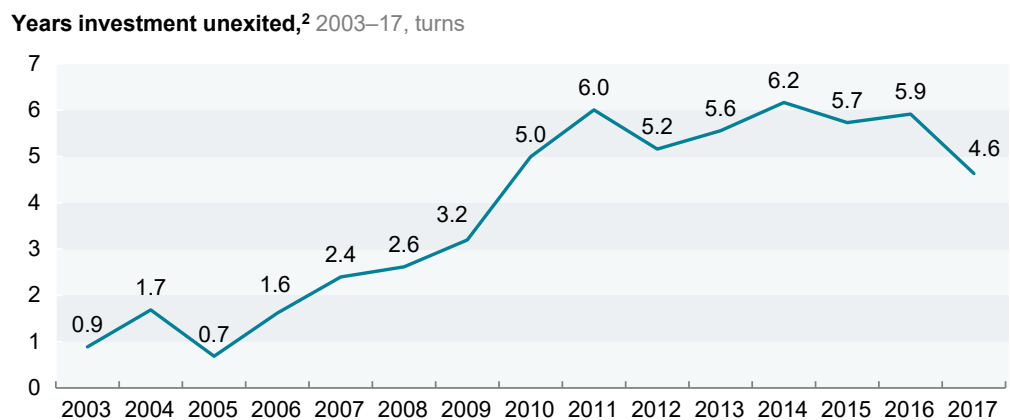
<sup>1</sup> Excludes venture capital and real estate investments. Exits updated through 2017.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

The increased pace of exits has arrested growth of unexited capital. The value of investments not yet exited in 2017 stands at 4.6 years of investment—well down from its peak of 6.2 years in 2014 (Exhibit 9).

Exhibit 9

**Unexited capital<sup>1</sup> dropped below an investment duration of five years in 2017 for the first time since 2009.**



<sup>1</sup> Unexited capital calculated as cumulative capital called minus returned-till date.

<sup>2</sup> Unexited capital divided by three-year trailing average investment.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis





# Investment: Four emerging trends

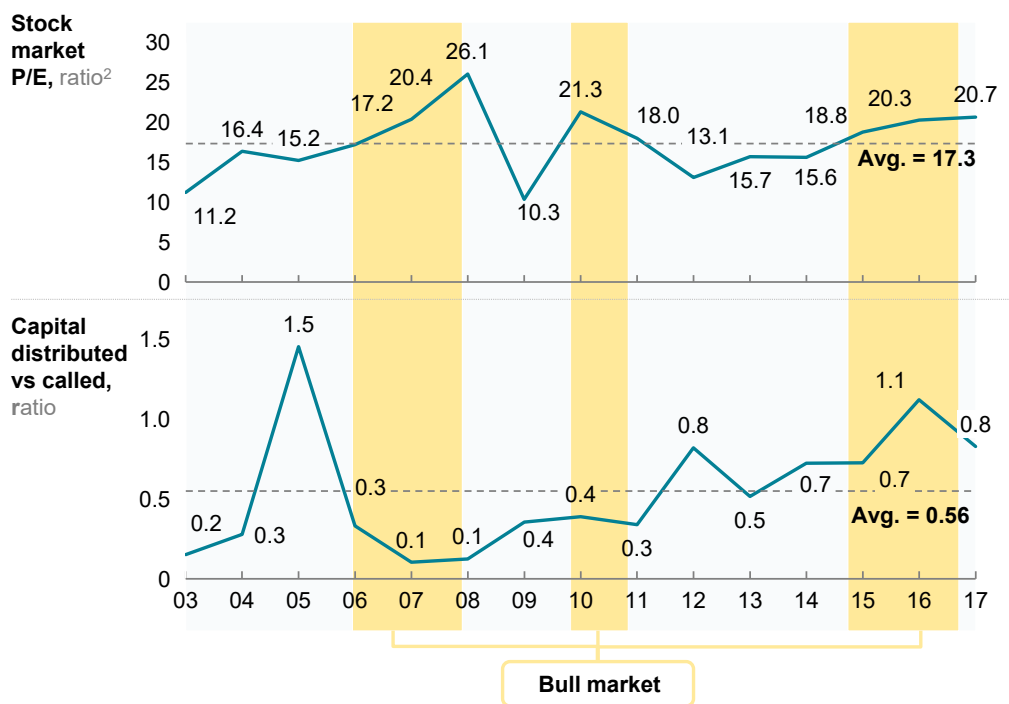
The industry's experience over the past decade and a half has shaped some common wisdom about good investment practice in India. These insights can be summarized under four broad themes.

## Influence over timing matters

Private-equity investments in India have tended to follow market momentum, with volume rising during bull phases and few, if any, contrarians to be found. For example, from 2003 to 2013, 70 percent of private-equity investments were made when asset prices—P/E multiples on listed stocks, for instance—were above long-term averages.<sup>4</sup> Over the past three years, private-equity exits grew faster as markets became more expensive, the result of fund managers becoming more disciplined about exits and less inclined to invest in an aging bull market (Exhibit 10).

Exhibit 10

### The ratio of capital distributions to calls<sup>1</sup> rose from 2015 to 2017—unlike during earlier bull markets.



<sup>1</sup> Excludes venture capital and real estate investments. Exits updated through 2017.

<sup>2</sup> Stock market P/E is defined as current market capitalization divided by 12-month trail earnings for top 200 Indian companies (by market cap).

SOURCE: AVCJ Research; Datastream; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

This activity contrasts with earlier bull periods—such as 2007 to 2008 and 2010 to 2011—when investments grew faster than exits. With stock-trading multiples above long-term averages and unexited investments from pre-2012 vintages at more than \$22 billion, we expect private-equity firms to continue to maintain a keen focus on exits.

<sup>4</sup> Vivek Pandit, "Private equity in India: Once underestimated, now underserved," February 2015, McKinsey.com.

### Minority is not the only game in town

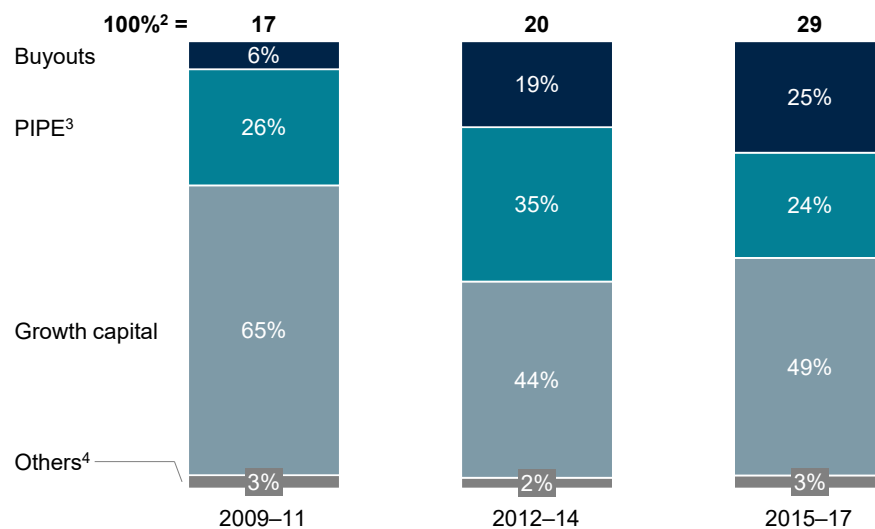
Several private-equity firms shifted focus from minority positions (largely growth capital) to buyouts, where they have greater control of strategy and talent as well as influence on the manner and timing of exits.

During the period from 2015 to 2017, one-quarter of investment was in buyouts, up sevenfold in value from the period from 2009 to 2011 (Exhibit 11). This shift reflects changes in both demand and supply. Investors had an increased appetite for control and took advantage of a growing number of buyout opportunities as promoters restructured portfolios, divested noncore businesses, or cashed out.

Exhibit 11

### Buyouts grew faster than other strategies and accounted for a quarter of investment from 2015 to 2017.

Share of investment by strategy,<sup>1</sup> \$ billion



1 Excludes venture capital and real estate investments.

2 Figures may not sum to 100% because of rounding.

3 Private investment in public equity.

4 Includes mezzanine/pre-IPO.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

As GPs become owners of businesses, rather than minority investors, they are beginning to recalibrate their organization and talent models and rewrite their playbooks. Further, they are investing in specialized operations capabilities and partnering more closely with experienced industry professionals. Twenty-eight of the 30 most active funds in India either have an in-house operating team or regularly engage senior industry professionals as advisers or partners. Their involvement includes activities such as assessing management, hiring staff, cutting costs, and developing growth capabilities.

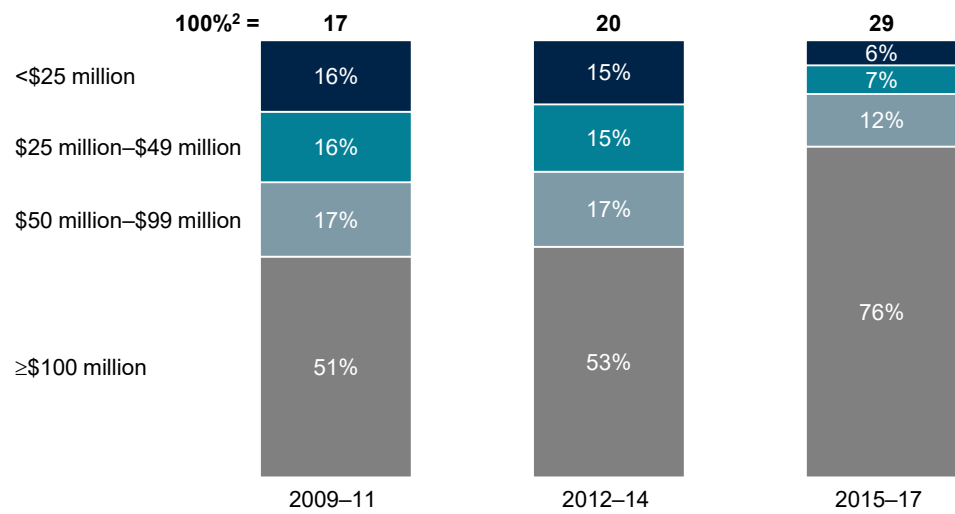
### Size and strategy matter

From 2015 to 2017, more than three-quarters of deal value was driven by deals of more than \$100 million (Exhibit 12). The number of deals in this category grew, as did the size of the largest deals. Eight deals were greater than \$500 million from 2015 to 2017, compared with only four in the previous six-year period.

Exhibit 12

### Deals greater than \$100 million accounted for three-quarters of investment from 2015 to 2017.

Share of investment by deal size,<sup>2</sup> \$ billion



1 Excludes venture capital and real estate investments.

2 Figures may not sum to 100% because of rounding.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

Growth in deal size is part of a larger global trend—as more money is directed to private markets, firms have raised bigger follow-on funds, leading to a rise in the “sweet spot” for future investments. As firms shift focus to larger deal sizes, we anticipate greater competition for deals of more than \$100 million. Strategies that “buy in” versus “buy out” at this level require very different investment skills and levers of control. The resulting pressure on entry prices will make proprietary sourcing and postinvestment value creation ever more critical. Simultaneously, we see deals of \$10 million to \$50 million presenting an opportunity for “growth and expansion specialists.”

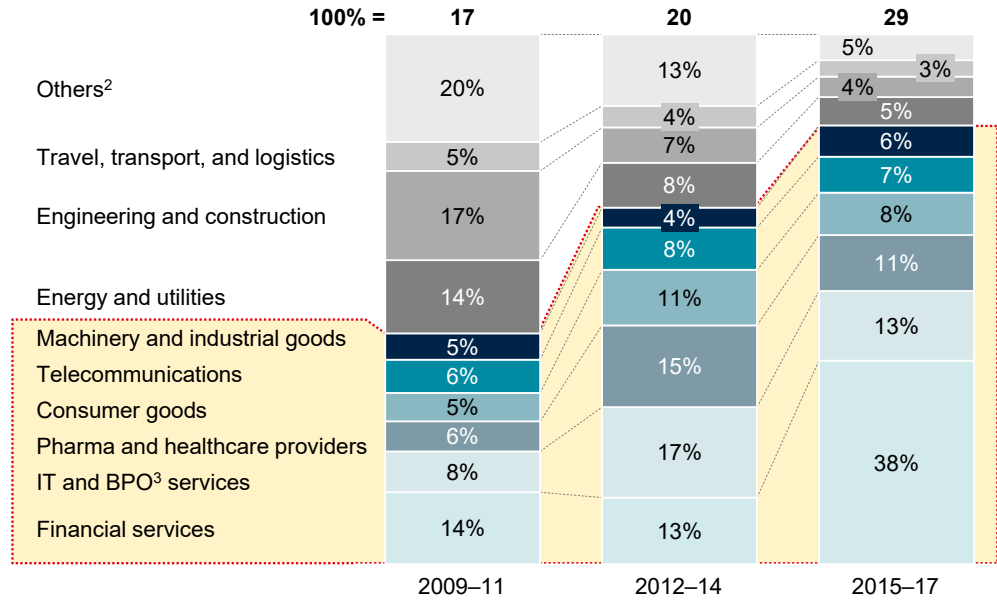
### Know your sectors deeply

Private-equity investment in India has coalesced into six sectors: consumer, financial services, healthcare, IT/business process outsourcing (BPO), machinery and industrials, and telecommunications. These sectors have grown steadily over the past nine years and collectively account for 83 percent of investment from 2015 to 2017—up from 44 percent from 2009 to 2011 (Exhibit 13).

Exhibit 13

**Six sectors accounted for more than 80 percent of investment—financial services drove growth.**

Share of investment,<sup>1</sup> \$ billion



1 Excludes venture capital and real estate investments.  
 2 Includes metals, mining and materials, automobiles, business and consumer services, and media and entertainment.  
 3 Business process outsourcing.

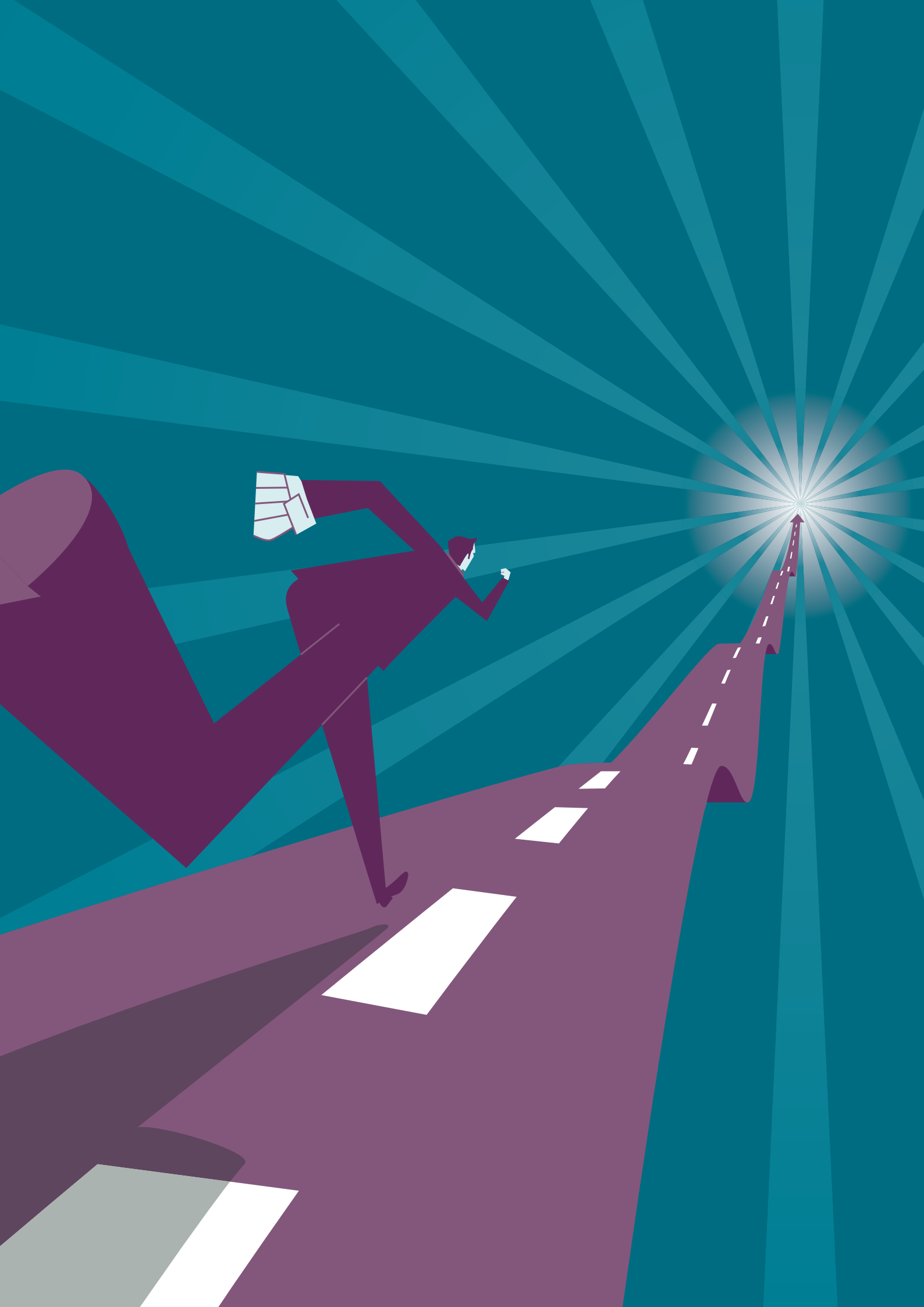
SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

One sector stands out: investment in financial services accounted for more than 90 percent of investment growth between the 2012–2014 and 2015–2017 periods. Fueled by growth and consolidation opportunities across consumer lending, insurance, microfinance, and banking, this sector accounted for two in every five dollars of investment made by private equity in the past three years.

While investment in sectors fueled by household consumption and income growth (such as financial services) or exports (such as IT, BPO, or pharmaceuticals) grew, those sectors underpinned by domestic investment and infrastructure development fell out of favor.

Finally, although sector-focused funds are few, many GPs are developing deep sector-based expertise among deal and operating partners. This expertise has provided some firms an edge, allowing them to underwrite greater value at the time of investment, achieve greater proprietary deal flow, and, in some instances, preempt auctions with greater conviction.







# Returns: Emerging differentiation by strategy

One reason for the growing optimism in Indian private equity is steadily improving returns. Average returns on exited investments have risen from 8 percent (2006–2008 vintage) to 22 percent (2012–2014 vintage) (Exhibit 14). Holding periods have stretched, particularly for older vintages, and unexited investments are likely to be a drag on returns for those vintages. We recommend that GPs and LPs find secondary exit opportunities or sell to avoid a prolonged drag.

Exhibit 14

## Returns at exit have risen for the most recent vintages.

Vintage	Investment, <sup>1</sup> \$ billion	Capital exited, % of investments	Returns, <sup>2</sup> %	Holding period, years
2003–05	4	85	24	4.6
2006–08	27	57	8	6.4
2009–11	17	34	16	5.1
2012–14	20	34	22	3.5
2015–17	29	3	51	NM <sup>3</sup>

1 Excludes venture capital and real estate investments. Exits updated through 2017.

2 Weighted average of gross-dollar internal rate of return (IRR) by investment year estimated for a sample of ~654 exits with private-equity investment made between 2003 and 2017 where both investment and exit values were disclosed.

3 Not meaningful.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

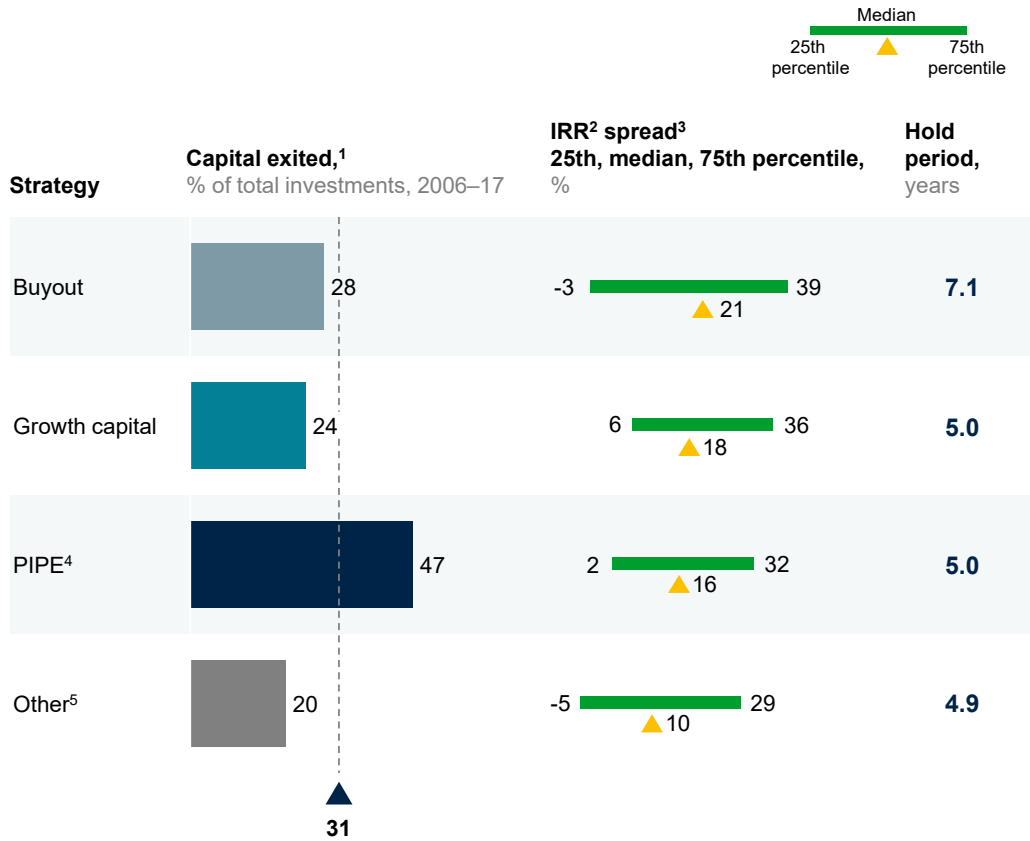
Our analysis of better return performance at exit revealed five factors that contributed to performance and should, therefore, inform strategy for fund managers.

### Buyouts can be high-return and high-risk

Our analysis shows that buyouts earn the highest return, with median returns at 21 percent (Exhibit 15). On the other hand, variance in returns—measured by the spread of returns between the bottom and top quartiles—is also higher for buyouts, indicative of the higher risk inherent in buyouts and the premium on effective execution.

Exhibit 15

**Exits and returns by strategy: Buyout strategy earned the highest return.**



1 Excludes venture capital and real estate investments. Exits updated through 2017.  
 2 Internal rate of return.  
 3 Based on a sample of ~534 exits with private-equity investment made in 2006–17 where both exit and investment values were disclosed.  
 4 Private investment in public equity.  
 5 Includes turnaround and mezzanine/pre-IPO.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

In addition, the average holding period for buyouts—just over seven years at exit—is longer than that for other strategies. Buyouts can be riskier if not executed correctly, and GPs stepping into this territory for the first time must consider whether they have the mind-set, talent, tool kit, and operating partnerships required to pull it off. There is a formula, and experience matters.

**Small can still be beautiful**

Returns have, until now, been better for small and midsize deals than for larger ones. In fact, median returns for deals less than \$25 million were more than twice those for deals of \$50 million or more. Returns for deals of more than \$100 million varied depending on sector. Poor performance in this deal class size is primarily explained by some large investments in the infrastructure and telecommunications sectors—particularly during the period from 2006 to 2008, in which returns were low. This deal size in infrastructure and telecommunications produced mixed results, with a median internal rate of return (IRR) of just one, far below that of other deal-size categories. However, deals of more than \$100 million in other sectors generated more favourable returns (Exhibit 16). With more capital

concentrated in deals of \$100 million or more—which accounted for three-quarters of total investment from 2015 to 2017—the performance of this deal size assumes greater importance.

Exhibit 16

**Exits and returns by deal size: Small deals earned higher returns**



1 Excludes venture capital and real estate investments. Exits updated through 2017.  
 2 Internal rate of return.  
 3 Based on a sample of ~534 exits with private-equity investment made between 2006 and 2017 where both exit and investment values were disclosed.

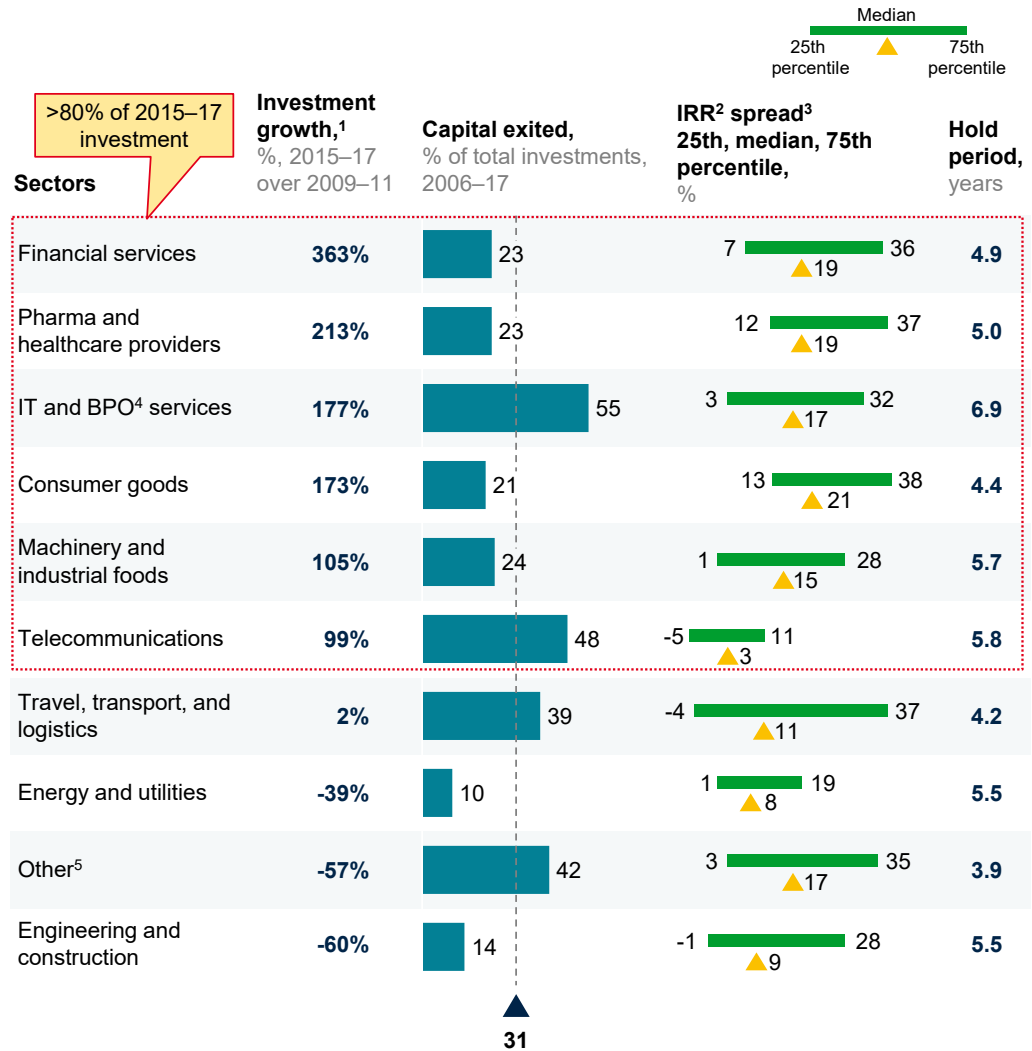
SOURCE: AVCJ Research; VCCEdge; McKinsey Principal Investor Practice analysis

**Know your sectors deeply, again**

Five of the six sectors with growth in investment (such as financial services and machinery and industrial goods) have performed well for private-equity investors in the recent past. Median returns for private-equity deals in these sectors ranged from 15 to 21 percent, based on exits to date, with telecommunications being the exception (Exhibit 17). Further, median returns at exit in energy and utilities as well as engineering and construction, both sectors in which private-equity investment has fallen, were below 10 percent, and 90 percent and 86 percent of their capital deployed is unexited, respectively. Poor historical performance and compressing multiples have caused investors to shy away from allocating fresh capital to these sectors.

Exhibit 17

**Exits and returns by sector: Five of the six sectors with investment growth have performed well.**



1 Excludes venture capital and real estate investments. Exits updated through 2017.  
 2 Internal rate of return.  
 3 Based on a sample of ~534 exits with private-equity investment made from 2006 to 2017 where both exit and investment values were disclosed.  
 4 Business-process outsourcing.  
 5 Includes metals, mining and materials, automobiles, business and consumer services, and media and entertainment.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

Five of the six sectors that attracted increased investment during the period from 2015 to 2017—telecommunications again being the exception—also showed double-digit growth in EBITDA during the period from 2008 to 2016.<sup>5</sup> These sectors were also among the six sectors with the highest shareholder returns on public markets.<sup>6</sup>

5 ProwessIQ, Centre for Monitoring Indian Economy, data from 2008 to 2016, prowessiq.cmie.com.

6 Thomson Reuters Datastream, Thomson Reuters, data from the period 2008 to Q1 2017, extracted October 2017, financial.thomsonreuters.com.

While past investments in select sectors have performed well, valuations at entry have been rich recently—median enterprise value (EV)/EBITDA multiples on private-equity investments in consumer goods and healthcare businesses exceeded 20 from 2015 to 2017. That performance will likely put pressure on returns at exit.<sup>7</sup>

**Know your strategy and build fit-for-purpose skills**

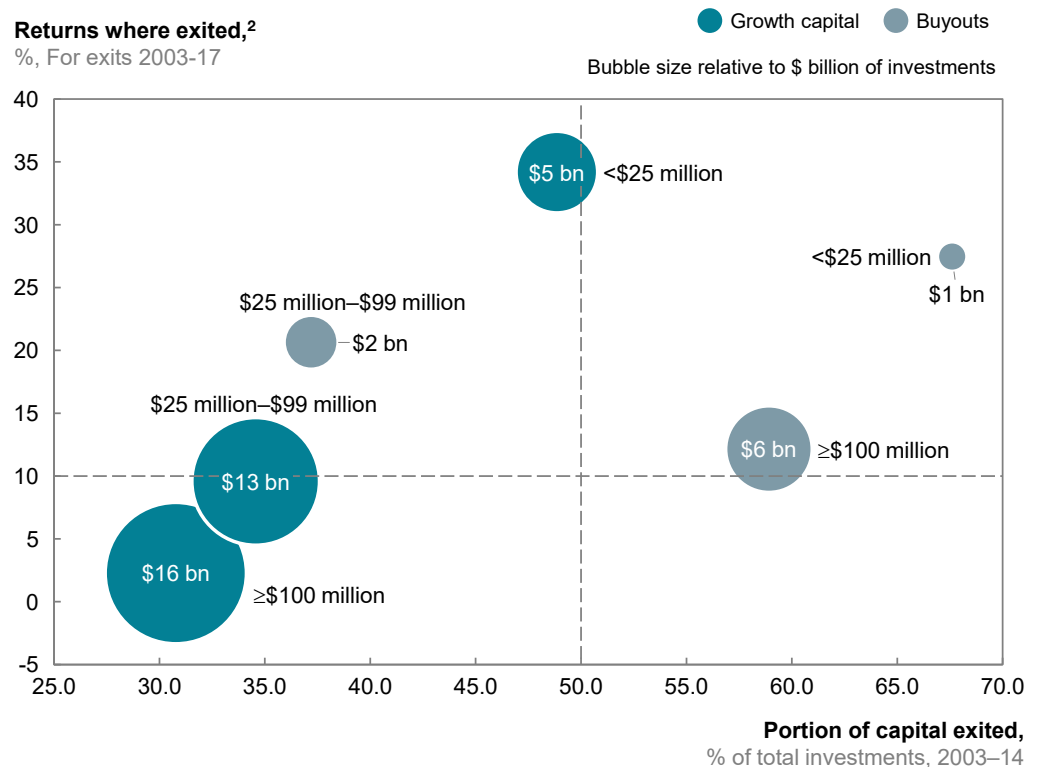
We analyzed the two dominant strategies in Indian private equity—buyout and minority stakes for growth investment—in a range of deal sizes (Exhibit 18). Our analysis of investments made from 2003 to 2014 shows that minority and growth investments larger than \$25 million attracted \$27 billion of capital through 2014 but also underperformed relative to buyouts and other deal sizes. A subset of these investments (minority and growth deals greater than \$100 million) accounted for nearly \$16 billion of the \$27 billion invested but earned only 2 percent. Further, nearly 70 percent of capital invested in these deals remained unexited at the end of 2017.

Exhibit 18

**Large minority investments underperformed buyouts and deals under \$25 million.**

**Return and exit performance versus investment—select strategies<sup>1</sup>**

**Returns where exited,<sup>2</sup>**  
%, For exits 2003-17



1 Excludes venture capital and real estate investments. Exits updated through 2017.  
 2 Gross-dollar IRR estimated for a sample of ~642 exits between 2003 and 2017 with private-equity investment made between 2003 and 2014 where investment stages and both exit and investment values were disclosed. Excludes sets with fewer than eight exits.  
 3 Value of investment (shown inside/adjacent bubble) rounded to nearest \$ billion

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

7 This analysis is based on a sample of 72 private-equity transactions from AVCJ Research and VCCEdge, extracted May 2018.

Among midsize and large deals, buyouts have performed better. Buyouts of \$100 million or more in deal size—which accounted for \$6 billion—earned a 12 percent IRR, while deal sizes of \$25 million to \$99 million earned more than 20 percent. Growth in share of buyouts for larger deals is a potentially healthy sign for future industry performance.

And while investments of less than \$25 million have performed well—buyout and minority deals each earned returns of more than 25 percent—the number of investments in deals of this size fell. Indeed, small-cap plays are difficult to scale. But, as several GPs raise larger funds and pursue larger deals, the midmarket opportunity still exists and offers an excellent opportunity for “growth specialists.”

### **Outperformance—superior performance of companies backed by private equity**

The search for alpha—superior returns vis-à-vis benchmarks—is of course the holy grail of private-equity investing, but it is being supplemented by a desire for “consistency at scale.” The industry appears to be succeeding, as businesses with private-equity backing typically grow faster than industry averages.

Over a seven-year period, businesses backed by private equity raised revenue and profit, on average, 27 percent faster than their peers (Exhibit 19). When measured on revenue growth alone, businesses backed by private equity outperformed their peers in every sector, and they outearned them on EBITDA growth in six out of ten sectors.

Selection bias—which arises as private equity attempts to invest in inherently better-positioned or -performing businesses—partially accounts for the positive performance of these businesses. And, while it is difficult to compare the impact of superior selection with postinvestment value creation, our research shows that companies backed by private equity are more aggressive in hiring talent, entering export markets, and acting on M&A opportunities.<sup>8</sup>

As fund sizes grow and competition on deals increases, we believe postinvestment value creation will become even more important as a source of differentiation.

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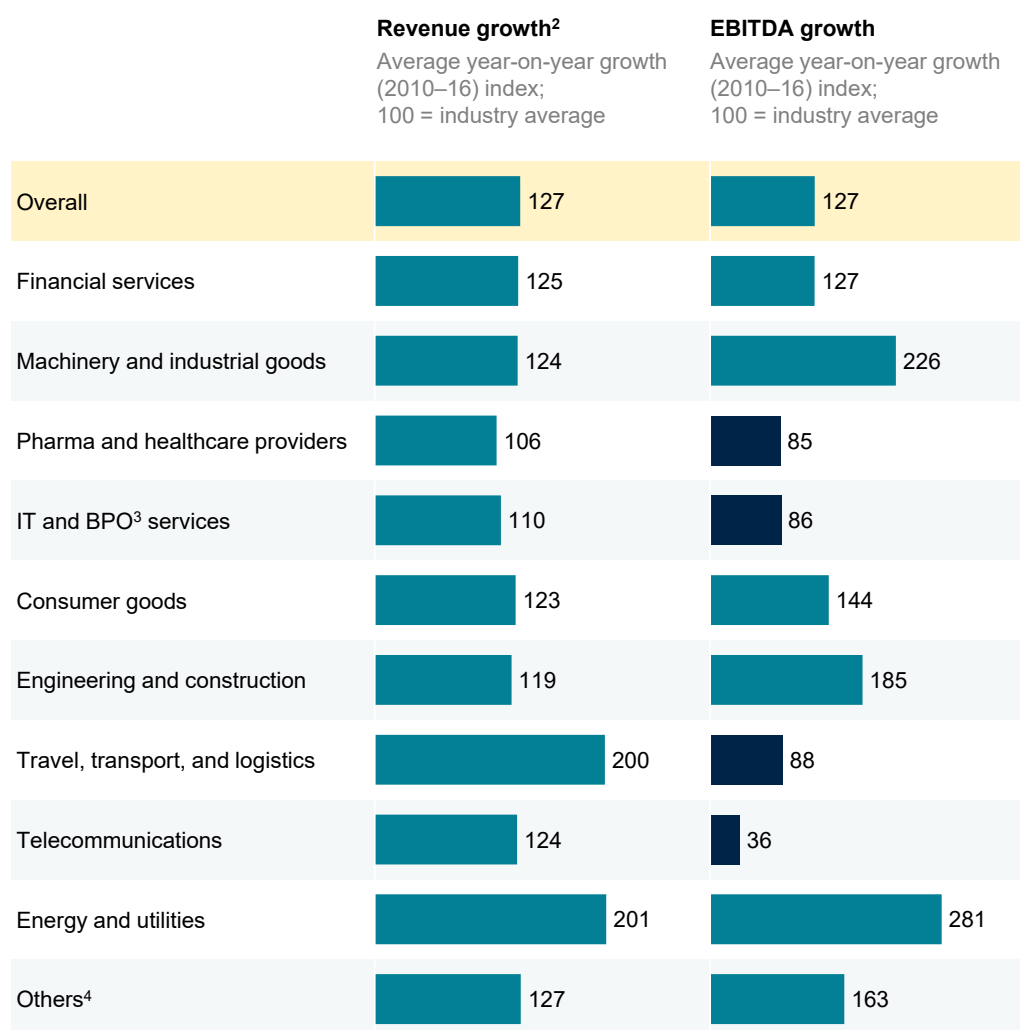
<sup>8</sup> Vivek Pandit, Toshan Tamhane, and Rohit Kapur, *Indian private equity: Route to resurgence*, June 2015, McKinsey.com.



Exhibit 19

**Companies backed by private equity grew revenue and profit faster than their peers in most industries.**

**Performance analysis: players backed by private equity indexed to industry average<sup>1</sup>**



1 Calculated average year-on-year revenue/EBITDA growth rates, based on a sample of ~440 portfolio companies that received private-equity investment between 2008 and 2016 and ~38,000 private/public players for industry benchmark across all sectors. For each year, sample size of players backed by private equity changed based on the portfolio status.

2 For year-on-year growth calculation, we refined the sample set by including companies for which financials were available for both base and current year.

3 Business-process outsourcing.

4 Includes metals, mining and materials, automobiles, business and consumer services, and media and entertainment.

SOURCE: AVCJ Research; Prowess; McKinsey Private Equity & Principal Investors Practice analysis



# Looking ahead—Five discontinuities

The aftermath of the global recession forced private-equity firms to adjust their approach to opportunity selection, value creation, and exits. These moves healed an industry and created a platform from which firms can address upcoming opportunities and challenges.

Over the next few years, we expect five emerging discontinuities to reshape the battleground, creating avenues for growth and attractive returns while also posing new obstacles. Private-equity firms able to adapt to these changes will be well positioned to capture the opportunities ahead.

## A flood of capital as LPs allocate more to private equity

Several estimates put the shortfall of assets against liabilities at public pension funds and corporate plans at more than \$2 trillion globally and rising.<sup>9</sup> At the same time, research indicates that returns from public markets are likely to be lower over the next 20 years than they have been during the past 20.<sup>10</sup> Private markets, based on their track record, continue to offer an avenue for higher returns.

This dynamic has, through 2017, created a buoyant fund-raising environment for private equity and related asset classes, such as private debt, real estate, and venture capital.<sup>11</sup> This is especially true for GPs with established track records and large institutional structures that can absorb, deploy, and manage large amounts of capital. Globally, fund-raising, by billion-dollar and five-billion-dollar funds, is rising fastest—the large funds are getting larger faster.

Similarly, in Asia, funds of \$1 billion or more account for almost 60 percent of capital raises, as LPs look to limit the number of relationships they manage, rather than spread or diversify exposure across a larger number of firms. Fund sizes for private equity in India have increased steadily, mirroring these trends. Increased fund size is also reflected in the migration of private equity toward larger deals and greater interest in control and buyout opportunities.

As the volume of funds allocated to private equity sees a significant increase, fund managers need to prepare for more competition on the larger deals, with higher valuations at entry increasing the emphasis on pre-deal investment theses and post-acquisition value creation. How GPs use their larger fee pools to adjust their tool kits, add talent, and gain access to value-generating insight and expertise will determine their success. Owning and running a business, rather than being a passenger alongside a promoter, will require a new set of capabilities. Some private-equity firms will have to rewrite their playbooks.

As LPs look to cap the number of firms they work with, many will choose to allocate funds across asset classes and consolidate strategies within a limited set of managers. For fund managers, this concentration can be an opportunity as well as a threat. Some firms may choose to build multiproduct and asset-class platforms to support absorption and deployment of larger amounts of capital and evaluate inorganic opportunities to scale up rapidly. But building tighter relationships with limited partners is not just about

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9 *The private-market investing revolution*, fall 2016, McKinsey.com.

10 For more information, see Richard Dobbs, Tim Koller, Susan Lund, Sree Ramaswamy, Jon Harris, Mekala Krishnan, and Duncan Kauffman, *Why investors may need to lower their sights*, McKinsey Global Institute, April 2016, on McKinsey.com.

11 *The rise and rise of private markets*, February 2018, McKinsey.com.

demonstrating scale. Funds must also assess what processes, talent, and technology they need to add—for example, in investor relations, advisory services, and risk and compliance reporting—to improve the investor experience for LPs.

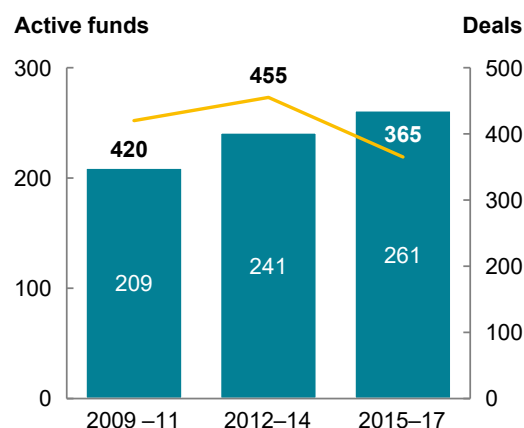
### Heightened competition, including from direct-investment teams of LPs

As LPs increase allocation to private equity and pay fees to external managers, their investment costs rise. In response, some LPs are building direct-investment teams and seeking coinvestment rights—playing the roles of partner and competitor to managers. This shift is already evident in India. Several LPs that have sizable indirect exposures in the Indian market are now developing direct-investment strategies and setting up their own teams. From 2015 to 2017, LPs invested \$3.4 billion directly in India—more than a threefold increase from the investment from 2009 to 2011, although a slight decline from the investment from 2012 to 2014 (Exhibit 20).

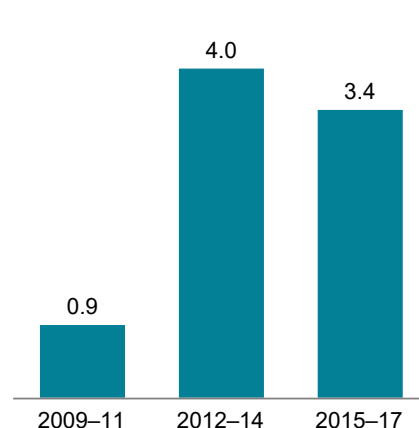
Exhibit 20

### The number of active funds grew faster than deal count; investment by limited partners and sovereign wealth funds have grown since 2011.

Active funds vs number of deals,<sup>1</sup>  
number



Limited partners' direct investment,<sup>2</sup>  
\$ billion



<sup>1</sup> Excludes venture capital and real estate investments.

<sup>2</sup> Includes deals where only limited partnership and institutional investors were involved as direct investors.

SOURCE: AVCJ Research; VCCEdge; McKinsey Private Equity & Principal Investors Practice analysis

With the number of active funds growing, and deal count falling, competition for deals has increased. From 2015 to 2017, the number of deals of \$100 million or more were double what they were from 2012 to 2014. And the number of investors who participated in these deals more than doubled. The increased interest in large deals is due, in part, to the growing willingness of investors to partner with other funds or with LPs, enabling them to spread their allocations and target larger deals.

As LPs increasingly have access to similar information and deal flow, and start to compete for deals, GPs need to assess the distinctiveness of their value proposition. They should consider whether they have market or theme expertise that enables them to manufacture deals and avoid high-cost auctions and whether this expertise shapes their due diligence,

enabling them to develop a sharper investment thesis (reflected in valuation) and more granular operational improvement plans.

### **A new pool of restructuring-led opportunities**

The restructuring of stressed loans, which amounted to \$146 billion on banks' books in December 2017, will create a one-time opportunity for investors with the risk appetite and operational turnaround expertise in several sectors needed to deploy capital at scale.<sup>12</sup> The Indian government has implemented a new bankruptcy code that gives the country's central bank greater powers to recover assets from bad loans and force companies into liquidation, essentially opening the door to investors and new deals.<sup>13</sup> Tighter rules on the recognition of nonperforming loans and consolidation of restructuring schemes announced by the central bank in February 2018 could further accelerate this process.

Traditionally, private equity has been hamstrung by the limited pool of privately owned companies available for investment. India has fewer than 500 privately owned companies with revenue greater than \$125 million, and taking a public company private in India is more complicated than in most other countries.<sup>14</sup> With the debt of more than 500 companies undergoing restructuring, the sale of some debt-ridden companies or their subsidiaries could substantially widen the pool of investable assets for private equity.

GPs must consider whether and how they will play this opportunity: distressed and special-situations investing is not for all and requires a set of capabilities and a playbook that will (and should) be outside the comfort zone of many firms. Yet there may be opportunities to partner with other actors—either strategic or financial investors—that have the operational expertise to turn around challenged businesses.

### **A new generation of promoters and managers more open to partnership with private equity**

As in much of Asia, most companies in India are owned by families. Family businesses have become more purposeful and sophisticated in their interactions with private equity over the past 15 years. Business owners are increasingly willing to consider private-equity firms for a variety of arrangements: as equity partners for cross-border acquisitions, as a source of debt financing for intrafamily settlements, or as potential acquirers of noncore businesses. Two in every five family-owned businesses are still run by the founder, meaning that many will prepare to hand over reins to the next generation. Transfer of ownership can be a catalyst for restructuring, particularly in diversified groups, presenting opportunities for private-equity involvement in building, consolidating, or disposing of businesses.

With the Indian economy having crossed the \$2 trillion threshold, many industries and markets have attained scale. In industries from apparel, retail, and food processing to construction and healthcare services, market share is transferring from subscale, family-run businesses to larger players with greater access to capital, talent, and technology. That amplifies growth for at-scale businesses that are potential private-equity targets. This landscape can be a magnet for private-equity investors with strong organizational

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12 Devidutta Tripathy, "India's stressed bank loans tick up to \$146 billion in December, RBI data shows," *Reuters*, April 2, 2018, in.reuters.com.

13 Anita Raghavan, "India's bad debt is looking better to investors," *New York Times*, May 29, 2017, nytimes.com.

14 ProwessIQ, Centre for Monitoring Indian Economy, accessed October 2017, prowessiq.cmie.com; and McKinsey Private Equity & Principal Investors Practice analysis.

capabilities. In many of these industries, however, businesses with the scale and maturity to absorb sizable private-equity capital are hard to find. And among such businesses that do exist, many have used public markets to fund earlier growth.

Private-equity firms have experimented by backing teams of industry veterans to target a specific market opportunity and building “platforms” through acquisitions. In industries as diverse as financial services, healthcare, and infrastructure, such platforms are becoming vehicles for consolidation and rapid growth.

Private-equity managers must consider how prepared they are to work with and benefit from engagement with family and professional management teams. Do they have deep, trusted relationships with promoters of diversified, family-business groups that will yield proprietary investment opportunities? Can they offer tailored financing solutions to fit a family settlement, overseas acquisition, or group restructuring? What is the playbook for attracting experienced executive talent, and are they equipped to incentivize and support a management team as it takes on greater targets and builds new businesses?

### An emergence and mainstreaming of impact investing

Private equity and purpose-driven finance have generally inhabited different worlds. But, as our recent research shows, “impact investing”—investing with the objective of generating social and environmental impact alongside a financial return—has begun causing these worlds to intersect. As a developing economy faced with several economic and social challenges, India is a natural recipient of such investment. Despite more than two decades of steady economic growth and declining levels of poverty, 500 million individuals still require secondary education and skill training, and millions of households lack ready access to banking and healthcare services.<sup>15</sup>

Impact investing is small in comparison with private equity—globally it accounted for about \$22 billion of investment in 2016, versus more than \$1.1 trillion for private equity—but it is growing rapidly. Further, our research shows that more than 60 percent of investment in India’s impact businesses comes from traditional private-equity funds. Since 2010, the annual returns for this class have been 11 percent, on average, with the top third returning 34 percent.<sup>16</sup>

Impact investments totaled an estimated \$5.2 billion in India from 2010 to 2016. With institutional investors becoming more focused on social and environmental issues, and large pools of domestic funding being available through the corporate social responsibility budgets of Indian businesses, growth rates more than 20 percent a year are possible. In fact, we estimate such investments could grow from \$1.1 billion in 2017 to more than \$2.5 billion annually by 2020.



Private equity in India is on the upswing, with recent market performance indicative of how firms have adjusted to a changing landscape. In our estimate, the next S-curve for Indian

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15 For more information, see *India’s technology opportunity: Transforming work, empowering people*, McKinsey Global Institute, December 2014, on McKinsey.com.

16 Vivek Pandit and Toshan Tamhane, *Impact investing: Purpose-driven finance finds its place in India*, September 2017, McKinsey.com.

private equity will be defined by fund managers that adapt their operating model to deliver consistency at scale. This includes investing in world-class operating team and partner capabilities, finding deal partners with distinctive sector-based investment theses (across cycles), building a preeminent brand that attracts target companies, and developing and retaining the scarcest of assets: talent.

# About the authors



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# Notes

# Notes

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- "Private equity exits: Enabling the exit process to create significant value," July 2018
- "High stakes: How investors can manage risk in the new infrastructure environment," June 2018
- *The rise and rise of private equity*, February 2018
- "From 'why' to 'why not': Sustainable investing as the new normal," October 2017
- "Why investors are flooding private markets," September 2017
- *Impact investing finds its place in India*, September 2017
- *European healthcare—a golden opportunity for private equity*, June 2017
- *A routinely exceptional year for private equity*, February 2017

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