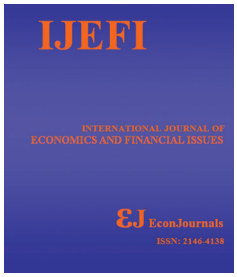

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Private Equity and its Role in the Development of the Indian Manufacturing Sector

Mohammad Ahmar Uddin[1]*, Syed Ahsan Jamil[2], Khaliquzzaman Khan[3]

[1]Department of Accounting and Finance, Dhofar University, Oman, [2]Department of Accounting and Finance, Dhofar University, Oman, [3]Department of Marketing and Management, Dhofar University, Oman. *Email: ahmar@du.edu.om

ABSTRACT

Manufacturing sector accounts for only 16% of gross domestic product (GDP) in India, while in China it is around one third of its GDP. Also the share of Indian manufacturing in the worldwide markets is dismal at 1.4%, while China it is now 13% from just 2.9% in 1990s. India also aspires to have such growth in its manufacturing sector. Growth of manufacturing sector is vital due to its multiplier effect on economy and employment. Every job created in the manufacturing sector creates two-three additional jobs in related activities. The aim of the Indian National Manufacturing Policy (2011) is to create to 100 million jobs and increase the share of manufacturing in GDP to 25% by 2022. Private equity (PE) as fi nancial intermediaries improves the allocation of resources from the investors and also provides various types of managerial assistance to industry enabling make them to be more competitive. This paper emphasizes the role that can be played by PE in the development of Indian manufacturing sector. Also the paper highlights the various types of assistance and problems in PE.

Keywords: Manufacturing, Private Equity, Development, India
JEL Classifications: E66, G20, G23, L26, L60

1. INTRODUCTION

Recognizing the vital role of manufacturing sector in a country's development, the Indian government placed emphasis on the growth of manufacturing in most of its five year plans. However in spite of the previous efforts the share of manufacturing has been stagnating at a low level of 17% of gross domestic product (GDP) for over the last two decades. India has been unable to build and maintain the competitiveness needed to grow. This may be due to the negative after effects of the protection that was given to Indian industry in terms of licensing prior to the 1990s. The significance of the manufacturing sector goes far beyond the production of goods. The manufacturing sector purchases goods and services for its functioning. Also the goods produced by the manufacturing sector are sold to other sectors (services and agriculture). Thus manufacturing stimulates the demand for goods and services in the whole economy and generates direct and indirect employment. Policy makers world over are trying to rebalance their economies to overcome the dependence on services. India, with its experienced labor force, scientific and technical base, managerial expertise along with a large domestic customer base has the potential to emerge as a major manufacturing hub for the global market. Indian manufacturing sector at present faces challenegs a number of challenges, such as reduction in trade barriers, increased productivity due to the technology revolution and the emergence of low cost manufacturing hubs (such as China and other South East Asian countries). In order to overcome these challenges the Indian manufacturing sector has to become more competitive. Figure 1 compares the global competitive index (GCI) and the share of manufacturing in the GDP of India and China. GCI ranking of India and China are 71 and 28 respectively. While the share of manufacturing in the GDP for India and China are 32% and 13% respectively.

Private equity (PE) is a form of financial intermediary which not only provides capital but also provides managerial assistance. Upon investing in a company they generally play an active role in the strategic management of the companies. This strategic assistance from PE can help the company to become more competitive. Thus PE can provide the necessary funds and offer managerial expertise to make the Indian manufacturing sector more competitive. Promotion of PE will enable the manufacturing

sector to fulfill the aims of make in India in terms of a faster growth rate, employment generation and becoming more competitive.

2. LITERATURE REVIEW

Manufacturing is an important driver of economic growth Chakravarty and Mitra (2009). Kathuria and Raj (2009) analyzed the relationship between manufacturing growth and output growth in Indian states and established that manufacturing functions as an engine of growth due to its inter sectorial backward and forward linkages. Therefore investment in one branch of manufacturing stimulates the other sectors of manufacturing as well. Spillover effects between manufacturing and other sectors are also very powerful (Myint, 1980; Cornwall, 1977; Hirschman, 1958).

The contribution of PE is attaining economic growth and job creation in well-known and holds a high priority in the economic policy of numerous countries (Bottazzi and Rin, 2002; European Commission, 2003; OECD, 2001). Access to finance for entrepreneurs in the manufacturing is another major problem (Uddin and Khan, 2015). Apart from financing, PE also provides value added services. The value added role played by PE has been stated by Gorman and Sahlman (1989). They help in obtaining additional finance, strategic planning, management recruitment, operational planning, introduction to potential customers and supplies, resolution of compensation issue. The assistance provided by a PE is important for an entrepreneur (Ansari and Uddin, 2009). Hellman and Puri (2002) have statistically confirmed that the services of PE are of economic significance. They are also an invaluable source of guidance and advice. PE provides non-financial assistance such as guidance on strategic matters, management recruitment, networking and market information (BVCA, 2003). Thus PE provides more than just financial contributions to their investee companies.

Previous researchers (Kaplan and Stromberg, 2009; Cressy et al., 2007) have shown that the performance of PE backed companies is better than Non PE backed companies in terms of company profits and growth. In EU PE participation has resulted in positive effect on the average per employee earnings before interest, taxes, depreciation and amortization by around 6.9% (EVCA, 2013). Davis et al. (2009), studied US firms between 1980 and 2005, and found that the productivity growth PE backed companies was higher than non-PE backed companies. Also, Bloom et al. (2009) studied medium-sized EU, Asian and US manufacturing firms found that PE-owned firms are particularly strong in operations management practices. Their findings have been depicted in Figure 2 below, which shows that the management score of PE backed companies is better than non-PE backed companies.

McKinsey (2015) researched the performance of Indian backed PE companies. They found that PE-backed companies grew faster both in revenue and profits and they also generated more employment than the non-PE backed companies.

Trends in the Indian PE have been depicted in the Table 1. As per Venture Intelligence Morgan Stanley, Arpwood Capital and

Figure 1: Share of manufacturing and global competitive index

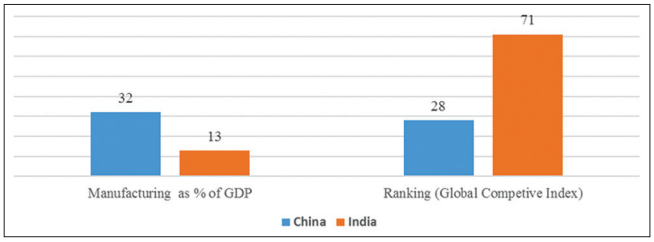
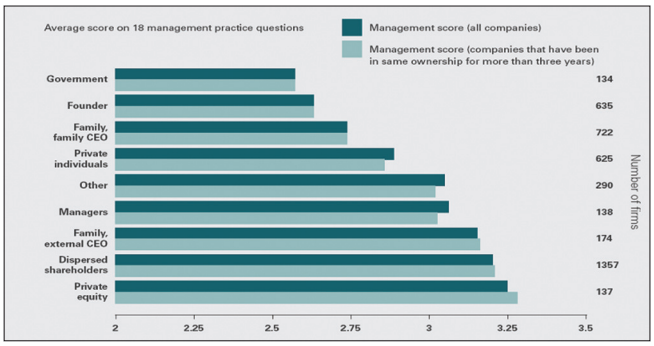


Figure 2: Comparison of management score of private equity (PE) and non-PE backed companies



Source: Bloom et al. (2009)

Avendus were the top PE advisor for the year 2105. While Spark Capital Advisors, Axis Capital and KPMG were the top PE Advisors for the year 2104.

The total PE deal value in 2014 grew 28% to $15.2 billion while the number of deals grew by 14% to 795. Number of active funds grew by about 30% in 2014, led by about 220 new funds investing in India (Venture Intelligence).

3. OBJECTIVES OF THE STUDY

Apart from financing, PE also provides a number of value added services (Gorman and Sahlman, 1989). This study tries to find out the perspectives of entrepreneurs with regards to the importance of assistance expected from PE. Keeping this aspect into consideration the following objectives were studied:

i. To study the trends of PE in India.
ii. To find out the assistive role of PE in the Indian manufacturing sector, we have formulated hypothesis.
   H1: For the manufacturing sector the non-financial assistance provided by PE is important.
iii. To find out if there is any differences in importance of the assistive role of PE in term of different manufacturing industries, we have formulated hypothesis:
   H2: The importance of assistance from PE differs industry-wise.
iv. To find if entrepreneurs in the Indian Manufacturing sector face problems in availing PE, we have formulated hypothesis:
   H3: Manufacturing sector faces problems in availing PE.
v. To find out if there is any differences in problems faced in availing PE for different manufacturing industries, we have formulated hypothesis:
   H4: The problem faced in availing PE differs industry-wise.

Table 1: Top PE Advisors in India

Rank	2015 (till September)			Rank	2014		
	PE name	Deals	Amount $M		PE Name	Deals	Amount $M
1	Morgan Stanley	1	1150	1	Spark Capital Advisors	6	450
1	Arpwood capital	1	1150	2	Axis Capital	4	427
2	Avendus	16	932	3	KPMG	3	259
3	Kotak	4	384	4	Ernst and Young	10	216
4	Barclays	1	315	5	Kotak	4	173
4	HSBC	1	315	6	Edelweiss Financial	5	141
5	Goldman Sachs	1	294	7	Signal Hill Capital	5	106
6	Investec Bank	1	256	8	Unitus Capital	18	91
6	Arden Partners	1	256	9	Sprout Capital	3	89
7	Allegro Advisors	2	211	10	Veda Corporate Advisors	2	78
8	o3 Capital	8	207	11	o3 Capital	6	77
9	Ambit Corporate Finance	3	194	12	ICICI Securities	1	70
10	Standard Chartered	1	170	13	MAPE	3	56

Source: Venture Intelligence

4. METHODOLOGY

Data for testing of the hypotheses was collected using a questionnaire from the entrepreneurs. The entrepreneurs in the manufacturing sector were asked to rate the importance (on a scale of 1-5, where 1 - least important and 5 - very important) of the various types of assistance that can be provided by the PE. 100 entrepreneurs in the manufacturing sector were selected randomly from the list of Indian Industry Association. SPSS 16.0 has been used to carry out the statistical tests.

5. RESULTS AND DISCUSSION

As can be seen from the Figure 3, entrepreneurs give importance to the various types of assistance, which PE can provide for their business. The company image, strategic planning and marketing help have been rated high while the technical and operational help has been rated low. The responses from entrepreneurs have also been depicted in the Figure 3.

Figure 4 shows the rating of the various types of problems faced by entrepreneurs while dealing with PE. Loss of confidentiality, time consuming negotiations and high cost of PE funding are the top three problems.

5.1. Statistical Test

Statistical tests have been undertaken related to the assistance that can be provided by PE to entrepreneurs. Tables 2 and 3 depict the results of statistical test related to assistance of PE.

Test results give P = 0.00. As P < 0.01, the hypothesis, H1 For manufacturing sector the non-financial assistance provided by PE is important, is accepted at 99% confidence level. Therefore entrepreneurs do expect non-financial assistance from PE.

ANOVA test gives the following values, F = 0.042 and P = 0.959. As, P > 0.05, the hypothesis, H2: The importance of assistance from PE differs industry-wise is rejected at 95% confidence level.

Tables 4 and 5 show the results of statistical tests related to problems faced in PE.

Figure 3: Ratings of assistance provided by private equity

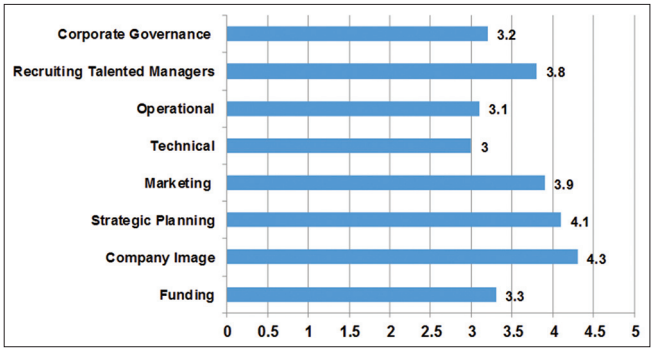


Figure 4: Problems faced by entrepreneurs in dealing with private equity

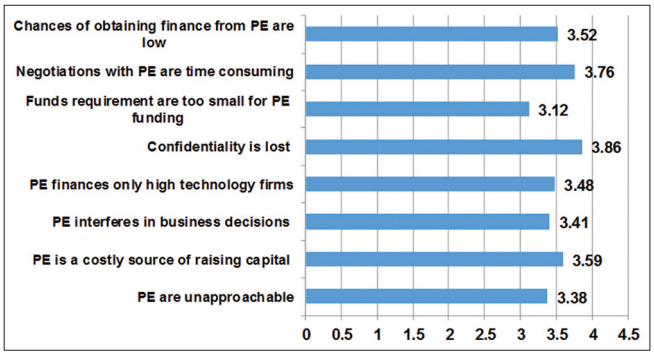


Table 2: Overall significance test: Assistance of PE

	N	Mean	SD	t	Significant (two-tailed)
$PE_{Assistance}$	100	3.58	0.8029	7.193	0.00

SD: Standard deviation, PE: Private equity

Table 3: Industry and assistance expected from PE

ANOVA	F	Significant
$PE_{Industry\ and\ assistance}$	0.280	0.839

PE: Private equity

Test results give P = 0.00. As P < 0.01, the hypothesis, manufacturing sector faces problems in availing PE, is accepted at 99% confidence level. Therefore entrepreneurs face problems in venture capital.

Table 4: Overall significance test: Problems of PE

	N	Mean	SD	t	Significant (two-tailed)
$PE_{Problems}$	100	3.51	0.87	5.860	0.00

PE: Private equity, SD: Standard deviation

Table 5: Industry and problems from PE

ANOVA	F	Significant
$PE_{Industry\ and\ Problems}$	0.106	0.959

PE: Private equity

ANNOVA test gives the following values, F = 0.106 and P = 0.956. As, P > 0.05, the hypothesis, H4: The problems faced in availing PE differ industry-wise, is rejected at 95% confidence level.

5.2. Comparison with Previous Studies

The literature review section discusses the assistance provided by PE firms. This study is in line with previous studies as it finds that PE apart from just financing can also add value to a company by providing a number of benefits. Empirical studies such have shown that entrepreneurs value the assistance provided by a PE. Hsu (2002) stated that entrepreneurs are prepared to bear a 15% discount in their firm valuation to be associated with a reputable PE. The reason attributed for this discount is the assistance other than financing which entrepreneurs expect from a PE.

6. CONCLUSION

Entrepreneurs rated the importance of the following types of assistance that can be provided by PE such as they can assist in strategic planning, marketing of products, technical, funding, branding, operations, manpower recruitment and training and improving corporate governance. Responses from the entrepreneurs show that they expect assistance related to most of the above areas from PE. Out of the above features the highest rating was for the help in improving company image by a PE. On the other hand entrepreneurs rated the technical assistance as lowest. Statistical test on the above features show that entrepreneurs give importance to the above assistance from PE. Also the assistance expected from PE does not differ industry wise. On the basis of which it is concluded that, entrepreneurs give more importance to the financial assistance that can be provided by PE. Also entrepreneurs rated the loss of confidentiality as the highest rated problems while dealing with PE.

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