Private equity investments: does the investment tenure matter for target performance?

Track: Management

Berezinets Irina Vladimirovna
Associate Professor, Graduate School of Management, St. Petersburg University

Ilina Yulia Borisovna
Associate Professor, Graduate School of Management, St. Petersburg University

Burov Alexander
Head of Retail Business Development Department, JSC "Bank St. Petersburg"

Private equity (PE) investments play a significant and growing role in a modern economy. PE funds, which operate in the industry, attract capital and distribute it across a wide range of portfolio companies. Globally, a demand for these funds’ investments increases: PE global capital raising has surged by almost 7 times from an estimate of $108 billion in 2003 to a peak of $1 085 billion in 2019 with a slight decrease in volume to $989 billion in 2020 due to a pandemic effect. The volume of deals conducted with participation of PE funds is dramatically increasing. For the first half of 2021 the value of M&A transactions closed by these funds amounted to $366 billion, although a number of buyout deals decreased in 2020 compared to five-year average (with the exception of technology and telecom sectors) being affected by COVID pandemic. Besides a provision of capital to such firms, PE funds bring managerial expertise and are actively involved in succession planning and post-investment support. As reported by many studies, private equity investments provide positive outcomes for portfolio companies, including the increase of company’s overall performance due to improvement of existing management practices and supervision of resources allocation.

As in case of any investment, private equity funds hold their stakes in companies’ capital for varying periods of time. Among important questions arising regarding these investments are the following - why would a PE fund choose to invest in companies for a particular period, and what is the impact of such investments on a portfolio company. Is there any relation between the investment tenure and the performance of investee?

This paper is focused on private investment in public equity (PIPE) transactions executed by PE funds. PIPE is a transaction, in which a private equity fund, hedge fund or another qualified
an investor purchases a privately issued share in a public company. Similar to initial and secondary public offerings, the main purpose of a PIPE is to raise additional capital for growth or to refinance current debt. Due to a number of benefits over other forms of equity financing PIPE investments provide public companies with a relatively inexpensive financing compared to public offering.

Private equity funds tend to choose targets with the potential of an increase in performance measures that affect intrinsic value of a company and seek to improve the performance of a target firm, achieve higher cash flows, and upgrade the target’s valuation even further. It is consistent with the agency theory approach and shareholders activism strategies. Activists are interested in closer monitoring and better motivating managers in order to increase company value. Corresponding changes in the organization might require “time to build” effect, i.e. changes in a performance measure would gradually show up over time.

Only few papers examine the effect of private equity investment tenure on target company performance results, while there are many studies devoted to PE investments impact on portfolio companies overall.

Therefore, this study investigating the link between a PE fund investment tenure and portfolio firm financial performance seeks to contribute to academic research and provide practically relevant conclusions.

PIPE targets are usually small and financially distressed enterprises. Such firms might have poor debt financing alternatives. By raising capital through PIPE transactions, companies might address the issue of inaccessible debt markets by internal restructuring to improve their solvency over the investment tenure of a private equity fund. Following this logic, a positive relation between the investment tenure and companies’ solvency might be anticipated. But the process of improvements could take some time over the investment period until the financial statement of the company will be recovered. A number of studies demonstrated that PE investors did not manage to improve target’s operational performance in a short-term. Scholars found that operational outcomes tended to decrease in a short-term perspective, while increased over a longer term. The effect of PE investments on portfolio company’s performance could depend on the size of investment. While sales and profitability improve with minority shareholdings, in case of obtaining a control ownership stake EBITDA (earnings before interest, taxes, depreciation and amortization) of a target company decreases. Based on the existing studies and practical considerations about the different effects of the PE investments on portfolio firms’ performance during the holding period we hypothesize that there is a non-linear relationship between a private equity investment tenure and performance of target companies measured by the cash flow growth rate and solvency.
This paper investigates the relationship between the tenure of private equity investments in public equity (PIPE) and the performance of European companies. The study of the link between the performance, as measured by cash flow growth and net financial debt to EBITDA ratio, and PIPE tenure is conducted using the sample of transactions during a period of 2005 to 2016 with public company targets based in 10 European countries (982 observations in total). Empirical research is conducted with the tools of statistical and econometric analysis. Among the characteristics of target’s operating and financial activities, used in analysis, are cash flow, size, profitability, risk, and debt ratio.

A non-linear relationship between PIPE investment tenure and target company’s performance has been found both in terms of its solvency (U-shaped), and cash flow growth rate (∩-shaped). The research results suggest that the cash flow growth rate increases over a period of PE investment until the certain point of time, namely 3.8 years of holding a portion of shares in a target company. After 3.8 years of being among company’s owners and supposedly active participation in its activities a decline in a cash flow growth is observed. Cash flow, as one of most important operational performance measures, could be expected to grow, but the rate of growth might increase only for some period after the investment is made, when PE investor attempts to take all the efforts to improve the target performance. Studies report the substantial increase in capital investments upon the acquisition of the ownership stake in a target company. Over time the growth rate could become to decrease or remain stable before the PE funds exits the portfolio firm. Estimation results suggest that the solvency measured by Net Debt/EBITDA ratio is decreasing during first 3.4 years of holding target’s shares by PE fund, after which the indicator tend to increase. These findings are consistent with an idea that the PE investor entering the firm is interested in higher growth to prepare the company for exit. The cash flow growth potential could become depleted over a period of investment that eventually would lead to exit of the investor. Growth opportunities and resources could decrease over time, that could be reflected in lower growth rate, higher debt and lower operating profit. Net Debt/EBITDA ratio could rise also because the target firm gains financial strength over time and could seem more stable for creditors to provide debt financing. The findings of this study demonstrate that the growth rate of the cash flow could decrease over time, while the growth itself may continue at a slower pace.