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The case for direct investing in private markets

By Sameer Chhabra, ET CONTRIBUTORS • Last Updated: Jul 21, 2024, 11:50:00 AM IST

Synopsis
The performance clock starts ticking when the investment takes place rather than when the capital is committed. Secondly, investors retain full discretion on which sectors, companies and deals to participate in and at what stages of investing

Companies often witness their fastest growth trajectories early in their life cycles resulting in significant value appreciation as their business expands. Private market investors have traditionally backed such early-stage, fast-growth companies through private equity. Such investing has grown by leaps and bounds creating a vibrant startup ecosystem in India.

The Private Market Play

Ultra-high-net-worth (UHNW) individuals and family offices got onto the early stage investing opportunity through the Private Equity and the venture funds route which made such opportunities available and popular. But fund investing has its own set of constraints and may not be the most optimum vehicle for all investors seeking early-stage investing.

Therefore, many Family offices and UHNI investors have ventured into building independent portfolios of unlisted equity and structured convertible debt options directly instead of participating through funds. There are several reasons for this trend to emerge and gain momentum.

Opportunity to Build a Focused and Concentrated Portfolio

Building your own portfolio directly allows large investors to commit capital on a deal-by-deal basis rather than through a fund. This has two key advantages: The performance clock starts ticking when the investment takes place rather than when the capital is committed. Secondly, investors retain full discretion on which sectors, companies and deals to participate in and at what stages of investing.

Growth and Acquisition Objectives

Private firms often target niche and underserved markets and segments that their larger companies overlook. By identifying and investing in start-ups with specialized products, services, investors gain exposure to unexplored markets and their growth potential. It also give insights into emerging trends and technologies and their evolution. Significant direct stake allows large investors, control on the investee company and thus provide future growth opportunities through acquisition.

Rationalized Cost of Management

Most PE / VC Fund offerings have a management fee and Profit share which is fairly steep as most fund managers still impose a generous 2/20 fee structure. The Management fees are charged on commitment amount and rarely on deployed amount of investment. Moreover, Profit share is charged for the entire return. In an emerging market like India, the listed market has delivered similar returns, with much lower costs, making private equity investing very costly.

Direct Holding of unlisted and startup companies is much cheaper as there is no overlay of management or profit share costs involved.

No Standardised Benchmarks and Inconsistent Performance

PE / VC has relatively shorter history of tracked performance in India and managers typically report the quartile in which the returns of their vintage funds fall. There is no consensus on the measurement techniques and standards to apply to derive returns on investment. Also, performance of Private Equity and Venture Funds have been fairly volatile and returns clustered according to vintage years across funds. Fund investors have therefore experienced inconsistent returns to the portfolio, leaving many large investors – individuals and family offices unsure about their portfolio performance.

This has resulted in many Family offices and UHNIs exploring the option of directly holding portfolios of Private Equity.

Challenges to Direct Investing

While Direct investing in Private markets looks attractive it comes with its own set of challenges, starting with the need for proper due diligence. A proper analysis into the business, strategy, financials and management of a company can be difficult for individuals and small family offices.

Family offices / Promoters understand the industries where they built their fortune and may not have insight into present-day opportunities, which may limit their options. Moreover, not all direct investors get a board seat or control over the management and therefore remain passive investors.

Also, Direct Investing does not solve for lack of liquidity or fair market price, unavailability of corporate data and transparency.

In Conclusion

While challenges remain, direct investing in Private Markets is a growing trend amongst Large investors as evident in the growing number of transactions in unlisted BFSI companies and several unicorns in the Startup ecosystem. As investors look towards newer avenues for growth, Direct Private Market investing is here to stay.

(The author of the article is Sameer Chhabra, Executive Director, Private Wealth, JM Financial.)