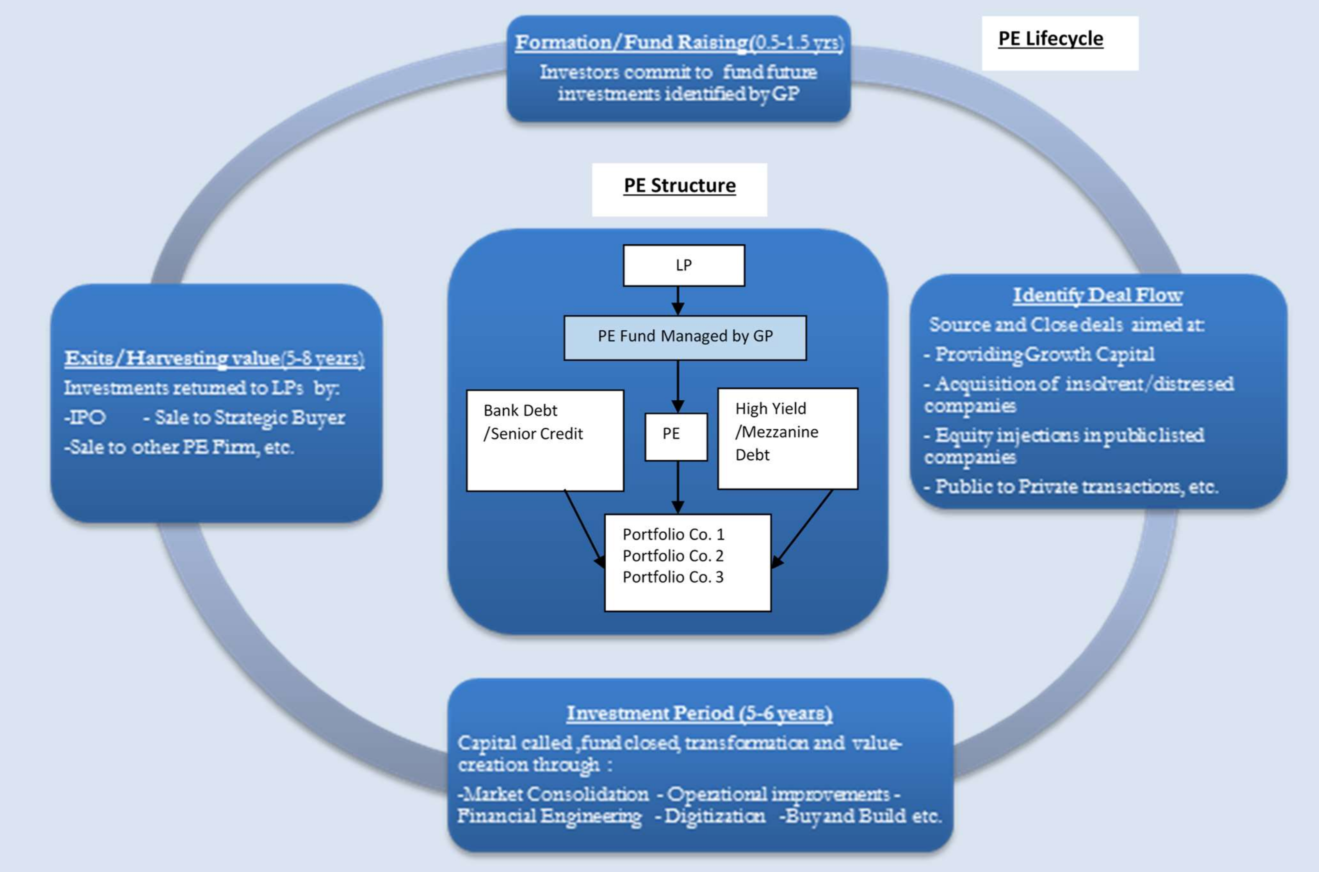
Box 4.2.2: Private Equity Funds in Pakistan

Figure 1: PE Lifecycle and PE Structure



Private Equity (PE) Fund-Structure and Lifecycle

PE is a buy-to-sell business model that allows high-net-worth individuals and institutional investors[207] to directly acquire ownership interest in companies. These funds are commonly structured as limited partnerships; PE Firms (General Partner) obtain capital commitments from limited partners (LPs/ investors) and manages a portfolio of companies generally charging management fees which is typically 2 percent of AUMs and 20% performance fees(on profits after accounting for hurdle rate).

Besides equity investments, PE funds may also engage in Leveraged Buy-Outs (LBOs) wherein they supplement equity investments through bank debt, senior credit facility or mezzanine (hybrid) debt.

PE is a source of patient capital for companies. Unlike mutual funds that have infinite lives, a PE fund has finite but longer lives generally spanning 7-12 years. The firms are continually involved in identifying deal flow or potential companies that could be invested in to create value. A number of investment philosophies guide a PE firm in choosing its target. It may buyout companies, provide expansion capital, undertake PIPE (Private Investment in Public Companies) or de-list and privatize them. Globally, in CY17, buyouts have been the popular category (**Table 1**).

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[207] E.g., pension funds, university endowments, insurance companies etc.

Table 1

Global Private Equity Backed Buyout Deals and Exits in 2017 by Type

Deal Type	US$ billion	Exit Type	US$ billion
Add-on	50.3	Trade Sale	145.0
Buyout	159.6	Sale to GP	65.2
Growth Capital	17.6	IPO & Follow-On	39.6
PIPE	17.9	Restructuring	0.2
Public-to-Private	101.6		
Recapitalization	0.1		
Total Assets	**347.1**		**250.0**

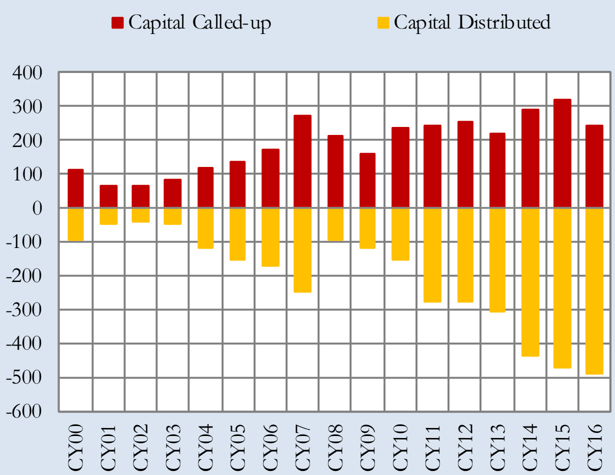
Source: Preqin

Figure 2

Global PE Capital Called and Distributed

Sizeable distributions were channeled back into the funds

(US$ billion)



Source: Preqin

These firms may invest at any stage of a company i.e. start-ups, expanding or mature. After a target is identified, PE firms may provide financial resources, strategic guidance, technical expertise through its professional team, technological support, cost cutting, or other operational improvements to create value and help companies actualize their potential. Such support is especially valuable for public sector companies that typically have outdated business philosophies and are in dire need of operational and strategic revamping. After enabling a company to reach its potential, harvesting this value through deciding on the most productive exit option is a crucial decision. Globally, sale to strategic buyers has been the popular exit option (**Table 1**).

<u>Global trends in fundraising, acquisitions and exits</u>[208]

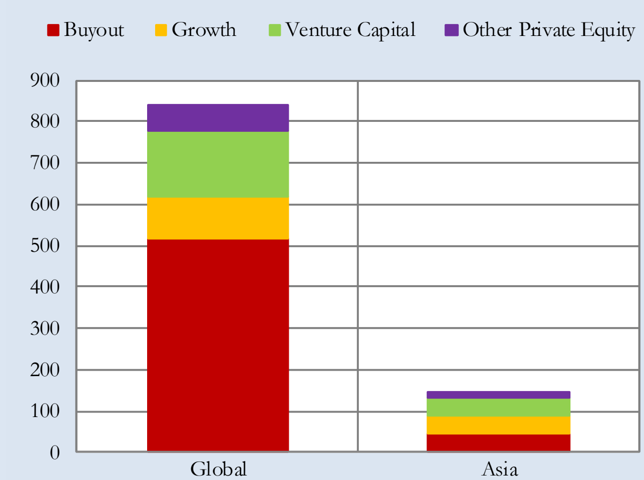
Globally, AUMs of PE stood at US$ 2.83 trillion as of end June-2017. The financial crisis had led to a build-up of huge inventory of companies with the PE funds. As market conditions became favorable in 2013-14, PE firms started exiting their pre-crisis huge inventory of companies at a brisk pace and distributed massive amounts of capital back to their LPs. Most of the distributions have ploughed back to the PE leading to a record year of fund-raising that remained strongest in 2017 witnessing an influx of US$ 453 billion (**Figure 2**). On the other hand, high valuations of firms, competition from corporate acquirers, and increased macro and geopolitical uncertainty had curtailed new acquisitions making the industry's Dry powder (unused commitments) reaching historic highs. Now the global PE industry is all set to begin a new fund deployment phase (**Figure 3**).

Figure 3

Dry powder with PE Firms

Global and Asian Composition in CY16

(US$ billion)



Source: Preqin

[208] Preqin Private Equity Online

Asian PE Industry

The Asian private equity and venture capital market had an AUM of US$484 billion as of end December 2016. China and Japan account for a major portion of investors (51 percent) followed by South Korea (12 percent), India and Hong Kong (10 percent each), Singapore (7 percent), Taiwan (4 percent), others (7 percent).

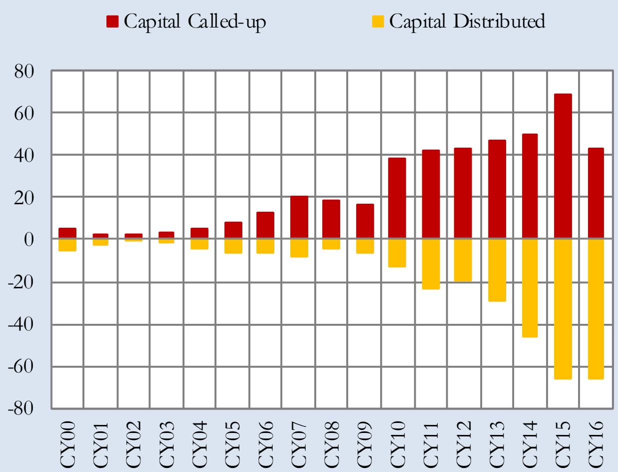
The Asian industry has raised total capital of US$ 562 billion since 2010 (South Asian[209] countries raised US$ 16.2 billion in 2017[210]), and has completed buyout and venture capital deals of US$521billion since 2010 (South Asian countries completed deals of US$ 78.8 billion in 2017[211]). In CY17, out of the global deal value of US$ 347 billion, deals worth US$ 62.5 billion have been managed by Asian PE while of the US$ 250 billion exits; exit deals worth US$ 22 billion have been managed by Asain PEs. China remains the dominating player representing 75 percent and 44 percent of venture capital and buyout deals completed. IT and health care have been the top industries accounting for 19 percent and 15 percent of global deal value, respectively.

Figure 4

Asia Focused PE & VC Capital Called and Distributed

Sizeable distributions channeled back into the funds

(US$ billion)



Source: Preqin

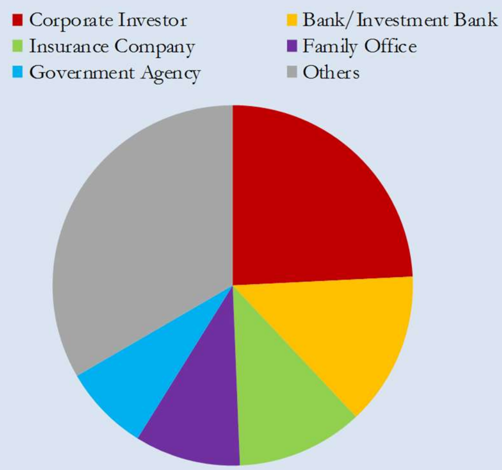
Although the fund-raising/ distribution patterns are similar in the global and Asian market, there is a marked contrast in investor composition. As against the developed markets of US and Europe where educational foundations and pension funds are the dominant investors, corporate investors, banks and insurance companies dominate the Asian industry. In China, recent regulatory changes in the framework for insurance companies has allowed them to launch PE funds increasing their presence in the sector (**Figure 5**).

Figure 5

Asia based PE &VC Investor Type

Insurance companies and Asset Managers account for 19 percent of investor base

(Percent)



Source: Preqin

Regulatory environment for PE in Pakistan

Initially, the Venture Capital Fund regulations were provided for in the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 wherein a business entity could undertake all businesses allowed under the NBFC framework subject to compliance with the progressively tiered capital requirements. However, in 2008 the regulatory framework for NBFCs was revamped by creating firewalls between asset management and other services. Henceforth, companies, which could undertake asset management and advisory services, could not simultaneously offer leasing, discounting, housing finance, investment finance services or venture capital investment, simply by complying with the minimum capital requirements. SECP notified the regulatory framework for the registration and regulation of Private Equity and Venture Capital Fund Regulations

209 Bangladesh, India, Nepal, Srilanka and Pakistan

210 Up to September-2017.Source: Preqin

211 Up to September-2017.Source: Preqin

in Pakistan in 2008 later to be replaced with Private Funds Regulations in 2015.

The regulations[212] define PE & VC Fund to be an unlisted closed-end fund established under trust structure and offered for subscription only to eligible investors[213] (capped at thirty).The fund may:

- Invest in securities of an unlisted company
- Turn around a listed company or a company listed on SME board
- Invest in an unlisted company engaged in business of investing in developing a new product or process or expansion of business

The Private Fund Management Company must have at least PKR 30 million in minimum equity. Utilization of borrowing for the funds has only been recognized for the Alternative Fund[214].

Bottlenecks towards successful adoption of the PE model in Pakistan

Worldwide PE firms have played a vital role in helping companies realize their potential and have either spurred or capitalized on industry's Mergers &Acquisition activities. A great variety of businesses in different industry sectors and development stages (start-up or large established companies) like high technology, industrial, healthcare, consumer services, financial and other sectors have benefitted from additional financial or intellectual resources offered by PE experts. For our local industry, it can serve as an impetus for the financial and real sector in the following ways:

i) As the funds have a longer investment horizon and are relatively illiquid they stay invested across market cycles. This tends to be a stabilizing feature for markets as the deployment of funds is sustained across boom/bust episodes.

ii) By offering long-term investment products to match long-term liabilities, it tends to mitigate the risk of maturity mismatch in the financial system. Secondly, by mobilizing resources from large investors it might provide another vehicle to direct resources towards the active/organized financial sector (as against the passive real estate investments or cash/gold hoardings).

iii) The PE funds can act as a potent force for improving standards of corporate governance, disclosure and transparency for the unlisted sector and the small-tier enterprises as they compete for funds from the private investors.

iv) Building momentum for corporate sector's exchange listing if IPOs turn out to be a profitable exit strategy.

v) Since China is leading the Asian PE industry, Chinese PE firms may invest in Pakistan further through local corporate acquisitions. The firms may provide capital to local unlisted corporations to expand further catalyzing the domestic momentum that is being generated under the CPEC collaboration. By bringing in the necessary technology, it may further dilute the country's need for imports, which are currently burgeoning under the pickup in domestic aggregate demand.

However, some challenges exist, which may hamper growth prospects of PE sector with the primary one being the PE firms' inability to mobilize funds from large investors. The trend in the growth of the discretionary/non-discretionary portfolios under management of AMCs when assessed as an indicator of funds that could be mobilized from wealthy families/individuals suggests a rather bleak picture. Although there has been a growth of around 26.9 percent over the last five years, the portfolio size still

[212] The regulations cover two types of Private Funds: "Private Equity and Venture Capital Funds (PE & VC)" and "Alternative Funds". Alternative Funds are defined to be those that invest in Portfolio of securities and other financial assets other than a Private Equity and Venture Capital Fund.

[213] A person who offers a minimum of three million rupees for investment in a Private Fund and furnishes a declaration to the PE Company that he understands the risk of investment.

[214] A Private Fund, which invests in portfolio of securities and other financial assets other than a Private Equity and Venture Capital Fund.

remain small at PKR 139 billion to offer meaningful funding to promote the sector up to the level required to realize the above benefits.

Secondly, although it is highly desirable that savings of institutional investors be mobilized towards long-term investment, a rather conservative regulatory approach (specification of investment criteria for mutual/pension funds and insurance companies) has been adopted to protect resources of insurance and pension funds clientele. The pension funds' defined investment allocation are confined to mutual funds while for the insurance sector, the allowed assets classes only allow a limited percentage in unlisted securities(indirect capital related sanctions on unlisted investments). These restrictions limit availability of funds to PE from institutional investors.

Also, equity investments from abroad in unlisted companies are to be repatriated on book-value as certified by an auditor. The option for repatriation at share market price is available when the exit route of PE is through an IPO. But many of the private corporations remain shy of public listing given the transparency, disclosures and regulatory formalities associated with such listings.

Currently, the PE industry has been vying the regulators for relaxation on these fronts to open doors for more investments in the industry and success of the sector depends on availability of such key enablers.