

Private Equity Financing and Financial Performance: A Critical Review of the Literature

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Abstract

Private equity is fast becoming an alternative source of capital for firms with a high growth potential as compared to the main stream sources of capital. The pertinent question here is; does private equity financing translate to better performance for firms that receive private equity? This paper examines the extent to which private equity funds affect the performance of firms in the Fintech sector in Kenya using a conceptual approach. The agency theory and diffusion of innovations theory underpin the direct and indirect relationships examined in this paper while also reviewing empirical literature. There are mixed findings on the link between private equity and financial performance whereby on one hand, private equity-backed firms have better financial performance than non-private equity-backed firms while other studies support the converse. Nevertheless, firm factors have generally been found to have a moderating influence on the link between private equity and financial performance in firms.

Key words: *Private equity, Venture capital, Growth, Fintech firms, Financial performance.*

1.1 Introduction

Private equity (PE) is fast becoming an alternative source of funding globally including the East African region especially for Small and Medium Enterprises (SMEs) and corporate entities and to some extent start-ups. This phenomenon is backed up by improved economic growth in the region and especially in Kenya where there has been a rise in the number of firms doing business in various sectors of the economy. According to the KPMG EAVCA (2017) report on the East African region, there has been a shift in PE investment from Agribusiness deals to financial services and manufacturing deals. During the period of 2015 to 2016, 25% of the deals recorded were in financial services while manufacturing trailed at 22%. However, Agribusiness accounted for 6% of the deals recorded in the same period, compared to 27% of the sector's deals recorded in the period 2007 to 2014. Consequently, the divergence in the sector interest in PE deals could imply a shift to the region's emerging trend to move from Agribusiness into value-adding industries and service sector industries. Therefore, with an increasing trend for PE firms to fund entities in the financial services sector would beg the question as to whether PE funds would translate to enhanced financial performance in recipient firms.

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Financial technology otherwise known as fintech refers to firms leveraging technology in order to deliver financial services to customers (EAVCA, 2018). It is notable that the Kenyan fintech industry has been undergoing rapid growth especially over the past five years due to technological innovations and changing customer preferences. The East African region has been undergoing a fintech revolution due to several enablers which include; demographic trends, digital infrastructure, data and technological trends and gaps in the financial services market (KPMG EAVCA, 2017; EAVCA, 2018). Some of the popular fintechs based in East Africa that have received PE recently entail; Azuri, BIMA, BitPesa, Direct Pay, Flutterwave, Jumo, Lendable, M-Kopa, Mobisol, Netguardians and Tala. These fintechs received PE funding ranging from \$5 million to \$80 million (EAVCA, 2018).

PE can be described as equity financing provided to young or mature firms with a high growth potential. Gillian and Wright (2008) define PE as risk capital provided in a wide variety of situations, ranging from finance provided to business start-ups to the purchase of large, mature quoted companies. PE can be in the form of venture capital (VC), leveraged buyouts or mezzanine finance. VC is a subset of private equity and it refers to equity investments made for the launch, early development or expansion of a business whereas leveraged buyouts involve a firm being acquired by a specialized investment firm using a relatively small portion of equity and a relatively large portion of external debt financing (Kaplan & Stromberg, 2009). Firm factors encompass the size of a firm as measured by the total assets of the firm and growth levels of a firm as measured by the ratio of intangible assets to total assets. Financial performance is one of the most common criteria used to determine whether a firm is on the right course of delivering optimal stakeholder satisfaction or maximum returns to shareholders. There are several measures of financial performance of firms ranging from returns, profit margins and economic value added. However, in this study the key parameters on financial performance range from return on equity and return on assets.

1.2 Research Problem

There is a growing body of empirical literature that have examined the question of whether PE backed firms outperform non-PE-backed firms. However, it is inconclusive as to whether PE capital accelerates financial performance of firms given the prerequisite of growth potential and

innovation in comparison to other types of financing. For instance, Meles, Monferrà and Verdoliva (2014) argue that PE backed firms have superior returns as compared to non-PE backed firms. Lahmann, Stranz and Velamuri, (2017) also contend that PE creates and adds more value to recipient firms. Nevertheless, the link between PE and financial performance is inconclusive since there are studies (Kaplan & Schoar, 2004; Lahmann et al., 2017) that argue that PE-backed firms may not necessarily have enhanced financial performance as compared to non-PE-backed firms.

It is notable from the existing literature that there is insufficient evidence of the effect of PE on firm performance of FinTech firms based in Kenya. This is despite the growing evidence from global and regional studies done thus presenting a contextual gap. The prevailing evidence on PE in Kenya is on its effect on firm growth, adoption and economic growth (Jagongo, 2012; Memba, Gakure & Karanja, 2012; Gatauwa & Mwithiga, 2014). Thus, this begs the question of – to what extent does PE affect and add value to firms? The issue of whether firm size and characteristics and growth opportunities leads to better firm performance also forms part of the question to be explored in this paper. From the finance literature there are mixed findings on the effect of firm size and growth on the link between PE and financial performance. This is considering the fact that PE funds tend to be directed towards firms with more growth opportunities.

1.3 Research Objectives

The main objectives of this paper include; first, to examine the effect of PE financing on the performance of Fintech firms in Kenya. Secondly, is to determine the moderating effect of firm factors (firm size and growth) on the relationship between PE financing and performance of Fintech firms in Kenya.

2.1 Theoretical Literature Review

This paper is underpinned by several theories including; first, the agency theory which was first expounded by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). The theory states that agents (top managers/directors) are expected to act in the best interest of the principal (shareholders). In this case the top managers are expected to make decisions that will ultimately lead to an increase in shareholder value. Nevertheless, there are cases where

agents pursue their personal interests super-ceding the organization's interest. Therefore, the agency theory underpins the relationship between PE and financial performance in this study.

Secondly, is the diffusion of innovations theory developed by Rogers (1962) where he sought to explain how, why and at what rate new ideas and innovations spread beyond the inventors. The theory further argues that there are four elements that influence the spread of an idea or innovation which entail; the innovation itself, channels of communication, time and the social system. That is noting that human capital is much needed in pushing the innovation to a wide range of firms or people. Therefore, the diffusion of innovations theory underpins the effect of growth and size on relationship between PE and growth.

2.2 Empirical Literature Review

2.2.1 Private Equity and Financial Performance

There is a substantive body of literature on the relationship between private equity and firm performance. For instance, Meles et al. (2014) undertook their study in 118 Italian PE-backed firms and observed that the effect of PE investments on the performance of PE-backed firms depends on the type of the PE, the length of the PE investment, the nature of the PE investor and the exit strategy. The study further indicates that PE backed firms outperform other firms implying a positive relationship between PE investments and firm performance. Similarly, Salerno (2019) argues that there is a positive relationship between PE and firm performance. Specifically, the study was undertaken in 553 European PE backed SMEs and found out that PE-backed family SMEs outperform non-family PE-backed SMEs over the post-investment period. However, the study did not consider corporate governance aspects associated with PE funds such as changes in the board of directors' composition or strategy. Nevertheless, there are studies that exhibit some scepticism on the aspect of PE having a positive relationship with financial performance of PE backed firms. For instance, Gompers and Lerner (2001) observed that in PE/VC financing of young firms, uncertainty and informational asymmetries are involved. The study argues that PE funds or angel investors might invest in strategies, research or projects that have high personal returns but low expected monetary payoffs to shareholders.

As much as there is substantial evidence as to the positive effects of PE on firms, there are also shortcomings worth noting pertaining PE investments. Wright, Gilligan and Amess (2009) indicate that there are drawbacks associated with PE investments such as the excessive use of buyouts and widespread trend of firm asset stripping. Also, Davis et al. (2011) observe that PE buyouts are associated with massive job cuts in PE-backed firms since they are regarded as agents of change that accelerate retrenchment but in other instances, they accelerate expansion. However, Kaplan and Schoar (2004) also register their indifference with regard to performance of PE funds and non-PE funds. The findings indicate that PE partnerships yield returns that are almost equal to those of S&P 500 implying that PE investing may not necessarily outperform non-PE investing. However, the study noted that PE fund performance increases with fund size and the general partner's experience.

In the Kenyan context, there is insufficient literature on PE and financial performance. However, much of what has been investigated is the link between PE funding and the growth of firms. For instance, Jagongo (2012) sought to establish the level of adoption of PE/VC in 106 micro, small and medium enterprises (MSMEs) based in Nairobi, Kenya in the quest to enhance industrial development. The findings indicated that PE firms were unwilling to fund MSMEs due to their volatility, inexperience and lack of attaining the prerequisites necessary to access PE funds. Similarly, Memba et al. (2012) examined the effect of PE on the growth of 100 SMEs in urban centres in Kenya. The study findings concluded that SME that use venture capital experience improved growth.

There is also a build-up of knowledge on PE investments in Kenya captured in technical reports and a few studies. In the Kenyan PE market, banks and development financial institutions are the top investors in PE funds while large firms and SMEs are the top recipients of PE funds (Gatawa, 2014). Technical reports such as KPMG/EAVCA report in 2017 indicate that there have been approximately 115 PE backed deals in EA from 2007 to 2016 with an estimated value of USD 1.4 billion as compared to over USD 4.5 trillion to the rest of the world. That implies a relatively small proportion of PE activity in East Africa (EA) thus being an opportunity to expand PE investments in EA and Kenya at large. Recent research on FinTech investments in EA has been conducted by EAVCA and Intelicap as seen in the EAVCA report in 2018. The

report notes that the FinTech industry in EA is rapidly growing due to a relatively stable macroeconomic environment, increasing technological innovations, demographic trends and gaps in the financial services market thus generating global investor interests in the FinTech sector.

2.2.2 Private Equity, Firm Factors and Financial Performance

In the finance literature, there is a general consensus that firm factors have a moderating influence on the link between PE and financial performance in organizations despite variations in research methodology and study context (Gatauwa, 2014; Kalidas, Kelly & Marsden, 2014; Salerno, 2019; Gatauwa, 2020). However, Lahmann et al. (2017) finds a contrary outcome that firm factors do not necessarily lead to enhanced performance.

Nevertheless, Salerno (2019) examines the moderating effect of firm factors on the relationship between PE and financial performance in 553 European PE-backed SMEs using ordinary least squared (OLS) modelling over the period 2007 to 2012. The findings indicate that growth opportunities have a mild moderate effect while firm size has a strong moderating effect on the link between PE and financial performance. However, Kalidas et al. (2014) has similar findings but uses a qualitative exploratory research design involving 15 respondents composed of VC fund managers, investors and intermediaries in the New Zealand VC fund industry. The study found that growth potential was a key factor in enhancing the financial performance of PE-backed firms. The growth potential was analysed in the context of a double growth phase which involves growth in the domestic market and in the off-shore markets.

On the contrary, Lahmann et al. (2017) while using the case study methodology in analysing the carve-out of QUNDIS from Siemens Building Technologie found that in large firms PE transactions, growth is not a significant factor. This is unlike small and medium size deals where the strategic focus is the growth factor. The study used secondary data and 9 semi-structured interviews via telephone with the management team and supervisory board members and investors. Kalidas et al. (2014) have similar findings where they found that firm size does not moderate the link between PE and financial performance. Simply, they contend that small firm size of NZ companies is not an advantage for innovation or firm success.

2.3 Conceptual Framework

The conceptual framework has combined the ideas of various theories underpinning PE as discussed in the literature. The framework presents the conceptualized interaction among PE (independent variable), firm factors (moderating variable) and financial performance (dependent variable). PE is operationalized by the amount of PE capital, PE strategy and the exit strategy while firm factors are operationalized by firm size and level of growth. Lastly, financial performance is operationalized by the return on assets and return on equity. In summary, the conceptual framework postulates that the relationship between PE and financial performance would be influenced by the firm factors as depicted below;

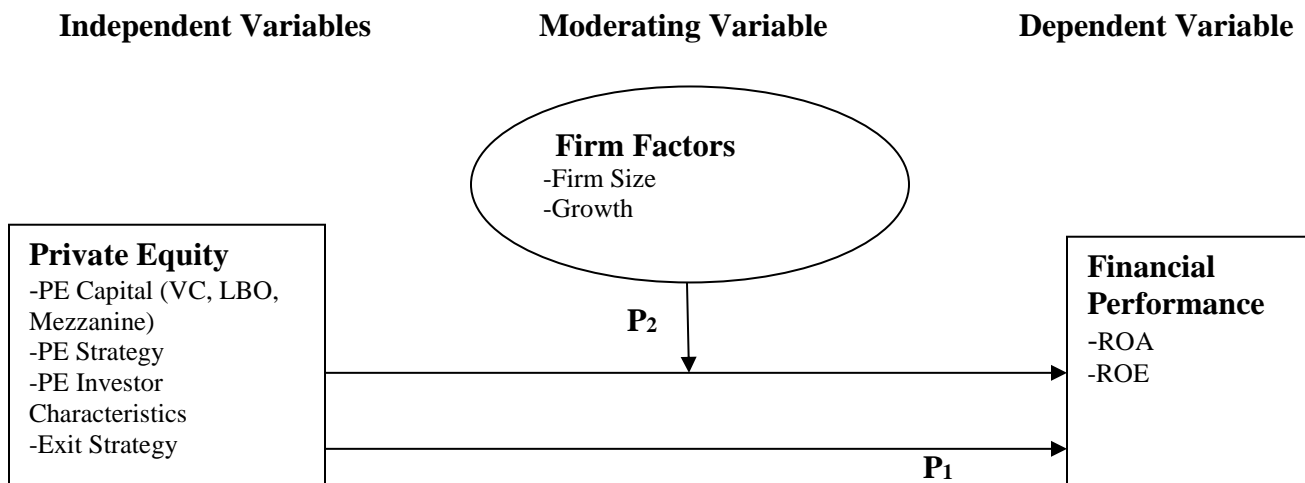


Figure 2.1: Conceptual Framework

2.4 Propositions

P1: There is a relationship between private equity and financial performance.

P2: Firm factors have a moderating influence on the relationship between private equity and financial performance.

3.1 Summary and Conclusions

There is an inconclusive debate on the relationship between PE and financial performance across developed and developing regions and markets. There is a body of knowledge that contends that

PE adoption translates to better financial performance in firms. On the other hand, there are studies that argue that PE-backed firms do not necessarily lead to superior financial performance due to shortcomings such as massive job-cuts, massive asset stripping and excessive use of buyouts. On the moderating influence of firm factors on the link between PE and financial performance, it has generated mixed findings. On one hand, firm factors have been found to moderate the link between PE and financial performance in firms while on the contrary firm factors have been found not to have a significant moderating effect on PE and financial performance. These are variations taking into consideration differences in research methodology and study contexts.

The areas for further research would entail; first, undertaking empirical studies on the interrelationship between PE, firm factors and financial performance in firms based in sectors that have mostly benefitted from PE investments such as the Fintech, Real estate, Agricultural, Financial services, Health sectors among others. Secondly, comparative studies can be conducted on PE and financial performance in PE-backed firms and non-PE-backed firms across the sectors mentioned above. Finally, exploratory studies could be undertaken on the link between PE and financial performance across the East African region.

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