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Lack of data-driven insights in private equity

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ABSTRACT

In a survey of senior executives of private equity firms conducted by Merger market on behalf of S&P Global, 43% of the respondents noted that data analysis could have the most positive impact on deal sourcing. Due to the leniency in disclosure requirements for private companies, private equity firms face difficulties in finding opportunities. This lack of visibility into the private equity market is detrimental to capital formation and overall economic growth. In this paper, we discuss the democratization of data as a solution to this problem.

Key words: Private equity, data, regulation, collaboration

INTRODUCTION

Private equity is often touted as a high-risk and high-return asset class and reasonably so. Often private equity firms will target distressed but structurally sound businesses. A lot depends on their ability to turn around such businesses with infusions of capital and capable management. However, we will be talking about the step that comes before this – discovering opportunities. Private companies need not publish financial and other key information. So, it is more difficult to discover opportunities in private firms than in publicly listed companies.

One can argue that the lack of visibility is what makes private equity so lucrative. Low visibility breeds risk which allows private equity firms to demand high returns. By this logic, it could also be argued that improvements in visibility could reduce risks in private equity and perhaps improve accessibility. Another benefit that could follow is improvements in capital formations.

However, a lack of data-driven insights is holding back these private equity market changes.

THE NEED FOR DATA IN PRIVATE EQUITY

In a survey of senior executives of US private equity firms, 43% of the respondents believed that increased use of data analytics would have the most positive impact on deal origination.[1] In private equity investments, deal origination is the process of finding opportunities to invest. It is impossible to think of a private equity firm doing well without efficient deal sourcing. So, it is surprising that 43% of the respondents admitted to under-utilization of data analytics for deal origination. It is even more surprising that only 3% of the respondents to the same survey stated they were capitalizing data analytics for deal origination.[1]

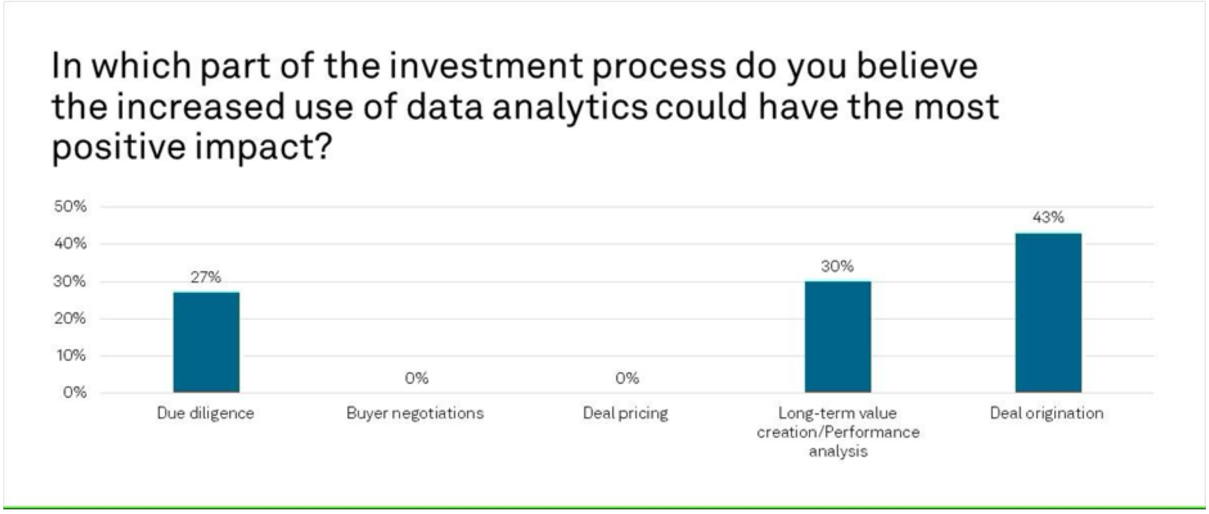

Figure 1: Source: S&P Global [1]

Another striking fact is that 30% of the respondents in the same survey believed that long-term value-creation and performance analysis is the private equity investment process in which data analysis would have the most positive impact. [1]

The key bottleneck in utilizing data analytics for private equity would be the lack of data. Unlike publicly listed companies, private companies need not publish financial information. Listed companies need to comply with various disclosure requirements that give insights into management quality, recent business decisions, and capital outlay.

To build investor confidence, listed companies would go out of their way to explain their business models, industry dynamics, regulatory environment, and their immediate and long-term goals. Such information could prove vital when looking at firms with never-seen-before value propositions. Private equity firms such as venture capital funds that deal with start-ups would find this practice incredibly helpful if it were followed in private companies. A big part of the deal-sourcing process relies on human expertise. Building this human expertise would be much easier with such practices being followed.

Now let us turn our attention to the quality of deal-sourcing data. When asked whether the data they rely on for pre-deal investment sourcing is largely real-time and high-quality, 43% of the respondents in the same survey did not agree.

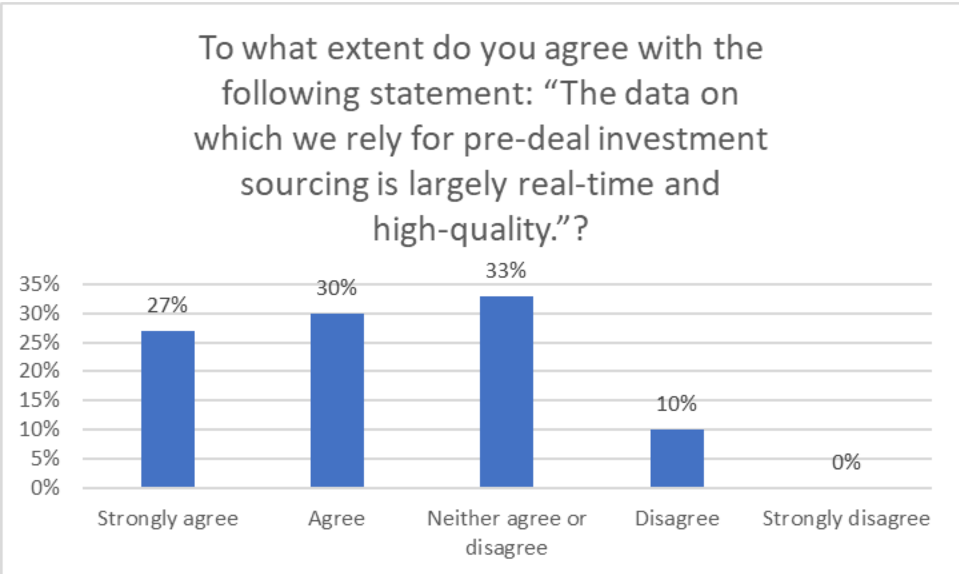

Figure 2: Source: S&P Global [1]

One of the managing directors responding to the survey said that they cannot get the kind of real-time data they anticipate as data tends to become stale very quickly because of fast market developments and internal changes in companies.

Another challenge for private equity firms is verifying the data they have collected. A respondent noted that this is difficult without additional sources and due to differences in data types, real-time data verification is challenging.

DEMOCRATIZATION OF DATA

A plausible solution to the lack of data in private equity would be the democratization of data and research. First, let us look at the cost of doing so. The main utility that private equity firms bring to the table is their ability to research and find value in opaque markets.

We have already discussed the difficulties in finding out facts regarding private companies due to the more lenient disclosure requirements. So, if we ask private equity firms to share their research systematically and periodically, most would be reluctant.

The private equity market is highly competitive. For a lot of private equity firms, their basis of competitive advantage is their ability to research. If a private equity firm knows about an opportunity, it is in their interest to keep this information to themselves until the deal goes through. In extreme cases, private equity might even want to maintain secrecy regarding emerging value propositions let alone the specific companies they are interested in.

After all, sharing the information only increases their competition. As a result, they might lose the opportunity entirely or the company they are interested in might be able to negotiate a better deal. Either would be against the interest of a private equity firm.

However, one can also argue the case for collaboration and data sharing. If we look at the bigger picture, there could be multiple private equity firms researching the same industry, or even the same company. Over time, each of these firms would develop a similar understanding of the subject at hand. Here, we must ask if this really is efficient. We will have multiple firms investing their time and energy in pursuing the same insights. While handing over all key insights and data on a platter to the competitors is questionable, there must be a case for sharing basic data gained from due diligence, at least for a price.

Private equity firms could benefit even more by not stopping at sharing information and going as far as collaboration. In addition to optimizing the man-hours spent researching key information, there could other forms of knowledge gains. When private equity firms specializing in two different approaches collaborate, they can understand different solutions to the same problems. As a result, new solutions, theories, and practices which combine different approaches could be developed.

An area where the debate over sharing and owning intellectual property has more vintage is pharmaceuticals. Governments need to formulate intellectual property laws in such a way that innovative companies have an incentive to keep researching and coming up with better medical solutions, and medicines remain accessible to those who need them. Hence, pharmaceutical companies are allowed to have rights over the manufacturing and licensing of medicines and other related products for a long but limited period.

In 1995, the Trade-Related Aspects of Intellectual Property Rights (TRIPS) came into effect.[2] In addition to protecting the rights of innovators and incentivizing innovation, the agreement also had provisions for member nations to act in the interest of public health. As per the World Intellectual Property Organization (WIPO) data, if we look at the number of pharmaceutical patents granted every year, we can see significant and sustained growth since 1995.[3]

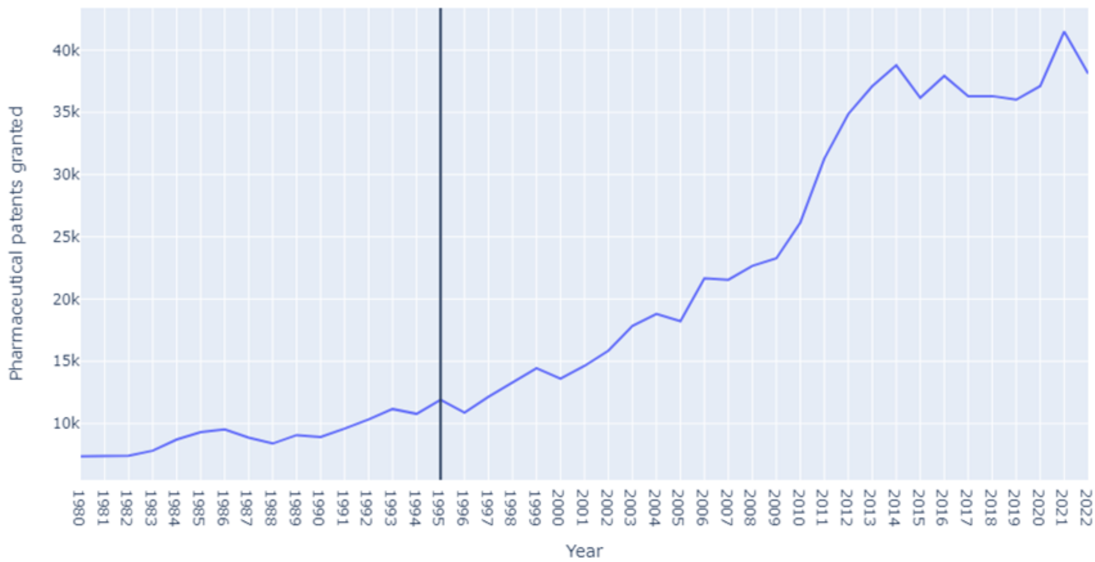

Figure 3: Source: WIPO statistics database [3]

In the context of pharmaceuticals, the long period over which innovative companies have an effective monopoly makes sense as pharmaceuticals will not lose their utility for users even in the long term. Even vaccines would be necessary for new-borns and children. However, we cannot say the same for business-related data. Such data becomes irrelevant after just a month or even a few weeks. Hence, data must be distributed with agility otherwise it would be a wasted effort.

When we look at the democratization of data from the perspective of regulators and governments, it would make sense for them to promote or even enforce it. With better collaboration between private equity firms, in the long term, there would be better visibility into the private equity market. As a result, the cost of capital could also go down for companies that truly deserve it. We could also see improvements in the management of various businesses. This is especially important for start-ups that are venturing into business models that have never been explored by anyone before. All of this could only mean a positive impact on an economic level.

CONCLUSION

From the survey conducted by Merger market on behalf of S&P Global, we gathered that data analysis is quite under-utilized in private equity. One could argue that due to the higher risks involved in private equity, data analytics tools must be applied when searching for opportunities in private equity and valuing companies. However, due to leniency in disclosure requirements, there is quite a bit of opaqueness in the private equity market. Due to the lack of data, there is limited potential for leveraging data analytics tools.

In such a scenario, we must question whether private equity firms as a whole can afford to spend man-hours on researching overlapping interests. While it might not make sense to share painstakingly acquired leads, there must be a case for sharing due diligence data, at least for a price. If this practice were to be adopted, there is a need to build a structure for the distribution of real-time data as data becomes stale and irrelevant in a matter of weeks.

From an economic point-of-view, collaboration among private equity firms would be a positive as it would mean better capital formation because of better visibility. In the long-term, it can also mean faster discovery of value propositions of start-ups and efficiency in managing them.

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