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The Impact of Private Equity on Exporting Activity

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Synonyms

Portfolio company performance; Exporting; Internationalisation

Introduction

Academic literature has shed light on many ways in which private equity (PE) investment can stimulate growth and performance improvements in portfolio companies. This article relates to the exporting behaviour of target firms. Specifically, we address the following questions: Is there evidence that PE ownership leads to improvements in exporting both in terms of the decision to begin exporting (propensity) and the intensity of exporting (growth rates in the volume of sales exported into existing and new export markets)? Is there evidence that the extent of and changes in exporting activity following PE-involvement across their range of portfolio firm investment activities *results from* improvements in financial performance [profitability] and economic performance [productivity]? Firm level relative efficiency is associated with the likelihood to export. Do PE investors provide and facilitate access to capital and resources that better enable their portfolio firms to access foreign markets? Firm level financial constraints are cited as an impediment to exporting. Is there evidence that any improvements in the exporting performance of PE-backed firms is due to the experience, capabilities and networks of the PE investor(s) and their active involvement in management or on company boards post-investment?

Evidencing whether PE backed firms are more (or less) likely to be internationalised in empirical studies, relative to other non-PE-backed firms, is challenging methodologically. Of course, PE investors may target firms that have existing export markets and/or are perceived to have export potential (Wilson et al., 2022a). International PE investors may acquire a firm with the aim of relocating key activities into other markets where they have a presence and/or to trade across international boundaries with some of their other portfolio firms, established customer bases or networks. Moreover, improvements in relative firm performance (profitability and efficiency) can be correlated with export activity *in both directions* e.g. efficiency increases exporting activity and/or internationalisation generates efficiency improvements. Empirical and theoretical studies that examine the changes in incentive, ownership and governance mechanisms implemented to enhance the post investment performance of PE-backed firms provide insights into how and why PE-backed firms may increase sales internationally.

The article is organised as follows. First, the article introduces the primary hypotheses concerning firm exporting, and outlines the primary benefits of exporting. Then, we review the existing empirical evidence of the impact of PE ownership on portfolio firm exporting.

Exporting by Firms

Research on the propensity and intensity of exporting by firms has focused on two main hypotheses. The first hypothesis argues that 'better' firms in terms of profitability and productivity performance and access to finance self-select into exporting. Such firms are argued to be better placed to overcome the barriers to exporting in terms of the costs and risks associated with transportation and distribution as well as asymmetry of information about foreign markets. The second hypothesis is the learning-by-exporting hypothesis which argues that exporting firms perform better than non-exporting firms. Exporting firms face competition in foreign markets that brings greater pressures on them to learn how to adapt and become more efficient than is the case for firms operating only in domestic markets. This advantage opens opportunities to further exploit existing and new export markets.

Exporting is recognised as an important indicator of a firm's (or country's) competitiveness, represents an opportunity for growth, and makes the firm more resilient to changes in economic circumstances in domestic markets. Participation in international markets confers a range of benefits; access to leading edge technologies and an international workforce; the building of networks and customer-bases along with many other less tangible benefits. All of which can add firm value. As one dimension of business growth, exporting is comparatively faster, less costly and less risky than other modes of internationalisation such as FDI or franchising. Nonetheless, exporting involves additional costs such as, market research, adaption to local regulatory conditions, transportation and trade finance and/or insurance, currency risk etc. that have to be considered against the anticipated benefits. There may also be learning benefits from exporting that enhance financial and economic performance.

Limited resources may impede internationalization, especially among SMEs (Bonaccorsi 1992; Westhead, et al., 2001; Wright et al., 2007). Financial constraints, may act as a barrier to exporting, especially for SMEs (Bellone et al., 2010; Riding et al., 2012). Studies indicate that exporting firms need to have access to the appropriate human capital expertise but that the nature of such expertise may differ between entering into and intensifying activity in export markets (Ganotakis and Love, 2012) and that there is a strong but complex relationship between innovation and exporting (Love and Ganotakis, 2013; Love and Roper, 2015). Overall, firms need to possess or develop the 'capabilities' to overcome barriers to exporting. These capabilities include the ability to learn, adapt and internalise knowledge, to allow them to absorb externally available information and adapt it for their own use. Having boards with directors who have experience of foreign markets and/or who are foreign nationals, may provide the specific human capital needed to benefit from exporting. Exporting may have the objective of raising firm profitability and sales growth but it can also impact on productivity growth along with the other qualitative benefits outlined above. From the perspective of PE investors directing a portfolio firm to international markets, by providing resource and capability, might be an important means of adding value to the firm in the short and medium term.

Exporting and Private Equity

Isolating the effects of PE ownership on portfolio firm exporting propensity and intensity involves controlling for endogeneity and unravelling the direction of causality in research design. Clearly the impact of PE on exporting activity can be investigated using alternative methods such as matched samples of PE and non-PE backed firms (propensity scores or matching algorithms) to focus on the exporting uplift of the change in ownership and governance. Moreover, endogeneity issues can be handled by using econometric techniques such as difference-in-differences (DiD) methods to track the relative export performance of firms that differ only in terms of ownership (change). Moreover, specifying and estimating multivariate models of the firm level determinants of export activity inclusive of a wide array of company and industry specific characteristics can provide insights into the factors that might give PE portfolio firms an exporting advantage. Micro economic theories of the firm level determinants of exporting are useful in guiding model specification.

Early evidence of the impact of PE ownership on target firm exporting was limited to an analysis based on a cross-sectional mailed questionnaire survey. Lockett et al., (2008), in a European study of 340 VC-backed firms (which includes PE-backed buyouts in the UK), argue and find support for the hypothesis that monitoring as opposed to value-adding inputs by PE firms will be more important for buyouts than for early-stage VC backed firms in assisting the international expansion of the business.

More recently, two studies (Lavery et al., 2021; Wilson et al., 2022b) examine empirically the exporting performance of PE-backed firms post investment with consistent baseline results. Lavery et al (2021) track UK PE buyouts in the S&P Capital IQ database from 2004 to 2017 and match PE target firms to historical firm-level accounts in the FAME database from Bureau van Dijk. To examine the exporting performance of PE portfolio companies relative to nonsponsored peers, they define a matched control group of non-PE-backed firms, which operate in the same industry as their PE-backed counterparts, and are of a similar size, profitability, and leverage in the pre-buyout period. They find that PE ownership increases exporting at both the extensive and intensive margins of export. Specifically, the probability of entering the export market increases by 4.6 percentage points when a firm is acquired by a PE investor. At the intensive margin, they document that PE-backed firms increase the value of their export sales by approximately 36 percentage points, relative to similar non-PE-backed firms. Similarly, exports as a share of total firm sales among buyout targets increases by around 3% more than in matched control firms.

The authors explore potential mechanisms through which PE ownership may stimulate firm exporting. They first find evidence that PE investors may help *alleviate financing constraints* facing their portfolio companies. That is, companies that are smaller and younger and therefore more likely to be financially constrained, exhibit considerably higher post-buyout growth in exporting activity relative to larger and older firms. At the deal-level, post-buyout growth in export performance relative to control firms is concentrated in private-to-private buyouts. Private target firms may have limited access to external funding compared to public firms or divisions of larger corporations, which explains that private-to-private buyouts experience a more potent post-buyout increase in exporting activity. At the extensive margin, private-to-private targets are around 6 percentage points more likely to become exporters relative to matched control firms. At the intensive margin, the value of exports grows by over 47% for PE-backed firms in private-to-private targets relative to control firms.

Another potential channel through which PE ownership may drive exporting is by inducing productivity improvements in target firms. There is a clear scholarly consensus on the positive impact of PE ownership on firm-level productivity (Harris & Wright, 2005; Davis et al., 2014, 2019). In the international trade literature, studies identify a causal link from firm productivity to exporting (Melitz, 2003; Manova, 2013). To assess whether different levels of firm productivity drive the relationship between PE ownership and exporting, the study categorises firms into high/low productivity in the pre-buyout period. PE investors add value to the low-productivity targeted companies by increasing their productivity level post-buyout and their likelihood to engage in exporting. The extensive margin of exporting, and to a lesser extent the intensive margin, adjusts disproportionately more for less productive target firms, compared to high-productivity targets.

Wilson et al (2022b) analyse a UK panel dataset covering the period 1998-2013 involving 2.6 million company-level observations of which around 10% are actively engaged in exporting. The authors find that the sub-sample of PE backed firms are more likely to engage in exporting (export propensity) and be internationalised post buyout than the large control sample of other firms. Moreover, in relation to export performance they find a positive export performance differential (export intensity) for PE-backed buyouts. Importantly, this study explores the routes through which PE funds, as ‘active investors’, affect the acquired company’s ability to enter and expand export markets. In line with Lavery et al (2021) the sources of improved export performance are attributed to first, the PE’s role in providing access to financial resources, increasing capital and operational expenditure, to boost both efficiency and the improvement in managerial processes; and second, by bringing expertise and relational capital via managerial change and board representation to their acquisitions. In terms of the second route the analysis provides detail through the inclusion of a wide range of control and explanatory variables in the models determining export propensity and export intensity. The models use a rich array of company specific variables reflecting performance and governance characteristics of firms.

The evidence suggests that there is a positive and significant relationship between total factor productivity (TFP) and *export propensity* and that firms with more knowhow, innovation and expertise are more likely to be exporters. The percentage of foreign nationals on the board has a positive and significant effect along with the average age and experience of the board directors on *export propensity*. Variation in director tenure and average number of multiple directorships are positive and significant whereas board size is negative suggesting that focussed directors are more effective in driving *export propensity*. With respect to *export intensity* (the share of sales that are exported), there is a positive and significant coefficient on PE backing indicating an uplift in export performance of firms post PE investment. Firms with PE backing appear to have a percentage export differential of more than 4% over the control group of non-PE backed firms, taking other factors into account. Examining the effects of the characteristics of the board of directors, Wilson et al (2022b) show that *export intensity* is positively associated with foreign nationals, multiple directorships, average age and experience and tenure variation. Ethnic background of directors and female directors on the board are found to be less effective in increasing export intensity. The paper finds evidence that foreign PE investors, PE syndicate and the board changes that are implemented post buyout have a positive effect on the export intensity of PE backed portfolio companies.

In line with other evidence of PE portfolio firm resilience (see for example, Wilson et al., 2012; Bernstein et al., 2019), Lavery and Spaliara (2022) study how the exporting performance of UK PE portfolio companies fared during the global financial crisis. While the crisis had a profound impact on international trade flows and firm exporting, the authors show that the exporting of PE-backed firms was significantly more resilient to the effects of the crisis, relative to a matched sample of control firms. PE target firm export sales value (export intensity) is around 20% (2%) higher during the crisis compared to matched non-PE-backed control firms. Moreover, the study finds that PE-backed companies were also less likely to exit the export market during the crisis. The authors attribute this resilience to a more efficient working capital and cash flow management which may have helped sponsored companies maintain their levels of exporting during the crisis relative to similar, non-sponsored firms. Working capital and cash flow management is particularly important in PE target firms given that buyouts often involve a substantial debt injection into targets. As far as trade is concerned, an increase in exports leads to higher working capital needs as firms may need to cover the costs of goods that have been produced but not yet delivered, reflecting the time lag in completing international transactions.

Conclusion

Given the consistency of recent empirical evidence on the positive impact of PE ownership on firms' propensity to export, and the intensity of their exporting, relative to similar, non-PE-backed firms, there exist several potential avenues for future research to shed further light on these findings. Given the growth and increasing globalisation of private equity as an asset class over the last three decades, and the subsequent growth in the number of active PE investors, it would be of interest to study whether PE-backed portfolio firms export to other non-domestic portfolio firms of their own PE investor, and to identify whether PE investors use their network of current and past portfolio firms to open up international sales channels for their investee firms. Along similar lines, as the PE market has expanded with more investors, club deals and secondary buyouts have increased in popularity among investors who often see benefits in co-operating with one another (Gara, 2022). Do PE investors work together across networks of investors and their respective portfolio companies to aid and accelerate the internationalisation of their portfolio firms? Answering such questions would not only improve our understanding of the internationalisation of PE portfolio companies, but also how PE investors may be able to use portfolio firms to benefit other firms in their portfolio, and how PE investors may be able to collaborate with one another through their portfolio firms, where there exist potential mutual benefits. As PE investment continues to internationalise and new models of PE investment emerge (e.g. SPACS) these questions have yet to be addressed in the literature to date.

Cross-References

- Post-buyout portfolio company performance
- Private equity value-added strategies
- Buy and Build Strategies in Private Equity
- Direct Investment
- Internationalisation of Venture Capital
- Operating Improvements in Private Equity Buyouts

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