Governance of Private Equity Investment in India: A Qualitative Approach

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The President:

Prof. Dr. Thomas Bieger

Preface

The United States was instrumental in developing the modern private equity phenomenon and practically exporting it to the rest of the World. But ironically and interestingly, at the time of writing this page, the private equity industry in the US appears to be on a ‘public and media trial’ because one of the presidential candidate’s association with a large private equity firm. This also, somewhat demonstrates the relevance of the topic of this dissertation. Nevertheless, my interest in the field of private equity has been more academic and was driven by the exponential growth of venture capital deals and their impact on my country of origin – India.

I am indebted and thankful to my research advisor, Prof. Dr. Martin Hilb, for guiding me in discovering relationships between corporate governance and private equity transactions. I also would like to express my sincere appreciation and thankfulness to my co-advisor, Prof. Dr. Roman Boutellier of ETH, Zurich, for reviewing and guiding my research effort. I am also indebted to Dr. Simon Grand, who inspired me to pursue qualitative research approaches and theories in order to obtain more practical insights into the research questions.

I am truly indebted to the private equity investors in India, who were patient with me and took my multiple phone calls at odd hours and shared their experiences with me. I am also very thankful to the other private equity partners who also provided inputs to survey questionnaires about their funds under the conditions of anonymity.

I am also very thankful to Dr. Georg Berkel of Siemens, for providing his insights on negotiation aspects that could apply to private equity transactions and deal making. I would also like to thank my other colleagues in Prof. Dr. Hilb’s doctoral group for all the memorable moments we shared on HSG campus.

Washington, D.C., October 2013 Vikas Uberoi

ABSTRACT (German)

Private Equity Gesellschaften stellen Eigenkapital außerbörslich zur Verfügung. Die Mittel dazu erhalten sie von einem weiten Kreis von Investoren, wie etwa Pensionskassen, Finanzinstituten, Unternehmen, öffentlichen Körperschaften oder vermögenden Privatleuten. Viele Private Equity Gesellschaften agieren weltweit und fördern so Wachstum und Innovationen. Typischerweise folgen sie dabei einem zyklischen Geschäftsmodell: Sammeln von Finanzmittels → Tätigung der Investition → Management der Investition → Ernten der Früchte der Investition → Rückzahlung der Finanzmittel und Aufteilung der Gewinne → (erneutes) Sammeln von Finanzmitteln etc. Diese Dissertation konzentriert sich auf die Phase des Investitions-Managements. Diese Phase ist entscheidend für Wertschöpfung und Kapitalrendite - und damit auch für die Fähigkeit der Private Equity Gesellschaft, in nachfolgenden Investitionszyklen Finanzmittel zu sammeln und sie in vielversprechende Unternehmen zu investieren. Die Dissertation geht er Frage nach, wie Private Equity Gesellschaften den Wert ihrer Beteiligungsunternehmen steigern. Dabei fokussiert die Arbeit auf Schwellenländer, insbesondere Indien.

Zur Beantwortung dieser Frage wurde ein qualitativ-empirischer Ansatz verfolgt. Es wurden fünf ausführliche Experten-Interviews geführt und Fragebögen von 12 Unternehmen ausgewertet. So wurden zwei Merkmale herausgearbeitet, die für die Rolle der Private Equity Gesellschaft gegenüber ihrer Beteiligungsgesellschaft charakteristisch sind: „Unbeschränktheitç und „Durchgriff". „Unbeschränktheit" bedeutet, dass das Management Team nach Tätigung der Investition in einem breiten Tätigkeitsspektrum tätig wird. Dazu zählt etwa die Erforschung von Wachstumsmöglichkeiten, die Durchführung von Analysen, die Erarbeitung von Kooperations-Strategien, die Lösung von Konflikten, und die Anleitung des oder der Unternehmer. Auf welche Tätigkeiten sich das jeweilige Management Team besonders konzentriert hängt nicht zuletzt von Persönlichkeit und Stärken seiner individuellen Mitglieder ab. Dabei kann die Private Equity Gesellschaft sowohl mit als auch ohne einem formalen „Board" (Leitungs- und Aufsichtsgremium) tätig werden. „Durchgriff" bedeutet dass Private Equity Gesellschaften bereit sind, jenseits einer reinen Monitoring-Rolle auf die Führungskräfte Einfluss zu nehmen, soweit sie dies für erforderlich halten. Die Ergebnisse der empirischen Untersuchung werden in die theoretischen Gerüste von „Creativity of Action", „Actor-Network" und „Conventions" gekleidet und so erklärt. Dadurch werden auch Erkenntnisse über die Corporate Governance - Funktion von Private Equity Investment Managern gewonnen.

ABSTRACT

Private equity firm is a generic expression for an investment intermediary that makes investments in private companies. Funds may be provided from a wide range of sources including pension funds, financial institutions and other institutional investors, companies, public bodies and high net worth individuals. Many private equity firms, as engines of economic growth and innovation, operate globally and typically most of them follow a simple operative cycle: Raise Funds → Make Investments → Manage Investments → Harvest Investments → Return funds and share profits → Raise Funds. The subject of this dissertation was focused on managing the investments as it determines the harvest value, returns on investment, the ability of a fund manager to raise additional capital, and ability to strongly compete for the candidate investee company, especially in India. Therefore, the basic question raised was: How does a successful private equity firm add value to its portfolio company in an emerging economy like India?

A qualitative empirical approach was used to answer the question raised in this dissertations. Based on extensive interviews with five private equity directors and survey responses from 12 companies, the role of private equity firm in governance of portfolio company investment, via a director was determined as: an unbounded function of the investor, via the director, to be prepared to empower the entrepreneurs and company executives to strategically grow the business. In this context, "unbounded" refers to the fact that once the investment is made all types of activities are within the scope of the directors and investment teams. These could include all types of relevant analysis, exploring growth opportunities, proposing and developing collaborative strategies, mediating conflicts, and guiding the entrepreneurs. The term "unbounded" also considers the fact that different directors and teams have different skills and motivations, which would determine the results of the governance during the holding period. It also implies that the activities of the private equity directors and investment teams may work with or without a formal board. The term "prepared" implies that the private equity directors and investment teams are willing to go much beyond their regular monitoring role to influence the executives when the situation calls for it. The theoretical framework of creativity of action, actor-network, and conventions, explained the empirical results and how the subject investors influenced the value of the portfolio companies. The framework also provides richness to the definition of investment manager's governance function.

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1. Introduction

1.1. Research Problem

At its peak in 2007-2008, more than 4,000 private equity firms were operating globally and raised approximately $670 billion per year.[1] The funds are provided from a wide range of sources including pension funds, financial institutions and other institutional investors, companies, public entities and high net worth individuals. Although the global recession over the recent past years has substantially hurt the fund raising ability of many private equity firms, the number of firms are still growing worldwide seeking new investment opportunities.[2] This also means that existing private equity firms and funds mangers may have to reinvent themselves to compete harder for the available funds and investment targets.

Private equity firm[3] is a generic expression for an investment intermediary that raise funds and investment them in equity securities in companies that are not listed on a stock exchange. Many private equity firms, as engines of economic growth and innovation[4], operate globally and typically most of them follow a simple operative cycle: Raise Funds → Make Investments → Manage Investments → Harvest Investments → Return funds and share profits → Raise Funds. This is depicted in Exhibit 1.

All of the steps in this operation cycle are very structured and are quite challenging to accomplish[5], and due to non-public nature of private equity transactions it is not clear on how the private equity firms add value to the investee firms. There are considerable number of reports and research studies using quantitative methods to decipher various deterministic factors and aspects of global private equity business.[6] Although informative, the results of quantitative studies tend to be less practical.[7] Therefore, there is relatively little

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[1] Preqin. Alternative Assets. Intelligent Data. Preqin Compensation and Employment Outlook: Private Equity, December 2011, p.3.
[2] Siegel, Wright and Filatotchev, 2011, p.185; KPMG, 2011, p.3. The report by KPMG mentions that limited partners' appetite for emerging markets attained a new high in 2011.
[3] For the purpose of this dissertation private equity firms include venture capital and buyout firms.
[4] Lerner and Tufano. 2011, p.43-53. The authors looked at various studies that support PE and VC as innovations in finance and adding value to the economies. Some studies were also discussed that do not show any social impact of PE investments.
[5] Discussion with investors and industry reports such as KPMG, 2010; The Parthenon Group, Organizational structures in PE, December 2008.
[6] Ibid., Siegel, Wright and Filatotchev, 2011, p.185, Cuny and Talmor, 2007, p.2.
[7] Siegel, Wright and Filatotchev, 2011, p.190.

understanding about the underlying management theories that explain the performance of private equity firms in adding value to the investee.[8]

Exhibit 1. Operation Cycle of a Private Equity Fund[9] (own illustration)

It is expected that the private equity firms influence the investee company at the time of investment (Step 2), the management during the investment period (Step 3), and the resulting company after exiting the investment (Step 4). The ability of the private equity firm to raise funds (Step 1) is strongly dependent on the reputation and track record (Step 5) of the fund mangers. Although there are multiple studies showing that private equity firms tend to increase the value of an investee company[10], much of this increased value is attributed to investment value, industry sector, economy cycle, proper due diligence, close monitoring agreements, exit strategies and various contractual agreements. Also, as a prevalent practice, private equity firms appoint director(s) on the investee company board to manage the investment. This has been the focus of some studies that suggest that active engagement of the director with the board and executive team influences the higher returns on investments. However, there is little literature on how the private equity director adds value.[11] Furthermore, most of the literature is based on private equity companies in the

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[8] Wright, Amess, Wier and Girma, 2009 show that popular theories like agency and stewardship only partially explain the structure of private equity deals but not how the value is added.
[9] Generic description of private equity fund operation. Own illustration based on general literature review. For example, Cendrowski et al, 2005, p.11.
[10] Cuny and Talmor, 2007, p.2, Authors reviewed literature for contemporary theories.
[11] Siegel, Wright and Filatotchev, 2011, p.190. Authors call for research in this area: Where do the gains in PE deals stem from – restructuring or management entrepreneurship? How do these gains differ between different deal types?

USA or UK. Emerging economies have witnessed increased private equity investments over the past decade, but there has been very little research with focus on their private equity industry. For this work, Indian economy was selected as the empirical setting for two main reasons: 1) Private equity investment phenomenon in India is relatively new, which can benefit from business research, 2) Private equity activities in India could better inform emerging qualitative theories that are independent of mature Anglo-Saxon and European socioeconomic constructs.

In emerging economies like India the private equity operations continue to function as described in Exhibit 1. However, the cross border transactions, socio-political and cultural nuances could further complicate understanding how private equity adds value. This leads to the basic problem identified in this research work: How does a successful private equity firm add value to its portfolio company in an emerging economy like India?

1.2. Research Objectives

The objective of this research is to explore the research problem and formulate a hypothesis to explain the underlying theoretical aspects and employ a contextual situation to qualitatively address the research problem.

There are considerable number of reports and research studies using quantitative methods to decipher various deterministic factors and aspects of global private equity business.[12] Recently, Acharya et al., (2013) looked at large private equity transactions in Western Europe and concluded that private equity backed buyout firms performed better than similar publicly listed firms. The attributed this better performance partly to financing structures and partly to operational improvements enabled by private equity partners' skills and backgrounds. Their work can be considered as seminal and somewhat provides impetus for the work presented in this research. Although informative, the results of such quantitative studies tend to be less practical because of speculative reasoning of the findings.[13] There is relatively little understanding about the underlying management theories that adequately explain the

[12] Ibid.

[13] Siegel, Wright and Filatotchev, 2011, p.193. "*Apart from the empirical research based on large firm- or plant-level datasets, more qualitative, case study-based research is becoming increasingly important …There is a growing appreciation of qualitative studies in corporate governance research in general since traditional, finance-driven empirical studies are unable to provide a full understanding of governance processes and mechanisms*"

performance of private equity firms in managing investments,[14] especially in emerging economies like India. For example, it can be argued that the supply of finance and skilled directors can help the performance of a company, but there is practically no research available that shows how the financing is used and how does a director influence the management decisions. Therefore, the focus of this research is on qualitative approach to understand private equity investment management and develop a framework to explain their performance related activities.[15]

Private equity firms are perceived to constitute of highly skilled and ambitious "deal-makers".[16] This holds true in India as well as other economies where private equity industry operates. The media, researchers and management practitioners, focus on the quantitative aspects of deal making such as, fund sizes, investment values, exit values, and return on investment[17]. It has been established that the reputation of fund managers in consistently providing high returns on purposeful investments is dependent on these quantitative aspects that allow the fund managers to continue in this business of private equity.[18] However, there is always a "story" behind each of these numbers and hence a "story" behind all of the five steps mentioned above in Exhibit 1.

In order to resolve the research question, certain elements of private equity transactions, private equity structure, relevant business and management theories, and relevant empirical context need to be highlighted to gain a better understanding of the research problem within the Indian context. The underpinning theories need to be evaluated to enable creation of a theoretical framework that would explain the situational context as well as form the basis for further applications in corporate governance research. A "mind map" in Exhibit 2 is used to set-up the broad idea of this research endeavor. This allowed for a systematic research method to explore key questions to help resolve the hypothesis and generate relevant research contributions to literature.

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[14] Wright, Amess, Wier and Girma, 2009. Popular theories like agency and stewardship only partially explain the structure of private equity deals but not how the value is added.
[15] There is practically very little qualitative work in this area.
[16] Pozen, 2007, p.86, "Private equity has recruited many CEOs with proven talent by offering large rewards for company outperformance without contractual protections for executive underperformance" …"Private equity firms recruit directors with extensive operating experience in the same industry as their portfolio companies".
[17] Most of the trade journals and research in finance focuses on quantitative aspects. For example, Acharya et al., (2013) use IRRs and correlations to conclude that operations and finance skills in PE GP explains better performance.
[18] Metrick and Yasuda, 2010, p.2337. Authors analyzed 238 PE funds for VC and buyout deals. One conclusion was that the investors seek their income based on past performance and reputation.

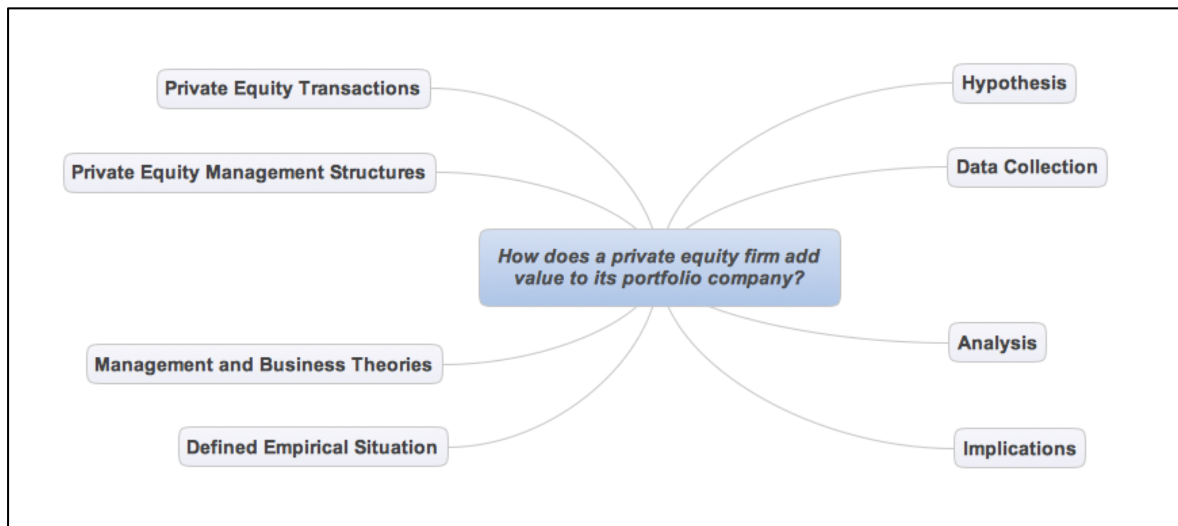

Exhibit 2. Research Problem Set-up (own illustration)

Expanding on the "mind map" shown in Exhibit 2, key relevant questions were raised that allowed formulating the research problem and hypothesis, which in turn allowed the author to identify the data that needed to be collected to prove or disprove the hypothesis. These key questions are listed below:

- What types of private equity investments and mechanisms are prevalent in India?
- What are the key factors that determine the value of the portfolio company?
- What are the key skills and private equity firm structures that allow managing investments in portfolio companies?
- What and how the data can be collected and analyzed to resolve the hypothesis and research problem?
- What relevant management, governance and business theories explain the performance of private equity firms?
- How could emerging economy like India be relevant to research on private equity?
- What could be a plausible hypothesis to test in order to address the research question?
- What could be the research and practical implications to the field of private equity?

Exhibit 3 depicts the logic of research method employed in this research to answer the above leading questions in order to resolve the research question and the hypothesis. The Left Pane shows analysis of literature information that

allowed formulation of hypothesis in the Right Pane and also informing the data collection and analysis process shown in the Right Pane. The results of the research inform the literature implication and resolve the research question.

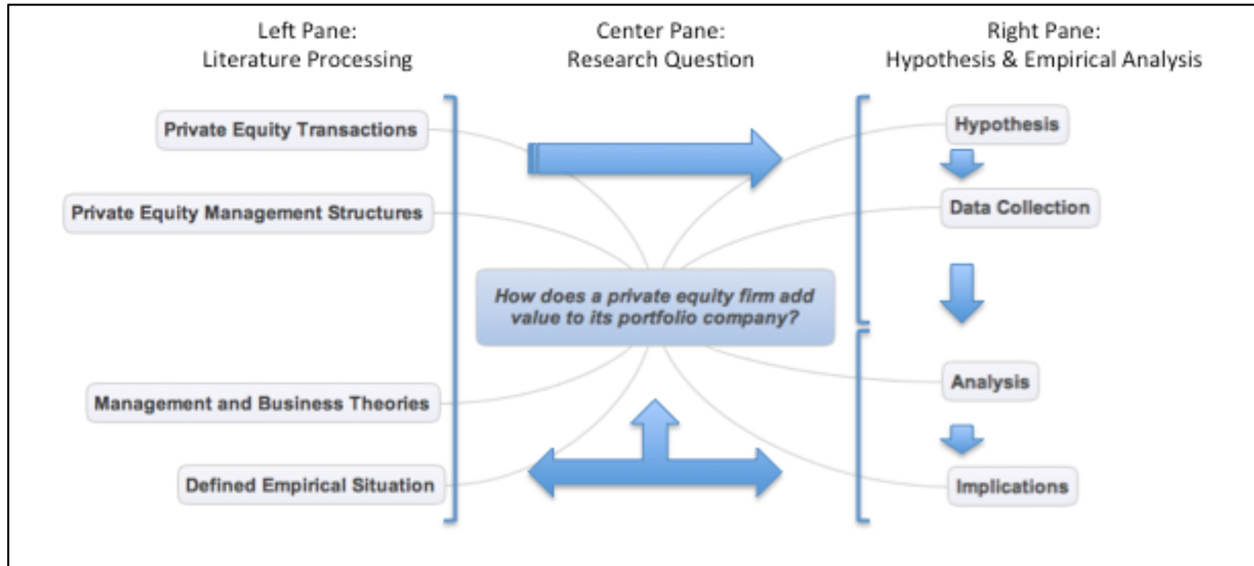

Exhibit 3. Research Logic (own illustration)

Literature search focused on the following key intentions: a) develop an understanding of relevant aspects of general private equity industry and operations; b) explore management theories that explain private equity transactions; c) understand the relevance of private equity industry in India; and d) form a literature and theoretical conclusion to generate a hypothesis to address the research problem.

Literature search coupled with preliminary conversations with private equity managers allowed creating a hypothesis to resolve the research question. Exploring the hypothesis allowed the author to decide on the scope of research activity and the extent of data gathering. Data was validated using practitioner reports and available literature, if any. Analysis framework developed in theoretical foundations exploration was applied to derive the implications of this research to practitioner as well as a researcher.

Qualitative approach[19] employed in this research relies heavily on research subjects' cooperation. Over a period from February 2009 to March 2013, the author communicated with more than 20 private equity executives in India.[20] Conducted general interviews with five and worked with two executives in depth to assess the activities of an investment manager/director. Given the non-disclosure nature of private equity business, there were no direct observations or confidential document evaluations. All information collected from the subject was based on trusted relationship. Author's research agenda was not disclosed to the subject, except that author was interested in understanding private equity business for academic purposes.

1.3. Definitions of Topics

Private Equity: Indian Venture Capital Association (IVCA) defines private equity (PE) "as a fund that typically provides funding to expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet."

Venture Capital: IVCA defines venture capital (VC) as "a fund that typically provides funding to startup firms and small businesses with perceived, long-term growth potential."

For the purpose of this dissertation venture capital is considered a subset of private equity.

Corporate Governance: Hilb (2005, p.10) defines corporate governance as a system "by which companies are strategically directed, integratively managed and holistically controlled in an entrepreneurial and ethical way in accordance with a particular context."

There are many definitions of corporate governance and understandings of corporate governance, and they will be evaluated in this dissertation as they apply to private equity investment management.

[19] Alasuutari, 2010, p.151, author stresses the formation of qualitative research carries on the humanistic approach, the practices that make up social institutions and produce the statistical relations.
[20] The list of targeted private equity firms is provided in the appendices.

1.4. Structure of Dissertation

Exhibit 4 shows the organization of this dissertation's sections according to the various topics covered to resolve the central research question.

Exhibit 4. Organization of Dissertation (own illustration)

2. Private Equity Background and Theoretical Foundations

2.1. Private Equity Industry Background

Although the concept of private financing by wealthy individuals is not new, the broad structure of a private equity operations can be traced to the War Finance Corporation created by the US Congress in 1918 to grant funds to essential war industries at that time and later to support agricultural and railroad industry.[21] Later, after the Second Word War American Research and Development Company and J.H. Whitney Company were formed by private investments.[22] In UK PE activity can be traced to Industrial and Commercial Finance Corporation (now 3i) established after the Second World War and backed by the government to spur rapid growth of war-ravaged economy.[23] The intended purpose of these entities was to provide funds for starting business enterprises (venture capital) and infrastructure development projects. The industry grew much more rapidly in the US compared to the UK, especially the buyouts. One of the most celebrated buyouts of the 1980s was US$25 billion takeover of RJR Nabisco by KKR.[24] After the recession of early 1990s, many new investors and private equity firms entered the market, when the UK private equity industry also became a huge economic force. Although buyout deals became big, up until the Year 2000, many private equity firms focused on venture capital feeding the hi-tech start-ups. After the dot-com "bubble burst" the industry slowed down and picked up again during 2005-2008 period.[25] Over the past decade the private equity industry became more focused on larger buyout deals in the US and UK. In 2005-2007 time period, the 10 largest funds raised in the US were between $6.5 billion to $20 billion.[26] During the same time, the venture capital investments activity has also continued to grow and expanded to continental Europe as well as emerging economies like India and China with many new players. Preqin (November 2010) reported that the period 2003 – 2008 saw unprecedented growth within the Asian private equity industry when a record $91billion was raised by 194 funds.[27] Given that the

[21] Cendrowski, Martin, Petro, and Wadecki, 2008, p.40
[22] Ibid. p.42.
[23] Yates and Hinchliffe, 2010, p.6.
[24] Ibid.; Cendrowski, Martin, Petro, and Wadecki, 2008, p.43.
[25] Ibid., p.51
[26] Ibid. p.52
[27] Preqin is the alternative assets industry's leading source of data and intelligence for a range of activities including investor relations, fundraising and marketing, and market research for 70 countries.

private equity transactions are strongly linked to markets conditions, the industry tends to go through cyclic phases.[28]

The "secretive" nature of the private equity industry and tax benefits has created some political pressure leading to regulatory reviews, especially for the leveraged buyout activities.[29] Increased regulatory and political pressure on alternative assets in both Europe and US is likely to impact the private equity industry. The Walker Report, in UK, published in late 2007 proposed disclosure and transparency requirements for private equity firms and their portfolio companies that meet the prescribed threshold levels: at least 1,000 UK employees; generate at least 50 per cent of revenues in the UK; and either had a value of more than £500 million when acquired by private equity firms or, had a market capitalization together with a premium for acquisition of control of more than £300 million.[30]

For now, the regulatory activity mostly applies to UK but the political and regulatory pressure is also growing in other jurisdictions, especially in India, which has a unique 'set-up' for private equity operations.[31] Nevertheless, with financial globalization and increasing risk appetite among global investors, the private equity activity is expected to continue to grow globally and continue to adapt to changing market conditions.[32]

For the purposes of this dissertation private equity investment includes all types of venture capital, mezzanine financing, and buyouts. Although not covered in the dissertation, the crux of the research question could apply to any kind of asset class investment that allows a director placement.

2.1.1. Modern Private Equity Operations Overview

Collectively, private equity firms invest and provide capital for a wide range of companies – from a small start-up firm to a large mature firm. In general, three most popular private equity practices include venture capital (VC), leveraged buyouts (LBOs), and management buyouts (MBOs).[33] Contemporary private equity firms raise capital from various investors to create a fund that is used for

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[28] Cendrowski, Martin, Petro, and Wadecki, 2008, p.51.
[29] Guardian Unlimited, Private equity code 'does not go far enough' by Elizabeth Stewart, November 20, 2007; BBC News. Private equity plan to open books, November 20, 2007.
[30] Walker, Guidelines for disclosure and transparency in private equity, November 20, 2007.
[31] Jain and Manna, 2009, p.129. The size of buyouts and taxes are main reasons for regulatory activities.
[32] Preqin Compensation and Employment Outlook: Private Equity. December 2011.
[33] Prowse, 1998, p.25.

multiple investments in different businesses. Generally, investments are made in new, stagnated, and under-performing businesses that cannot raise capital from debt or public equity markets.[34] In many buyout situations, corporate governance mechanisms are employed for better performance of the company.[35] Also, in expansion financing situations with venture capital funding, corporate governance mechanisms are employed to mange the investments.[36] The basic private equity model works because it tends to align the interests of investee executives with the private equity investor.[37] The ultimate goal of both parties, as far as the investment is concerned, is to grow the business value and then sell (exit). Although the investments add instant value in terms of liquidity, in order to make tangible returns on investment the private equity firm ensures that the business performance improves after investments are made. Much of the mechanisms that improve the business are linked to new strategies, monitoring agreements, investment structure and roles & responsibilities of various parties over the holding period.[38] On the risk side, a failed investment rewards no one and there is practically very little research on why the investments fail. Most private equity funds have a predetermined life of at least 10-12 years depending on the jurisdiction and the type of fund. The investors in the funds (limited partners) are therefore contractually/legally obligated to continue the partnership. The upside for private equity firm (general partners) is that recessions could be easier to bear with improved opportunities to make cheap investments seeking higher returns. The downside is that the past investments are difficult to exit. Reports show that over a period of past 10 to 12 years, which includes two recessions, private equity firms delivered at least 13 percent return on investment.[39] Private equity's long-term investment approach, "lock-in" provisions and ability to cope with market conditions allow this consistent delivery of returns.[40] This aspect continues to attract institutional investors to private equity funds, especially the reputed ones. In the past five years, private equity firms have invested over one trillion dollars worldwide, including many multi-billion dollar individual investments.[41]

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[34] Prowse, 1998, p.25.
[35] Nikoskelainen and Wright, 2007, p.29. The study was limited to 321 exited buyouts in the UK during1995-2004 period.
[36] Bonini, S., Alkan, S., and Salvi, A. 2012, p.37. The study looked at 164 VC investments in Western Europe and US.
[37] Although this is intended but reality could be challenging, which is the key essence of the research question.
[38] Prowse, 1998, p.26.
[39] Preqin. Private Equity, December 2011; Acharya et al., 2013, showed that the PE returns in UK were consistently higher than the returns in similar public companies.
[40] Discussion with investors.
[41] Metrick and Yasuda, 2010, p.2303.

Private equity funds are often ranked and categorized based on the value of the funds under management and/or size of deals they make.[42] Broadly there are two categories buyout funds and venture capital. Buyout funds, depending on the typical deal sizes, are generally categorized as lower-market, middle-market and upper market. It has to be kept in mind that these categories would change depending on jurisdictions and the prevalent economic environment.[43] For example in UK in 2009: deals below £50 million were categorized as lower market; between £50-£500 million were middle market; and above £500 million as upper market.[44]

The upper-market is dominated by the large firms mostly established in US and UK. Firms in the mid-market could further be categorized as 'captive', 'semi-captive' or 'independent'.[45] A captive firm exclusively obtains funds and invests on behalf of the parent company– usually a financial institution – mostly large banks and investment banks such as Citi Group, Goldman Sachs, etc. An independent firm is funded via external investors. A semi-captive firm is a combination of captive and independent type – funded by both the parent company and external investors. Individuals who had previously worked in a captive or semi-captive environment establish most of the independent firms.[46]

Venture capital funds, mostly independent types these days, finance start-ups and young growing companies. These would generally fall into the lower market category mentioned above. However, some investors in the upper and middle market buyout firms, especially captive or semi captive, could also establish a separate venture capital fund.[47] In some jurisdictions venture capital are established as quoted entities, which offer individuals the opportunity to participate in venture capital with particular tax advantages.[48]

Private equity firms can be further sub-categorized by the sector specializations. Typically, the specializations could be in technology, life sciences, infrastructure, energy and manufacturing. Some firms use a general approach and are open to all types of companies. These days there is a push towards "green" funds and "socially responsible" investments driven by the requirements of limited partners.[49]

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[42] Yates and Hinchliffe, 2010, p.8.
[43] Private Equity in 33 Jurisdictions Worldwide, 2011.
[44] Yates and Hinchliffe, 2010, p.8.
[45] Ibid.
[46] Ibid.
[47] Yates and Hinchliffe, 2010, p.9.
[48] Private Equity in 33 Jurisdictions Worldwide, 2011.
[49] Preqin Special report. Overview of Private Equity Cleantech Market. May 2011

In this dissertation a private equity firm refers to independent type with general approach investments unless noted otherwise.

2.1.2. Private Equity Operational Framework

High net worth individuals and institutional investors provide the capital to the private equity funds, which the fund managers use to gain credit leverage and invest in targeted portfolio companies. The institutional and other investors often make direct investments in publicly listed equities that are less risky. But, they use private equity firms as intermediaries for high risk capital.[50] Exhibit 5 shows a simple view of how the private equity firms serve as intermediary for various investors.

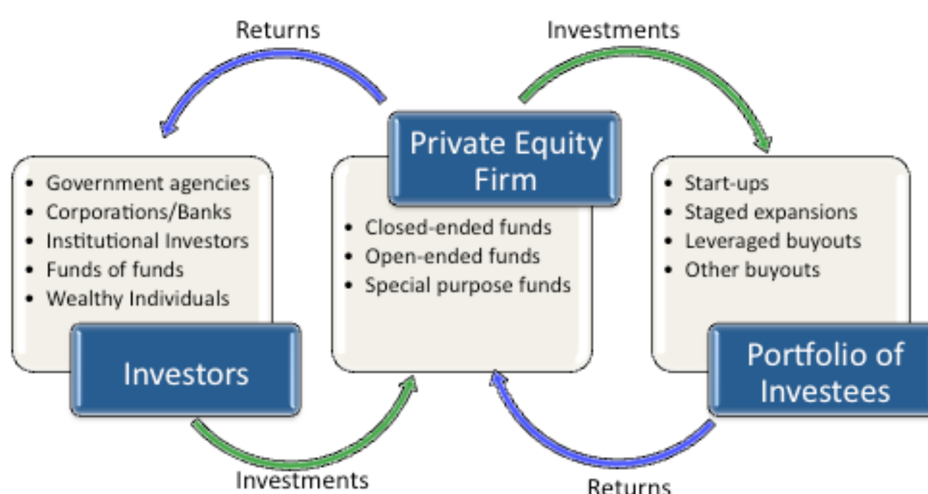

Exhibit 5. Private Equity Firms Act as Intermediary for Investors

(own illustration)

Institutional investors account for majority of total investment in private equity funds, with the remainder sourced from endowments, wealthy individuals, and sovereign government funds. Collectively, all investors participating in a fund are legally referred as limited partners.[51] The private equity firm, the intermediary, serves as the general partner and fund manager. Limited partners share in the risks and benefits of the performance of companies in which the fund invests, but they have little active involvement or oversight in the

[50] Fenn, Liang and Prowse, 1995, p.8.
[51] Ibid.

management of the partnership.[52] Investors are attracted to private equity by the prospect of risk-adjusted returns that are generally higher than the returns from listed equity markets.[53] Traditionally, retail access to this market has been limited and is usually via listed private equity investment trusts or venture capital trusts.[54]

2.1.3. Limited Partnership Overview

The Exhibit 6 shows a typical contractual partnership structure and fees arrangements between the investors (limited partners) and fund managers (general partners). It also shows a general life cycle of a typical fund, with fund raising period, investing period, management period and fund closeout period. Periods shown are typical in US and UK market but they could be longer depending on jurisdiction, especially in some emerging economies where the stock exchanges are not fully developed and private equity firms are based overseas.[55]

The general partners initiate the purpose of the fund with a target value and investment strategy. The willing investors, limited partners, provide most of the capital. The general partners contribute only a marginal share to the fund, but are responsible for the active management of the partnership and the portfolio of investments. The funds are generally set up as a limited liability structure to avoid unlimited liability of investment professionals. Limited partners pledge or commit their capital to the fund. The committed capital is withdrawn from the fund during investment period. The general partner is compensated with an annual management fee of 1.5-3% of the funds committed capital.[56] The compensation rate structures tend to be similar across the industry.[57] Newer private equity firms may tend to have a little higher compensation compared to established firms because they could be incentivized to create higher quality results than the old firms.[58]

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[52] Yates and Hinchliffe, 2010, p.61.
[53] Yates and Hinchliffe, 2010, p.61.bid.
[54] AltResearch, 2003; Walker, 2007. Now a few private equity funds have been listed in the UK and US stock markets.
[55] Private Equity in 33 Jurisdictions Worldwide, 2011.
[56] Cendrowski et al., 2008. P.7
[57] Ibid.; Preqin Compensation and Employment Outlook: Private Equity. December 2011.
[58] Gompers and Lerner,1999, p.2182.

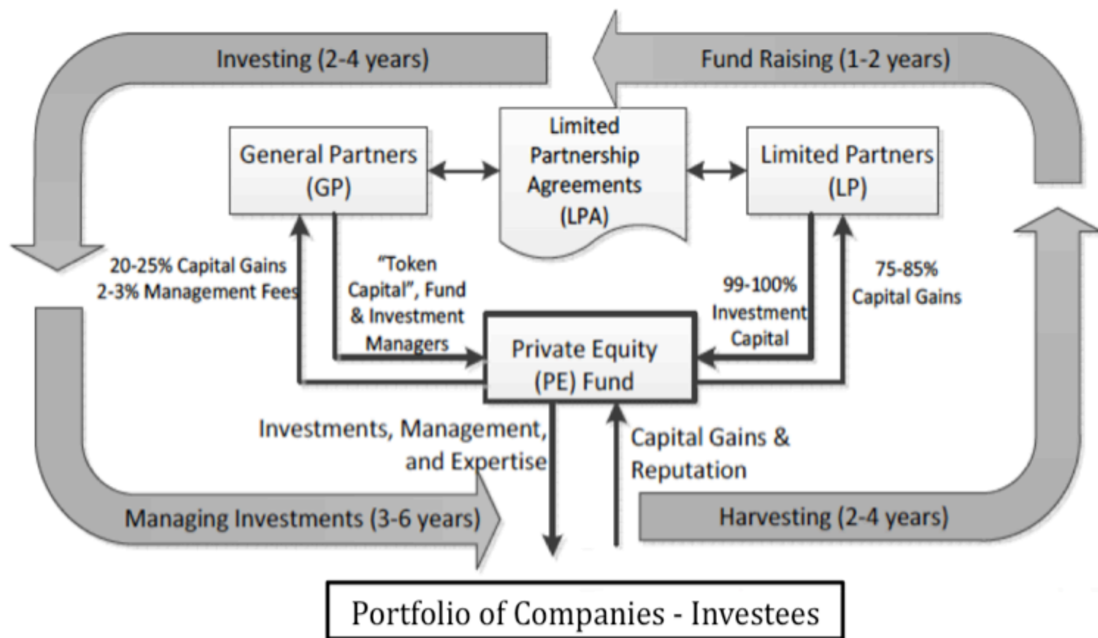

Exhibit 6. Relationships Between the Private Equity Firms (General Partners) and Investors (Limited Partners)[59] (own illustration)

Once the Limited Partnership Agreements are in place the fund managers start the investing activity. There are three basic processes employed in the investing period: Target and select the investees; Structure the deals; Manage the investments.[60] Private equity firms select investees where they believe they can add substantial value as a result of investment, expertise, and management. Invariably, all investees are either small with high growth potential or large and stagnated with no other source of raising capital.[61] The general partner is sufficiently incentivized to increase the value of the investee companies via active ownership, directing development of long-term strategies and ensuring that management is held accountable for and motivated to achieve business objectives and financial targets.[62] The recent Preqin compensation survey shows that average total remuneration of a general partner is over $1.5 million for managing $100 million fund and more than $5 million for managing $800 million fund.[63] Besides the general partners, the directors and other investment

[59] Exhibit adapted from McCahery and Vermeulen, 2008; Cendrowski et al., 2008.
[60] Fenn, Liang and Prowse, 1995; Cendrowski et al., 2008.
[61] McCahery and Vermeulen, 2008, p.8.
[62] Pozen 2007, p.86.
[63] Preqin. Alternative Assets. Intelligent Data. Compensation and Employment Outlook: Private Equity, December 2011, p.5.

professional on the fund team also need to be incentivized to ensure robust monitoring.[64]

After a successful exit from an investee company, the limited partners generally receives 75-80% of the profit as capital gains, while the remaining goes to the general partner as carried interest. The carried interest structure, allows alignment of interests of both the limited and general partners.[65] Typically, carried interest is paid only after a minimum rate of return to the limited partners is achieved and after the original investment amounts are returned to the limited partners.[66] For investors, the limited partnership is an attractive structure due to two major factors: limited liability and taxes. The liability of the partnership is limited to the capital contribution. Limited partnership structures, in most jurisdictions, avoid double taxation.[67] In most jurisdictions, the limited partners in the fund are treated as if they were direct investors in the portfolio companies.

It has to be kept in mind as mentioned earlier, that the reputation of fund manager is paramount, especially in a very competitive environment on both ends – Limited Partner and Investee. An investor seeking a private equity general partner has multiple options. All investors are not the same in their selection process – some are more sophisticated than others leading to significantly different returns from their private equity partnerships. The differences are attributed to the investment teams skills, motivations and early access to higher quality funds.[68] The lower returns by banks and fund-of-funds could be due to market seeking objectives other than rent seeking objective.[69] With the economic downturn, many institutional investors are increasingly using consultants to target high quality funds.[70] Ultimately, these differences can also be attributed to the institutional governance strategies.

Meanwhile, a business as potential investee that is seeking private equity investment also has multiple choices. A fund manager with excellent reputation could ease out the competition, especially during the recessions. Reputation may also play a role in negotiating the agreements and managing conflicts with both the limited partner as well as investees.[71] Furthermore,

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[64] Ibid.
[65] Prowse, 1998, p.29.
[66] Yates and Hinchliffe, 2010
[67] Private Equity in 33 Jurisdictions Worldwide, 2011.
[68] Lerner, Schoar and Wongsunwai, 2007. Authors conducted a study on institutional investors and found that endowments realize 21% better returns than other institutions.
[69] Ibid.
[70] Preqin Special Reports, Alternative Investments Consultants. November 2010
[71] Yates and Hinchliffe, 2010, p.121; Balboa and Marti, 2007, p.475.

there are other entities including consultants, lawyers, advisors and brokers involved with all three parties who have been increasingly influencing the outcome of the deals. Given the informal structure of the industry and the level of competition, these entities act as valuable information conduits for partners and facilitate networking opportunities.[72] Exhibit 7 depicts an overview of this competitive environment.

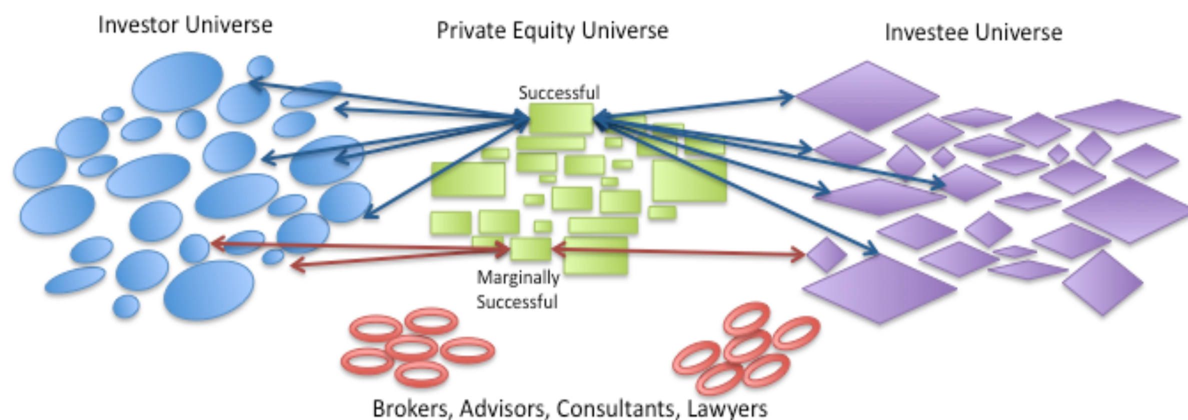

Exhibit 7. Competitive Environment in Private Equity Transactions (own illustration)

In the 'Investor Universe' there are different types of entities with varying investment capacities, risk appetites, and requirements. 'Private Equity Universe' has various firms with different sizes, expertise, jurisdiction base, marketing capabilities, investment portfolios, and reputations. In the 'Investee Universe' is practically any company with growth potential and willing to trade control with investments. The market is as diverse as it can be with little regulated market place, which needs specialized 'market makers' such as brokers and consultants who facilitate the selection process. The investment needs are intrinsic to the investees. In venture capital and management buyout type of businesses, the potential investees generate the initiative to seek out private equity investors. Consultants could help the business create a sound strategy to meet the purpose or private equity firms target them via consultants.[73] On the other hand, brokers could help private equity firms seek

[72] Fenn, Liang, and Prowse,1995, p.8.
[73] Preqin Special Reports, Alternative Investments Consultants. November 2010

out potential investees. In a competitive environment, it is possible that multiple private equity firms show interest in one promising business. After screening, due diligence, and negotiations, typically one investee will only have one private equity firm's investment. On the other end, one private equity fund will have many investors (limited partners) and each investor would typically invest with many private equity funds (general partners).[74]

This dissertation discusses the investment processes limited to private equity transactions that typically involve one private equity firm providing the financing.

2.1.4. Investee Selection and Deal Structuring Process

Ultimately, the private equity industry exists and continues to grow for only one reason: ability of investment managers to add value to their portfolio of investees.[75] This requires selecting the right companies and creating the right deal structures. Exhibit 8 depicts a generic business life cycle and a spectrum of target investees.

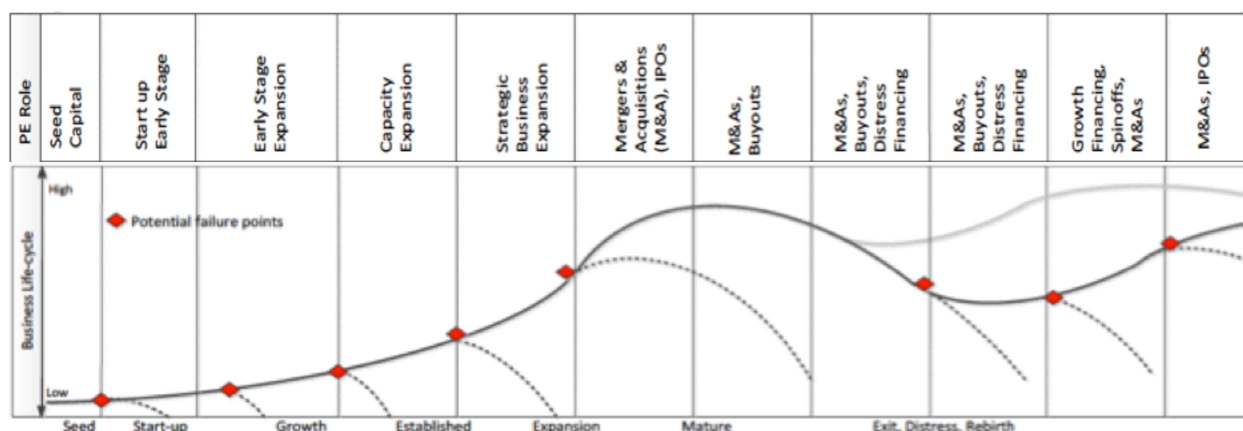

Exhibit 8. Different Company Stages in Business Life-Cycle and Private Equity (PE) Investment Role (own illustration)

A generic life-cycle of a modern corporation can be summarized as: A small firm owned and operated by an entrepreneur → firm owned and operated by a family → larger family owned firm operated by managers → A complex, large

[74] Prowse, 1998, p.23.
[75] Cuny and Talmor, 2007, p.1; Metrick and Yasuda, 2010, p.2304

firm with many owners operated by professional management teams. All companies have operating capital requirements that are generally fulfilled by bank lending. However, companies could potentially reach a point of failure or stagnation if the capital requirements are not met. In particular, banks could be unwilling to make loans to early stage firms with little collateral. Private equity funds, as intermediaries, help provide the collateral and invest in companies that need growth capital or restructuring capital.[76] In some jurisdictions, to avoid banks and excessive regulations, like in India, private equity firms tend not to involve banks when structuring investment deals.[77]

In order to seek and attract private equity investments, a potential investee creates a business plan and growth strategy, which is marketed to generate interest among private equity universe. Private equity investor receives many such plans either directly from investees or via their agents. The private equity investor goes through a screening process to generate targets to gather further information.

The private equity investor generally considers the following factors when selecting an investee:[78]

- Experience and a sense of commitment of investee executives;
- Product and service offerings of the company;
- Potentially strong marketing position;
- Potentially high margins;
- Potential to generate an internal rate of return in excess of the hurdle rate within three to five years – hurdle rate and time requirements are influenced by the jurisdiction and projected economic conditions at the time of exit; and
- Potential exit opportunities.

Screening time is variable and is highly dependent on market conditions. Once the screening is complete the potential targets are engaged to initiate a deal. The deal making process is highly dependent on prevalent market conditions, business culture of jurisdiction, and locations of both private equity firm and target investee. Because the deal making process is quite demanding, the investor appoints a team of internal or external legal and financial advisers who specialize in the process. A typical deal making process could take up to 12 weeks.[79] A generic process is outlined in Exhibit 9.

[76] Fenn, Liang, and Prowse,1995, p.7.
[77] Jain and Manna, 2009, p.147. Leveraged positions involve excess regulatory hurdles and transparency.
[78] Fenn, Liang, and Prowse,1995; Kaplan and Stromberg, 2001, 427.
[79] Yates and Hinchliffe, 2010, p.24

Broad steps in a deal making process include:

- Prepare and complete an information memo regarding the investee's initial business plan;
- Prepare and complete management presentations and proposed business plan;
- Appoint relevant advisors;
- Agree of heads of financial terms;
- Obtain exclusivity to protect the private equity firm;
- Conduct due diligence, which typically includes financial, legal, taxation, operational insurance, property, environmental, pensions, operational, information systems and management assessment;
- Secure bank lending in case of leverage type deal and set up appropriate covenants;
- Negotiate the deals, agree and create legal documentation, including acquisition, equity and debt documents; and
- Hold a legal completion meeting to sign the deals.

As private equity firms expand globally and looking for larger deals, even a simple deal can involve complex structure and dynamics involving many players who bring creativity and various expertise to the deal making process.[80]

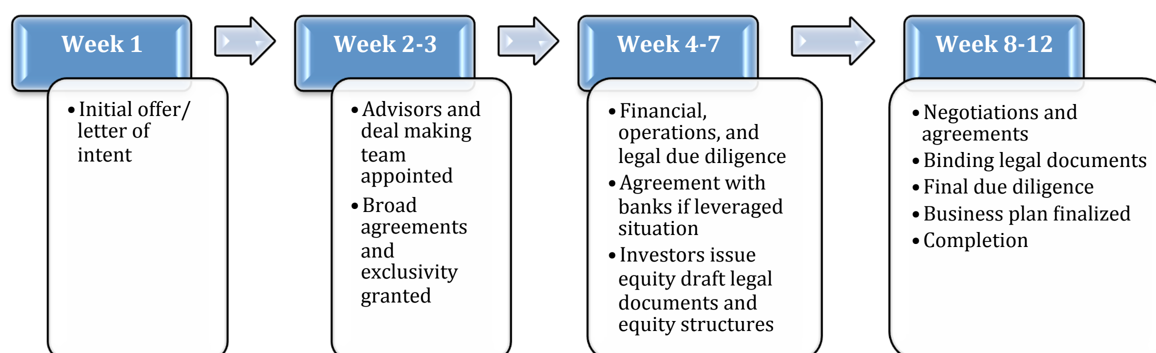

Exhibit 9. Outline of a typical deal-making process (adapted from Yates and Hinchliffe, 2010, p.24)

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[80] Yates and Hinchliffe, 2010; Kaplan and Stromberg, 2003, p.281.

Once the investment deals are completed based on due diligence and projected business plans, the actual challenge of creating the value via investment management comes into play.

The investment agreements generally outlay the potential role of private equity firm during the holding period and reporting requirements for executive management team of the portfolio company. Investment management tests the assumptions that are made during the deal making process and mitigates all uncertainties in favor of both the private equity investor and the investee. The issues related to executive management, compensation packages, human resources, investor expectations, lenders, taxes, adding value, adjusting deal structures, refining projections, and adapting to changing market conditions, are considered during investment management.[81] All these factors often create challenging business decisions that need to be made under very demanding conditions.

After the deal structuring process is complete, typically the investee will go through a transition period to adopt the new equity structure, initiating agreed upon business strategy, and resolve any pending issues that arise during the due diligence process. The transition process is closely monitored via management reporting and boardroom interactions. Typically, a private equity firm will appoint a director on the board for at least monitoring purposes.[82] In some cases, especially in lower market segment the private equity firm investor who created and negotiated the deal would continue as director on board of the investee business. Larger private equity firms tend to separate the deal making executives from investment management executives. There are advantages and disadvantages to each approach. From one perspective it could be argued that the private equity firm's deal making executives also act as directors to continue to build on the established relationships with the investees executive management teams. On the other hand, it could be argued that investment management requires different skill set and motivation compared to the deal making.[83] In some firms a combined approach is employed, where investment management executives will closely work with the deal-making executives to monitor the investee performance.[84]

[81] Fenn, Liang, and Prowse,1995, p.45.
[82] Yates and Hinchliffe, 2010, p.310.
[83] Ibid.
[84] Ibid.

At the minimum director will monitor the monthly financial information such as accounting statements and projected budgets. According to typical agreements, any material change to business strategy could be captured in budgeting process and require director's approval. This requires timely reporting by investee executive management except for justifiable delays. A delay could potentially cause concerns amongst the private equity portfolio executives leading to investigations, conflicts and damaging trust issues. Alternatively, the director could take an engaged approach to oversee the investee business on a more frequent basis gaining detailed knowledge of business to allow swifter actions if needed. The degree of engagement of directors varies with the type of investment and the purpose of the investment.[85] Factors like private equity general partners' past entrepreneurial experience; industry sector expertise; type of deal; and geographic proximity to the investee business play an important role in meaningful monitoring and oversight role.[86] The size and type of deals are also significant factors depending on the skills of the investment manager.[87]

The expectation of the private equity firm is that the investee business at the minimum performs the way it was projected during deal structuring process. Monitoring of portfolio companies allow a private equity firm to report the fund performance to the limited partners. The reporting requirement is typically part of the limited partnership agreements. Monitoring also helps the firm to review the investee performance for its own investment management purposes. Invariably over the holding period, there will instances where just monitoring and reporting is not sufficient and the director needs to intervene to ensure that right strategies are adopted. Any unforeseen risks and situations that result in underperformance of an investee business the private equity firm via its investee director could take measures such as change business strategy, infuse more money into the investment, augment management teams with required expertise, restructure the equity deal, and look for early exit/sale opportunities to minimize losses. In dire circumstances investment dissolution process could be initiated.

After a successful holding period, the director plays an increasing role during the exit process, which changes from monitoring and governance to active management. Most common exits, depending the investee business size are either a trade sale or initial public offering. The type of exit has implications

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[85] Fenn, Liang, and Prowse 1995, p.55.
[86] Lerner, 1994.
[87] Metrick and Yasuda, 2010, p.2304.

for limited partners, general partners and the investee executives.[88] Trade sales are quicker and allow faster return on investment to all parties and executive managers may tend to lose their control on the company. Seeking an initial public offering allows for the executive managers to continue in the business, but it requires extensive planning and regulatory compliance. Depending on the jurisdiction the general partners could be required to stay with the newly listed company as directors and not allowed to sell stock for a couple of years. This could add time on harvesting the returns and add uncontrollable market risk.

2.1.5. Clarification of the Research Question

All aspects of private equity business described above are important in adding value to the investee. Some of these aspects include identifying the right investment target in the right sector with good executive management, conducting proper due diligence, using the right consultants and advisors, conducting solid valuations, creating the right agreements with the executives, having the right director during the holding period, finding the right exit, and negotiating the exit. Although it is not essential to conclude which aspect is more important, one thing is clear that a director via corporate board functions, in part, manages the private equity investment in a portfolio company. In addition, the Indian private equity firms covered in this research primarily invested in early stage capacity expansion and strategic growth expansion stages. These allow for refinement of the research question:

How does the private equity firm, via the director, add value to an early stage expansion type of a portfolio company?

The notion of "director" and "board function" invokes the concept of corporate governance, which is essential to understand to answer the research question. It is also essential to understand how the private equity firm organizationally supports and enables the director to perform his/her function on the investee board. The intent of this research is to create a framework that incorporates both the corporate governance and the private equity organizational aspects in order to answer the research question.

2.1.6. Defining the Scope of Applicable Corporate Governance Aspects

Recently, private equity business, emerging economies and corporate governance have independently received significant attention from the

[88] Yates and Hinchliffe, 2010, p.362.

investment firms, media, academics, corporations, regulatory bodies, and "think-tanks". In the wake of accounting scandals of the past decade and the recent real-estate "bubble burst" leading to global recession, the number of empirical studies conducted on the impact of corporate governance practices and structures on various aspects of a firm has increased significantly.

Most definitions of corporate governance are broadly structured and apply more to publicly listed companies and in some cases to family firms depending on the jurisdiction. Sir Adrian Cadbury defined it as "the system by which companies are directed and controlled".[89] From financial perspective, corporate governance deals with the ways in which suppliers of finance assure a return on their investment.[90] In a somewhat broader sense corporate governance could be defined as a set of mechanisms through which firms operate when ownership is separated from management.[91] This definition is further broadened as "the complex set of constraints that shape the ex post bargaining over the quasi rents generated by the firm".[92] Then there are definitions for good governance encompassing practically all stakeholders "the objective of a good corporate governance framework would be to maximize the contribution of firms to the overall economy—that is, including all stakeholders. Under this definition, corporate governance would include the relationship between shareholders, creditors, and corporations; between financial markets, institutions, and corporations; and between employees and corporations. Corporate governance would also encompass the issue of corporate social responsibility, including such aspects as the dealings of the firm with respect to culture and the environment."[93] Given the complexity and broad aspects of crporate governance, OECD tends not to define corporate governance but outlines a framework as "OECD Principles of Corporate Governance".[94]

Ultimately, corporate governance of public firms has implications for the overall economy. Nevertheless, from practical perspective for both public and private companies, corporate governance needs to be narrowed down to the activities of the board of directors who ultimately embody the principles of corporate governance – for good or bad. It could also be termed as "strategic governance".[95] Given the secretive nature of board activities this is easier said

[89] Cadbury Committee, 1992, Introduction.
[90] Shleifer and Vishny, 1997, p.737.
[91] Claessens, 2003, p.5.
[92] Zingales, 1998, p.499.
[93] Claessens, 2003, p.6.
[94] OECD, 2004.
[95] Schmidt and Brauer, 2006, p.18

than done.[96] This apect is important to consider, especially in private company boards.

Moving to practice of corporate governance, The "New Corporate Governance" framework proposed by Hilb (2005) provides a strategic understanding of coporate governnace.[97] Hilb (2005) defines corporate governance as a system "by which companies are strategically directed, integratively managed and holistically controlled in an entrepreneurial and ethical way in accordance with a particular context." Hilb (2005) further outlines a "Reverse KISS" principle to practically meet the corporate governance objectives:

- Keep it **S**ituational such that board is a change agent;
- Keep it **S**trategic such that board is the value driver;
- Keep it **I**ntegrated such that board performs as a team; and
- **K**eep it Controlled such that board is the controller.

Key aspects of Hilb's definition and priniciples are very closely aligned to the private equity firms investment objectives. Private equity firms largely thrive on entrepreneurial activity and adding value via governance mechanisms.[98] The 'situational' and 'contextual' aspect of Reverse KISS principles apply because each investment is different in many ways and more importantly, unlike other definitions that call for long-term impacts of governance, private equity investments use a short, somewhat fixed term operational framework.[99]

There are two distinct implications of corporate governance related to private equity firms:

- Impact of corporate governance practices, national laws, regulations, and instiutions on attracting financing, especially in emerging economies;[100] and
- Application of corporate governance principles in governing the portfolio of private equity firms itself.[101]

A typical private equity firm could realistically ignore the implications mentioned above, except that framing their reputation in corporate governance

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[96] Ibid., p.17. Most boards operate in highly secretive ways and are difficult to observe.
[97] Hilb 2005, p.10. Provides a practical ways to understand and implement good governance principles.
[98] Nikoskelainen and Wright, 2007, p.3.
[99] From traditional corporate governance perspective, the private equity investment in a business is for about 5 years but the firms themselves have much longer lives.
[100] Claessens, 2003, p.16.
[101] Nikoskelainen and Wright, 2007, p.19.

context could help them attract institutional investors.[102] However, academic and institutional research has shown strong support for both implications.

From research perspective, this dissertation goes beyond the traditional definitions of corporate governance and seeks to deconstruct the corporate governance aspects to form a framework for generic function of governance. From that perspective it could be argued that "functional governance" of a business enterprise is as old as history of business itself, but in the wake of multiple scandals in the past, "formal corporate governance" of public firms became the central focus of many research and regulatory entities.[103] This triggered many questions ranging from most basic like the purpose of a modern corporation to complex on how to refine laws and regulations to hold a corporation accountable.[104] Reverse KISS Principle also addresses these concerns.[105]

2.1.7. Separation of Ownership and Control

Issue related to the separation of ownership and control in firms has been the central focus of many academics and a challenge for management practitioners. For the most part, it all started with the notion of private property rights leading to the rise of entrepreneurship.[106] This coupled with the legal framework that made corporations legal entities or properties led to the rise of capitalism, as we know it today.[107] Although, the nature of a corporation has evolved over the past two centuries, the broad notion of private property rights has essentially remained the same: The owner of a property has the rights to use, profit, and abuse the property within the norms of jurisdiction and social expectations. However, implications of these rights are different within a generic lifecycle of a modern corporation leading to the issues related to directing and controlling the property – a corporation.[108]

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[102] Fenn, Liang, and Prowse 1995, p.57. "A favorable track record is important because it conveys some information about ability and suggests that partnership managers will take extra care to protect their reputation, and because experience itself is regarded as an asset."
[103] Monks and Minow, 2008, Introduction
[104] Dalton and Dalton, 2005, p.5.
[105] Hilb, 2005, Introduction
[106] Berle and Means, 1932, (2007 Edition), p.5; Gomez and Korine, 2008, Introduction
[107] Daily, Dalton, and Rajagopalan, 2003, p.151.
[108] Berle and Means, 1932, (2007 Edition), p.111.

Most early stage company entrepreneurs can exercise all three rights: control and direct the organization as they felt best suited to their goals and also motivate the employees towards achieving the goals; be the residual beneficiary of the profits; and abuse (sell) the rights in extenuating circumstances. These rights can be depicted as in Exhibit 10.

Exhibit 10: Proprietor with rights: Ownership (O); Use (U); Profit (P); Abuse/Sell (A)[109] (own illustration)

In an entrepreneur-operated firm, the legal frameworks and relevant stakeholders, typically employees and society, accept the rights of the entrepreneur to exercise the property rights within some limits. The limiting factors include government regulations and markets where the entrepreneur operates.[110]

In a private firm that is owned by a family but has non-family members as executives, there is a little separation of ownership and control if the family closely monitors the firm's activity and has free access to all aspects of the company. The executives have little discretionary powers.[111] However, it is plausible that in an old family firm, where there are many family members with ownership rights, quite a few conflicting scenarios can be developed where governance may or may not be an issue. For example, one the hand, a family business operated by the entrusted and well-respected head of the family, may not require governance mechanisms. On the other hand, if the family business is large and a non-family member is the chief executive, then governance mechanisms could limit discretionary powers. Nevertheless, the ownership and use rights of each family member could be seen as being diluted, while they can still profit or sell its rights. This scenario can be depicted as in Exhibit 11.

Finally, in a public firm with many shareholders, the issue of separation of ownership and control is more pronounced. The roots of contemporary

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[109] Exhibit created based on various discussions in Gomez and Korine, 2008, p.238-246. This serves as a framework to discuss the subsequent topics.
[110] Gomez and Korine, 2008, p.47.
[111] Gomez and Korine, 2008, p.89

corporate governance issues are embedded in the division of these rights amongst many individuals with many different purposes.[112] This can be depicted as in Exhibit 12.

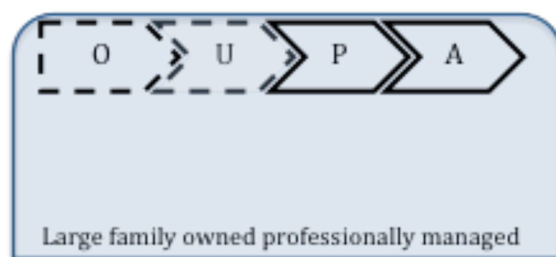

Exhibit 11. Rights of Family Members in a Family Owned Firm (own illustration)

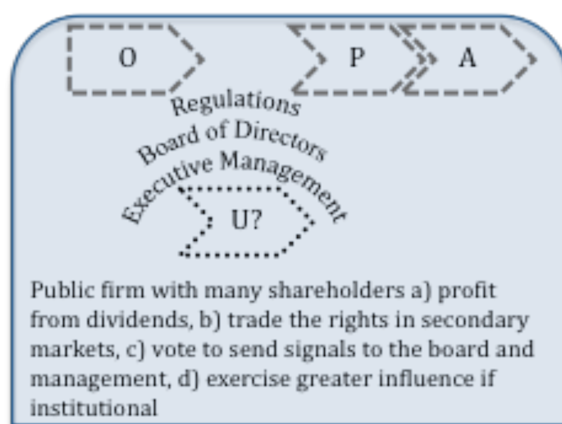

Exhibit 12. Rights of Shareholders in a Public Firm (own illustration)

Since there are many types of organization structures, business models and institutional settings, it is not explicitly clear what the separation of the ownership rights and control rights mean in a modern corporation. Related to that, it is not clear what are the roles of governance and management function. For example, in most publicly listed companies in the US, the board chairman and chief executive officer is the same person. In Western Europe, this role is separated. However, with certain assumptions, economics and organization theories for management and governance have been promulgated and some have become dominant paradigms. Nevertheless, given the context of public

[112] Ibid. p.137.

firm, the theories and practices of corporate governance as well as management have continued to evolve over time.[113]

Berle and Means (1932) developed a detailed depiction of Modern Corporation and somewhat concluded that since the implications of divisions of rights in the modern corporation are not clear in economic, social and political contexts, the idea of corporation will continue to evolve in order to clarify such implications.[114] One way to look at the issues related to public company governance, is to reflect upon what do shareholders of a public firm actually own? When a person buys a stock, the same property rights apply: use, profit, and sell. Stockholder can use the rights in the hope to indirectly influence the management but it is debatable that the purpose of a small stockholder is to influence the management.[115] One can use the stocks in different ways - collateral, lending, hold to balance portfolio, income as dividends. If profit is the sole motive then at the opportune time, the shares can be sold at a moments notice – especially in the current high-tech financial markets. Each individual will tend to use the share to maximize the utility to suit his or her need during the ownership. Company sells stock in the primary market to raise capital with an implicit promise of future growth. So in a way, maybe, the firm is only responsible to the stockholders who buy stock at that time of the primary offering. For how long do people keep the stock? Do the company executives really care about the stockholders who purchase the shares in the secondary market? Does the board of directors or management actually take into consideration all such individual shareholder rights? Whether shareholders are relevant or not, and given that many executives themselves are shareholders, a case can be made, that in the absence of clarity in governance, shareholder value consideration brings focus to the decision-making.[116]

Also, there are institutional shareholders who have a larger voice because they tend to buy a block of shares.[117] Directors or investment managers representing the institutions can influence the boards to some extent.[118] From one perspective, institutional investors are influencing the corporate governance practices by becoming sufficiently professional and organized.[119] This point is applicable to this research because the private equity funds comprise significant amount of investments from institutional investors who generally tend to have

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[113] Gilson and Whitehead, 2007, p.9.
[114] Berle and Means (1932), 2007 Edition, p.313.
[115] Monks and Minow, 2008, p.33.
[116] Tirole (2001), p.33.
[117] Bhojraj and Sengupta (2003), p.472.
[118] Ibid.
[119] Theuriallat, Corpataux and Crevoisier, 2008, p.323.

a motive beyond profit maximization. For example, certain investors want to only invest in socially responsible businesses.[120]

In public corporations, in the absence of clarity, the executives and directors try to maximize their goals in the short term while the functions of governance continue to evolve as companies become more global, more complex and more regulated. Maybe this is the essence of work of Berle and Means (1932) – that without the ownership, the companies can be either controlled via government regulations or self regulated if markets are efficient enough. Also, a point to be made here is that the emergence of contemporary large public company is counter-intuitive to the notion of private property rights, which fueled the economic growth by encouraging the owner to make the most efficient use of the resources and capital.

Over the past three decades, private equity firms and more recently hedge funds have been instrumental in leading the changes in the practice of corporate governance. In particular, the LBOs and the emergence of the markets for corporate control of public firms have shown to restructure the governance mechanisms in order to align the goals of governance towards long-term growth. A simple reason for much of success private equity firms can be explained by the fact that they give meaning to ownership once again by concentrating the outstanding shares in fewer hands.[121] Private equity LBOs generally tend to make the control part of property rights meaningful once again.

It should be noted that the market for corporate control does not only come from shareholding but also from bondholding and credit control.[122] This is important to reflect upon, because in a private equity LBO both debt and equity play a significant role in valuations.

In order to validate the research question, as it has been discussed above, it can be argued that private equity firms add value to portfolio firms by making the ownership and governance more relevant leading to internal efficiencies of the corporation allowing growth oriented strategies.

[120] Monks and Minow, 2008, p.173.
[121] Cumming, Siegel and Wright, 2007, p.7.
[122] Bhojraj and Sengupta, 2003, p.472.

2.1.8. Organizational Structures and Governance Mechanisms in Private Equity Industry

From mechanistic perspective, the modern private equity model was driven by the economic situation in the US in the 1980s, when debt was cheap and institutional investors were willing to divert capital to private equity type entities.[123] The main reason for this diversion was that the public company CEOs tended to frequently misuse the excess company capital leading to underperformance. These companies were sought out by the private equity funds as targets to buy, strip underperforming operations, and then resell the companies. Therefore, in a way the failures of corporate governance and executive management in public firms helped create the modern buyout houses.[124] However, with changes in corporate governance practices and evolving private equity industry in global economy, the narrative of relation between private equity and corporate governance has changed.

The private equity investments may already account for 10-15% of investment markets. However, due to the recent global economic slowdown the institutional funding could be less available in the near future. This has put more pressure on the private equity firms to become more efficient and to be more competitive in attracting investors. Therefore, corporate governance frameworks adopted by private equity firms to manage themselves and the portfolio companies could be more emphasized in creating a promising avenue for better performance.[125]

In a private equity limited liability partnership, the institutional investors as providers of capital and limited partners can have access to investment information but have little rights to interfere with the day-to-day activities and investment strategies of the general partners. This is primarily due to the contractual nature of partnerships. We can use the legal frameworks and fees arrangements to explain the structure of these funds.[126] But it does not fully explain the dynamic nature of governance that results in improved performance of the portfolio firms. For instance, the nature of contracts could be similar in most funds but the performance is not. The successes are probably dependent on the individual fund manager's competencies.[127] In addition, the private equity industry is practically unregulated compared to public firms, which

[123] Wright et al., 2009, p.354.
[124] Cumming, Siegel and Wright, 2007, p.2.
[125] Steger and Frigast, 2005, p.2.
[126] Yates and Hinchliffe, 2010, p.61.
[127] Metrick and Yasuda, 2010, p.2304.

makes its governance functions even more interesting from research perspective.[128]

Taking listed companies private, as well as the introduction of substantial leverage into the balance sheet of acquired portfolio companies is relatively new to European private equity industry.[129] This coupled with tremendous growth in the industry could be perceived as making various socio-economic stakeholders nervous and creating the need for transparency and corporate governance in private equity firms. These issues have been instrumental in recent introduction of minor regulatory frameworks on private equity industry requiring more transparency, especially in UK.[130] But the requirements are generally perceived of little value in having an impact.[131] OECD also published a steering group report to start making efforts towards a more regulatory environment for private equity sector.[132] Such regulations have not really followed to the US markets, but are a growing concern for institutional investors seeking private equity partnerships in emerging economies.[133] Irrespective of the regulations, private equity funds are evolving into little more transparent investment vehicles because institutional investors demanding better risk management and encouraging the fund managers to adopt better valuation techniques and controls.[134] Also, buy-out groups attempt to improve their reputation and image by joining respectable industry associations.[135] Finally, in search for more stable capital, some private equity funds increasingly raise or are planning to raise money by listing funds on public markets, which do expose them to regulations with some degree of transparency.

The contractual nature of private equity in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity are themselves capable of disciplining opportunistic behavior by fund managers and advisors. In addition, given the nature of competition for raising capital and seeking better portfolio companies, the private equity firms

[128] Cumming, Siegel and Wright, 2007, p.4.
[129] European private equity was more focused on venture capital type deals until the 1990s.
[130] Walker, D. Guidelines for disclosure and transparency in private equity, November 20, 2007.
[131] Guardian, 2007; BBC News, 2007.
[132] OECD, 2007. The OECD steering group on corporate governance, The role of private pools of capital in corporate governance
[133] Private Equity in 33 Jurisdictions Worldwide, 2011. One of the recurring questions asked in the survey was the status of corporate governance in respective jurisdictions and its impact on private equity industry.
[134] Pappas, Allen and Schalock, 2009, p.23.
[135] British Venture Capital Association, European Venture Capital Association, Indian Venture Capital Association, Private Equity Council in the United States, etc.

are assessing and taking steps to evolve in better organization structures that influence fund performance.[136]

In a typical private equity firm, there are four distinct parts where corporate governance functions may play a significant role: 1) Governance of the firm overseeing multiple funds; 2) Management of a single fund overseeing multiple investments; 3) Management of each investee company within the fund portfolio; and 4) Management of the investee firms after the private equity exits investees or closes the fund. These are shown in Exhibit 13.

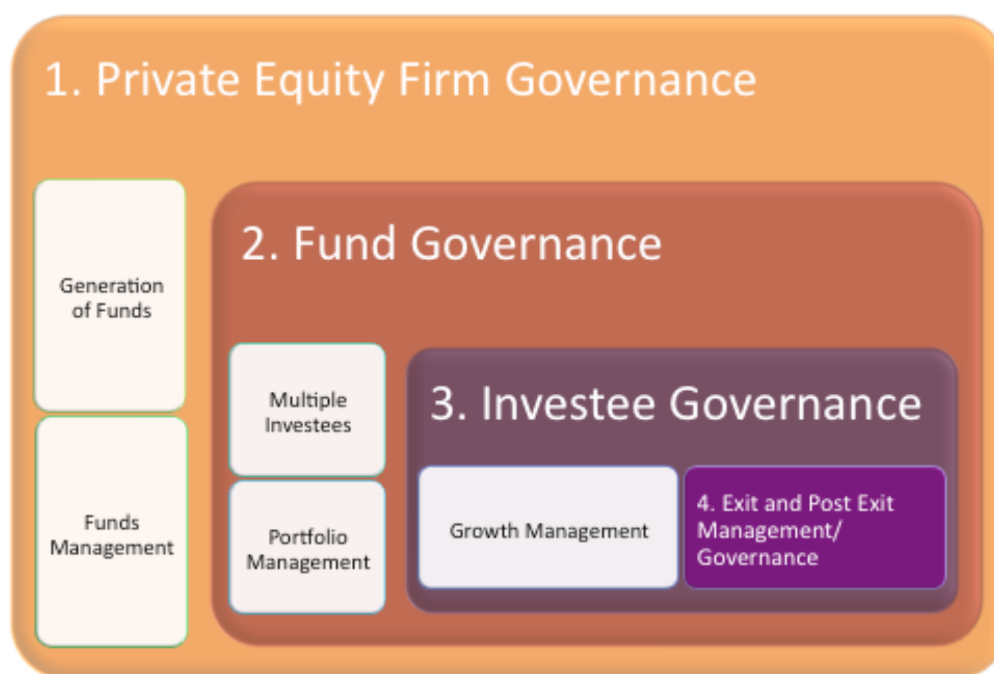

Exhibit 13. Functional Governance Application in Private Equity Firm (own illustration)

Depending on the complexity of organizational structure,[137] all four functions can pose unique problems can impact the performance of the funds. Governance of the firm overseeing multiple funds tends to apply to a large company operating the upper market segment. These could be captive funds under a parent investment bank or a major private equity company like 3i, KKR, Carlyle Group, etc.[138] In addition, most investment banks with limited private equity practice are listed entities in US or Europe and may indirectly be

[136] Pappas, Allen and Schalock, 2009, p.23.
[137] Pappas, Allen and Schalock, 2009, p.24.
[138] Captive fund managers work on the behalf of a parent company, which could be diversified in its operations.

governed under the corporate governance regulatory frameworks, which may have little impact on investment governance question raised in this work.

In many middle market and low market private equity firms, there are generally one or two funds, which makes the firm governance same as fund governance. There are two elements to fund governance: a) governing the many limited liability partnerships that created the capital pool for the fund; and b) governing the portfolio of investments. Governing the partnerships involve regular reporting and relationship management. Financial reporting serves the purpose of letting the limited partners know the status of investments but it is difficult to judge the fund value until the exit sale is realized. This can be a cause of uncertainty and potentially raise trust issues amongst partners in a long-term investment. Therefore, the general partners need to share enough information with the limited partners to increase transparency and manage/govern the relationships and their expectations.[139] Since each fund has many limited partners, most of the reporting and limited partners' expectations are included in the covenants of limited partnership agreements. Some partnership agreements allow limited oversight on funds management.[140] Governing the portfolio of investees is solely the responsibility of general partner and is also carried out via reporting mechanisms but general partners have more rights and control over information gathering and addressing any discrepancies via the appointed directors.

The focus of the question raised in this research is on the third point mentioned above – Investee Governance. In relation to this function, McKinsey[141] analyzed 70 successful international private equity deals and found that the primary source of value creation in the majority of these deals was the out performance of the company – not price arbitrage, not financial engineering and not overall sector gains or stock market appreciation – just better management of the business. More importantly, McKinsey found that this out-performance was primarily driven by changes to the way the boards of these enterprises worked - what McKinsey called "a more engaged form of corporate governance". In the past few years, other management researchers[142] have reported similar findings. The evidence suggests that private equity transactions appear to be associated with incentive and governance mechanisms that enhance performance.[143] Many large private equity firms, as

[139] Fenn, Liang and Prowse, 1995, p.60.
[140] Ibid.
[141] Beroutsos, Freeman and Kehoe, 2007, p.5.
[142] Gompers, Kovner, Lerner and Scharfstein, 2006; Metrick and Yasuda, 2010, 2337; KPMG Report 2010, KPMG looked at 17 investment cases to study the impact of PE on the companies.
[143] Bonini, Alkan and Salvi, 2012, p.37.

a policy, tend to hire a seasoned independent director for each new private equity deal. However, it has been demonstrated that independent directors not necessarily impact the rate of return on deals in closed-ends funds in European context.[144] The performance could be driven by the characteristics of the deal (exit-way, holding period and shareholding).[145] In another study, it is suggested that the characteristics of the investor influences the values of the deal in private equity transactions.[146]

Within the context of governance of exits, a study on 321 exited buyouts in the UK in the period 1995 to 2004, realized value increases, which were attributed to some extent to the corporate governance mechanisms resulting from a leveraged buyout, especially managerial equity holdings.[147] On the other hand, in an emerging economy where formal institutions that protect property rights are weak, the investments do not realize the full potential value on exit, especially in initial public offering situations.[148] Also, after the exit, institutional investors have been slow to respond to the widespread presence of takeover defenses in the charter of firms whose shares they hold through private equity fund. Private equity funds need to maintain a reputation for dealing well with successful managers of portfolio companies – it is privately rational, but socially inefficient, for funds to have their portfolio companies adopt takeover defenses.[149] Legality and strong institutions have a strong influence on the exit strategy. The empirical evidence indicates that initial public offerings are more likely in countries with higher legality index. Legality index can govern the controls for country specific stock market capitalization, market conditions, private equity manager skill, fund characteristics, entrepreneurial firm, and transaction characteristics.[150] Exit strategy brings up issues for governance and changes in the management that can have great impact on the value created for the investors.[151]

Governance functions discussed above pose some issues that are in interests of the investors, which makes governance of the private equity firm itself an important issue. Like in any other company, governance of the private equity firm and the fund(s) itself can have a direct bearing on the issues governance of an investee company.

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[144] Caselli and Gatti, 2007, p.345.
[145] Ibid.
[146] Dai, 2007, p.561.
[147] Nikoskelainen and Wright, 2007. p.19
[148] Lin and Chuang, 2011, p.585. Authors used the data from 525 IPOs in Taiwan.
[149] Klausner, 2003, p.756.
[150] Cumming, Siegel, Wright, 2007, p.5.
[151] Cuny and Talmor, 2007, p.10.

2.1.9. Conclusions, Reflections and Hypothesis

Research on public companies, to some extent, does offer data on board's ineffectiveness in instances of corporate scandals or poor company performance. Such findings have often been used by the relevant regulating agencies to institute extra regulatory controls on the boards and the companies. Regulations such as Sarbanes-Oxley at best have improved transparency in American companies to some extent but at worst stifled economic growth forcing many companies and investors to explore growth opportunities in other nations. This is somewhat true for other mature capitalist economies. In comparison to these countries, in continental Western Europe and Japan the board structures tend to give relatively more power to the board of directors as opposed to executives. But these structures are also heavily regulated leading to boards with strictly defined functions with limited role in strategy and innovation. It could be argued that given the current economic environment and recent corporate scandals, the actual role played by the directors has moved away from the intended purpose of the board. Many studies have attempted macro level quantitative studies to link the company success to effective corporate governance practices but it is difficult to point to conclusive evidence that shows that corporate directors were instrumental in the successes.

Recently, private equity business, emerging economies and corporate governance have independently received significant attention from the investment firms, media, academics, corporations, regulatory bodies, and "think-tanks". In the wake of accounting scandals of the past decade and the recent real-estate "bubble burst" leading to global recession, the number of empirical studies conducted on the impact of corporate governance practices and structures on various aspects of a firm has increased significantly. The global recession and multiple bankruptcies, while questioning corporate boards, rejuvenated the role of private equity firms in corporate control of "once-public" companies. The private equity firms also are at the center of creating new growth opportunities in developed as well as emerging economies. With an increasing impact of private equity transactions on national economies, there is an increasing research interest in private equity firms and the lessons that can be learned from a board directed by private equity fund managers. In addition, private equity activity is on the rise in emerging economies, especially Eastern Europe, South East Asia, Middle East, and India. Many of these economies are still in the process of forming sound corporate governance practices, which are supposedly being influenced, to some extent, by private equity funds managing high growth firms and seeking exit strategies for investee companies, especially when the companies make initial public offers. It is fair to argue that

the activities of private equity backed directors could inform the public company boards and their regulators, both in developed and emerging economies to create better governance practices. Although the traditional economic theories explain certain aspects of private equity transactions, they do not fully explain how the private equity fund managers as directors in their investee companies enable growth.

Exhibit 14 describes the overview of the private equity contextual situation based on the research question and literature review. The top pane shows the workings of private equity transactions. The general partners (GPs) and limited partners (LPs) enter into binding limited partnership agreements (LPAs). LPs provide majority of the funds available for funding. The GPs generally start with a target value for a fund and fund-raising timeframe. Once a fund closes, the fund managers seek out potential investee companies. Exhibit 14 also shows a spectrum of company types based on business life cycle that the GPs target. Targeting is strongly linked to the investment strategy that the GPs market while seeking the LPs. Three important elements of investment strategy are: stage of the company in the life cycle; industry sector; and range of investment values. So invariably, a fund will focus on specific life-cycle stages and tend to focus on specific industry sector. However, some large venture capital funds could use a generic approach to industry sectors. The business stage, sector and jurisdiction will tend to determine the investment values. The Exhibit also indicates that the businesses have growth capital requirements that are met by private equity funds because other ways to raise capital are quite limited.

Exhibit 14 also shows a generic ownership rights in business life-cycle stages prior to private equity funding. Depending on the life-cycle stage, the private equity investment will invariably alter the ownership structures. Focus of this research was on companies that are in early capacity expansion and strategic expansion business stages.

Once the investees are selected and deals are made with all the due diligence and legal agreements, the biggest challenge is the investment management during the holding time. The role played by the private equity firm could range from hands-off monitoring and need-based advising to active directing and controlling via a governance board that includes other directors and executive teams. This role is also determined by the business life-cycle stage and size of the investment. It has to be kept in mind that from the investee's perspective the private equity firm places a director on the board to fulfill monitoring role. However, from GP's perspective the director is an investment manager. The

investment charter agreements generally outlay the role of the director. Ideally, both the investee and GP would prefer that the role of the director is only limited to hands-off monitoring. Investee prefers hands-off monitoring because the investment has already been secured and since investee knows most about the business he/she would not want the private equity director to interfere in operations. Private equity fund manager would also prefer hands-off monitoring if the deal implementation goes as planned. However, that is seldom the case.

Like any financial deal, there is always asymmetry in information that becomes apparent once the investment manager/director is appointed to implement the deal. Also, there is concern about the person appointed as the director. Often times, the investee company executives prefer the original dealmaker as the director. In smaller private equity funds, this is more feasible compared to larger funds. This issue is prevalent in private equity industry across the globe. For a general type of fund with no special sector focus, the fund managers are often not equipped with the operational skills that are needed to oversee a wide range of industry sectors. In addition, the fund managers are more motivated and excited by making deals even though their reputation on raising funds and seeking investee companies depends on the performance of portfolio companies. Once a director/investment manager is appointed, the challenge of executing the growth strategy begins. In the recent economic downturn, the challenge of managing an investment and creating value is even bigger compared to financial euphoria in pre-2008 era. This highlights one aspect of the research problem: How does a private equity firm achieve intended investment results via governance functions?

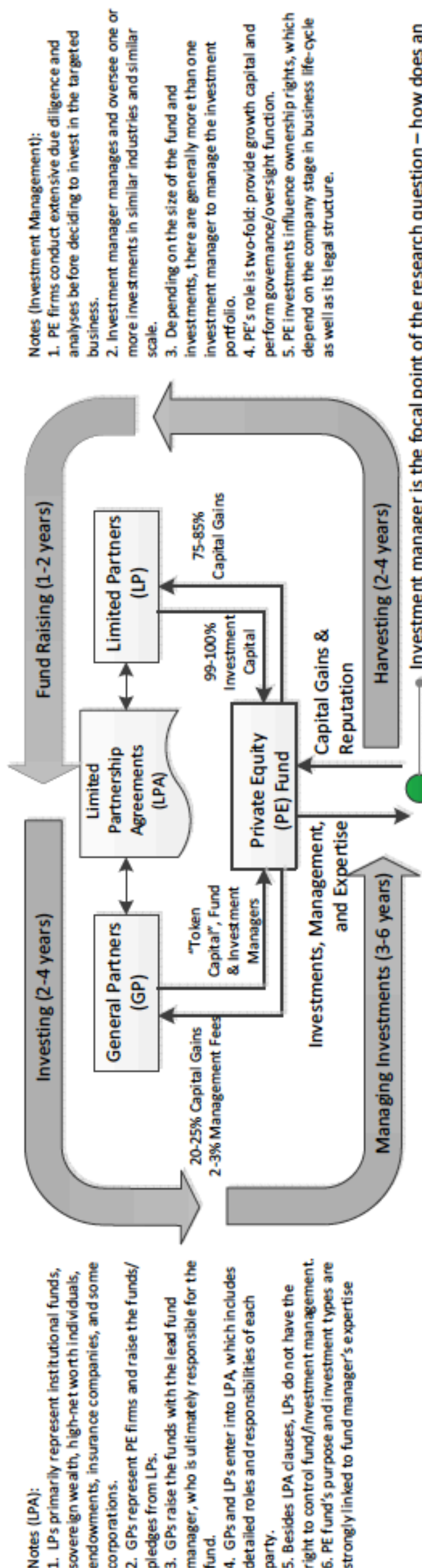

Exhibit 14. A Notional Representation of the Research Question (own illustration)

Board effectiveness of public companies has been the focus of many management research studies, especially over the past decade that witnessed many corporate scandals that impacted global economy. Most of the contemporary corporate governance research, within global context, employ's one of the dominant theories to focus on comparative practices across various economies to understand company performance as it relates to multitude of factors associated with board effectiveness. The conventional wisdom holds that the board of directors of a company can more successfully carry out its purpose if the directors are totally 'engaged' with the unique issues related to the company. Although this could be said for practically any entity that has a purpose, the broad focus of this dissertation is on board of directors' level of engagement in corporate governance. In particular, the focus is on the private equity placed director on the board.

The board's purpose and level of engagement are related and dependent on the type of the industry, economy, regulatory environment and culture in which the company operates. These factors, to some extent, also determine the controlling and directing power exercised by the board of directors. The growth stage of the company itself also determines the purpose of its board. It could be somewhat inferred that board's purpose and effectiveness is determined by the level of engagement. Given some of the constructs mentioned above, the relevance of engaged form of corporate governance is strongly linked to the hypothesis of this research:

HYPOTHESIS: Private equity firms add value to portfolio firms during the investment management process via 'engaged form of governance mechanisms'.

- It is assumed that the distinction between governance and executive management functions in private equity investment context is not the same as public company context, where the governance is prescribed framework oriented and regulations driven.
- Governance in private equity context is highly situational – "one size does not fit all".
- The scope of governance for the selected situational context is limited to the holding period duration. The duration does not include the activities, per se, associated with investee selection, deal-structuring agreements, exit preparation, actual exit and post exit. These activities will tend to have some bearing on the holding period activity, especially when someone on deal-making team is also the director as well as exit

strategy manager – this is often the case in many private equity deals in India.
- For the purposes of this research the actual outcome of the exit value is immaterial and not within the scope of this research – exit value depends on the exit opportunities that exist depending on the economic and political environment at the time of exit.

2.2. Theoretical Aspects of Corporate Governance and Private Equity Investment Management

The researchers from the fields of economics, law, management, sociology, philosophy, organizational studies, behavioral studies and psychology have contributed tremendously in understanding the evolution towards the modern corporation and how the global and local economic environments have influenced some of the changes.

'*The economic power in the hands of the few persons who control a giant corporation is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another*' [152]

This quote from Berle and Means (1932, p.46) captures the essence of corporate governance needs and hence various theories explaining it. The need for corporate governance is related to restraining managerial powers, but it is the managerial powers coupled with manager's creativity and leadership that enables the growth of corporations impacting not only the shareholders, but also all stakeholders. This paradoxical situation in itself is of interest to many researchers.[153] From practical perspective, there is a growing belief amongst institutional investors that the board directors can positively influence the company performance and are willing to pay premiums for companies that demonstrate commitment to improved governance.[154] This can put pressure on managers, via the board of directors, to trade autonomy with duty to act in the interest of the shareholder. This belief and pressure on the executive management, especially in the wake of multiple scandals over the past fifteen years, has offered the researchers a problem to address by demonstrating and theorizing the relationship between corporate governance and company performance. The researchers from practically all social science areas have shown interest in this problem, leading to some theories becoming more

[152] Berle and Means 1968 (original 1932), p.46.
[153] Kose, J., Litov, L. and Yeung, B. 2008, p.1725.
[154] Gillian and Starks, 2003, p.13; Claessens, S. 2003, p.16.

popular than others, but the dynamic complexity of this organizational and institutional situation is yet to be captured by any one theory.

Nicholson and Kiel, (2007), Turnbull (1997) and Charreaux (2004) reviewed and described many theories of the firm and evolution of theories relevant to corporate governance. All three reviews combined, describe theories from multiple disciplines including microeconomics, macroeconomics, information theory, organizational economics, law, finance, accounting, management, psychology, sociology and politics. Instead of proposing an integrative theory, Turnbull (1997, p.200) notes that it is likely that one theory is insufficient for understanding, evaluating, and designing governance structures. Charreaux (2004, p.40) proposes an integrative model to explain contemporary corporate governance. It is also noted that the study of corporate governance and dominant theories, historically, have been devoted to Anglo-Saxon large public corporations within a particular national institutional context, law, religion and culture.[155]

Agency theory proponents primarily tend to focus on relationships between board independence and aspects of firm performance.[156] Other popular theories are stewardship theory, resource-based theory, stakeholder theory, and team production approach. Stewardship theory proponents focus on corporate performance in relation to the company's executive management on the board.[157] Resource-based or resource dependence theory focuses on the relationships of board's 'resourcefulness' with various aspects of firm performance.[158] Stakeholder theory emphasizes providing 'return' to all critical stakeholders of the firm.[159] Finally, the team production theory views the role of the board as a mediator to resolve conflicts and enable better strategic decisions.[160]

Only the predominant and emerging theories are summarized in this section and their applicability to the research question is discussed.[161]

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[155] Turnbull, 1997, p.185.
[156] Fama and Jensen, 1983, p.304
[157] Donaldson and Davis, 1991, p.52.
[158] Hillman, Withers and Collins, 2009, 1415.
[159] Turnbull, 1997, p.192.
[160] Blair and Stout, 1999. 280. Team production approach has been described within corporate law. The initial ideas of team production were promulgated by Alchian and Demsetz 1972.
[161] Although the contemporary theories of a firm, agency theory and stewardship theory are more pertinent as they deal with agent-principal problems. Other the corporate governance theories such as institutional theory, stakeholder theory, resource-based theory, are beyond the scope of this research.

2.2.1. Review of Contemporary Corporate Governance Theoretical Background

Agency Theory: Jensen and Meckling (1976) proposed a theory of the firm that resolves the issue of separation of ownership and control as described in Section 2.1.7 with agency problems and financial theory. The works of Adam Smith show that ownership and property rights enable innovation, entrepreneurship and economic growth leading to creation of wealth.[162] The separation of ownership and control in public firms made Berle and Means (1932) challenge the applicability of theory of property rights as enablers of economic growth. Jensen and Meckling (1976) resolved the issues by developing agency theory model that explained the corporate governance structures as a proxy of ownership that can still control and direct the agents, but at a cost. The agency cost to the company, indirectly to the shareholders, was related to agency conflicts. However, as far as minority and retail shareholders are concerned, it can be argued that the developments in information technology, financial markets and regulations made the companies a little more transparent and lowered the transaction costs for shareholders to access information and sell shares as they please. This is a direct cost to the shareholder and is a preferred way to control the ownership of stocks and profit from them. This makes fragmented shareholders somewhat irrelevant in the governance of the firm.

In its most basic form, agency theory resolves the problems that arise in a situation when one party (principal) contracts with another (agent) to make decisions on behalf of the principal. The contracts, no matter how much detailed and enforced, are subject to hazard because of the human nature and contextual organization where agent needs to make decisions. Human nature concerns with self-interest, bounded rationality, and risk aversion.[163] Organizational concerns are related to conflicts amongst members and asymmetrical information distribution. These issues make it costly for principals to know agent's motivations and accomplishments. Agency problems develop because agents, once contracted, could potentially hide information and/or take act in their own interest instead of the principal.[164] This motivates the principals to bear the cost of monitoring the agents and provide incentives. Corporate governance contractual and monitoring frameworks offer the shareholders some mechanisms to limit the powers and restrain self-serving opportunistic behavior of executive management. These

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[162] Jensen and Meckling, 1976, Introduction
[163] Turnbull, 1997, p.199.
[164] Dey, 2008, 1145.

mechanisms, combined with agency theory's definitions of the firm and agency problems, constitute the specification of the agency model. Among many organizational issues, the agency theory explained why a manager of a leveraged firm would make less optimal choices compared to the choices he would make if he were the sole owner.[165]

To further qualify the agency model for organization structures, Jensen & Meckling (1994, p.6.), reflected on human nature and discussed five alternative models of human behavior: Resourceful, Evaluative, Maximizing (REM); Economic (money maximizing); Hierarchy of Needs; Social Victim; and Political (perfect agent) models. REM Model at best described the rational part of human behavior that sustains the organizations. Although some researchers have challenged the assumptions of agency theory, it has been well accepted by most researchers as well as the practitioners, concluding that corporate governance is an endogenous response to a firms' business and economic environment and that performance correlates with the agency conflicts and governance mechanisms.[166] Despite the flaws of corporate governance system in the US, agency theory explains many decades corporate environment including the LBOs and provides room for reforms to make it better.[167] Some researchers have shown that agency theory application could lead to inefficient strategic decisions.[168] Some researchers concede that agency theory dominates corporate governance research, but its behavioral assumptions stand in direct competition to the worldviews held by most organizational scholars.[169] Further it has been argued that organizational scholars could present alternative views on governance theories.[170] It has been questioned that under the conditions of imperfect information, are the agents really that opportunistic and is that the main transaction cost? On the contrary it has been suggested that transaction costs exist for problems of communication, cognition and interpretation.[171] A dominance of such opportunistic thinking can be misleading for the firm level strategy. It is plausible that active empire building and opportunism may not be the norm and that managers may instead prefer to enjoy the quiet life.[172] In addition, the notion of opportunism and empire building being bad for the company can be challenged too. For example, CEO driven investments of Philips in Taiwan in the 1960s led to the betterment of the company when other

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[165] Jensen and Meckling, 1976, p.32.
[166] Dey, 2008, 1147.
[167] Holmstrom and Kaplan, 2003, p.7.
[168] Krafft and Ravix, 2005, p.85.
[169] Lubatkin, 2005, p.213.
[170] Ibid., p.214.
[171] Hodgson, 2004, p.415.
[172] Bertrand and Mullainathan, 2003, p.1072.

investors mostly ignored it.[173] Agency theory model analysis could make such action non-viable. The recent economic recession shows that interests of both the managers and shareholders were aligned in the short-term and ignored the long-term, while being enabled by the corporate directors, leading to a catastrophic situation.[174] There have been a few suggestions to reform the corporate governance framework in financial firms by instituting penalty clauses and stakeholder congress for improved oversight.[175]

There are others who question the assumptions of agency theory and its applicability in a modern corporation that has large fragmented shareholding, large employee base, and other internal/external stakeholders.[176] From regulatory perspective, OECD's Principles of Corporate Governance encompass all possible stakeholders and not just the shareholders, which limits the scope of agency theory. In addition, the agency theory is constructed from legal perspective based on a series of contracts between various parties in a corporation, where employees and outside stakeholders are not considered as having a legal recourse.[177] In situations with unionized labor there is still some legal recourse, but the labor and external stakeholders are considered out of scope of agency theory.[178]

Given the constructs of these theories in applying to public firms, the theories fall short of fully explaining the role of corporate governance structures and frameworks adopted in various jurisdictions. However, the concentrated ownership and interests alignment of owners, directors and management, these theories could potentially better explain aspects of governance functions in a private equity situation. With all the criticism in literature about agency theory and its application in Modern Corporation, it is actually more applicable to private equity industry.[179] Especially, when Michael Jensen, the main proponent of agency theory on corporate governance and organization, claimed that the era of public corporation as the dominant engine for economic growth is over and is being "eclipsed" by the private equity business model. From that perspective, private equity firms' competencies and operating mechanisms might be better suited for governing and managing the growth of firms.

[173] Van der Putten, 2004, p.514.
[174] Grove et al., 2011, p.434; Pirson and Turnbull, 2011, p.460.
[175] Nicholson, Kiel and Kiel-Chisholm, 2011, p.481.
[176] Fairfax, 2006, p.676; Margolis and Walsh, 2003, p.270.
[177] Blanche and Hatchuel, 2011, p.430.
[178] Asher, Mahoney and Mahoney, 2005, p.12; Kochan and Rubinstein, 2000, 370.
[179] Bartlett, 2006.

Considering the application of agency theory to private equity transactions, the LBOs have been touted as a result of failure of corporate governance in public firms.[180] On one hand it can be argued that agency theory explains the failures of public firms and why LBOs tend to be better off from the concentrated shareholding perspective. On the other hand, private equity fund managers as general partners are no more than the agents of the institutional investors, who in turn are agents of all the individuals who are investing in the institutions. Therefore, the fragmentation in ownership remains. Also as a result of LBOs many stakeholders including the employees and customers could be marginalized. Although the private equity firms with the leveraged buyouts have restructured many corporations and continue to do so, agency theory only explains the failure of public firms that creates the market for corporate control. As a theory of a firm, agency theory does not fully explain the newly created entities as a result of LBOs. In a typical LBO the 'new firm' managers and fund managers can enter into extensive contracts and take care of agency problems. The contractual and incentive frameworks tend to explain the success of some private equity managers. But agency theory is limited in explaining what do the fund managers actually do and how do they know what is the right thing to do within the legal frameworks.

Generally in a VC backed firm, especially start-ups, both the entrepreneur and VC are looking for an upside of the venture with no short term gain– the venture failure would cost more to the entrepreneur and positive outcomes will help the entrepreneur to obtain additional financing. This somehow aligns the interests removing the agency problem and entrepreneur will rarely act as an agent as per agency theory.[181] Another significant piece of VC-entrepreneur relationship is advisory and enabling function that VC brings along with the financing. However, it is up to the entrepreneur to take advice. Agency theory is limited in addressing this issue.

Stewardship Theory: To overcome the shortcomings of the agency theory, stewardship theory was promulgated, according to which the managers can be motivated or incentivized to act as effective stewards in the interest of the shareholders and collaborate with less monitoring independent directors.[182] The big assumption contrary to agency theory is that the managers can be trusted to make the right decisions. Some studies do show that managers, in their creative pursuits, take actions not necessarily for financial gains but for the

[180] Jensen, 1989 (revised 1997), p.62.
[181] Arthurs, J.D. and Busenitz, 2003, p.153.
[182] Davis, Schoorman and Donaldson, 1997, p.24; Donaldson and Davis, 1991, p.59.

sake of firm's long-term development.[183] Stewardship theory views human behavior differently than agency theory. In agency theory a man is driven by self-centered and driven by financial gains, while in stewardship theory more than just maximizing his own financial gain drives a man.[184] These views could allow the organization structures and governance mechanisms to be different.[185] Theories on stewardship give the manager high authority and discretion and might be able to explain certain types of family firm boards. It may also explain non-profit and public sector organizations.[186]

Stewardship theory, like agency theory, does not consider other stakeholder such as suppliers, customers, employees, intermediaries and general public. Therefore, it remains an incomplete theory of a modern firm. It does not also address the situations where a man is driven by his own self-interest. Both agency and stewardship combined can address the issues a little better but it will depend on the manager's personality traits to see which theory applies.

Alignment of principal-agent interests is inherent in private equity transactions, although this alignment is more because of self-interest, which is explained better by agency theory. According to stewardship theory, the agent is motivated not only maximizing self-utility but also by the interests of the principal. An entrepreneur cannot "turn-off" his self-utility because that's what drives him. Therefore, from one perspective the premise of stewardship theory does not apply to an entrepreneur.[187] However, in typical LBO deals, stewardship theory may apply better because agents are not necessarily entrepreneurs – they are high-level executives and fully understand the reasons for LBO deals and are willing collaborators with the private equity investment teams. Yet, the theory does not explain how the principals work with the agents to add value to the LBO. Since the research question focuses on the holding period where a private equity firm, via a director, adds value to a portfolio company, and as discussed earlier in this section, both agency and stewardship theories fall short of providing an answer to how the value is added, especially in an emerging economy like India that is culturally, politically, institutionally and socially very different from Anglo-Saxon and Continental European economies.

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[183] Fiss and Zajac, 2004, p.505. The authors used their analysis on German corporations that have resisted US-type shareholder approach.
[184] Davis, Schoorman and Donaldson, 1997, p.27.
[185] Donaldson and Davis, 1991, p.52.
[186] Kluvers and Tippett, 2011, p.282.
[187] Arthurs, J.D. and Busenitz, 2003, p.156.

Resource-based theory: The resource-based or resource dependence theory holds that the board members have social capital embedded in elite networks, access to financial capital and relationships with industry partners.[188] The proponents of this theory maintain that the success of a company is highly dependent on these resources that can only be accessed via the board.[189] However, the study conducted by Nicholson and Kiel (2007, p.599), demonstrate that firm performance is least likely explained by resource dependence theory of corporate governance. The concept of resource-based view seems quite applicable to PE/VC backed companies because the investors as resources on the boards, not only bring capital but also expose the companies to a network of resources and relevant expertise that would not be easily available otherwise. Therefore, resource-based view addresses the advisory function of the private equity fund managers/directors. This aspect integrated with a combination of agency and stewardship theory can be closer to explaining VC-entrepreneur relationships. However, this still does not fully explain how the PE/VC director activities creating the value during the holding period.

Team production theory: An alternative approach, a 'team production model', conveys that the role of governance mechanisms of a corporate board is to facilitate stakeholders' investments by ensuring the managers' neutrality and independence.[190] Team production occurs when individual efforts of many lead to a cooperative output - the firm's value creation does not result from the agency relationship but from the interactions between the individuals.[191] Such a notion applies better to the modern corporation because employees, shareholders, managers, and other internal/external parties, all contribute to the value creation in a firm. This alludes to the role of corporate board is not to direct and control performance, but to allocate the profits and act as mediation entity to resolve disputes among team members.[192] Therefore, instead of acting on behalf of the shareholders alone, the directors are required to act in the name of the firm and to maximize 'the joint welfare of the team as a whole'.[193] Although this team approach is closer to the OECD Principles of Governance or stakeholder theory in a normative sense, it does not explain the motivation of board members who would want to adopt this type of role in large public firms. In a way, the asymmetric information and moral hazard problem with the managers does not go away but is transferred to the directors.

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188 Barney, 1991, p.101.
189 Zahra and Pearce, 1989, 293.
190 Blair and Stout, 1999, p.282.
191 Ibid.
192 Ibid.
193 Ibid.

In one study researchers used data from 140 small Norwegian firms and found that from team production approach, leadership behaviors and processes have a greater impact on boards' strategy involvement than structural leadership characteristics alone.[194] The board structures are not normative and are setup depending the leadership strength and cooperation from other board members. This is an important finding for private equity type of investments because similarities like concentrated ownership, smaller boards, strong leadership requirements and willingness (due to alignment of interests) of directors and executives to work closely to create better strategies that can be implemented by the executive managers.

In another study on 321 successful exited buyouts in the UK, it was found that corporate governance mechanisms had little to do with high returns, instead the management's co-investment with the private equity strongly correlated with the high returns.[195] It can be argued that managers' co-investments align their interests with that of private equity fund manager leading to a better cooperative boards.

In conclusion, agency and stewardship theories offer alternative views of human nature and provide divergent prescriptions for governance - social categorization theory as a complementary alternative emphasizes a situational and social view of human nature that could explain top managers' discretionary behaviors that influence firm performance.[196] Agency theory and stewardship theories may explain why the modern private equity type of business exists, especially the LBOs and why LBOs improve corporate governance mechanisms compared to the failing public entity. The theories may also explain the contractual frameworks put in place during the LBO and VC deal-making process. This includes formalizing board activities. The limited partnership contracts could also be explained by these theories where institutional investors are principals and private equity fund managers are agents. These theories coupled with the resource-dependent and team production theories, to quite an extent, may explain successful boards that are backed by PE/VC investors. However, a single theory is insufficient in explaining how the private equity directors add value to portfolio firms.

[194] Machold, et al. 2011, p.378.
[195] Nikoskelainen and Wright, 2007. p.19
[196] Knapp, Dalziel and Lewis, 2011, p.303.

2.2.2. Emerging theories relevant to private equity

Private equity investment management in addition to being a financing method is more of a governance method.[197] In addition, as opposed to traditional corporate governance practices, private equity practices focus on a range of managerial, governance and entrepreneurial aspects.[198] The principal-agent theories described earlier do cover managerial and governance aspects but explicitly lack entrepreneurial aspects.[199] Klein et al. (2013, p.41) refer to entrepreneurship as judgmental decision-making under uncertainty as opposed to practical views of entrepreneur such as self-employment, startups, product innovation, etc. To account for entrepreneurial aspects in addition to managerial and governance mechanism, relevant emerging theories are described in this section.

Theory of Creativity of Action: Microeconomic theories use individual as the unit of analysis with the assumption that rational choice applies, where a person has choice to make in a situation.[200] The assumption is that the person will make the choice that maximizes the utility of his/her rights. The rational choice theory is somewhat flawed because an individual does not know what maximizes the utility in a complex environment.[201] In addition, the choices are not present in a situation but rather emerge as a result of interaction between the actor and his environment leading to a sense of intentionality.[202] However, economic theory based on rational choice (pre-ordained situation with choices) reduces the complexity of reality and provides us with valuable tools to understand reality to some extent but it does not explain the dynamic nature of creative evolution in a situation.[203] Hans Joas (1996, p.146.), while developing the theory of creativity of action shows that the choices for an actor emerge in a social situation but the utility of choices may not be very clear in a complex situation. This can also be a critique of Jensen's model in Agency Theory that assumes that all shareholders have the same choice and that the manager's make choices that would not be in the interests of the shareholders. Although the critiques are valid, it is also true that economic theories assumptions do explain marginal situations.

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[197] Klein, Chapman, and Mondelli, 2013, p.39.
[198] Ibid. p.40.
[199] Padilla, 2005, p.47. O'Sullivan, 2000, p.407.
[200] Joas, 1996, p.146. – critiques rational choice theories developed by Max Weber and later Action Theory by Talcot Parsons that these have trickled down to contemporary economic theories.
[201] Joas and Beckert, 2001, p.272.
[202] Ibid. p.273.
[203] Ibid. p.284.

Hans Joas (1996, p.148) describes "*…an analysis of the intentional character of human action, the specific corporeality and the primary sociality of all human capacity for action…what emerges is a picture of the creativity of human action*"

There are four concepts to the Theory of Creativity of Action:[204]
1) Intentionality; 2) Corporeality; 3) Sociality; and, 4) Situation.

- Intentionality aspects
    - Goals are cause of actions. Set goals interrupts fluidity of human interaction
    - Goals emerge in process - actions cannot explain the motives and goals
    - Cognitive ability of actor aids in iterative process of clarifying goals using flexible means - situation is constitutive of actions
    - Changes the notion of perception - familiarity and capacity of action
    - Norms and values do not always provide unequivocal answers
- Corporeality aspects
    - Body is the instrument/tool for actions in action theory
    - Actor exercises control over body
    - Instrumental and non-instrumental relationships
    - Meaningful loss of intentionality - when we intentionally lose control to act rationally
    - Actor has a self-image, which is dependent on development process
    - Sociality precedes the ability to act as an individual
- Sociality aspects
    - Only a genetic and not a structural precondition to human action
    - Human beings are constantly re-inventing themselves with new experiences and new knowledge
- Situation aspects
    - Rational decisions are difficult to make in complex situations
    - Actor creates a situation where the means and ends are not separated
    - Situation, means and ends are constantly changing in an iterative process oriented framework and cannot be determined at the beginning of the process

[204] Joas and Beckert, 2001, p.272-276; Joas, 1996, p.145.

Intentionality is somewhat related to the intentions of a human being as an actor and sociality describes the interactions of the actor within a situation that creates choices. Corporeality describes the physical ability of the actor to act upon the choices. This complements the notion of entrepreneurship as judgmental decision-making in uncertainty as described by Klein et al. (2013, p.41).

Two elements of theory of creativity of action need further exploration: relationship of entrepreneurship to innovation and defining situational contexts. The following two theories fill in these gaps.

Actor Network Theory: Actor Network Theory of Bruno Latour (1999) better explains the situation that consists of other actors and knowledge artifacts with implicit or explicit associations with each other. The interaction between the actors and the situation (sociality) creates choices, which allow entrepreneurial actions leading adding creativity to the existing situation.

'Theory' of Conventions: Gomez and Jones (2000, p.701) define conventions as unwritten rules that emerge over time in an organization that govern the behavior of actors by conforming or non-conforming to the conventions. Gomez and Jones describe the following aspects to define the concept of conventions:

- A convention eliminates uncertainty in situations that is beyond the comprehension of one individual alone
- Conventions evolve but provide stability by defining norms in the absence of rationality
- A convention is based on shared belief
- Change in an organization comes by adopting new conventions

It can be argued that a change in convention is manifestation of innovation. It is not important to understand how the conventions emerge but it is important to recognize that the conventions make people act in a certain way. For example, most men do not worry about the historical significance of wearing a tie in a professional setting but we conform to the convention. Property rights, regulations, stock prices, company laws, information access, directors, managers, etc., are all part of the network that interacts based on conventions. The conventions undergo evolution and change. Conventions can change over long period of time or they can change all of a sudden. For example, conventions in an organization can change with new leadership. Conventions can change over night by changes in laws. The changes in conventions and

actor networks lead to changes in the situations, which provide choices to an actor on an ongoing basis. The situations however, are unique to each individual because people interpret and use the conventions differently based on the extent of their personal engagement (intentionality) in the situation.

Directors, managers, owners, stakeholders are all actors in situations where choices emerge for them. The situations can change irrespective of the actor under study. For the purpose of this research, the private equity fund manager is the main actor who needs to make choices. The interaction with the network provides choices, which changes certain conventions, which in turn changes the choices for other actors. Certain knowledge artifacts like documents and contracts will also change with an impact on the choices of other actors.

Using the theories discussed above – Theory on Creativity of Action, Actor Network Theory, and Theory of Conventions – a framework can be developed to study the private equity investment management and understand the situations, the emergence of choices, development of knowledge, and actions taken by the directors to govern and manage the portfolio companies. An attempt is made to depict this framework in Exhibit 15.

If we take a minor shareholder as the actor, then company charter, bylaws, stock prices, company information, board decisions, CEO, directors, other shareholders etc., are all part of the network situation. The choices that emerge for the shareholder are to sell the shares, incur transaction cost to gain more information, vote on proxy statements to change conventions, incur monitoring costs, etc. The network situation might change depending on the intentionality and corporeality of the shareholder. If this shareholder is an institutional investor, then the choices are different and impact on the situation is different. We can use the director as the main actor and develop the choices (as in agency theory, stewardship theory, resource-based theory, and team production approach) if intentionality and situation information is known. Implications of institutional theory can also be accommodated in this actor-network framework. The network situation encompasses cultural, national and institutional conventions, which have a bearing on the choices that an actor perceives.

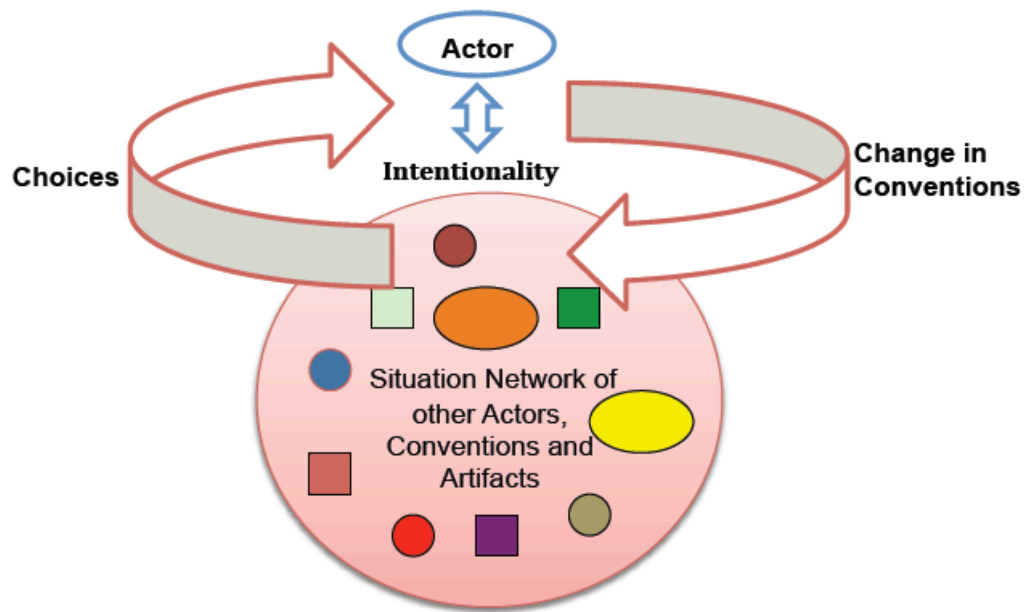

Exhibit 15. Depiction of a generic situational context: Sociality and Intentionality creates Choices for the Actor to influence Conventions (own illustration)

The proposed framework itself is meaningless unless the situations can be defined within the context of the research subject. So in a sense, the theoretical aspects will depend on the knowledge created from the empirical situation. Therefore, any research methodology itself will be dependent on the success in gaining access to the empirical elements. For example, the theory and research results can be rich if researcher gains access to various groups private equity groups, their fund managers, and can observe the situations in portfolio companies. On the other hand, the research outcomes can be weak if researcher gains only a limited access to the situation network. Given this uncertainty, it is still not clear that if this knowledge-based-view of private equity can be developed that is rooted in the theory of social action and emerging ideas on conventions. Any gaps in the theoretical framework also will be identified to see what other pieces of emerging research fill in the gaps to develop a robust knowledge based view.

2.3. Private Equity and Corporate Governance in India

2.3.1. Background Private Equity in India

Private equity firms have been instrumental in enabling economic growth in India. Foreign private equity firms started to become active in India in late 1990s.[205] With economic liberalization after the early 1990s, between 1995-2000, several foreign firms like Baring Private Equity partners, CDC Capital, Draper International, HSBC Private Equity, Chrys Capital, West Bridge Capital and Warbug Pincus entered the market as foreign funds and hired Indian managers to focus on information technology sector investments.[206]

These venture funds were highly successful till the dotcom burst after which many foreign investors pulled out of India.[207] This gave Indian entities like ICICI to expand private equity activity into non-information technology sectors. With a few successful exits[208], the investment activity increased tremendously for the next four years. In 2007, the total transactions value was about $20 billion. The high priority for development of infrastructure, anticipated to need US$500bn in the next five years, makes construction one of the most popular segments for investments. Preqin private equity outlook survey indicated that in 2012 most investment opportunities existed in Asia in small to mid-market buyout funds, with Greater China and India being the two most attractive investment destinations.[209]

During the mid 1990's, laws for venture capital funds formally started taking shape. The Securities and Exchange Board of India (SEBI) issued the SEBI (Venture Capital Funds), Regulations, 1996. These regulations were amended in 2000 on the recommendations of K.B. Chandrasekhar Committee.[210]

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[205] Jain and Manna, 2009, p.140. The first venture capital fund was launched by financial institutions in 1984 by ICICI to encourage entrepreneurship in emerging technology sectors. Followed by a risk capital fund established by Technology Development and Information Company Ltd. and IFCI. Earlier success encouraged commercial banks to establish venture capital funds. In late 80's and early 90's, various private sector funds were created.

[206] Ibid.

[207] Jain and Manna, 2009, p.141.

[208] Ibid., p.146. "Bharti Airtel –Warbug Pincus deal ($292 million) in 2001, was a huge catalyst for growth in Indian private equity activity. As a result of the deal, Bharti expanded from two mobile telecom areas to about 23 in 2004. Warbug sold its 5.65% stake to Vodafone in October 2005 and made around US$ 1.3 billion. In another deal in 2003, ICICI Venture made leveraged buyout of Infomedia from the Tata Group. ICICI Venture helped the investee establish a new business growth model and made a successful exit in 2007 in a trade sale."

[209] Preqin Investment Consultant Outlook: Alternative Assets. H2 2011.

[210] http://www.sebi.gov.in

In India private equity activity has to comply with some restrictions such as use of investment instruments; funds cannot be listed on stock exchange; and no leverage available from Indian banks for funds investing in Indian companies.[211] For a domestic venture capital or private equity fund, registration with SEBI is required under SEBI Regulations of 1996. Foreign pools of capital are also required to register with SEBI according to Foreign Venture Capital Funds Regulations of 2000 to invest in existing domestic private equity fund or to operate as an independent private equity fund. Over the past several years Mauritius, a small tropical Island in the Indian Ocean off the east coast of Africa, has been a conduit for over 40% of total foreign direct investment and majority of private equity investments in India.[212] Besides Mauritius, India has Double Taxation Avoidance Treaty with over 80 countries. Under the treaty with Mauritius, India cannot tax the capital gains made in India by a Mauritius resident. It is fairly easy for a general partner to incorporate a fund in Mauritius and obtain residency certificate. Moreover, Mauritius does not levy a capital gains tax. More than 600 funds are established in Mauritius. It is estimated that on annual basis Indian government potentially looses about $600 million in tax revenue and that this 'Mauritius route' could potentially be used for money laundering schemes.[213]

Private equity funds in India can be established under the Indian Trusts Act of 1882 as a private trust or under the Indian Companies Act of 1956 as incorporated companies or under Limited Liability Act of 2008 as limited liability partnerships.[214] Each type of legal vehicle has implications for both the limited partners and general partners. Some of the attributes of these three different types are shown in Exhibit 16 and Exhibit 17. Exhibit 16 is specific to domestic private equity firms, while Exhibit 17 compares domestic private equity to foreign private equity firms.

Under the current Indian tax laws, non-residents and Foreign Venture Capital Investments (FVCIs) are not entitled to any tax exemptions and are taxable on their income received, accrued/deemed to have been accrued, or received in India including dividends, interest and capital gains. However, if the non-resident or FVCI is an entity incorporated in a country with which India has signed a double taxation avoidance treaty (DTAA) then, the provisions allow the non-resident or FVCI to pay tax to the extent that such tax is more

[211] Jain and Manna, 2009, p.146.
[212] Ibid.
[213] Jain and Manna, 2009, p.146.
[214] Private Equity in 33 Jurisdictions Worldwide, 2011. Chapter on India – Raising Funds.

beneficial to the non-resident or FVCI than the tax payable under the DTAA.[215]

Fund Entity / Attributes	Domestic Funds		
	Trust Fund	**Private Incporated Company**	**Limited Liability Partnership**
Legal Basis	India Trust Act of 1882.	Indian Companies Act of 1956	Limited Liabitly Act of 2008
Regulations Compliance	Low	High	
Liability	Unlimited. Investors (limited partners) are not liable for the actions of the trustees.	Limited to captial contribution. Investors could be liable if the entity is used for illegal conduct.	
Tax	At individual level	Taxed at entitity level	
Set up Process	Takes about 3 weeks and nominal registration fees. Register the deed with local revenue authority	Takes about a month. Requires minimum of two shareholders and two directors. Requires articles of association, Rs. 20,000 to Rs. 30,000 as fees.	Takes about a month. Requires minimum two partners. Rs. 20,000 to Rs. 30,000 as fees.
Minimum Capital Requirements	No minimum	minimum capitalization Rs. 100,000	No minimum
Minimum Officer Requirements	Not mandatory to appoint a custodian	At least a company secretary is captial is more than Rs. 50 million.	Registered Office for communications. Maintain register of directors and members.
Account Maintenance	Beneficiary can inspect.	Regular filings and annual reports. Punishable by fines for non-compliance.	
Public Access	No direct access		
Fund Manager's Fiduciary Duties	Treat as own but in the best interest of investors (beneficiaries). Severly liable for failing to meet the fiduciary duties. Gross negligence settled per investor agreements.	In the best interest of the entity and client's funds. Punishable by fine, imprisonment ot both. Gross negligence settled as per investor agreements.	
Termination	Fund liquidation or termination allowed under law as long as 75% of the investors pass a resolution.		

Exhibit 16. Regulatory Attributes of Domestic Indian Private Equity Funds[216] (own illustration)

[215] Private Equity in 33 Jurisdictions. p.97.

[216] Illustration based on India survey included in Private Equity in 33 Jurisdictions Worldwide, 2011.

There was a tax proposal initiated in 2009 that was supposed to become effective in 2012, which could have made some of the tax provisions unfavorable.[217]

Fund Entity / Attributes	Domestic Venture Capital or Private Equity Funds			Foreign Private Equity Funds
	Trust Fund	Private Incporated Company	Limited Liability Partnership	
Regulator for funds specifically set up for Venture Capital or Private Equity Operations	Venture Capital Funds (VCF) and Foreign VCF (FVCI) are reuired to be registered as such with Securities and Exchange Board of India (SEBI) under Regulations of 1996.			
Registration Requirements	Minimum capital of Rs. 500,000 to set up. Minimum commitment of Rs. 50 million before start of operations. Application fees of Rs. 100,000 and registration fee of Rs. 1 million.			
Compliance	Compliance issues are same as non VCF but SEBI has the right to investigate the accounts and operations any time. Portfolio managers with certain minimum experience and with at least Rs. 20 million under management have to be registered with SEBI in accordance with Intermediaries Regulations. In 2007 regulations for investment advisors were proposed. Regulations are stringent if investing in public companies.			
Tax	Private equity and VCF funds registered with SEBI are tax exempt but the partners pay capital gains tax. This exemption only applies to certain industry sector that government is encouraging to grow such as technology and some infrastructure projects.			Not tax exempt unless the home country has double taxation avoidance treaty with India. There are about 80 such treaties - Singapore, Netherlands, Mauritius and Cyprus have been most popular.
Investing in Fund	Domestic investors may invest without registration. Limit to invest in offshore VC is US $500 million. Funds cannot be raised via public announcements or advertisements.			Register with SEBI as FVCI. Not permitted to invest in indian VCF as a foreign direct investment with permission from the Reserve Bank of India.
Investing operations	Cannot invest more than 25% of fund value in one investee. At least 66.67% invested in unlisted companies. Not more than 33.33% in IPO; Debt; preferred listed stocks with I year lock-in; special purpose entities promoting the fund. Issue a memorandum to SEBI with investment strategy, key partners, details of entity, tax implications and fees payable. File quarterly reports with SEBI. No regulations on profit sharing.			

Exhibit 17. Regulatory Attributes of Domestic Indian Private Equity Funds[218] (own illustration)

Exhibit 18 shows typical structures to exploit tax benefit provisions. For example, American based onshore institutional investors invest in US partnership funds, treated as partnerships for U.S. federal income tax purposes ("Onshore Funds"). The tax-exempt and non-US, institutional investors invest in tax exempted limited partnerships based in jurisdictions such as Cayman Islands ("Offshore Funds"). The offshore funds are typically treated, as corporations for U.S. federal tax purposes. The onshore and offshore funds typically invest in offshore entity treated as a partnership for U.S. federal income tax purposes. The partnership funds usually set up a Mauritius or Singapore holding company to make the investment in the Indian securities to

[217] Semenov et al., 2011, p.7.
[218] Illustration based on India survey included in Private Equity in 33 Jurisdictions Worldwide, 2011.

gain access to the Indian treaty network. The general partners are based in the US but they set up an Indian sub-advisory entity to manage the investees and employ local investment personnel. The domestic private equity firms establish the funds and limited liability partnership in Mauritius with direct investment from international institutional investors.

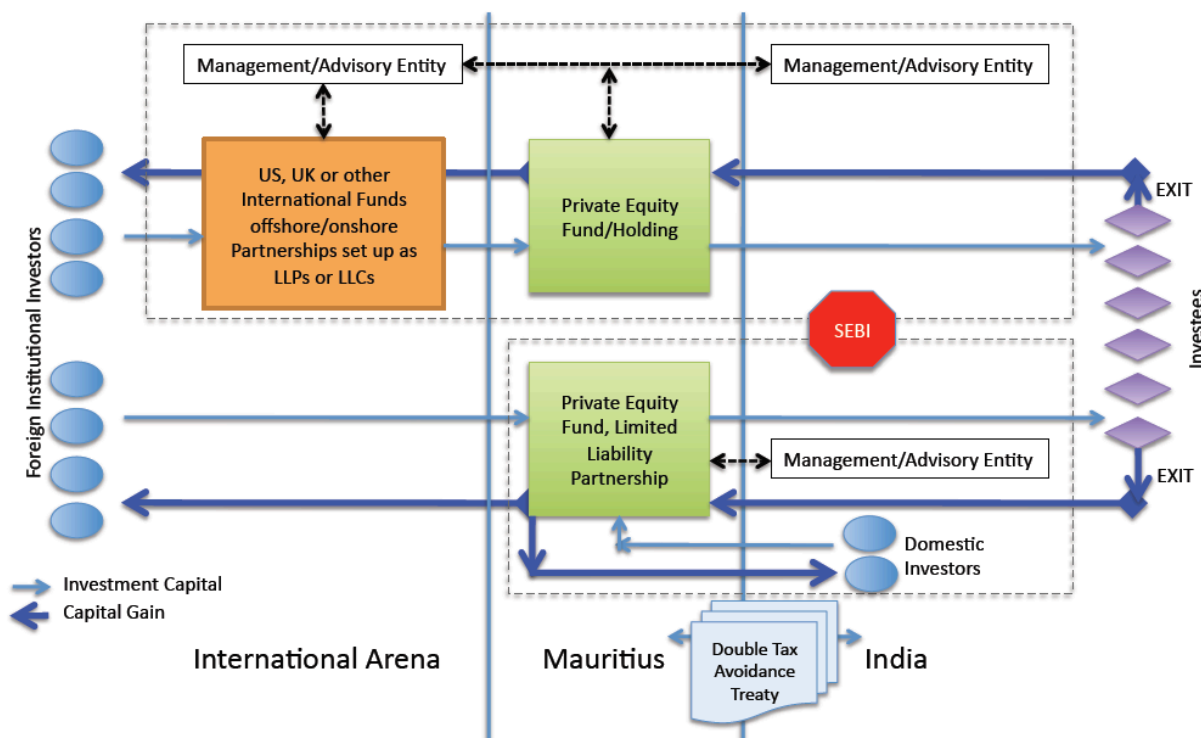

Exhibit 18. Typical Private Equity Funds Setup in India[219] (own illustration)

With Indian Government's focus on strong economic growth, the tax regulations in India have continued to evolve to attract foreign funds but at the same time hoping to prevent abuse of tax treaties has been challenging.

Although the establishment of private equity firms was initially based on UK/US models but overtime the industry developed unique characteristics adapting to the Indian regulatory and market conditions. Some of the positive influences include: fairly large stock market enabling exit opportunities; fairly developed capital markets; relevant institutions; entrepreneurial environment; good supply of motivated and talented professionals; increasing professional and sophisticated services industry.[220] Some of the negative factors include: an

[219] Illustration based on discussions with private equity investors and Semenov et al., 2011, p.12.
[220] KPMG, Private Equity India Survey, 2010, p.42 "several PE firms are adopting the western model and are now building separate operating teams to support their portfolio companies. This should bring

unstable tax environment; cumbersome and costly regulatory compliance; equity preferences over debt; corporate governance issues; and significance of family owned companies. Leverage buyouts and public-to-private transitions are not the norm like many deals in the US and UK. Most investments opportunities are either in infrastructure funds and venture capital type structures.[221] In 2004-2007 timeframe, prior to global credit crunch, Indian private equity deals grew from $1.7 billion to $13.2 billion.[222] Information technology sector accounted for third of all private equity investments in early 2000s. Investment in other sectors such as energy, manufacturing, life sciences, and real estate are on the rise.[223]

In the current global economic environment private equity industry in India is being very closely watched because of high uncertainty and tremendous growth opportunities. Currently the private equity industry is characterized by declining deal volumes, lower average deal sizes and lower returns leading to reduced allocations by Limited Partners. At present, typical fund size averages $350 million with average investments of $25-30 million. The average was closer to $50 million in 2007. Given the fairly large stock market in India, there is an increase in private equity investment in publicly traded transactions (PIPEs).[224] The global financial crisis caused concern amongst fund investors regarding the challenges related to Indian private equity industry. Most important are the existing investments that were made during the boom time pose a high risk leading to lower risk appetite for newer investments.

The regulatory background is important in Indian context because private equity creates a relatively narrow space for the firms to operate. This partly explains the reasons why most PE firms operating in India are less motivated to invest in LBO and MBO activity. Also, the PE firms that invest in strategic expansions prefer straight equity transactions as opposed to leveraged positions. However, recent movement on changing regulations have impacted the priorities of both the general partners and limited partners.[225] Easing

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increasing benefits to the portfolio companies and help further demonstrate to the Indian business community that PE capital, although expensive, is indeed smart money."

[221] Woeller, 2012, p.1340.

[222] Jain and Manna, 2009, p.142.

[223] Ibid., p.143.

[224] Stewart and Shroff, 2007, p.87.

[225] KPMG 2009, p.5, "GP priorities have changed significantly from issues external to their portfolio firms, such as tax, regulations, deal closing costs or the worry about unrealistic valuations of deals, to operational issues: domain skills, innovation and corporate governance. However, GPs have yet to develop the competencies required to be effective post investment in nurturing portfolio companies and providing operational and strategic support; LP priorities are similarly related to performance issues with the added layer of concern about the lack of skilled GPs."

regulatory barriers to foreign investment into India has supported the growing complexity and interest in India's private equity market.

Prior to the credit crunch period that started in 2008, the extent of director's engagement was dependent on the size of the investment, number of investments in a portfolio, size of the private equity firm and the power related to equity ownership. However, during the current economic and market conditions, with an increased competition and increased complexity of global market place, private equity firms prefer a strong equity position in investee companies that allows the private equity directors a more engaged form of monitoring, directing and controlling.

2.3.2. Brief History of Corporate Governance in Indian Economy

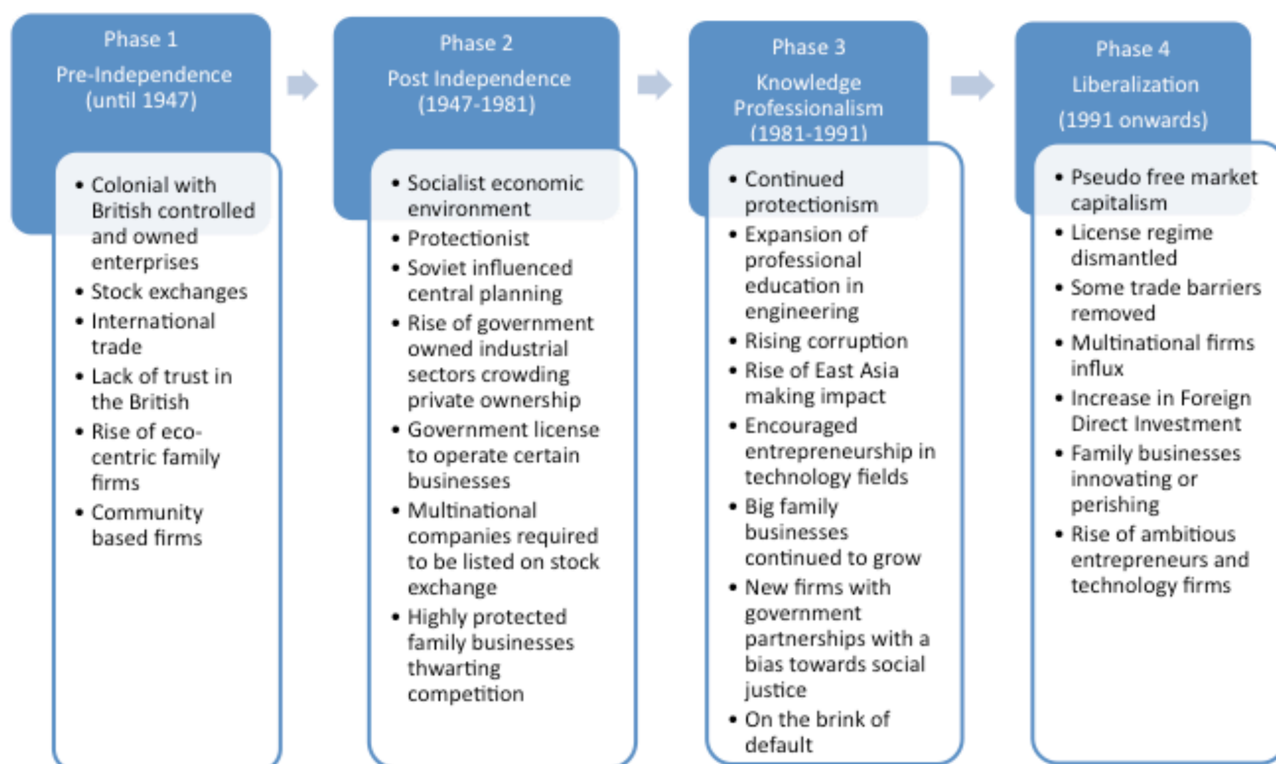

Exhibit 19. Different Phases of Indian Economy Transition (own illustration)

Corporate governance regulatory framework in India started to take some shape only in the late 1990s, but it still needs to be institutionalized in real sense.[226]

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[226] Gollakota and Gupta, 2006; Pick and Dayaram, 2006; Khanna and Palepu, 2005; 2004; Chakrabarti, 2005; Goswami, 2000.

Historically, India has been through four distinct politico-economic phases as depicted in Exhibit 19.

A distinctive feature of Indian economy is that the concentrated ownership by a few families as persisted throughout the historical phases.[227] However, the leading family groups have changed. Concentrated ownership in any economy exists because of institutional voids and specialized intermediaries in capital markets.[228] In India companies like TATA Group have consistently used their power to promote innovations and sustainable socio-economic environment. Such groups also acquired ability to consistently reinvent themselves with changing political landscape. Large family firms that were unable to cope with changes have either perished or demoted to inconsequential entities.[229]

The development of corporate governance framework in India is very recent. The framework for corporate governance was instituted in India in 1998.[230] Therefore, prior to Infosys' listing on NASDAQ in 1999, the executive directors may have had more control over the "informal Board function" to make it more of "Personal Entrepreneurship".[231] Then more recently, starting in 2006, as per the Securities and Exchange Board of India (SEBI), the public company boards cannot have more than 50% members as executive directors if chairman non-executive and not more than 30% if chairman is an executive.[232]

As Indian corporate governance measures are very recent, and in the wake of Satyam scandal,[233] the requirements for independent directors has created two interrelated problems for Indian companies. First, finding independent directors who not only meet the legal requirements but also behave as independent in the boardrooms.[234] Second, Satyam scandal triggered corporate governance reforms that are essential for Indian companies to continue to attract foreign direct investments and private equity funds investors. Exhibit 20 shows the net foreign institutional investment for each year over the past

[227] Ibid.
[228] Khanna and Palepu, 2005, p.488.
[229] Ibid.
[230] Chakrabarti, 2005, p.3.
[231] Infosys is one of the most celebrated Indian software services firm; Khanna and Palepu, 2004; Chakrabarti, 2005.
[232] http://www.sebi.gov.in/commreport/cl492007.html
[233] www.forbes.com. Reported on 1/7/2009. "Satyam Systems, a global IT company based in India, has just been added to a notorious list of companies involved in fraudulent financial activities, one that includes such names as Enron, WorldCom, Societe General, Parmalat, Ahold, Allied Irish, Bearings and Kidder Peabody. Satyam's CEO, Ramalingam Raju, took responsibility for broad accounting improprieties that overstated the company's revenues and profits and reported a cash holding of approximately $1.04 billion that simply did not exist."
[234] This aspect applies to most other economies with corporate governance frameworks including US.

decade.[235] Although many investors pulled out in 2008 as result of global economic downturn, the investments started growing again in 2009 and 2010.

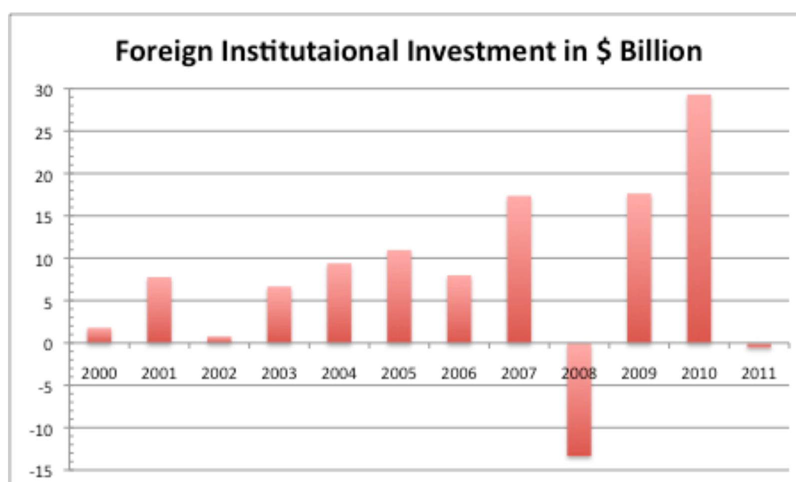

Exhibit 20. Foreign Institutional Investment in Indian Markets (www.indianinfoline.com)

2.4. Reflections and Conclusions on Applying Theoretical Aspects to Private Equity Investment Management in India

Within the context of private equity research question raised in this dissertation, agency theory, stewardship theory, resource-based theory, institutional theory, and team production approach do have strong underpinnings because the shareholding is concentrated between the private equity firm and the executive management while other stakeholders matter little in the short-term. In addition, the activities of both parties are contractually driven, including monitoring options and reporting requirements. The deal structure is created to align the interests of both parties. The director placed on the investee board uses governance functions to ensure that the actions of executives are value-adding and in the interest of the company and the investor. However, these theories are difficult to apply to the creative processes and entrepreneurial activity of the board at a micro level.

There is limited corporate governance and private equity investment management research applicable to Indian context. Therefore, from research perspective it is possible to create a broad qualitative framework that

[235] http://www.indiainfoline.com/MarketStatistics/FII-Activity. The website tracks daily balance of foreign institutional investment activity in equities and debt market.

incorporates traditional and emerging theories to explain private equity investment management activities.

Corporate governance frameworks, although strongly linked with national institutions and cultures,[236] serve one purpose – oversee the activities of a firm,[237] which in turn exists and is organized around sustainable business strategy that promotes growth.[238] Further, the strategy, irrespective of the firm view, is formed around an actionable growth idea or innovation,[239] which in turn is generated by certain individual(s).[240] However, entrepreneurship and innovative thinking as key to growth of companies and being central to both the management and board's role, the traditional governance theories address these factors at macro level and not necessarily at a micro level. Given the contemporary operations of private equity business, the traditional theories do apply to some aspects such as contractual relationships between LPs and GPs and those between GPs and portfolio companies. However, the qualitative framework that incorporates theories on creative action, conventions and actor network could better explain the investment management piece of the operations. Since the research question is about investment management process, the other aspects of private equity business are beyond the scope of this research. Exhibit 21 shows the summary of theoretical applications in private equity transactions with this research focus area being highlighted.

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[236] Buck and Shahrim, 2005, p.44.
[237] Branston, Cowling, and Sugden, 2006, p.205.
[238] Bower and Gilbert 2005, p.445.
[239] Ireland, Hitt and Sirmon, 2003, p.965.
[240] McMullen and Shepherd, 2006, p.149.

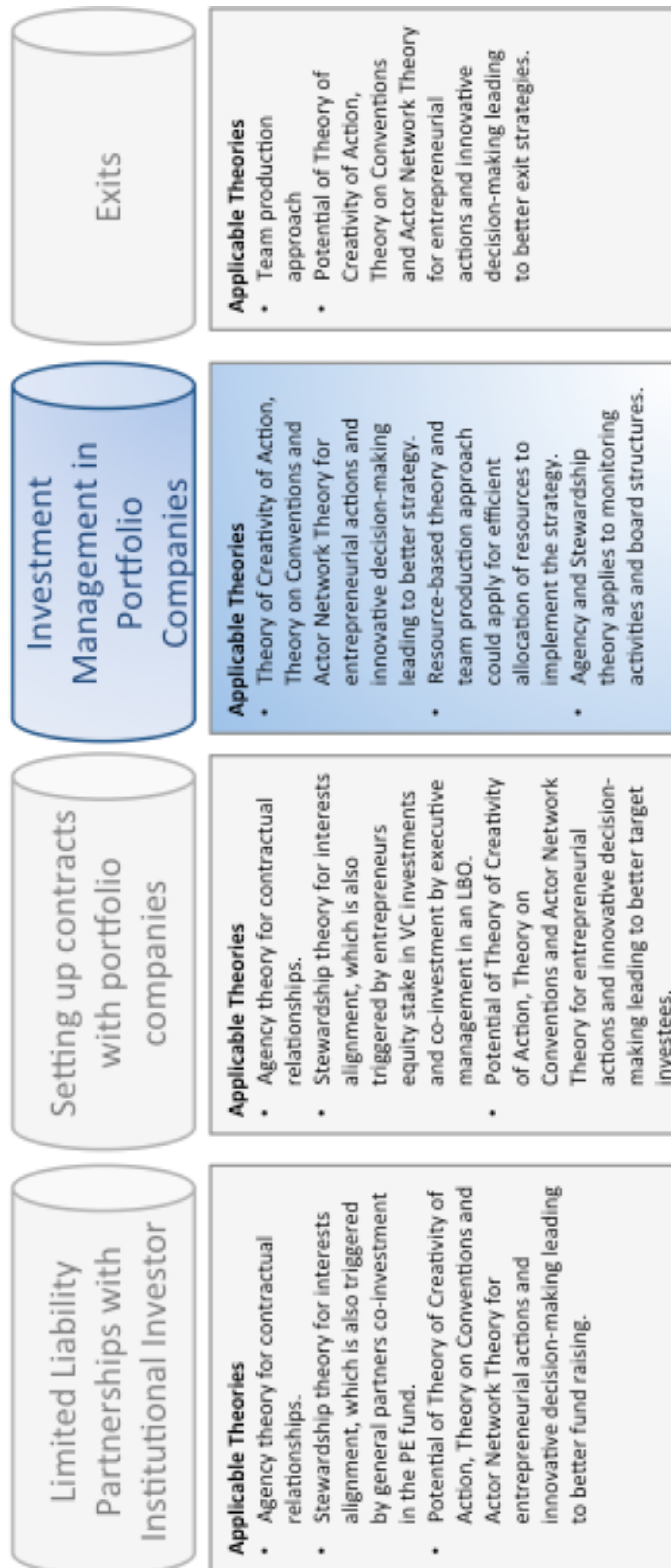

Exhibit 21. Applicability of various theories in PE investment transactions (own illustration).

3. Empirical Analysis

3.1. Objectives

The private equity principles are highly dependent on relationships with unstructured yet communicative network that includes consultants, brokers, advisors, investors, politicians, government officials, relevant institutions and other industry partners both internationally and domestically. Identity of the external financier has been shown to be associated with greater innovation.[241] Maintaining a reputation within this network is paramount for obtaining quality information and continuing to be successful in private equity investments as it is somewhat of a mediated market.[242] In addition, Gompers et al., (2006) argued that a large component of success in entrepreneurship and venture capital is attributed to skill. These aspects are difficult to conclusively capture solely based on quantitative research, especially in economies where the western economic thought based theories do not totally apply because of non-western values, traditions, social norms, and institutions.

The intent of this research is to explore qualitative approaches to understand the mechanisms of governance in investment management. In general there is a growing demand for better understanding of business organizations using qualitative and grounded approaches.[243] Siegel, D., Wright, M. and Filatotchev, I. (2011, p.193) reviewed trends in private equity and corporate governance research. They found that a substantial amount of recent quantitative research has helped build extensive databases, but without much theory exploration that would apply to private equity and institution effects. They noted that qualitative research is becoming increasingly important in gaining theoretical insights into process-related aspects of private equity and corporate governance, especially in international arena.

The central research question raised in this work is how does an Indian private equity firm add value to its portfolio companies. Reviewing the literature on general private equity operations allowed creating the hypothesis that private equity firms add value to portfolio firms during the investment management process via ‘engaged’ form of governance functions. The objective of the empirical analysis is to explore the validity of the hypothesis to address the research problem.

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[241] Balboa & Marti, 2007, p.476.

[242] Bruton, Filatotchev, Chahine, and Wright, 2010, p.495.

[243] Alasuutari, 2010, p.139 “The increased demand for quantitative research is especially due to the fact that advanced market economies have witnessed a climate of increased accountability in public expenditure and a requirement that research should serve policy ends”.

3.2. Target Research Group

The global recession and multiple bankruptcies, while questioning corporate boards, rejuvenated the role of private equity firms in corporate control of "once-public" companies. The private equity firms also are at the center of creating new growth opportunities in developed as well as emerging economies. With an increasing impact of private equity transactions on national economies, there is an increasing research interest in private equity firms and the lessons that can be learned from a board directed by private equity fund managers. In addition, private equity activity is on the rise in emerging economies, especially Eastern Europe, South East Asia, Middle East, and India. Many of these economies are still in the process of forming sound corporate governance practices, which are supposedly being influenced by private equity funds managing high growth firms and seeking exit strategies for investee companies, especially when the companies make initial public offers. It is fair to argue that the activities of private equity backed directors could inform the public company boards and their regulators, both in developed and emerging economies to create better governance practices. Although the traditional economic theories explain certain aspects of private equity transactions, they do not fully explain how the private equity fund managers as directors in their investee companies enable growth, especially in emerging economies.

Private equity industry and research in the US, UK and other developed economies have matured to quite an extent. However, the private equity transactions are relatively new phenomenon in emerging economies. There are limited practitioner reports and research on performance of private equity transactions in emerging economies. There is a lack of theoretical understanding on how the private equity fund managers enable the growth in economies where enforceable regulations are lacking and uncertainty is high. Finally, due to lack of sound corporate governance practices and unregulated private equity frameworks, the emerging economies offer a "large playground" for a researcher – both empirical and theoretical.

Indian economy, as one of the large emerging economy and as the largest democracy offers a rich empirical setting where private equity deals are growing and at the same time there is a movement towards creating corporate governance regulatory frameworks for public companies. This dissertation attempts to develop a qualitative approach and a knowledge-based view to understand private equity transactions in India. Therefore, the private equity

firms investing in India were targeted to resolve the research question and support the hypothesis.

3.3. Research Methods

Qualitative approach employed in this research relies heavily on research subjects' cooperation in answering the questionnaire surveys and extended phone interviews. Over a period from February 2009 to March 2013, the author communicated with private equity firm executives in India.[244] The author conducted general and in-depth interviews to assess the private equity industry and activities of investment managers/directors. Given the non-disclosure nature of private equity business, there were no direct observations or confidential document evaluations. Author's research agenda was not explicitly disclosed to the subject, except that author was interested in understanding private equity investment management aspects for academic purposes.

Following approaches were used to collect data for empirical analysis:

1) Background information on Indian private equity industry and corporate governance situation was collected from published practitioner reports, research articles and conversations with private equity fund managers or their investment directors in India.
2) Initial survey and extended phone interviews were conducted with select private equity directors and fund managers to develop support for hypothesis.
3) A private equity and venture capital database was purchased from Indian Venture Capital Association, New Delhi. The database provided contact information and private equity company/funds information. There were more than one thousand private equity companies listed in the database. After screening and omitting companies with no contact information, angel investors, advisory firms, and no Indian office, questionnaire surveys were sent to 136 private equity fund managers and the directors in India. 12 firms responded to the surveys. The survey is provided in the appendix section.
4) After a screening process on a few Indian private equity professionals who had right mix of talent and experience with relatively broad spectrum of investees, some of their investment management experiences were discussed to highlight the type of activities they are

[244] The list of targeted private equity firms is provided in the appendix section.

involved in as directors. Five private equity professionals were interviewed in this process.

3.3.1 Assumptions and Scope

- It is assumed that the distinction between governance and executive management functions in private equity investment context is not the same as public company context, where the governance is prescribed framework oriented and regulations driven.
- Governance in private equity context is highly situational – "one size does not fit the other".
- The scope of governance for the selected situational context is limited to the holding period duration. The duration does not include the activities, per se, associated with investee selection, deal-structuring agreements, exit preparation, actual exit and post exit. Although these activities will tend to have some bearing on the holding period activity, especially when someone on deal-making team is also the director as well as exit strategy manager – this is often the case in many private equity deals in India.
- For the purposes of this research the actual outcome of the exit value is immaterial and not within the scope of this research – exit value depends on the exit opportunities that exist depending on the economic and political environment at the time of exit.
- Due to confidentiality reasons, names of entities involved and exact deal structures will not be discussed. Values and structures of the deals have no bearing on the hypothesis and research question. Approximate values will be mentioned where necessary.

3.4. Limitations

Following limitations are inherent in the scope of research methods:

- Access to private equity directors and fund managers is highly limited in India. Due to the highly secretive and competitive nature of private equity industry, investment managers do not want to share the 'inner' mechanisms of their deals. Less than 10% firms responded to survey questionnaire. The richness of direct observation of the activities and processes is only compensated to some extent by extended interviews with some of the directors.
- Although the private equity business covers the whole business life-cycle spectrum of companies, there is very little LBO and MBO activity in India and none of the investors interviewed were involved in these

aspects. Also, the angel investors were omitted from the surveys because they tend to be individuals with their own wealth and not necessarily established as a PE/VC fund. Therefore, the research findings only apply to start-ups, early stage investments and expansions.
- There were no inputs sought form: entrepreneurs and executive management teams of portfolio companies; institutional investors who are part of limited liability partnerships; and advisors/consultants/other experts in private equity industry. Although all these parties are integral part of investment chain and would have had valuable insights to provide.
- There is little research literature devoted to Indian private equity industry, therefore some available articles, market reports and consulting firm reports were relied upon for background information.

3.5. Empirical Findings

3.5.1. Subject Private Equity Investment Management Synthesis

This part of the study used an initial survey questionnaire and extended phone interviews with three private equity directors/fund managers. The scope of phone discussions included their experiences, their understanding of private equity industry in India, and general background of their funds.

Characteristics of the subject investment managers -
- Education and Experience – Within the Indian context the subjects are highly qualified with 'elite' educational background including engineering from prestigious Indian Institute of Technology and MBA from either Indian Institutes of Management or from a US University. Each of them have about 20 years of extensive experience including: engineering/manufacturing; investment banking; mergers and acquisitions; structured finance; rating debt and equities; establishing new private equity funds; fund raising; targeting potential investees, deal structuring; and entrepreneurship; and directing multiple investees for private equity houses. All have worked with large private equity houses before and now are managing their own funds.
- Cultural Background – Lived and worked in India within multicultural environments as it relates to Indian context.[245]

[245] Given the fact that Indian populace consists of people who speak different languages and follow different cultural and religious traditions, it tends to bear on the local business culture. Over the past 15 years, the business environment has also become very international adding to the multicultural aspects.

- Personality traits – Ernest demeanor; fairly knowledge about global politico-economic landscapes; well read; soft-spoken; and passionate about Indian socio-political issues.

Characteristics of the subject private equity funds –

- Each fund value was less than $400 million with not more than 1.5% of GPs co-investment.
- Funds specialized in investments requiring growth to expansion capital and some spinoffs. All funds were sector agnostic.[246]
- Specialization based on past and current market requirements as well as expertise of the team – includes general partners plus few additional resource with the right mix of talent and skills. All subject funds had less than 10 members each including the GPs, senior executives, directors, and associates
- Management and advisory teams based in India (Mumbai and New Delhi) but fund(s) and LPAs established in Mauritius. Therefore, the LPAs are governed by Mauritius laws, which allow a choice to follow UK Common Law or US Law.
- Funds registered with Securities Exchange Board of India (SEBI) as Foreign Venture Capital Investment (FVCI) fund. This exposes the firms to Indian foreign direct investment provisions and Reserve Bank of India regulations on the type of permissible deal structures.
- Potential limited partners are sought directly by the general partners and also via placement agents in some cases.
- Limited partners primarily include foreign institutional investors seeking long-term investments.[247] Domestic capital is available but rarely sought because it may add some regulatory compliance issues.
- Limited partners are apparently attracted by team's reputation, team members' continuity commitments, credibility in the industry, and skills demonstrated by track record.
- Limited partners have little rights in directing the investments and investment management - Limited partners receive quarterly performance reports.[248]
- Investees are targeted using top down sector studies, intermediaries, limited partners network, references of past entrepreneurs, and industry conferences.

[246] "Indian Company Law imposes some constraints and guidelines on the rights of private equity in the but there is still enough operating space to invest across industry sectors" – subject investor
[247] "most investors represent pension funds" – subject investors
[248] "LPs are invited to serve on the investment committee that decides on target promoters but they choose not be involved" – subject investor

- Preliminary due diligence is primarily conducted by general partners and supplemented by financial and legal due diligence agencies; market research agencies; strategic consultants; references supplied by the investee; and technical consultants within the target industry sector.
- Final selection is based on sector analysis, products offerings, potential of growth, past performance, valuation, potential exit opportunities, terms of deal structure, and assessment of executive's interests alignment with the investor – Investment team provides unanimous consent. Exhibit 22 shows the location of various offices relevant to this work.

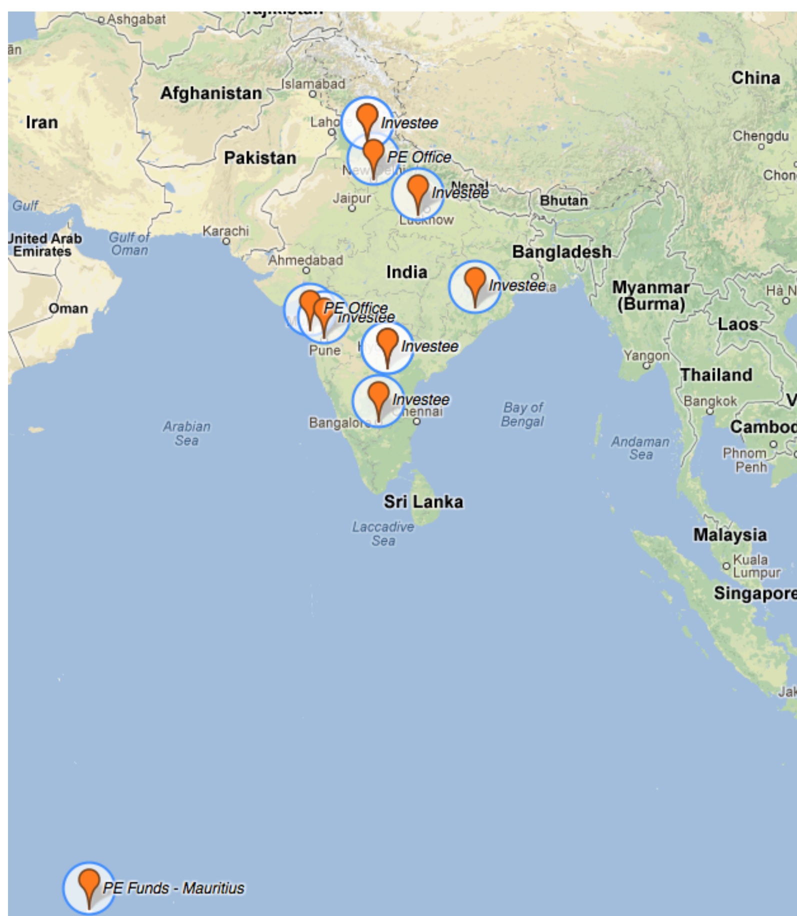

Exhibit 22. Locations of Subject Private Equity and Investee Offices in India (own illustration)

- Investors prefers simple deal structures with straight equity and avoid leveraged position – banks involvement increases the exposure to regulations, which can cause restraints and add time to exit. Investment in portfolio companies is generally less than 50 million dollars with equity stake ranging from 5% to 40%.

- The private equity fund(s) associated with the subject investors, as limited partnership agreements, are established in Mauritius as shown in Exhibit 23.

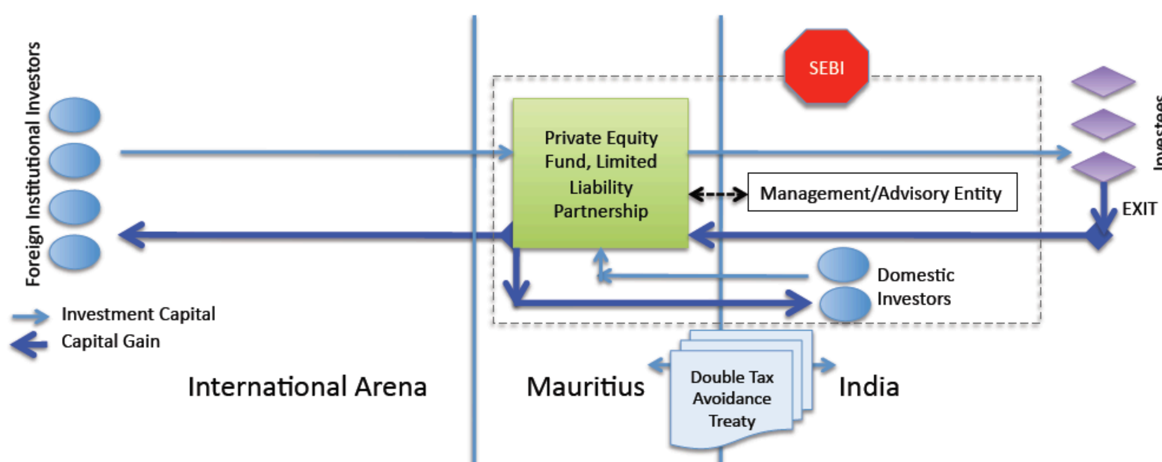

Exhibit 23. Setup of Subject Private Equity Funds (own illustration)

- Investments are monitored via a sophisticated and structured portfolio review process at the fund level[249] – the deal structures offer great flexibility to the private equity firms to appoint directors who could offer hands-on monitoring.
- Besides investment and deal structure agreements, the value is added by recruiting the right talent to monitor the investments, improving management information systems to identify and mitigate risks in a timely fashion, strengthening boards, providing strategic decision support system, and capital budgeting process.
- Investment managers/directors are invariably fully engaged with each investee performance and activities – in some cases that require unique industry skills, external directors are appointed along with private equity manager.
- Some of the risk exposures include: currency exchange rates as the limited partners invest in US Dollars but the investees receive Indian Rupees; commodity risk depending on the investee's industry sector; additional investment requirements; cost overruns; time to exit;

[249] Some details of deal agreements and internal processes were discussed with two investors only for author's understanding purposes but not revealed in this report as agreed with the investors.

intellectual property related frauds; and human resources retention risk.[250]

Based on the results of the initial informal survey and some discussions with select investors, a questionnaire was prepared that was sent to 136 PE/VC firms operating in India. Twelve firms provided inputs to the questionnaire. A summary of general information and target selection is shown in Exhibit 24 and Exhibit 25.

Survey Summary - General Information

Specialization in business life-cycle stage			
Seed Capital/Start-up	-	Mergers/Acquisitions	2
Early Stage Expansion	4	Initial Public Offerings	-
Capacity Expansion	6	Leveraged Buyouts	-
Strategic Expansion	5	Distress Financing	-
Spinoffs	1	Listed firms	-
Reason for Specialization			
Fund Manager(s)/Partners expertise	7	Regulations	2
Local market conditions	5	Competitive advantage	4
Background of fund manager(s)			
Investment Banking	4	Technical Operations	1
Private Equity/VC	8	Corporate Strategy	4
Structured Finance	4	Management Consulting	3
Accounting	1	Other	1
Past performance overview of the fund manager(s)			
1st Fund	7	4th Fund	-
2nd Fund	2	More than 5 Funds	1
3rd Fund	-		
Key factors that allow a PE firm or fund manager to raise funds			
Track record	8	Operations guru	2
Continuity of Investment Team	8	Finance guru	-
Personal Credibility	4	Other	-
Reporting to LPs on fund status			
Monthly	-	Semi-annually	-
Quarterly	8	Annually	2

Exhibit 24. Table showing the survey findings on general fund information

[250] "Talent retention became a huge problem in pre-2008 era on both the promoter side as well as private equity side…people leave for the lure of bigger and better companies or even form their own companies adding to the competition and infringing on intellectual property" – subject investor

Survey Summary - Investing Aspects

Item	Count	Item	Count
Selecting the investment targets			
Top down sector study	8	References	5
Intermediaries	8	Industry conferences	5
Nurture LP network	2	Specialized knowledge	7
Conducting due diligence analysis			
In-house	9	Market research agencies	5
Financial and legal diligence agencies	9	Consultants	7
Factors considered to finalize investments			
Sector analysis	10	Valuation	9
Industry attractiveness	7	Terms agreements	8
Management team	9	Alignment of interests	7
Track record	6	Potential exit mechanisms	8
Profitability	7	Equity percentage	6
Strategy	8	Other	-
Financing structure preference			
Straight equity			10
Leveraged Positions			1
Decision making on investments			
Unanimously by investment committee			7
LPs influence the decisions			1
GPs make the decisions			4

Exhibit 25. Table showing the survey findings on investing aspects

Many of the items listed in Exhibits 24 and 25 corroborate the general information obtained from the investors in phone conversations. Key points to highlight include the specialization aspects: early stage investors are distinct from later stage focus firms. The later stage investors will invest in capacity expansion and strategic expansion. Some of later stage investors also invest in spin-offs and merger activities. There was a void in investing in start-ups, IPOs, LBOs, distress financing and PIPEs. Although the survey was sent to firms that had LBOs listed as their activities in the IVCA database, but they chose not to respond. These firms tend to be bigger international private equity houses that have set up offices in India. This void also indicates that these firms are yet distinct in the way they operate. Primary reason for these distinctions is related to fund manager's experience over time.

Another point to note is that the majority of the respondents were working on their first fund, which could be the reason that explains their eagerness to participate in the research. As a trend, fund managers who have already built their reputation in the industry by working with large private equity houses form many of the new private equity firms. They also tend to bring key people from their old teams into the newly formed companies to show team continuity.

This probably allows them to raise funds from the institutional investors that they already know.[251]

An interesting point is that the firms are relatively weak in technical operations. It is interesting because it has been reported that the LPs have expressed concerns over operations competencies of the GPs.[252] This could be explained by the fact that the first funds generally have only a handful of people working on the teams and they tend to bring in outside consultants to help in operations. They also tend to hire industry specific operations talent on the portfolio companies. This is also evident from Exhibit 24 and discussions with the investors.[253] Most respondents indicated they use help of consultants in due diligence activities.

3.5.2. Findings on General Investment Management Protocol

Initially, for the first few weeks the investment manager oversees the transition of investee firm to the new deal structure, establish reporting mechanisms and address high priority pending issues from due diligence activities. Invariably during the transition period the investment manager is involved with the executive investee team almost on a day-to-day basis, if possible. This would depend on other investee deals that are being worked.[254] It also depends on the physical office location of the investee businesses and private equity offices.

During the initial weeks no attempt is made to restructure the board other than the addition of private equity investment manager as a new director.[255] By this time, typically, the existing board members and the investment manager already know each other because they have had worked together to negotiate the deal structures and investment schedules. Although the actual investment governance/monitoring/investment management process starts once the transition is complete, the interactions with the board and the entrepreneur could provide signals that a keen investment manager picks up to better understand the executive team dynamics. This generally happens inadvertently

[251] All three investors who were interviewed shared the same approach towards establishing their own funds.
[252] KPMG (2009, p.5)
[253] "it is difficult to nurture operations skill in-house as the first fund but in my previous job we could afford to have operations talent on our teams…the easy fix is that we maintain close relationships with key industry consultants who can help us out when needed" – subject investor.
[254] "As it is our fund we cannot afford to hire new talent so we have to manage everything between five of us, which means everyone is targeting deals, implementing the deals, and managing the deals...the GP has to continue courting the LPs to prepare for the next fund" – subject investor
[255] "only in a few cases the boards are somewhat sophisticated but in most family business the boards are very informal with little purpose…I would go to the extent to say that even me as a director is a misleading title if you are thinking of a director in a public firm" – subject investor

during the investee office visits and observing the relationships and interactions amongst the executive team members and the board members. At the minimum, active monitoring requires oversight and information processing to ensure the executive management does not unjustifiably deviate from the broad agreements with the private equity investor. Invariably, within the first 2-3 months many issues arise that were overlooked during the deal structuring process. These could surface in monthly management reports or noticed by the director. In any case, the director is responsible to resolve the issues and direct the changes to budget or strategy.[256]

3.5.3. Findings on Investment Management Aspects

Each of the five subject investment managers had served as a director to multiple investee businesses in the past 10 years including their current funds and past tenure at other private equity houses. The directors were asked to describe their experiences that were uniquely challenging offering them rich learning experiences. The idea of learning from challenging situations is aligned with the scope of this qualitative work as it provides the situational contexts that allow for creativity.

Investor Role in Different Business Cycles: The subject investors primarily focus on entrepreneurs/promoters seeking financing for capacity expansion and strategic growth expansion.[257] Both areas significantly differ in characteristics. First, in capacity expansion the entrepreneur generally knows what needs to be done and is only looking for financing to expand a proven business and business model.[258] This normally requires low level of engagement from investment management team. The strategic expansion can be more complex. It could be about changing the business model and entering new markets. In addition to financing, this requires more strategy building, industry expertise, and resources.[259] The investment team and directors are more closely engaged in strategic expansions.[260]

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[256] "you can call me a director, but as a general partner and fund manager I have a team that is working with me at the back-end to conduct analysis and most of our work is done outside of board periphery" – subject investor

[257] These business cycles are depicted in Exhibit 14, Section 2.1.9.

[258] "going in we assume that the promoter knows what is the best course of action since he is the expert at what he has done successfully and all we would need to do is monitor and find the right opportunity to exit...but, this happens very infrequently" – subject investor

[259] "strategic expansion could be very tricky because the promoter could have great ideas but to make them work we need to bring in a lot of outside consulting help and even hire key people as company executives…it requires much more analysis and a lot of trust building to ensure that everyone is on the same page" – subject investor;

[260] "…and I know that the industry pundits put a lot of emphasis on our role as oversight and monitoring.. but no promoter wants that…so it is very important to take a partnership or collaborative

According to one investor, “in some situations we do not know who is running the business but we have to be very delicate in how we help the promoter so that all decisions are his to make”. These reflect upon important distinctions in different business life-cycle stages.

For early stage investing it is still different role that the VC has to play. In response to a survey question, one GP respondent wrote “The entire power and energy of a startup comes from the promoter and there is no perk greater than independence and autonomy for a true entrepreneur. Large funds like ours don’t appoint directors in portfolio companies because it is costly and they usually add little value - in addition they ruin the morale and passion of the promoter.” Another respondent shared a similar sentiment. This is in contrast to the idea of ‘engaged’ governance. However, in the same type of VC investments, another successful large fund appoints a board position in all portfolio companies and provides mentoring and guidance to ease the way for the entrepreneur.[261]

Although no one with LBO was interviewed or responded to the questionnaire, it can be argued that the level of engagement in LBOs is yet very different from other stages of business cycle. These differences are captured in Exhibit 14 (Section 2.1.9.), which shows that in early stage to expansion stage, the role to investment management team is more of advising and monitoring and for LBOs it is more towards directing and controlling.

It is important to point out that monitoring and advising do not mean low level of engagement. Most investors see monitoring as always staying updated on the company activities and always being prepared to help the entrepreneur when needed. This requires significant engagement with the company generated information and continuous monitoring of relevant risks. Ideally, it is the function of monitoring that creates the opportunities for advising. Advising can take many forms too – one investor mentioned, “no matter how drastic a change is needed, we want to make sure that it takes the form of adviser rather than dictating the terms to the promoter”. It can be argued that

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approach to the meetings…in other words, I am not meeting them so they can answer my questions on capital budgets or strategies…I am meeting them to hopefully add value to their lives by discussing ideas about efficiencies and growth” – subject investor

[261] These VCs were not interviewed but responded to an email question: “Would you agree with the following statement: Value in a portfolio company is created because our directors go above and beyond the board duties and monitoring to help the entrepreneur and his executive team.”

monitoring and advising are the only relevant methods to govern in these cases because the percent equity stakes for the subject investors tend to be low. Another investor mentioned - "at the end of the day, if the entrepreneur does not want to work with the investor there is very little that you can do about it, so invariably, in many long established family businesses there is an uphill battle". This is also a learned attribute – apparently, when the private equity industry was new in India many investors were trying to prove themselves and they would take more of a directing and controlling approach, which was also accepted by the entrepreneurs because the investments were accepted with much gratitude and reverence for the PE investors.[262] In LBOs, directing and controlling make logical sense because the PE firms generally have a large stake both in value and percentages. It also needs to be kept in mind that directing and controlling function resides with the board, which consists of other directors and executive team. The PE investor can only influence the directing and controlling function of the board, if there is any.

The remaining part of this section will focus on monitoring and advisory activities of the subject investors.

Director Activities: Some of the investors' responses are presented in this section to highlight their perspectives on monitoring and advising.

General Monitoring Responses –

"At the minimum what we try to do is set up a management information system at the entrepreneurs offices and train them how to use it for reporting purposes. This occurs during the transition period and is always agreed upon during the deal making process and so far I have not run into any situation where the promoter is unwilling to cooperate. In order to ensure continued cooperation I share the analysis with the promoter on a regular basis"

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[262] "..another important aspect I would like to add here…that over the past years I have seen many changes in the attitudes of the entrepreneurs ..I would say that ten years back predominant attitude was more of humility and willingness to work with the investor because we provided the much needed financing that no one else would provide. But during 2006-2007 timeframe and in the current environment, many promoters want very little oversight from the director…and if the director or private equity fund managers push for more information, then often times it backfires when the promoters state the obvious …that it was you who took the risk…the main reasons for this change is availability of many private equity options in the market and the promoters also have become smarter about the private equity phenomenon, which is still quite new in the Indian market….so we as private equity suppliers have learned to cope with this change…by taking extra time to understand the promoters better before signing any agreements....and also by controlling the flow of investment on as needed basis" – subject investor

"At any given time I have a few businesses to work with and invariably they are always outside of my home office and I have to regularly go to Mauritius too, so depending on the business relationships, phase of the investment and our equity stake the meetings vary - some need more time than others but at the minimum I do visit their offices twice a month - one visit to their city could include meeting the promoter two to three days consecutively if the need be, but these days video conferencing helps a lot and a lot of things get accomplished over phone and emails"

"Many times I would email them interesting, articles or news items about their technologies or businesses, which probably gives them a sense that I am looking out for their interests - at the end of the day, it is natural for entrepreneurs to respect actions more than talk."

One investor was asked if he sees himself as an entrepreneur: "No, I have never started a business and yes, there are many entrepreneurs who moved to private equity industry - I only see myself as an enabler of entrepreneurship or push the entrepreneurs to be as creative as possible"

According to one investor's experience - "given that our team is stretched thin over all the portfolio companies, we have to prioritize on the level of engagement that is needed for each company, so investing in some lower risk capacity expansion deals and some relatively higher risk strategic expansion deals offers a better balance of portfolio. For example, on one hand our investments in a bank expansion and another in a personal loan business expansion required relatively little effort on our part and we made three times the returns on exit. On the other hand, significant larger investment in a strategic expansion of extraction contracting business required a very high level of engagement over the past six years with a lot of hurdles and now there is an expectation that the investment will see some returns that were not expected for a long time."[263]

Investment Specific Responses –

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[263] Investor is not associated in this business any longer but has followed the activities because he was closely engaged with the business for a long time as a director. At the time of private equity investment in about six year back, the portfolio company was a contractor extraction services to both government and private enterprises. Two friends founded the company about 15 years ago and as the company grew it became a larger two-family-run business with operations in northern and eastern India. It became one of the leading extraction and treatment operators in India due to its environmentally sustainable, less invasive, techniques relative to conventional processes. The revenue and profits of the company were solid from Indian standards but required investment for domestic and International expansion as the Indian industry was liberalized.

“The banking and financing businesses were fairly sophisticated and the PE financing was used to modernize the business as well increase the customer base. The monitoring activities worked well coupled with regular monthly meetings. The extraction services business was very interesting and challenging. In 2006-2007 timeframe price and distribution was fully deregulated and some mining blocks were opened for private ownership and operations. This provided the impetus for the company to seek investment for growth and strategic expansion.”

“We were able to capture this unique business that had an awesome platform to exploit the newly created opportunities within the domestic market”

“The private equity funding was for expansion in domestic market, the company explored joint ventures in South East Asia and Africa. All of these expansion possibilities ran into unforeseen situations. In domestic market extraction rights were acquired but the company has not yet received environmental clearance. The joint foreign ventures failed because the Asian partners withdrew due to recession and African market has been very slow to develop demand.”

“With all these failures early on, the biggest challenge was to make the board and executive management team to accept me as an entrusted team member. Both partners were well meaning and obviously very knowledgeable about their operations - in such niche businesses it is understandable that the entrepreneurs want more of your time before the deal and want less after the investment. It is very easy for them to think that the investor cannot add any value other than the investment”

“For the most part, the monthly board meetings were run more on formality basis with little impact on the company. So most of my meaningful meetings were outside of the boardroom. I would travel to Delhi almost every week to meet the two partners and try to squeeze in suggestions that could be value adding. For example, the site supervisors at remote locations develop specific cost plans and schedules but they do not have access to peripheral information. Plus, they are not connected to the other remote supervisors. I suggested an ERP system to allow real-time information exchange so that the operations can be better understood and controlled from cost perspective. That went well and we were able to start exploring how to best implement the ERP system. That also ran into snags for a while but once the ERP system was finally implemented the company was able to standardize operating processes in all

locations and was able to utilize the resources and equipment more efficiently to truly become an integrated company"

"But the point is that at the beginning, as an investment manager and director, you want to do a lot of things at once but it will never work if you come in strong. It is all about building trusting relationships so that a sense of partnership develops so that opportunities for growth and efficiencies do not pass by"

"In another instance, while I was visiting one of the sites, I stopped by the village where the company was funding a charity school. I talked to the teachers, principal and hung around with the children for a while. Then after I went back to Delhi in my next visit for a board meeting I mentioned my trip and briefly described by school visit - it turns out that the honorary chairman of the board was the one who started the school. He really appreciated my gesture of going out of my way to visit the school. The chairman is a very well respected senior family member.[264]"

"I was further able to influence the decision making process so that the executive team things more in terms of return on capital rather than profit margins on existing contracts and for the new contract bids - later we were also able to hire a new CFO with the right skills"

"So for the most part, with all the setbacks in international and domestic expansion, which can still work out, the efficiencies and growth realized in the existing contracting business kept the business profitable."

The experiences described by this investor provide an insight into the extent of engagement the director went through to add value to the business. Some of the activities described above go beyond monitoring and advising. The same investor had the following to say when asked to distinguish him from the entrepreneurs:

"Of course there is a distinction even though both of us are 'owners' of the equity - the entrepreneur is the one who has to live with the business for a long time, while I am only in it for relatively short period, so all the decisions and methods of executing the strategies are his to make. I see my role as enabling us to be "on the same page" and enabling role can work both ways. Many times my ideas are challenged and I have to go with the better ideas that the

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[264] Within Indian cultural setting, the respect for the wishes of family elders is a norm, especially in traditional business families.

entrepreneur brings up, and once in a while my ideas are the better ones. Besides that, my role is to validate the new business strategies on an ongoing basis and look at bigger picture to spot any new risks and work with the team to mitigate them as much as possible”

When asked about alignment of interests and relationship building, the investor said the following: “Well, the current situation is that the promoter made an acquisition a while back and now trying to make an initial public offering only for that part of the business and transferred the private equity stake to this new business so that there is an exit for the investors - the point is that the promoter offering an exit solution is rare, which says a lot about the relationship developed with the private equity firm. Of course the promoter is in a business that will require additional investments in future so it is very important for him to develop his reputation too”

In another investment experience, in 2007 one of the subject investor financed capacity expansion of automotive parts manufacturing business. The investor had close to 40% stake in the business. The CEO and investor had great relationship of trust and all the investment had been made to establish a new manufacturing unit. All was going well but in a tragic turn of events the CEO of the company passed away. The son of the CEO took over the business, as it is very normal in a family business. According to the investor: “this put us in a crises mode because the son had zero background in manufacturing - he was young and had very little work experience and there was no one else in the company who was qualified to run the company. We had a lot of money at stake in this promising business” “…this is quite common in family businesses in India, without the business founder things fall apart. While the executives were good in what they did but they are yes-men and not strategic thinkers - frequently there is a lack of succession planning - anyway, we spent many days a month trying to test the son but he did not have the right skills and drive to take charge of the business, furthermore, we were not in a position to run it ourselves because that’s not what we do”

“Through our network we were able to find a very qualified senior executive who was willing to join the company and run it but it was a costly proposition as we were already short on cash - we had no choice because the new plant was just sitting there and gathering dust, however, we could not appoint him because it was not our decision to make and the son was not willing to make that choice ”

“When I proposed this idea to the new CEO (the son) he became very insecure thinking that we are trying to take over the business. I personally met the son and his family at his house a few times trying to counsel and convince them that we want to preserve the business for the family and grow it the way their late father had hoped - every time I would meet the son I would try to explain the importance of hiring a new manager and I tried all sorts of coaxing, cajoling, contractual pressure, impact on his family’s welfare - I even brought in seasoned HR consultants to mediate so that the family understands that we have their interest on our minds - unfortunately, nothing worked.”

“The existing operations also started to suffer because the new CEO (the son) was not equipped to provide any direction and with time the son started to feel the financial pain too as the suppliers started calling in for payments. There were three plants including the new plant - we found another company that was willing to buy a stake in one of the plants with profit sharing partnership and were willing to pay reasonable amount of money to make the deal. The son bought into this idea because he was getting all the proceeds from the deal, which eased him and the family financially. This made the son more willing to trust us giving him advice. So finally we were able to bring in the new manager and it took a little more time to start the operations again”

“All of this took almost two years to get back on the right trajectory after a huge time and cost overrun for a manufacturing business, but it all ended up well - the son matured over time and the new business manager is still there working hand in hand with the CEO (the son) - we were able to make a trade sale to exit and made two times the returns on investment value. We learned a lesson and now we do include in our deal clauses that we reserve the right to appoint new executives to the company if the need arises”

This experience also shows how much the fund manager is willing to be involved with the portfolio company if the situation calls for it – reiterating the point that the idea of monitoring and advising takes on a very different meaning in private equity environment.

One of the subject investor’s portfolios included an investment with a broking and financial products distribution firm. A couple of accounting professionals started the firm more than 30 years ago. It started as an accounting advisory service, which later grew dramatically to become a stock broking, private wealth management and a well diversified financial services firm. At the time of private equity investment in late 2007, the company had more than 500 client service offices in India and a few offices overseas. The executive

management team was highly skilled, 'new economy' professionals, and sophisticated in business sense. They had implemented sophisticated operations and systems that enabled the company growth. All economic indicators were very promising for growth of Indian economy as well as financial sector and capital markets.

"This was a growing and profitable business valued at approximately $500 million and had another private equity investor. The investor wanted an exit, which created the need for a new private equity partner - we believed that we picked a perfect investment that had tremendous growth opportunity, so with about $125 million we bought out the stake of existing private equity firm plus some additional stake."

"It was very promising and in exciting industry sector. The company had highly knowledgeable, experienced and motivated executive team I had grown to like during the deal structuring process. It already had great operations setup by the previous private equity firm - but them there is a reason why private equity is the most risky asset class! Irrespective of in-depth due diligence and sophisticated risk analysis and growth projections, most of the times things never go the way you want them to go – That is also the exciting part of my role as a director on company boards."

"The financial services business ran into the 2008 credit markets downfall right after we made the investment. On top of that, the liquidity received from the investment was parked in mutual funds just before the crash - this changed my role drastically from overseeing a promising growth that would pay for itself to finding ways to stop the bleeding. The good part was that the situation allowed the executive management to be more open to my inputs, although sometimes it takes a while for the executive management team to accept the new director as a working team member."

"With market going down the business volume went down and broking was seriously impacted. Around that time, the regulations governing mutual funds abolished entry fees - the fees structures were also changed on broking activities and now the company was in a situation where both the value of individual trade and volume of trade went down. The obvious resolution from my perspective was to shut down many of the offices countrywide, but that is not an easy decision for the entrepreneurs. It is a sensitive area and I had to do a lot of groundwork with my own team in Mumbai to obtain the relevant information to prioritize various offices as cost centers before proposing the solutions to the board - it took a few weeks before the board warmed up to the

idea of closing office and finally I worked with the executive team to fast-track the shutdown."

"The board. with two independent directors that the previous private equity company had placed, three executive management team members and myself, was fairly sophisticated in terms of regular monthly meetings, discussion of issues and recording of minutes with a follow up action items. There was also video conferencing facility in case a board member's inability to make it to the meeting. The board meetings were good to have but most of my meaningful work and interaction with executive management as well as independent directors occurred outside the board agenda - the purpose of the board was to basically recap the information exchanges and strategy discussion I would have had outside the board-room"

"At that time we were not even sure for how long and to what depth the US mortgage problem would impact Indian financial sector. Nevertheless, in a very short time the company shut down about 200 offices and prepared to shut down additional offices if the situation did not become stable. As a result of this effort the business continued and in 2010 we started to see an economic upturn - with further business diversity in derivate products, the company started lending operations against collateral. At present there is a new CEO that I identified and we are hoping to achieve substantial growth and successful exit"

This experience reflects the crises created by the market conditions that are not in anyone's control, yet the director and his investment team increased the level of engagement to help the company stay on track.

One of the subject investor focused on food and agricultural sector and had minority stakes in portfolio companies with an average investment value of $5 million – "we do more hand-holding and guidance than what we would want to do given our resources, but most of our investments are with relatively small family firms where the entrepreneurs know their business operations very well. However, they solicit a lot of help from us because they are small require macro expertise - these are generally low-tech companies and we do what we can do to help them understand the business landscape. An entrepreneur by nature is a source of new ideas and we have to make sure that new ideas align with the strategy and not become a distraction. Some of the relationship management tools we have are guidance, pacifying, sharing analysis, enforcing contracts if the need be, threatening early exits, mediation, etc. - for example, in one of the investments marketing team was not behaving properly due to

changes in the top management that was brought in by the previous VC so we had to intervene - it took us six months to resolve the issues and streamline the transition. Most of our portfolio companies in the food business extensively depend on marketing teams so conflicts between management and marketing teams can lead to poor performances - in such cases we serve as mediators and try to resolve internal company conflicts."

"Most of the times we are very well aligned with the management teams in all our investments. We engage with the promoters at least once a week and internal conflicts do not happen very often but two conflicts in one year can pose issues for us because we are a very small team and working on our first fund with small budgets. Other examples include the brothers as owners not getting along or father and son not getting along leading to talks about splitting the business shares - that is the nature of a family business in India and we try to mediate as much as possible and bring outside help if the need be"

One of the investor said "I do not see myself as a director or anything that is within the scope of traditional corporate governance because I will try to do whatever it takes to make a portfolio company successful - I could be better off without even having a place on the board as a director because there are many implications if legally I am a director - at any rate, the idea of boards in Indian family firms does not mean much".

From perspectives shared so far, although some are contrary to others and some complement each other, we can start to define governance in private equity investment management as an unbounded function of the investor, via the director, to be prepared to empower the entrepreneurs and company executives to strategically grow the business. The term "unbounded" is used because once the investment is made the only thing the investor does not do is make and implement the decisions for the business owners – everything else is within the scope of the directors and investment teams activities. The term "function" implies that the activities of the private equity directors and investment teams may work with or without a board a formal board. The term "prepared" implies that the private equity directors and investment teams are willing to go much beyond their monitoring role to influence the executives when the situation calls for it. This definition complements the idea of entrepreneurship referred by Klein et al. (2013, p.7) – judgmental decision-making under uncertain condition. In other words, the private equity governance function empowers the entrepreneurs to do what they do best.

As a speculative question, the investors were asked if the results of such investments would have been different with a different director and different private equity firm. The responses were fairly consistent that the successes would be different and probably they would do things differently if they face similar situations again.

One investor mentioned, "after having been involved with many entrepreneurs over the past 10-12 years, I have come to realize two things - first, entrepreneur's creativity trumps the market conditions, and second, the only tool I have as a director is my earnest desire to build a relationship of respect and confidence with the entrepreneurs and their teams. So yes, the results would surely be different because the relationships by nature are personality driven - for some people it is very easy to create relationships, maybe on the golf courses or sharing interest in cricket or something else, and that is perfectly fine because there are as many ways to develop relationships as number of people. But, I believe I work extra hard to get into the mind of the entrepreneur and others on the board or management teams"

"As I mentioned earlier, the relationships with the entrepreneur are very delicate, especially in the beginning, I do not want to overwhelm the entrepreneur with excessive meetings and reporting. Nevertheless, I need the information to learn about the operations and explore opportunities for growth - so my first sense of active approach is to establish a relationship, which allows the entrepreneur to introduce me to his operations and other executives and employees. It does not happen overnight and cannot be wished. If their offices are located in Mumbai, maybe I can see them more frequently but if the relationship is not there, then I will not get the relevant information"

Another investor's comments: "a different person and team would most probably be creative in different ways and enable different solutions…maybe even better solutions...bottom-line is that no VC director or fund manager can sustain in this industry if they do not enable growth…as significant equity holders, we do have the right to exercise power play but that is the last resort….it is of benefit to no one....and if we are willing to put an effort in building meaningful relationships, then we never have to exercise that power…and I never have"

One investor's comments about exit: "during the exit process most of times the entrepreneurs have little choice but to depend on us because they know that we have superior ability to find exit opportunities - but we totally enable the

entrepreneurs to actively participate in the exit process because most of the times it is an exit for us and not necessarily for them."

One investor's comments about skills: "there are many different aspects of this business if we consider the full life cycle of a fund and with all the competition, one can be successful in many different ways. Private equity industry is also a very small world - everyone knows everybody else so reputation counts a lot and relationships matter the most. The hard skills like understanding finance, business, various industries, etc., are definitely a must have skills but that is not enough, especially in a country like India. The soft skills such as understanding people allows us to develop partnerships and also decide on who to invest with…but it is difficult to get it right all the time…most people who have been in this business for a while realize that humility, patience and earnestness count more than other aspects."

Another investor's comments on general requirements: "There are so many different variables in the deal - right industry, right promoter, right management team, right timing, etc. Even if we have a high percent of equity stake we still need to depend on management team and need to influence the decision makers, which finally boils down to rapport with the managers and understanding their egos, operations and needs. We can never understand the context of operations as well as the entrepreneurs and have to depend on them and have to build trusting relationships. Most foreign PE firms hire local managers and maintain US investment committees - it's a different challenge because it creates two levels of trust where decision making could be suboptimal on frequent basis."

"Internal evolution of private equity firm is important including talent building and reputation creation - creating right kind culture, establishing meritocratic and collaborative environment because everyone is dependent on the same pool of capital. That allows us to find good micro opportunities even if economy is bad. For instance, many deals from 2007 still have not exited because of high valuations at the time of entry."

Another comment about requirements "I think I can firmly admit that the day I start to make money-making or wealth creation for myself as a priority, I will loose my edge in this business - the excitement of overcoming new challenges with different businesses, new ideas, and different people is what keeps me going. Having said that, I would like to add that this notion of overcoming challenges is what I bring to the table that adds potential value to the investment - of course actual value that is realized, and is very much dependent

on the exit options that come our way. I believe that in India the exciting times in private equity are here to stay for a quite a long time and I am loving every bit of it"

The investment management activities appear to be highly subject to the market conditions as well as the relationship between the director and investee executives. The issue of alignment of interest appears to be a moving target, which is good in the initial stages and then can become complicated depending on the willingness of entrepreneur/promoter to work with the private equity firm's director and prevailing market conditions. The directors appear to be constantly redefining the alignment of interests in the face of market conditions or other issues. However, the most surprising element is that once the investment is made, the private equity fund general partner, as the principle, has little choice in exercising power or control with or without a director.[265] Another aspect worth noting is that the private equity investment management practices are still evolving in India as evident from the investors' experiences over the past 10 years.

The idea of corporate board, board structure, board purpose, and its effectiveness is loosely defined in private equity portfolio companies. In professional services companies like financial sector the boards tend to be more sophisticated. The sophistication is also influenced by series of private equity investments that tends to strengthen the boards with each investment. The other end of the spectrum is family businesses where the boards tend to be functionally irrelevant.[266]

Although not entrepreneurs in traditional sense, the subject investors appear to be constantly looking for potential opportunities to grow the investee business. They do make a distinction in their efforts and roles as directors compared to executive manager's role as the final decision maker as well as the executor. In literature there are references to hands-on monitoring or day-to-day monitoring but the situations described by the subject investors are different from

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[265] This corroborates the issue reported by Bain & Company, 2010. The report specifically mentions a growing trend of entrepreneur's reluctance to allow private equity investors to exert direct management oversight: *"Promoters and CEOs are generally not comfortable selling large equity stakes to outside investors….PE funds are often seen as a source of capital and not as an added source of expertise and best business practices. With low stakes, many promoters expect PE firms to be passive investors rather than activist owners that can provide business guidance."*

[266] Bain & Company, 2010. *"Many privately held Indian companies lack the transparent reporting and appropriate board oversight PE and VC general managers insist upon in the companies in which they invest. While having nothing to do with PE investments, the fraud and manipulation of accounts at Satyam Computer Services shook investor confidence and increased calls by shareholders for independent, tougher governance standards. Most observers expect that pressure for additional measures to strengthen corporate oversight will continue."*

monitoring. The subject investors seem to consider monitoring as the establishment of management information system that allows for regular analysis and reporting. So at best, the role of director appears to start as monitoring and then finding ways to build trusting and cooperating relationships that allow influencing business strategies and also learning more about practical issues related to specific business.

Exhibit 26 provides a summary of the survey questionnaire results that corroborate many perspectives of the interviewed investors. The survey results show that even if a director is working with the portfolio company executives, there is a team at the back end helping the director in analysis, risk monitoring and making decisions on how to best approach the company executives in keeping the interests aligned. This clarifies the meaning of monitoring. Most respondents strongly agreed that director's level of engagement is critical in adding value to the portfolio company. The high level of engagement in the survey question was defined as a director who actively monitors the firm activities, visits/interacts frequently with the executive management team besides the board, attends all board meetings and is prepared to mitigate problems. A low number of respondents also agreed that the value creation is also a function of market conditions and exit valuations. Significant number of respondents also indicated that the soft skills such as patience, determination and multicultural understanding are important for a director.

In the interviews the investors mentioned that their level of engagement is not really dependent on the equity stake or director incentives but most of the survey respondents claimed that GPs equity stake factors in the level of engagement. Almost half of them claimed that director incentives do matter. These issues could use more exploring because the nature of incentives was not clarified. It is possible that because most of the investors who chose to respond were working on their first funds and had small teams to manage the portfolio companies, may have led to an internal prioritization of engagements based on value of investment and percent of equity stake. However, majority of respondents mentioned that level of influence on the portfolio companies does not depend on GPs equity stake. This strengthens the findings that level of influence is more related to level of engagement and less on PE's stake in equity.

The last survey question about the failure of investment or low returns, was mostly attributed to tough market conditions and misjudging the business and executives. This is an understandable point because it probably indicates the

elements that categorize private equity as one of the most risky asset class. On the positive side, when these three elements are favorable, the returns are high.

Survey Summary - Investment Management

Approach used to manage the investment during the holding period			
Each investment is treated on a case-by-case basis			5
Structured portfolio review process where all partners voice opinions			9
Flexibility for the deal team in managing the deal			7
Factors that influence value creation in a portfolio company			
Talent recruitment on GP team	6	Strategic decision support	9
Improving MIS/ERP	8	Capital budgeting	7
Cost accounting	4	Monitoring	8
Strengthening Board	8	Entrepreneur Relationship	7
Risks monitored			
Industry sector	8	Intellectual property	7
Currency risk	2	Fraud	3
Commodity risk	-	Human Resources related risks	5
Financing risk	6	Political	-
Risk of time and cost overrun	8		
Typical make-up of Investment Management Team			
Partners	9	Management Analysts	7
Finacial Analysts	6	Industry Specific Analysts	2
Director on the board different from the lead deal-making GP or fund manager			
Yes	2	No	8
Director's level of engagement in the investee company			
Highly engaged	8	Low level of engagement	-
Engaged on need basis	2	As agreed upon in the terms	1
Level of director's engagement impacts the value creation			
Strongly agree			8
Depends on market conditions			2
Depends on exit options			2
Fund portfolio is more important			-
Important skills for a director to be engaged and create value			
Investment Banking	2	Corporate Strategy	7
Private Equity/VC	5	Management Consulting	4
Structured Finance	3	Multicultural understanding	7
Accounting/Legal	2	Patience and determination	8
Technical Operations	3	Other	1
Typically number of investments that one director oversees			
One to three	2	Five to ten	2
Less than five	5	Fund manager is on all boards	1
Level of engagement dependent on GP's percentage of equity			
Yes	2	No	8
Level of influence dependent on GP's percentage of equity			
Yes	4	No	6
Level of engagement dependent on incentives for the director			
Yes	5	No	5
Main reasons for failed investments			
Lack of cooperation from the entrepreneur's executive team	5	Tough market conditions	8
Lack of sufficient oversight provided by the director	1	Misjudging entrepreneurs abilities	9
Lack of sufficient oversight of GP over the directors and portfolios	2	Misjudging product/services growth potential	8
Faulty due diligence, information and analysis provided by the consultants	2		

Exhibit 26. Table showing the survey findings on investment management

3.5.4. Applying Qualitative Framework Aspects to Empirical Findings

It is widely believed and demonstrated that the private equity firms are able to exercise control over the investee firms via concentrating equity in fewer hands. This is generally true in buyout of public companies by PE firms. This could also be the case in non-listed management buyout deals in large family firms where private equity takes the majority stake. High equity stake and/or concentrated ownership allow the private equity investment managers authority to restructure the boards, management teams, and operations. At the other extreme, in early stage venture investments, the ownership is actually diluted because prior to investment the 100 percent equity is held by the entrepreneur(s). In these situations, the investment amount is generally low and the entrepreneurs not only need the capital, they also need availability of operational expertise.[267] This is because the investee company, as an entrepreneurial entity, is more akin to an idea that is yet to become fully operational. In such cases, even with minority stakes, the private equity directors on investee boards are often allowed to play strategic roles in empowering the entrepreneurs and their teams. In expansion stages, especially in India, the equity stake is often transferred from one private equity firm to another private equity firm specializing in expansion aspects. Often times the equity stakes are increased leading to further dilution. The private equity directors often find creative ways to ensure that the interests of the entrepreneurs are aligned with those of the private equity GPs. In the empirical analysis, the methods adopted by the subject investors, as principles, were not related to incentivizing the entrepreneurs or business owners (agents). They were more related to empowering them to make the optimal strategic decisions. Klein et al. (2013, p.7) also mention that in entrepreneurship governance in private equity business, the principle-agent issues apply more to GPs and LPs partnerships. The empirical findings in this research also indicate that LPs have little or no role in influencing the GPs in investment management and decision making process.

The investment management examples and perspectives shared by the subject investors in this qualitative research provide insights that can be explained by a framework incorporating the theories on creativity of action, actor-network and conventions. Using and applying the qualitative framework,[268] a typical subject investor is defined as an actor who enters a situation that comprises of

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[267] In many early stage and seed venture capital in India the amount of invest could be $100,000, which generally goes to basic expenses to maintain the entrepreneurs so that they can continue exploring the feasibility of their ideas. Although this has high risk but numerically it is much less than a few million dollars invested in typical strategic expansion investments.

[268] See Section 2.2.2 for description and literature basis for creating the framework.

two main sets of components: 1) other actors such as the executive managers and other directors of the investee company; and 2) conventions such as current business strategies, process, policies, contracts, ideas, a common sense about industry specific context, manifestation of issues, etc. The actor at the time of entering the situation has a sense of loosely defined purpose that is informed by his past experiences, personality traits, skills, ambitions, private equity firm's expectations, investment team analysis requirements, investor agreements, market conditions, etc. The interactions between the actor and the situation create a notion of sociality, which in turn creates choices. The choices either allow the actor to influence the conventions or inform his/her intentionality. The choices, when made are only meaningful if the investor is physically able to carry them through and influence the conventions. This aspect is referred as corporeality.

Exhibit 27 attempts to capture the above description. The subject private equity investors' intentionality appears to be constantly changing with interactions with the promoters, executive teams and other directors.[269] For example, in the automotive business, the investor tried many things before the owner finally changed his mind and made decisions to accept the proposed solutions and carry them through. These changes are referred as change in conventions. The situation is described as corporate 'board' because even in the absence of tangible board meetings or formal board structure, the subject investors are carrying out their role under the purview of an 'engaged director' and using governance mechanisms to influence the conventions whenever they can.

Three elements of the qualitative framework include the situation that comprises of other players such as executive managers, other directors, and current norms (conventions) that need to be changed or managed according to investor agreements and current market conditions. If director's intentionality and choices adopted prevail then new conventions are formed potentially adding value to the investment. However, with various interactions and interrelationships within the contextual situation, the director's intentionality could be influenced such that better choices emerge that add value to the investment. For example, in the case of extraction service business, the choice to create an ERP system emerges as a result of interacting with the current information gathering processes (including the other actors and operating systems).

[269] Intentionality only determines director's sense of engaging with the situation that ultimately results in complex choices, which continue to inform the intentionality till the new conventions are adopted.

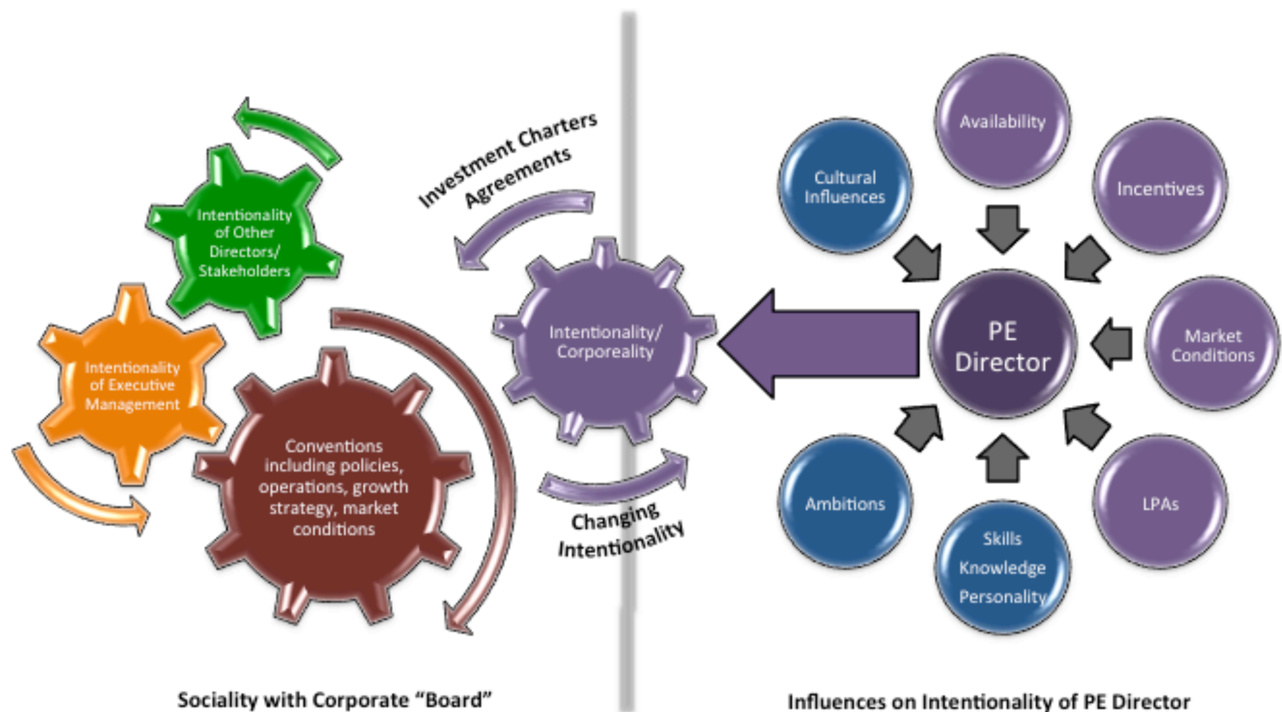

Exhibit 27. Dynamics of Engaged Form of Governance in PE Investee (own illustration)

The adoption of choice only becomes feasible when other actors, who are decision makers (the investee partners), interact with the subject investee and the similar choice emerges for them. So in this framework, the choices are emerging not only for the subject investor, but also for everyone else in the network situation. When choices are adopted and carried through, the conventions change. The situational context keeps on evolving as long the business engagement exists – the conventions and actors could be changing frequently. Similar argument can be applied to the broking business when it is decided to invest the cash raised from private equity firm in mutual funds. This also can be applied when they were faced with hostile market conditions; they decided to close down multiple offices around the nation. Even when things are going well in portfolio companies with no issues, the investors are still interacting with situations and conventions continue evolve because of strategic decisions made and actions taken by the executive teams.

This framework also explains the determination of the subject investors to stay in the situations even when the investees do not encourage his involvement. The determination, humility, personality traits, ambitions, etc., all inform subject investors intentionality and sociality in network situations. This also explains why different investor/director in place of our subject investors will

end up with different situations with the same investee leading to different choices and results.

The framework also explains that the choice of collaborating with a subject investor in a meaningful manner emerges whenever executive teams interact with him/her, but they decide not to act on that choice and keep the convention of not indulging the subject investor. This also informs us of the notion that conventions change when other actors accept the change as a new way forward. Therefore, in the framework described, the situation, network, actors, intentionality of actors, choices and conventions define each other based on sociality. Also, any pre-determined ideas or objectives hold little meaning because they change if interacting with certain situation a choice emerges that allows for a better convention.

Although not tested, the framework could explain the limited partnership agreements, investment decisions, and exits. Since the intentionality of each actor is continuously being informed by the choices with sociality, after the exit these situations will cease to exist for the subject investor. New situation with new investee, new actors, and new conventions network will emerge with another investment where this dynamic process of creativity will continue for the subject investor.

The intent of this research was not to demonstrate applicability of traditional theories, but to create a qualitative framework using the theories on creativity of action, actor-network, and conventions, that explains private equity director's activities. However, the qualitative framework used in this analysis could potentially complement the traditional governance and management theories such as agency theory, stewardship theory, team theory of production, and resource-based theory. For instance, sociality of a private equity placed director with the corporate board creates situations that could determine the applicability of one or more traditional theories. The cases discussed by the private equity investors in this work can be categorized as situations that could be explained by one of the traditional theories. For example, the brokering business case situation can be explained by team production or resource-based approach. The situation in automotive manufacturing business or extractive business could present an agency problem that is resolved with considerable effort on director's part to realign the interests. The initiative taken by the entrepreneur in extractive business, to find a way of creating a tangible exit for the private equity investment, demonstrates stewardship theory. Therefore, it can be argued that the qualitative framework allows for a flexible approach in applying the traditional theories.

3.6. Reflection and Conclusion on Empirical Analysis

Supporters of public equity business model have put forth the contractual structures, easy credit markets, long-term views, as well as lack of regulations as the main reasons for the success of private equity mangers. This could be true. But there is a gap in research on how these managers actually develop the governance competencies. There is practically very little research work that shows what do these private equity fund managers and investment managers actually do to make the difference in governance functions, especially in an emerging economy like India. Therefore, study of private equity transactions offer a rich empirical setting to understand how the directors backed by private equity firms potentially enable better governance functions in Indian economy's context.

The central research question raised in this work is how does a private equity firm add value to its portfolio companies. Reviewing the literature on general private equity operations allowed creating the hypothesis that private equity firms add value to portfolio firms during the investment management process via 'engaged' form of governance functions. The objective of the empirical analysis is to explore the validity of the hypothesis to address the research problem. The empirical analysis adopted a qualitative method including, survey questionnaires, email conversations and phone interviews with private equity directors and fund managers to gain insights into the activities they get involved and understand their approach to manage their portfolio investments.

Although limited to a few investors' extreme experiences in working with the portfolio companies and survey analysis from 12 respondents, the role of private equity firm in governance of portfolio company investment, via a director was determined as: an unbounded function of the investor, via the director, to be prepared to empower the entrepreneurs and company executives to strategically grow the business. In this context, "unbounded" means that once the investment is made all types of activities are within the scope of the directors and investment teams. Among other activities, these could include all types of relevant analysis, exploring growth opportunities, proposing and developing collaborative strategies, mediating conflicts, and guiding the entrepreneurs. The term "unbounded" also considers the fact that different directors and teams have different skills and motivations, which would determine the results of the governance during the holding period. It also implies that the activities of the private equity directors and investment teams

may work with or without a formal board. The term “prepared” implies that the private equity directors and investment teams are willing to go much beyond their regular monitoring role to influence the executives when the situation calls for it.

This definition of governance function agrees with the hypothesis and clarifies the meaning of “engaged governance”. However, these findings are limited to Indian private equity firms specializing in capacity and strategic expansion investments in Indian companies. In particular, the results are limited to the cases and professionals covered in this research. Therefore, they cannot be generalized for other similar situations. This specificity is inherent in qualitative work. It also has to be kept in mind that private equity industry in India is still evolving with other aspects of the economy such as corporate governance practices, regulations governing the foreign investments and sophistication of family businesses.

The proposed definition needs to be further strengthened and refined by qualitatively exploring additional investments across all industry sectors and across full business-life cycle stages. The theoretical framework of creativity of action, actor-network, and conventions, explained the empirical results and how the subject investors influenced the value of the portfolio companies. The framework also provides richness to the definition of governance in private equity investments as discussed above.

4. Recommendations

4.1. Recommendations for Practice

Private equity firm is a generic expression for an investment intermediary that makes equity investments private companies. Funds may be provided from a wide range of sources including pension funds, financial institutions and other institutional investors, companies, public bodies and high net worth individuals. Many private equity firms, as engines of economic growth and innovation, operate globally and typically most of them follow a simple operative cycle: Raise Funds → Make Investments → Manage Investments → Harvest Investments → Return funds and share profits → Raise Funds. The subject of this dissertation focused on managing the investment as it determines the harvest value, returns on investment, the ability of a fund manager to raise additional capital, and ability to strongly compete for the candidate investee companies, especially in India. Therefore, the basic question raised was: How does a successful private equity firm manage and add value to its portfolio companies?

Using the empirical setting in India, the role of private equity firm in governance of portfolio company investment, via a director was determined as: an unbounded function of the investor, via the director, to be prepared to empower the entrepreneurs and company executives to strategically grow the business. In this context, "unbounded" means that once the investment is made all types of activities are within the scope of the directors and investment teams. Among other activities, these could include all types of relevant analysis, exploring growth opportunities, proposing and developing collaborative strategies, mediating conflicts, and guiding the entrepreneurs. The term "unbounded" also considers the fact that different directors and teams have different skills and motivations, which would determine the results of the governance during the holding period. It also implies that the activities of the private equity directors and investment teams may work with or without a formal board. The term "prepared" implies that the private equity directors and investment teams are willing to go much beyond their regular monitoring role to influence the executives when the situation calls for it.

The investors who contend that oversight of entrepreneurs hampers the entrepreneurship might benefit from the idea that frequent interactions and active discussions with the entrepreneurs can actually empower the entrepreneurs leading to better relationships and potentially better investment returns.

There has been an increasing concern amongst the suppliers of private equity capital pool about the ability of firms to cope with the recession and changing market conditions. In the past, during the peak years prior to 2008, the focus of private equity concerns were related to external factors such as tax implications, complying with regulations, closing costs due to many intermediaries, control of due diligence process, and unrealistic valuations during the deal structuring process. In the current economic environment the focus has changed to enhancing operational skills, innovative approaches and corporate governance. Corporate governance of the exit entity has been an afterthought leading to exit IPOs not keeping up with the projected stock values. This creates a reputation concern for general partners, limited partners, Bombay Stock Exchange regulators, and of course the new shareholders. Other exits such as acquisitions can somewhat mitigate these issues at the expense of compromised return on investment for limited partners, general partners and investee executives if they also exit. Most general partners still need to develop competencies to effectively provide operational support to the investees, which could significantly impact the exit opportunities. Although there is sufficient professional talent in Indian market, it is difficult to find people with deep operational and exit management skills. Most general partners have either been entrepreneurs themselves or worked in UK or US for a private equity firm and then used that skill-set to market them in Indian private equity industry. When selecting a general partner, the limited partners look for team depth, fundraising skills, access to potential investees, operational skills and refined exit management skills. Keeping in mind all the issues mentioned above, and given the competitive environment, the private equity firms that can demonstrate the value added via operational skills will tend to be more attractive to limited partners as well as investees. In addition, in the next few years, the firms that are able to develop the depth of operational skills will lead the way for other firms and professional talent development, in turn directly transforming the industry landscape as well as indirectly impacting the corporate governance practices and foreign direct investments.

In general, the investors can benefit from the findings that soft-skills in the directors and investment management teams not only complement the operating skills, but also create better value and reputation for the fund managers. The willingness and action-oriented approaches to go above and beyond the prescribed role as investment manager and director may go a long way in creating better results for private equity firms operating in India.

4.2. Recommendations for Research

Considerable number of reports and research studies using quantitative methods to decipher various deterministic factors and aspects of global private equity business. Although informative, the results of quantitative studies tend to be less practical in understanding the activities of the directors. There is relatively little understanding about the underlying management theories that fully explain the performance of private equity firms in managing investments, especially in emerging economies like India. In addition, there is a growing concern amongst many institutional investors about operational skills of many Indian investment management teams in private equity firms. The focus of this research was on qualitative approach to understand the workings of successful private equity managers and develop a qualitative, theoretical framework to explain their activities.

The qualitative analysis and theoretical framework adopted in this research helped define how an engaged form of governance works. This might be difficult to decipher using quantitative methods, especially when the indications are that soft-skills are of utmost importance in the private equity investment management. Quantitative studies have been successful in indicating the importance of finance skills or operations skills by creating variables based on investors' résumés but they provide little context on how these skills really add value. The analysis framework adopted in this research is not new but does provide insight into new way of looking at corporate governance in private equity investment management. There is practically very little research that shows how do these private equity investment managers use governance functions to influence the executive managers and strategic decision-making.

The researchers could benefit from exploring qualitative approaches in conducting research in private equity arena. The theoretical framework of creativity of action, actor-network, and conventions, explained the empirical results and how the subject investors influenced the value of the portfolio companies. The framework also provides richness to the definition of governance in private equity investments as discussed in this research. As a further research agenda, the proposed governance definition and theoretical framework could be further strengthened and refined by qualitatively exploring additional investments across all industry sectors and across full business-life cycle stages.

The qualitative framework used in this analysis could potentially explain the traditional governance and management theories such as agency theory, stewardship theory, team theory of production, and resource-based theory. For instance, sociality of a private equity placed director with the corporate board creates situations that could determine the applicability of one of the traditional theories. These can be further investigated to add richness to both the framework and the traditional theories.

4.3 Limitations

Following limitations are inherent in the scope of this study:

- Access to private equity directors and fund managers is highly limited in India. Due to the highly secretive and competitive nature of private equity industry, investment managers do not want to share the 'inner' mechanisms of their deals. Less than 10% firms responded to survey questionnaire. The richness of direct observation of the activities and processes is only compensated to some extent by extended interviews with some of the directors.
- Although the private equity business covers the whole business life-cycle spectrum of companies, there is very little LBO and MBO activity in India and none of the investors interviewed were involved in these aspects. Also, the angel investors were omitted from the surveys because they tend to be individuals with their own wealth and not necessarily established as a PE/VC fund. Therefore, the research findings only apply to the early stage investments and expansions covered in this study and should not generalized without further investigation.
- There were no inputs sought form: entrepreneurs and executive management teams of portfolio companies; institutional investors who are part of limited liability partnerships; and advisors/consultants/other experts in private equity industry. Although all these parties are integral part of investment chain and would have had valuable insights to provide.
- There is little research literature devoted to Indian private equity industry, therefore some available articles, market reports and consulting firm reports were relied upon for background information.

Appendix

Initial Questionnaire for General Information – (Sent to a select few investors)

1. Which business life-cycle stage does the company/fund specialize in?
2. Why this specialization? Is it because of Fund Manager's expertise/past experience?
3. What is the past performance record overview of the fund manager as a fund manager? How many funds? Success record?
4. How do you find the LPs? Use gatekeepers/consultants (middle-men)?
5. What type of LPs do you target? What capital ratio of foreign to Indian LPs?
6. What are some of the key factors that allow a PE firm or fund manager to raise funds?
7. How are funds raised?
8. Are there any limitations in Indian market? Legal? Cultural?
9. What laws govern the partnership agreements?
10. Do the limited partners have rights to direct your investment and management strategies?
11. How often do you need to report to LPs on fund status?
12. What type of investments do you target?
13. How do you select the investment targets?
14. Who does the due diligence? Analysis?
15. What factors are considered to finalize investments?
16. What financing structure do you prefer? Does the investee management team influence the structure?
17. How are the decisions made when finalizing the target investment?
18. What approach is used to manage the investment? Is there a system in place or each investment is treated on a case-by-case basis?
19. Besides investment and financing structure, what other factors influence value creation in the portfolio company?
20. How involved is the fund manager in investment management?
21. Do you bring outside executives/industry experts to manage/monitor a company?
22. What are some of the risks that you monitor?
23. What types of risk-management mechanisms are in place?
24. How many investment managers are used for a typical fund?
25. How long is a typical investment management time frame?
26. When do you typically start considering exit strategies?
27. What exits strategies do you consider?
28. Are the exit strategies considered in parallel?
29. Once an exit strategy is decided, how long does it take to close the deal?
30. What investment management risks are considered while preparing for exit?

Targeted Private Equity Firms in India for Empirical Analysis

AAVISHKAAR	CATAMARAN VENTURES	INDIA ALTERNATIVES	NVP INDIA
ACCESS INDIA FUND	CHEEKOTEL VENTURE FUND	INDIA EQUITY PARTNERS	OMNIVORE CAPITAL
ACCION	CHRYS CAPITAL	INDIA INFRASTRUCTURE DEVELOPMENT FUND	PARACOR CAPITAL ADVISORS
ACTIS	CLEARWATER CAPITAL PARTNERS	INDIA INNOVATION FUND	PROVIDENCE EQUITY
ADITYA BIRLA PRIVATE EQUITY	CREATION INVESTMENTS CAPITAL MANAGEMENT	INDIA VALUE FUND	QUADRIA CAPITAL
ALOE PRIVATE EQUITY	**CX PARTNERS**	INDIA VENTURE	RABO EQUITY ADVISORS
AMBIT PRAGMA FUND	DFJ	INDIACO VENTURES	REDCLAYS CAPITAL PRIVATE EQUITY FUND
AMP CAPITAL INVESTORS	DEG India	INDIAVENTURE	RELIANCE PRIVATE EQUITY
AMPLUS CAPITAL ADVISORS	EIGHT CAPITAL	INDOUS VENTURE PARTNERS	RESPONSABILITY
APAX PARTNERS	EPLANET CAPITAL	INVASCENT	SABRE PARTNERS
APOLLO MANAGEMENT	EREDENE INFRASTRUCTURE	**JAFCO ASIA**	SAGE CAPITAL
AQUARIUS INVESTMENTS	EURINDIA	JM FINANCIAL INVESTMENT MANAGERS	**SEAF INDIA INVESTMENT ADVISORS**
ARGONAUT PRIVATE EQUITY	EVERSTONE CAPITAL ADVISORS	KITARA CAPITAL	SECURA IMC
ARTH CAPITAL	EVOLVENCE INDIA FUND	KKR	SEQUOIA CAPITAL
ARTHVEDA FUND MANAGEMENT	EXPONENTIA CAPITAL	KOTAK INVESTMENT ADVISORS	SIDBI VENTURE CAPITAL
ARTIMAN VENTURES	FAERING CAPITAL	KUBERA PARTNERS	SMP
ASCENT CAPITAL ADVISORS	FIDELITY GROWTH PARTNERS INDIA	LIGHTSPEED VENTURE PARTNERS	SREI VENTURE
ASIAN HEALTHCARE FUND	FIRSTLIGHT ACCELERATOR	LUMIS PARTNERS	STANDARD CHARTERED PRIVATE EQUITY
ASK PRAVI CAPITAL ADVISORS	FORUM PARTNERS	MADISON INDIA CAPITAL	SUBHKAM VENTURES
AUREOS CAPITAL	**FORUM SYNERGIES**	MATRIX INDIA	SUMMIT PARTNERS
AVIGO	GAJA CAPITAL PARTNERS	MAYFIELD FUND	SUN-APOLLO
AXIS INDIA FUND	GTI	MCAP FUND ADVISORS	TATA CAPITAL PRIVATE EQUITY
AXIS VENTURE CAPITAL TRUST	**GLOVOC**	MILESTONE CAPITAL ADVISORS	THOLONS CAPITAL
AXON CAPITAL	HDFC PROPERTY FUND	MORPHEUS CAPITAL ADVISORS	TLG CAPITAL
BAIN CAPITAL	HEADLAND CAPITAL PARTNERS	MOTILAL OSWAL PRIVATE EQUITY ADVISORS	TRIANGLE REAL ESTATE INDIA FUND MANAGERS
BARING PRIVATE EQUITY ASIA	HELION	**MULTIPLES ALTERNATE ASSET MANAGEMENT**	TUSCAN VENTURES
BESSEMER VENTURE PARTNERS	HELIX INVESTMENTS	NAVIS CAPITAL	TVS SHRIRAM GROWTH FUND
BLACKSTONE	I-FARM VENTURES	**NQCAP**	**VARHAD INVESTMENT MANAGERS**
BLUE RIVER CAPITAL MANAGEMENT	**ICICI VENTURE FUNDS MANAGEMENT CO.LTD.**	NETWORK ENTERPRISES FUND	VLS FINANCE
BRICK EAGLE	IDFC ALTERNATIVES	**NEW ENTERPRISE ASSOCIATES**	WALDEN INTERNATIONAL
BRIDGE CAPITAL	**IDG VENTURES INDIA**	NEW SILK ROUTE	WARBURG PINCUS
BTS INDIA PRIVATE EQUITY FUND	IFCI VENTURE	NEW VERNON	WAYZATA INVESTMENT PARTNERS
CANBANK VENTURE CAPITAL	IL&FS INVESTMENT MANAGERS	NEXT ORBIT VENTURES FUND	WEBEL VENTURE CAPITAL
CARLYLE	IMPACT INVESTMENT PARTNERS	NEXUS VENTURE PARTNERS	WESTBRIDGE CAPITAL PARTNERS

Indian Private Equity Information – Survey to Verify Findings (sent to 136 firms)

1. Which business life-cycle stage does your company/fund specialize in?

☐ Seed Capital/Start-up
☐ Early Stage Expansion
☐ Capacity Expansion
☐ Strategic Expansion
☐ Mergers/Acquisitions
☐ Initial Public Offerings
☐ Leveraged Buyouts
☐ Distress Financing
☐ Spinoffs
☐ Listed firms

Comments:

2. Why this specialization?

☐ Fund Manager(s)/Partners expertise
☐ Local market conditions
☐ Regulations
☐ Competitive advantage

Comments:

3. What is the background of fund manager(s)?

☐ Investment Banking
☐ Private Equity/VC
☐ Structured Finance
☐ Accounting
☐ Technical Operations
☐ Corporate Strategy
☐ Management Consulting
☐ Other

Comments:

4. What is the past performance overview of the fund manager(s)?

☐ 1st Fund
☐ 2nd Fund
☐ 3rd Fund
☐ 4th Fund
☐ More than 5 Funds

Comments:

5. How do you predominantly find Limited Partner (LP)?

☐ Consultants
☐ Placement Agents
☐ Direct Contact with LPs

Comments:

6. Do you have a preference for a type of LP?

☐ Indian Institutional
☐ Foreign Institutional
☐ Other
☐ Sovereign Capital
☐ Fund of Funds

Comments:

7. Rough ratio of Foreign to Domestic Capital in your funds?

:

Comments:

8. What are some of the key factors that allow a PE firm or fund manager to raise funds

☐ Track record
☐ Continuity of Investment Team
☐ Personal Credibility
☐ Operations guru
☐ Finance guru
☐ Other

Comments:

9. What are limitations, if any, to operate in Indian market?

☐ Regulatory
☐ Political
☐ Cultural
☐ Other

10. What laws govern your the partnership agreements?

☐ Indian Company Law
☐ Double Tax Treaties
☐ Other

Comments:

11. Do the limited partners have a right to direct your investment and management strategies?

☐ Yes ☐ No

Comments:

12. How often do you need to report to LPs on fund status?

☐ Monthly
☐ Quarterly
☐ Semi-annually
☐ Annually
☐ As needed

Comments:

13. How do you select the investment targets?

☐ Top down sector study
☐ Intermediaries
☐ Nurture LP network
☐ References of past entrepreneurs
☐ Industry conferences
☐ Specialized industry knowledge
☐ Other

Comments:

14. Who primarily does the due diligence analysis?

☐ In-house
☐ Financial and legal diligence agencies
☐ Market research agencies
☐ Strategic consultants
☐ Technical consultants
☐ All of the checked above plus

Comments:

15. What factors are considered to finalize investments?

☐ Sector analysis
☐ Industry attractiveness
☐ Management team
☐ Track record
☐ Profitability
☐ Strategy
☐ Valuation
☐ Terms agreements
☐ Alignment of interests
☐ Potential exit mechanisms
☐ Equity percentage
☐ Other

Comments:

16. What financing structure do you prefer?

☐ Straight equity
☐ Leveraged Positions
☐ Combination of Equity and Loans

Comments:

17. How are the decisions made when finalizing the target investment?

☐ Unanimous decision of investment committee
☐ LPs influence the decisions
☐ GPs make the decisions
☐ Other

Comments:

18. What approach is used to manage the investment during the holding period?

☐ Each investment is treated on a case-by-case basis
☐ Structured portfolio review process in place where all partners voice opinions
☐ Flexibility for the deal team in managing the deal
☐ All checked above plus

Comments:

19. Besides investment and financing structure, what other factors influence value creation in the portfolio company?

☐ Talent recruitment on GP team
☐ Improving MIS/ERP
☐ Cost accounting
☐ Strengthening Board
☐ Strategic decision support
☐ Capital budgeting
☐ Monitoring
☐ All checked above plus

Comments:

20. What are some of the risks that you monitor?

☐ Industry sector
☐ Currency risk
☐ Commodity risk
☐ Financing risk
☐ Risk of time and cost overrun
☐ Intellectual property related risks
☐ Fraud
☐ Human Resources related risks
☐ Political
☐ All checked above plus

Comments:

21. What is a typical make-up of Investment Management Team?

partners, financial analysts, management analysts and other industry specific team members

Comments:

22. Who typically serves as the director on the board of portfolio company?

Comments:

23. Is the director on the board generally different from the lead deal-making GP or fund manager?

☐ Yes ☐ No

Comments:

24. If the director is different from GP/lead deal-maker, then during a typical holding period how often does the GP interact with the director regarding the portfolio company?

☐ Weekly ☐ Biweekly ☐ Monthly ☐ As needed ☐ Other

Comments:

25. Do you bring outside executives/industry experts to manage/monitor a company?

☐ Yes ☐ No ☐ As needed basis

26. How long is a typical investment management time frame?

Between to years

Comments:

27. Rate the director's level of engagement in the investee company
☐ Highly engaged – Actively monitors the firm activities, visits/interacts frequently with the executive management team besides the board, attends all board meetings and is always prepared to mitigate problems.
☐ Engaged on need basis – Monitors the activities, attend board meetings, and intervenes the decision making if the need be.
☐ Low level of engagement – Monitors the activities based on the information provided by the executive team and reports the PE investment committee to obtain direction
☐ As agreed upon in the terms of deal/investment
Comments:

28. Do you believe that level of director's engagement impacts the value creation in the portfolio company?
☐ Strongly agree because
☐ Somewhat agree but the valuation is very dependent on market conditions and exit options
☐ Tend to disagree because
☐ Value of the fund portfolio is more important than individual investments
Comments:

29. What skills are important for a director to be engaged and create value in the investee company?
☐ Investment Banking
☐ Private Equity/VC
☐ Structured Finance
☐ Accounting
☐ Technical Operations
☐ Corporate Strategy
☐ Management Consulting
☐ Multicultural understanding
☐ Patience and determination
☐ Other
Comments:

30. Typically, how many investments does one director oversee?
☐ One to three
☐ Less than five
☐ Five to ten
☐ Fund manager is on all boards
☐ Other
Comments:

31. Is the level of engagement dependent on GP's percentage of equity in the investee company?
☐ Yes ☐ No
Comments:

32. Is your level of influence on the board and executive management dependent on GP's percentage of equity in the investee company?
☐ Yes ☐ No
Comments:

33. Is the level of engagement dependent on incentives for the director and general partners?
☐ Yes ☐ No ☐ Somewhat
Comments:

34. In your experience, does the level of directors' engagement depend on the business life-cycle stage?

High	Low	Business Cycle
☐	☐	Seed Capital/Start-up
☐	☐	Early Stage Expansion
☐	☐	Capacity Expansion
☐	☐	Strategic Expansion

☐ ☐ Mergers/Acquisitions
☐ ☐ Initial Public Offerings
☐ ☐ Leveraged Buyouts
☐ ☐ Distress Financing
☐ ☐ Spinoffs
☐ ☐ Listed firms

Comments:

35. As we know that not all investments are successful - In your experience, what have been the main reasons for failed investments?

☐ Lack of cooperation from the entrepreneur's executive team
☐ Lack of sufficient oversight provided by the director
☐ Lack of sufficient oversight of GP over the directors and portfolios
☐ Tough market conditions
☐ Faulty due diligence, information and analysis provided by the consultants
☐ Misjudging entrepreneurs abilities
☐ Misjudging product/services growth potential
☐ Other

Comments:

36. When do you typically start considering exit strategies?

Comments:

37. Do you typically have a mechanism in place to ensure that an investment is always "exit ready"?

☐ Yes ☐ No ☐ Somewhat

Comments:

38. What exits strategies do you consider?

☐ IPO
☐ Trade sale
☐ All checked above plus
☐ Secondary sale
☐ Promoter buyback

Comments:

39. Are the exit strategies considered in parallel?

☐ Typically yes
☐ Depends on market conditions
☐ Typically no

Comments:

40. Once an exit strategy is decided, how long does it take to close the deal?

up to years

Comments:

41. The "exit deal manager" is typically....

☐ Same as our director on the board
☐ Fund manager
☐ General Partner
☐ Investment committee
☐ Other

Comments:

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