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What Are The Determinants of Governance Private Equity Firms?

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Abstract: *Attesting of their attraction to entrepreneurship, we studied how private equity firms are governed? Thus, we noted during our literature review, that the organization of the private equity industry was based on the Anglo-Saxon model of Limited Partnerships and that governance determinants can rely on the characteristics of the investment funds as well as the profile of the General Partner. Therefore, we have been able to justify that the determinants of governance are essentially based on factors relating to the VC / Buy Out typology, the size and the affiliation degree of the investment fund and those relating to the GP's participation in the capital that align the interests of the Limited Partners with those of the General Partner.*

Key Word: *Governance, Private Equity Firms, General Partner, Limited Partners.*

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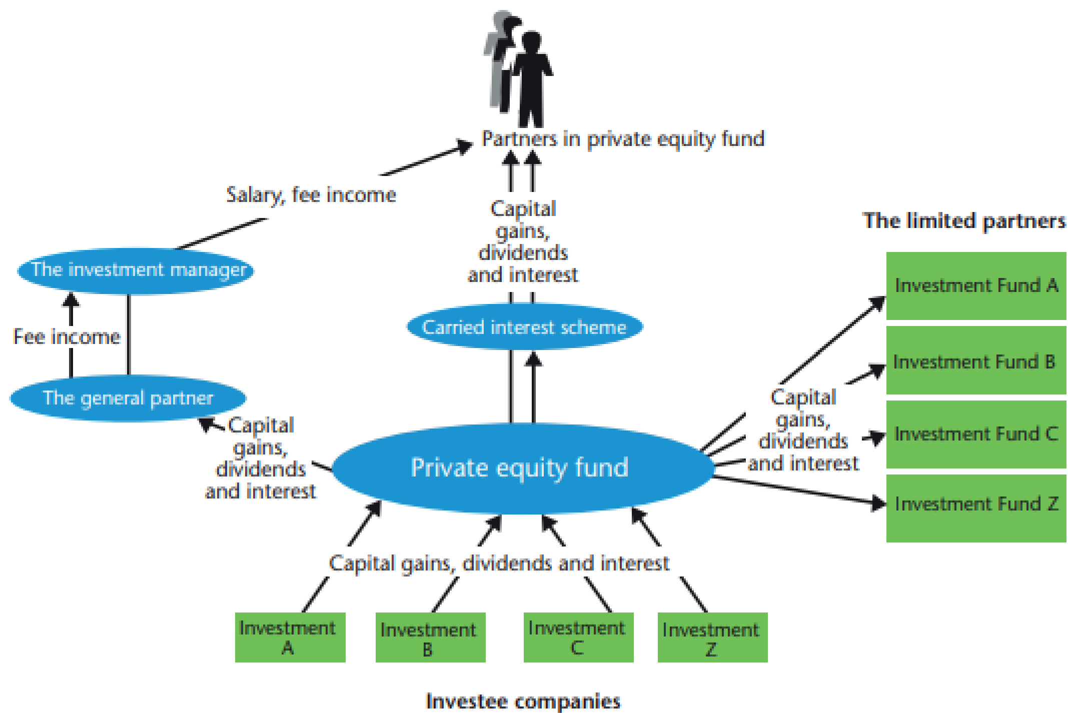
I. Introduction

In recent decades, Private Equity (PE) has evolved significantly to become a significant industry compared to the small niche sector it represented. Today, it is considered able to play a crucial role in the economy, stimulate innovation and growth in promising start-ups or expanding companies, as well as by promoting the restructuring of firms (Davila and al, 2003).Indeed, it is made up of two main segments, namely venture capital, which offers financing during the early stages of the company's life, and is characterized by its favorable impact on innovation as well as the transmission capital that is interested in buying back leveraged companies that have arrived at a more mature stage of life (Glachant and al 2008). The description of Private Equity presented by Barry (1994) presents it as a type of successful financial arrangement: "private fund investors put their money for long periods in the hands of venture capitalists (VCs) whose skills are uncertain and who only commit themselves with small amounts of their own funds. VCs are looking for promising companies, eventually placing the funds in risky businesses, run by entrepreneurs with unknown skills and future unpredictable efforts. "If this definition raises the interest of shedding light on the specificities of this mode of financing which constitutes only the "downstream" part of Private Equity, this research work would focus essentially on the "upstream" part of this industry.The question then is, how can investors in this asset class control their investments without being involved in the management of Private Equity companies? In other words, is there a private equity mode of governance? Therefore, the problem defended in this work is what are the governance determinants of Private Equity Firms?

II. Theoretical Framework and Hypothesis

In the first part of our literature review, we noted that the organization of the private equity industry in France was based on the Anglo-Saxon model of Limited Partnerships. These include specialized structures closed in the investment in unlisted companies with limited life. Thus, the operation of private equity can be summed up in the figure below:

Figure: Structure of a typical private equity funds



Source: Gilligan and Wright (2014).

Investors place their capital in a mutual fund whose management is entrusted to a management company that decides only on investments, the organization of the follow-up of portfolio companies and outflows. According to the Anglo-Saxon legislation, we have discerned that the investment fund is organized as a Limited partnership grouping investors whose liability is limited to the contribution of investors (limited partners - LPs) and a fund manager (General partner - GP), whose liability is full and the capital contribution reduced. During the first five years of the fund, the General Partner selects investment opportunities (Targets) and conducts transactions (Deals) by gradually raising funds from the LPs within the limit of the capital limit (Commited Capital) (Gilligan and Wright, 2014).

Thus, the extension of the analysis of our research work on the governance of private equity has allowed us to note that the "private equity company" is generally at the heart of a dual contractual relationship.The usefulness of the numerous reports and "good practice" guides published by the EVCA (2007) and Walker (2010), lies in the concrete actions formulated, concerning the governance mechanisms of the Private equity firms, notably the composition of the Board, the frequency of the interactions and contacts between the limited partners and the GPs as well as the staggering or financing modalities of the investment funds. In addition, the AFIC study (2010) shows that the supervisory function of the governance of management companies is mainly assumed by the board. Thus, we have noted that trust is a mechanism associated with any form of transaction and cooperation that accompanies and complements the traditional economic mechanisms of market and hierarchy, Charreaux (1998). It is therefore a natural part of corporate governance mechanisms. As a result, limited partners can maintain close relationships with their General Partners to continue to gain access to detailed information (Lerner and Schoar, 2004). The purpose is to ensure better monitoring of the existing fund, facilitate future reinvestment decisions and further develop personal relationships (Muller, 2008).

The relevance of this relationship for the understanding of private equity governance practices allowed us to build a research model that integrates, first of all, the intervention mechanisms of the LPs including the seat on the board of directors, the frequency of interaction and staggered funding; secondly, the determining factors of LPs involvement in this governance. The amplification of governance debates following the economic crisis prompted private equity professional associations to publish governance reports such as Walker's report (2010), the ILPA in 2009 and which were updated in 2011. The best practices recommended by these reports and which aim to manage at best the double agency relationship (linking on the one hand, the LP with the GP and the latter with the head of the target company), we have allowed to largely justify the assumptions made in our research model including factors related to investment funds (VC / Buy Out typology, size, degree of affiliation) and those relating to the profile of GP (compensation, equity participation, experience) that align the interests of Limited Partners with those of the General Partner.

The EVCA (2007)and Walker (2010) reports recommend the intensity of the monitoring and the presence of the limited partners in the first years of the creation of the investment funds. The portfolio, in this phase of creation, is even more fragile and more exposed to the risk of bankruptcy. Hence the hypothesis (1), the intensity of the tutoring in the first years of fund creation.

A range of studies (Lerner and al (2004), Phalippou and Zollo (2005), Glachant, Lorenzi and Trainar, (2008) ...) on the performance of private equity funds had noted the correlation of the intensity of Typology monitoring (venture capital / buy outs) which constitutes a strong motivation to integrate the typology of private equity funds as determining the monitoring or governance of this type of organization (hypothesis 2).

The principles of ILPA (2009, 2011), the Walker report (2010) and the EVCA study in 2007 encourage the transparency of information and the distribution of funds raised for a good appreciation of the management of GPs. Thus, the size of funds (fund size) also appears to be a crucial determinant for monitoring (hypothesis 3).

As for Demiroglu and al (2007) shows that Private Equity Group (PEG) transactions are perceived as less risky by creditors because they are considered more skillful in the monitoring and control of holding companies or because the reputation of the concept of the group serves to mitigate the costs of debt agency and thus lowers the need for banking supervision and control. Hence the interest of assuming (hypothesis 4) that the intensity of the monitoring of funds is negatively correlated with the independence of the fund (affiliation to groups).

The extension of our literature review also notes that the Limited Partner may be sensitive in its degree of monitoring and control of the investment fund to certain data concerning the General Partner.

In fact, the recommendations of the Walker (2010) report and the BVCA (2007), EVCA 2007 and ILPA (2009, 2011) guidelines indicate, on the one hand, a minimum participation percentage for the GP for each investment fund that he manages. This limits the control motives and reduces the interventionist behavior of the GP in favor of other riskier agency relationships. This assumes that the intensity of the funds' monitoring is negatively correlated with the GP's participation in capital (Hypothesis 5). On the other hand, the manager's experience appears to be a crucial determinant for monitoring, especially when most studies dealing with fund performance stress this aspect (hypothesis 6). In the report of Phalippou and Zollo (2005), whenever funds receive returns on their investments, the amount is proportionally distributed to LPs, GPS in the form of "fees and carried interest". Thus, the remuneration of the management could justify its strong implication in the process of creation of value for funds and decrease the intensity of the monitoring (hypothesis 7).

III. Material And Methods

In this research work, we focused on the analysis of the governance system of private equity firms, which was based on a quantitative questionnaire study aimed at 1814 American and European General Partners constituting the Thomson Reuters database in two languages (French and English). In this quantitative study, we used regression method of analysis to test the hypothesis proposed. Data was analyzed using SPSS and has collected from 164 General partners.

IV. Result and Discussion

The investors in the sample confirm their activism at the level of their holdings, through a strong presence on the boards of directors. More than 58% of them sit on the boards of the funds. That said, the high presence of investors in the board is a means of control.The average number of hours devoted per month by the investor to the fund is about 3 hours per month (36 hours per year), in direct contact with the GP including meetings. Indeed, the average frequency of organized meetings is about two per year. That said, the frequency of interactions in Private Equity is greater than that of investing in a traditional company.

In the sample, the average number of capital calls on which investors allocate their financing is 8 rounds. This can be explained by the reluctance of investors in the sample to commit all their funds, while allowing them to have the opportunity to renew their commitment or to abandon the project. The high number of calls for funds makes it possible to deduce that investors consider the staggering of financing as a means of controlling and monitoring the management of Private Equity companies.

Based on the empirical literature on governance (Gompers and al, 2001), we were able to construct a governance index that corresponds to the average measures of the governance mechanisms identified to measure the level of involvement of the limited partners. . And to improve its quality, a reliability analysis based on the calculation of cronbach's alpha has been carried out.

Consequently, the results of the regression of all characteristics enabled us to show that the governance index can be explained solely by the size of the fund (hypothesis 3), its type (hypothesis 2) and its affiliation to the group (Hypothesis 4) as shown in Table 1 below:

Table 1: Coefficients[a]

Model	Not standardized Coefficients		standardized Coefficients	t	Sig.	Correlations			Collinearity Statistics	
	A	Erreur standard	Bêta			Simple	Partial	Partie	Tolerance	VIF
(Constant)	1,276	3,913		,326	,745					
Fund Typology	-2,762	1,275	-,144	-2,166	,032	,044	-,171	-,127	,782	1,278
Fund Development stage	,003	,892	,000	,003	,998	,107	,000	,000	,877	1,140
Fund size	3,151	,845	,260	3,731	,000	,502	,287	,219	,710	1,408
Equity participation	-,204	,569	-,026	-,360	,720	,249	-,029	-,021	,656	1,524
Management fees	,791	,649	,084	1,217	,225	,366	,097	,072	,722	1,385
Carried interest	,325	,585	,037	,556	,579	,268	,045	,033	,791	1,264
Experience	,178	,789	,015	,225	,822	,304	,018	,013	,739	1,353
Affiliation degree	3,425	,582	,487	5,886	,000	,619	,427	,346	,505	1,979

This is all the more justified and reinforced by the results of the regression step by step. Since this type of treatment proposes a model with a high explanatory power while respecting at best the principle of parsimony.

Table 2 : Coefficients[a]

Modèle	Not standardized Coefficients		standardized Coefficients	t	Sig.	Correlations			Collinearity Statistics	
	A	Erreur standard	Bêta			Simple	Partial	Partie	Tolerance	VIF
(Constant)	1,489	3,085		,483	,630					
Fund Typology	-2,918	1,186	-,152	-2,460	,015	,044	-,193	-,144	,894	1,119
Fund size	3,103	,826	,256	3,757	,000	,502	,287	,220	,733	1,364
Management fees	,740	,628	,079	1,178	,241	,366	,094	,069	,762	1,312
Carried interest	,340	,557	,038	,611	,542	,268	,049	,036	,861	1,161
Experience	,127	,769	,011	,166	,869	,304	,013	,010	,769	1,301
Affiliation degree	3,405	,569	,484	5,984	,000	,619	,431	,350	,522	1,916

Admittedly, the results of the regression analysis of the governance index only on the factors related to the profiles of the leaders, show that it is explained by the experience (hypothesis 6) and the remuneration of the leader (hypothesis 7) but those of the analysis of all the factors as well as the step-by-step regression method do not reveal the characteristics relating to the General Partner. Thus, experience and executive compensation do not improve the explanatory power of the research model adopted.

The assumption (5) that the intensity of the tutoring is correlated with the manager's share in the capital is the result of several research studies which conclude that the Limited Partners often put in place mechanisms allowing the shareholder director to increase his share capital in order to align its interests with those of investors, or sometimes as a reward for achievements in terms of performance compared to the planned objectives. Agency risk is partly a function of the manager's profile. In general, the more money managers invest in their businesses, the less likely they are to make decisions that reduce the value of their investment and therefore less likely to behave in a manner that is contrary to the interests of Limited Partners. On the other hand, it is difficult to achieve the optimal balance between incentive and control given its endogenous nature to reduce agency conflicts (Baker and Gompers, 1999). Thus, the absence of the variable "participation in capital" finds its explanation in this reasoning that Frinha (2003) supports.

According to his analysis, the leader may not be willing to increase their share of capital for constraints related to their personal wealth and the risk aversion of allocating a significant portion of this wealth in a unique participation. However, this vision remains implicit and renders the interpretation of the limited partner's level of commitment in governance based on the GP's participation in difficult and complex capital.

V. Conclusion

In conclusion, the identification of the dimensions of the monitoring enabled the construction of the governance index in order to measure the level of involvement of the investor in the governance of these private equity investments. On the one hand, it is true that the level of commitment varies according to certain characteristics of the investment fund, notably its typology, size and affiliation, but the hypothesis that the

intensity of the monitoring is important during the first years of fund development, has not been verified. On the other hand, the governance index can be explained by the manager's competence and compensation in terms of years of experience in management fees and carried interest. Although the manager's share of capital is admitted as a risk-reducing factor, it is not limited as much to the control intensity of Private Equity companies.Although the literature on Private Equity has increased significantly over the years, this area has remained relatively unexplored. Our research work makes valuable contributions on the ground, of which three important contributions deserve to be highlighted.As private equity remains one of the least well-understood segments of today's financial markets, several avenues of research are opening up, including the respect of good practices in this industry and the treatment of the tax side of portfolio investment in this asset class.

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