Corporate Governance and Human Capital: Evidence from SMBO Boards

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Consistent with predictions made in the late 1980s, the buyout market has grown tremendously and, together with the private equity (PE) model, has become a global phenomenon. One consequence of the maturity of the market is substantial secondary management buyout (SMBO) activity. In an SMBO, the ownership structure and governance mechanism are retained as the initial (primary) buyout is acquired by new PE financiers. The popularity of SMBOs has created some controversy, especially regarding whether the benefits for PE funds come at the expense of the longer term health of portfolio companies.

In our recent paper we examine reasons for SMBOs’ popularity and whether they create value for the portfolio companies. We extend the agency theory traditionally applied in buyouts by incorporating as a complementary theory the strategic entrepreneurship perspective, which suggests that PE directors not only monitor managers but also provide advisory resources to help in identifying and exploiting growth opportunities. As a result, our study contributes to multi-theoretical work on corporate governance.

Agency theory suggests SMBOs are unlikely to generate significant additional improvements in performance, because the benefits of reducing agency costs were already realized in the primary buyout. We argue, however, that there may still be agency costs in SMBOs. The new PE partners and executives entering after an SMBO may introduce new expertise to enable the firm to identify and exploit new growth opportunities. Hence, there remains the potential for performance improvements. In particular, we focus on PE involvement on the board and how the nature of PE board members’ monitoring and advisory skills and education affect SMBO performance.

Using a unique hand collected sample of 200 UK SMBOs, we show that the governance benefits associated with the buyout model may continue beyond the primary buyout. However, the effects in the SMBO phase depend on the PE directors who serve on the portfolio company’s board, and whether they act more as monitors or advisers. For example, some PE partners and executives may be better at financial monitoring and cost-cutting while others may be better at exploiting growth opportunities. We argue that the variety of PE directors’ skills have different effects on monitoring and advising managers to reduce agency costs and exploit growth opportunities with consequences for post-SMBO performance. SMBOs therefore introduce change by recognizing that board composition shifts as entrepreneurial firms move into the next phase of their development and that can affect performance.

Our theory and empirical findings have implications for management and shed light on the longer term impact of PE and, in particular, the sustainability of boards with PE directors. PE directors’ high level of business expertise enhances a firm’s post-SMBO growth. In addition, financial experts with a specialty in monitoring can squeeze costs from SMBOs and improve profitability. Their experience does not, however, appear to contribute to growth, contradicting the view that financial experts with M&A experience can boost growth. What type of PE-director expertise is most effective in promoting growth? A surprising finding is that PE directors with experience in operations lack the specific expertise needed to enhance revenue growth in portfolio companies. Rather, the evidence suggests that PE firms should put independent directors with operational skills on the boards of portfolio companies. Given that SMBOs are a significant presence in many economies, our findings highlight the need for firms and their financial backers to hire independent board members with the complementary skills and expertise to make a positive social and economic impact.

This post comes to us from Professor Ranko Jelic at the University of Sussex’ School of Business Management and Economics; Dan Zhou, a lecturer at the University of Reading’s Henley Business School; and Professor Mike Wright at Imperial College London. It is based on their recent paper, “Sustaining the Buyout Governance Model: Inside Secondary Management Buyout Boards,” available here.

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