From governing to managing:
Exploring modes of control in private equity relationships

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Abstract

There has been limited investigation into the control mechanisms used by private equity (PE) firms to manage the relationships with their portfolio companies. Through a multiple case study approach, this study describes the role and characteristics of controls used by PE firms to manage their portfolio companies and the factors associated with their relative importance in different contexts. Evidence shows that control mechanisms play an important role in directing the actions of portfolio companies and that there is significant variation between PE firms in terms of the mix of contracts, outcome and behaviour controls adopted. In addition, this study shows that PE firms intensively use social controls to build reciprocal trust and achieve control outcomes. Finally, the analysis reveals that the equity arrangement and cognitive style of managers are key factors in explaining the choices and relative importance of controls in PE relationships.

1. Introduction

Private equity (PE) firms have largely escaped the attention by MA researchers. This is somewhat surprising given the increasing economic significance of PE investment. Fundraising by US PE firms grew by more than 100 times between 1985 and 2006 (Bloom et al., 2009), the Western European market grew by more than 50 percent in 2005 alone (Wright et al., 2007), and in 2016 PE assets under management reached nearly $2.5tn worldwide (Preqin Report 2017). One reason for the lack of research into the control mechanisms used by PE firms is the view that these ownership arrangements have implications primarily for the financial and governance structures of invested firms (Bloom, Sadun & Van Reenen, 2015; Gompers, Kaplan & Mukharlyamov, 2016). Although much of the, especially early, research into PE focuses on the effects of increased financial leverage and changes to corporate governance practices associated with PE ownership, it is recognised that PE firms will often take a far more active role in the management of their invested companies (Bernstein & Sheen, 2016; Gompers et al., 2016). This was acknowledged early on by Fenn et al. (1997, p. 4):

> Private equity managers acquire large ownership stakes and take an active role monitoring and advising portfolio companies. In many cases they exercise as much control as company insiders, or more.

Prior literature, mainly in the fields of economics and finance, typically examines PE agreements from an agency perspective. This has led to a predominant focus on the financial contracts and corporate governance structures associated with PE ownership (i.e. increased leverage, concentrated ownership, managerial equity ownership and board participation) which are argued to reduce agency costs and increase the exit value of PE investments (Kaplan & Strömberg, 2009; Wright et al., 2009). However, it has been acknowledged that many monitoring and control activities of PE providers are “largely non-contractible, yet may have real consequences” (Bottazzi et al., 2008, p. 489), suggesting that a much wider range of mechanisms are likely to contribute to the success of PE relationships.

In addition, most extant contributions have focused on leveraged buyouts of publicly listed firms in the US and UK markets. While these deals are typically the largest in value, Strömberg (2007) reports that in the period from 1970 to 2007, public-to-private buyouts accounted for less than 10% of total PE transactions and less than 30% of total transaction value. This is even more pronounced in continental European countries, which have a greater focus on private small-to-medium enterprises and family owned firms, where the focus is on entrepreneurship, managerial succession and market expansion. This significantly reduces the scope for governance structures to add value through the reduction of agency costs, and instead shifts attention to the mechanisms and processes used to actively monitor and direct the actions of managers in the invested firms.

In this study we describe the role and characteristics of control mechanisms that PE firms use to control their portfolio of companies. In addition, we identify the factors that explain the choice and relative importance of controls employed by PE firms across the firms they invest in. To examine these issues, we conducted six PE case studies in one country of continental Europe (i.e. Italy). The empirical evidence shows that the PE firms implement a wide range of mechanisms to provide strategic advice and assistance to managers of their portfolio companies as well as to monitor and control their activities, and reveals those factors, i.e. ownership and cognition, that are particularly influential in shaping the selection and relative weight of controls implemented by PE firms.

Our study contributes to the literature in two main ways. First, we describe the mechanisms commonly adopted by PE firms to manage their portfolio firms. Consistent with prior literature, we find that financial contractual agreements and formal governance mechanisms (i.e. board participation and managerial equity ownership) are relatively standard components of the package of controls used by PE firms (Wright et al. 2009). However, a wider range of control mechanisms – joint planning and goal setting, policies and procedures, performance monitoring, partner selection and personal interaction – were also frequently found to be key in managing portfolio firms. While these mechanisms were consistently used by PE firms across their portfolio of companies, there were significant differences. In particular, certain portfolio firms were managed through a much greater reliance on social control mechanisms. Second, we provide evidence on the factors that explain variation in the use and relative importance of controls in PE firms. While a number of factors emerged from our analysis, there were two factors that seemed to have a particularly strong influence over the choice and relevance of control structures employed — (1) the ownership arrangement of the PE firm (i.e., whether they held a majority or minority equity position), and (2) the cognitive style of the portfolio firm top manager(s) (i.e., entrepreneurial or managerial). Based on these factors we develop an initial framework for understanding control choice in PE relationships. In doing so, we also highlight the importance of psychological determinants in the choice of controls at the organisational level (Hall, 2016).

The remainder of the paper is organized as follows. The next section defines PE and reviews the literature examining how invested firms are controlled. The research method is then described. Findings that emerge from the interviews analyses are presented and a theoretical framework is offered to explain the control structures observed. Conclusions and suggestions for future research are presented in the final section.

2. Literature Review

PE is a form of financial intermediation in which a PE firm raises capital from institutional and individual investors to make direct equity investments in a portfolio of private organizations.[1] PE is distinct from most other forms of financial intermediation in at least three respects. First, compared to blockholders of publicly listed firms (i.e., shareholders that hold a large proportion of ownership), PE firms invest in privately held organisations (Metrick & Yasuda, 2011).[2] Second, unlike mutual and hedge funds, PE funds are closed-end investments with capital locked-in for the life of the fund, typically between seven to ten years (Kaplan & Strömberg, 2009). During this period the PE firm uses fund capital along with debt financing to take large, often controlling, equity positions in private firms. Third, in contrast to the typical investor in public companies, the significant ownership stakes of PE firms enable them to "actively influence actions of the management of the companies they invest in" (Metrick & Yasuda, 2011, p. 623).[3]

Research examining control by firms is predominantly informed by agency theory. This literature considers PE as an alternate governance structure to public ownership, and examines its relative effectiveness at alleviating costs that arise from divergent interests and information asymmetry between the principal (owners) and the agent (managers). The main theoretical proposition is that PE governance structures are superior to those of public organizations as they provide more powerful incentives for managers to take actions that are aligned with the interests of owners. Governance structures in firms with PE ownership typically entail increased levels of managerial equity ownership and performance-based compensation, highly leveraged capital structures, and enhanced monitoring through board participation and timely access to information (Bernstein, Lerner, Sorensen &

[1] The unit of analysis in this study is the PE firm rather than the PE fund. The PE fund is a pool of capital raised from institutional investors and wealthy individuals, and is typically organised as a limited partnership (Kaplan & Schoar, 2005). The capital provided serve as limited partners, while the PE firm acts as the general partner and makes the investment decisions. PE funds usually have an agreed upon timeframe in which the PE firm must invest the capital and provide a return to the limited partners. PE firms are not limited to a single fund, and may manage multiple funds.

[2] Transactions may involve either firms that are privately owned (private-to-private) or publicly-owned, in which case the PE firms undertakes a buyout of existing shareholders to take the firm private (public-to-private).

[3] PE firms can also be differentiated from angel investors and venture capitalists. Angel investors are typically individual investors who use their own money to fund small startups or entrepreneurial ventures, whereas PE firms use investor's capital to make investments in a portfolio of companies (Metrick & Yasuda, 2011). Venture capitalists are often considered as a subset of PE, however, they can be distinguished by their focus on early-stage or emerging firms, with higher growth and associated risk, and typically do not take majority control (Kaplan & Strömberg, 2009).

Stromberg, 2017; Kaplan & Strömberg, 2009). The combination of equity ownership and tighter monitoring reduces information asymmetry and incentives for managerial opportunism (Baker & Wruck, 1989), while debt obligations imposed by high leverage minimizes concerns over the allocation of free cash flow (Jensen, 1989).

Despite significant attention towards PE governance and its consequences, the existing literature provides an incomplete picture of control arrangements within and across PE firms. First, the majority of studies examine buyouts of publicly listed firms (public-to-private transactions), with relatively little attention given to other forms of acquisition (Metrick & Yasuda, 2011).[4] In private-to-private transactions, agency theory is likely to provide only partial explanations for performance outcomes and choice of control structures, as ownership is often already highly concentrated prior to the transaction. Second, while prior research considers the relative effectiveness of PE as a governance structure, examination of the actual control elements of these structures has been largely ignored. As a result, we know little about the actual control mechanisms and how they vary across PE arrangements. Furthermore, the few studies that do report on the actual mechanisms associated with PE governance (e.g. Baker & Wruck, 1989) are mostly limited to formal contractual mechanisms associated with public firm buyouts, with little examination of the role of other control mechanisms.

2.1 Control mechanisms in PE

Control in PE arrangements refers to the ability to monitor and direct the behaviour of invested firm management during the post-investment period (Drover et al., 2013). As most prior research has been conducted from an agency perspective, the concern has largely been centred upon understanding how control is achieved through formal contracting. Formal contracts represent binding legal agreements that detail the rights and obligations of parties throughout the course of a relationship (Poppo & Zenger, 2002). Contracts vary in complexity with more complex contracts containing greater precision and detail on contractual terms (Carson et al., 2006; Poppo & Zenger, 2002). Contracts commonly specify the roles and responsibilities of each party, monitoring procedures, performance expectations, and the potential sanctions for noncompliance. Particularly important in PE arrangements is the allocation of contractual rights that enable direct intervention in the operations of an invested firm, such as veto rights over major strategic decisions, access to additional capital, changes to managerial personnel, determining compensation structures, and liquidation rights (Fenn

[4] One of the only studies investigating management control in this context is that by Bruining, Bonnet, and Wright (2004). Drawing on the framework of Simons (1995), they examine how management controls are implicated in the formulation and implementation of strategy in a case study of two firms that went through a management buyout.

et al., 1997). Contracts may also contain contingency provisions, whereby the allocation of control rights between the investor and the investee is dependent on observable measures of performance, such that if the invested firm performs poorly the PE firm gains greater control (Kaplan & Strömberg, 2003).

More specifically, PE contracts typically include the allocation of three classes of rights (Kaplan & Strömberg, 2003). First, cash flow rights, which refer to the redistribution of cash flow from the company to its investors. Cash flow rights can be made contingent on certain performance measures ("performance vesting") or on the occurrence of certain events ("time vesting"). Second, control rights, which concern the voting rights and board seats that give the power to influence corporate decisions and are granted to the shareholders depending on the kind of securities they hold and on the contractual agreements they initially specified. The allocation of control rights are often made contingent upon publicly verifiable "signals" that are correlated with the state of the firm (Aghion & Bolton, 1992). Kaplan & Strömberg (2000) have shown that contracts are made contingent on a set of signals, such as financial performance measures, non-financial performance measures, and sale of securities. With a contingent allocation of control rights, the controlling party maintains its power only as long as certain predefined conditions are met. Third, liquidation rights relate to the possibility of triggering default of the company in order to force liquidation of the firm in order to obtain payments that are owed to the providers of financial resources. Liquidation rights differ depending on the level of seniority of the claims held by capital providers.

Although there has been little first-hand research, it is generally acknowledged that PE firms activate a far broader range of mechanisms in their control efforts that extend beyond ex-ante contractual specifications (Fenn et al., 1997; Nama and Lowe, 2014).[5] To ensure the ex-post performance of contractual obligations and commitments PE firms will often implement a range of control mechanisms. Formal controls can be categorized as either output or behaviour controls (Dekker, 2004; Ouchi, 1979). Output controls focus on the achievement of predetermined objectives. PE firms set explicit goals for managers of an invested firm, often emphasizing cash flow and long-term value (Wruck, 2008), monitor achievement of these objectives, and align compensation to goal attainment. Behaviour controls regulate firm activities by specifying how tasks are to be performed and placing constraints on the behaviours of invested firm managers, including planning processes, codified rules

[5] Nama and Lowe (2014) is the only study we are aware of that examines the role of accounting mechanisms in PE firms. Their focus is on how accounting is intertwined with PE activities across the different parts of a PE value chain. However, only limited insight is provided into the role of accounting as a control mechanism for influencing managerial behaviours in invested firms.

and operating procedures, and authority structures. A recent investigation by Bloom et al. (2015) shows that PE-owned firms tend to adopt merit-based hiring, promotion and compensation policies, and implement difficult targets tied to both short and long term firm performance, relative to firms with other ownership structures (e.g., government, private and family ownership).

PE firms may also rely to some extent on implicit understandings and social norms to achieve effective control. Parties may be incentivized to fulfil obligations and commitments through social relations and non-legal sanctions instead of formal contracts that are enforceable by courts (Macaulay, 1963; Macneil, 1978). Coordination in such arrangements is premised on norms of flexibility, solidarity, and information exchange (Poppo & Zenger, 2002). These norms facilitate adaptation to unforeseen events, commitment to common interests, and effective problem solving through the sharing of private information. Central to social relations is the notion of trust, which allows written contracts to be left incomplete without the concern of opportunistic behaviour (Carson et al., 2006).

To develop trust, organisations rely upon a range of social controls (Dekker, 2004; Hoetker & Mellewigt, 2009; Ouchi, 1979). Social control mechanisms are arrangements that foster socialization and interaction between firms (Velez et al., 2009). Mechanisms can include direct contact through site visits, information exchange through meetings and informal contacts and shared decision making (Dekker, 2004; Fenn et al., 1997). Through repeated exchanges the PE firm and investee managers develop personal ties and an understanding about the expectations of the other party (Uzzi, 1997). This interaction leads to enhanced trust and provides the PE firm potential access to private information about the intended actions of managers. Another mechanism for developing trust is personnel selection (Dekker, 2008). This can occur during investment selection or post-acquisition. PE firms go through rigorous processes to identify investment targets and during this process they acquire information about the capabilities and reputation of key managers, especially when acquisition is private and does not occur by means of auctions (Fenn et al., 1997). PE firms often have control rights over the hiring and firing of key personnel. The potential importance of personnel selection for effective control is suggested by Acharya and Kehoe (2008) who find that in nearly seventy percent of PE transactions the CEO is replaced at some point during the life of the investment, and more than a third occur within the first 100 days.

A potential impediment to social control is that investor and investee managers often have only limited contact prior to the transaction. This suggests that social control is unlikely to act as a substitute to formal contracting. However, some case study evidence indicates that even if complex formal contracts are constructed, they can have limited importance for ex-post control. In an investigation of venture capital investments Graebner and Eisenhardt (2004) find that control is often not exercised through “monitoring and ratification of specific choices” but is directed through “broader issues of strategic advice and connections” (p. 398) and an emphasis on “social exchange, interdependence and cooperation” (p. 400). For instance, they report that investors and managers rarely resort to contractual rights (e.g. board votes) to resolve conflicts but seek mutually acceptable outcomes irrespective of who has formal control of the firm.

Given the limited evidence on control choices made by PE firms, we pose the following research question:

> **RQ1:** What control mechanisms do PE firms use to manage their portfolio companies and what are their roles and characteristics?

2.2 Factors associated with PE control structures

No prior research has empirically investigated the reasons for variations in the choice and relative importance of the controls used by PE firms to management the organisations they invest in. However, a few studies in the financial contracting and inter-organizational relationship literatures point to certain organisational and contextual attributes that might be associated with differences in PE firm control mechanisms.

Kaplan and Strömberg (2003, 2004) investigate variations in contractual arrangements between venture capitalists (VCs) and entrepreneurs. Their research suggests that prior history of the entrepreneur, relationship duration, industry characteristics, and degree of reliance on human capital, will influence the formal contractual arrangements implemented. Consistent with agency theory, they find that the pay performance sensitivity of the entrepreneur’s compensation is associated with the perceived level of risk; for instance, entrepreneurs with previously successful ventures had less performance sensitive incentives, while performance sensitivity declines the longer the relationship between the VC and the entrepreneur, consistent with the expectation that the level of information asymmetry will decrease over time. Industry characteristics are also found to be influential — industries where explicit performance standards are relatively noisy (i.e., in high industry volatility, high R&D, emerging sectors), VCs rely more on time vesting (compensation dependent on time spent with the firm) than performance-dependent incentives. Industry volatility was also associated with VC voting control rights, as was the amount of fixed to total assets — this is suggested to increase the effectiveness of VC interventions as the firm is less reliant on intangible assets (i.e., the human capital of the entrepreneur) for future performance. Another study from the financial contracting literature by Bacon, Wright, Meuleman and Scholes (2012) shows that the anticipated amount of time remaining until the PE firm exits the investment is associated with the use of certain human resource management practices. They report that the longer the time to exit, the more likely the invested firm will implement high performance work practices (e.g., training, job flexibility, internal promotions, performance-based pay). They also find that the type investment strategy is an important consideration, with PE firms following a “buy-and-build” strategy more likely to be associated with the adoption of high performance work practices in their portfolio firms than those following a “cost-reduction” approach.

The literature on inter-organizational relationships emphasizes the importance of ownership for considering how control is likely to be exerted. The two main types of equity alliances are joint ventures and minority alliances (Das & Teng, 1998; Gulati & Singh, 1998). PE arrangements are more akin to the latter, where one partner makes a direct equity investment in the other. Because minority alliances do not involve the creation of a separate entity the ability to exert control through hierarchical mechanisms is lessened. Hierarchical control is typically achieved by the investing partner sitting on the board of directors of the invested organisation. Participation in board meetings provides a degree of influence and oversight of major decisions, and a forum for the exchange of information and resolution of disagreements. PE firms may also take a majority position. While majority ownership generally means that the relationship is no longer ‘inter-firm’, as one entity effectively becomes a subsidiary of the other, for most PE arrangements the entities remain separate (Lehn & Poulsen, 1989). While majority ownership has the benefit of conferring residual control rights to the PE firm (Grossman & Hart, 1986), it may also provide a greater ability and motivation to implement a wider range of hierarchical control mechanisms.

These prior studies provide an initial basis for investigating the factors associated with variation and emphasis in the control choices of PE firms and represent the basis for the following research question:

> **RQ2:** What are the key factors that explain the selection and relative importance of control mechanisms used by PE firms to manage their portfolio companies?

3. Research setting and methods

3.1 Sample selection and PE firm characteristics

Our research is conducted through an embedded multiple-case design. In particular, we studied six PE firms by looking at more than one unit of analysis. More specifically, we considered how the six PE firms control their portfolio companies (at the time of interviewing, the six PE firms had active investments in a total of 64 companies). The comparative analysis of these arrangements allowed us to use a replication logic and examine each case to confirm or disconfirm insights deriving from the others. We studied first in more detail three cases to develop a tentative framework of how PE firms control their portfolio companies and then other three with the purpose of predicting similar results (a literal replication) or contrasting results but for anticipatable reasons (a theoretical replication) to refine the original framework (Cooper and Morgan, 2008; Yin, 2009; Caglio and Ditillo, 2017). Given the purpose of identifying factors that influence the selection and emphasis of control mechanisms to manage this relationship, we selected PE firms by considering criteria that prior literature suggests might be relevant. The sample considered was provided by a large consultancy firm. This firm has a specialist arm in PE advisory services with a significant network of associations within the PE sector. Based on our criteria, the consultancy firm made initial contact with six PE firms, all of which agreed to participate in the study. Our aim was to analyse the control of portfolio companies from the perspective of the PE firm and reflect upon their decisions related to the characteristics and emphasis of different control mechanisms. In particular, we use this analysis to develop a theoretical framework based on those factors that were identified as key in explaining the selection and relative importance of control mechanisms in different PE agreements.

The sample of PE firms were determined based on the following criteria. First, we sought variation in the ownership position taken. Some of the firms in our sample specialised in taking majority stakes (Firm M) or minority positions (Firms C, F) in companies, while for others the type of ownership position was not a primary consideration when making investment decisions (Firms A, I, X). Second, the investment stage. Common to all PE firms were expansion capital investments, in which the PE firm provides financing to a firm with an established technology or market position to enable more rapid growth by, for example, increasing production capacity, furthering product development, or penetrating international markets. Other PE firms also engage in replacement investments (Firms A, F, I), in which existing shares are purchased from another PE firm or financial institution, while two PE firms also engaged in leveraged buyouts (Firm A, M, I, X). None considered start-up/early-stage or rescue/turnaround investments, preferring to focus on firms that had proven track records.

The third consideration was the industry sector invested. We selected PE firms that undertook investments in a wide range of industries, to examine whether and how their approach varied to controlling firms operating in different industry contexts. However, each PE firm had certain guidelines and restrictions concerning which industries were to be excluded. Common restrictions included investments into weapons, tobacco, and gambling industries. Other restrictions included real estate and financial services (Firms A, F, C) and capital goods (Firm M). These were generally put in place because of the perceived risk and uncertainty of these sectors following the global financial crisis. Firm X had particular guidelines to avoid firms operating in highly regulated and labour-intensive industries as well as firms that were managed by families. Firm M, conversely, was active in seeking investments in firms undergoing family succession or transition to professional management.

The final dimensions considered were the size and geographical location of firms they invested in. Firm A focuses on smaller sized enterprises with significant growth potential, while Firms F, I, X and C considered also medium sized operations. Firm M focused on larger investments (40 to 125m Euro) in medium sized companies. In some cases the funds were used by the target company to make further business acquisitions. In terms of geographical location, Firms A and C invested only in companies that were in relatively close proximity (specific regions of Italy), while Firms F and I considered investments across Italy. Firm X specialised primarily in Italian firms with international operations, while Firm M made investments in companies located in the UK and continental Europe, including Italy. A summary of these factors and other characteristics of the six PE firms are reported in Table 1.

<Insert Table 1 about here>

The management structure of the PE firms are similar. Typically there are at least two executive committees, which can have overlapping members; one that is concerned with identifying and making new investments and another that is concerned with monitoring the performance and relationship with existing portfolio companies. There are some variations in how the PE firms make decisions regarding portfolio firms. For instance, Firm F has multiple teams that manage the operations of a subset of portfolio firms, whereas Firm M has three operating committees tasked with overseeing different decisions: strategic committee (e.g. reviewing and revising strategic plans on a 6 monthly basis), human resources and compensation committee (e.g. appointment of key managers, setting annual incentive targets), and special projects committee (e.g. implementation of key strategic initiatives).

Also common amongst our sample of PE firms is that investments typically occur in either of two ways. The first is through auctions, in which the PE firm engages in a competitive bidding process. The second is through proprietary transactions, in which the other transacting party may be another PE firm (secondary buyout), a parent company (division spinoff), or private owners or entrepreneurs. Proprietary transactions typically arise from tender submissions made to the PE firm or through personal and professional networks (e.g. financial institutions, investment banks, financial boutiques and advisories, consultants, CPAs, trade associations). In one instance the PE firm made initial contact with the company through cold-calling.

3.2 Data collection and analysis method

In the first phase of the study we conducted two interviews with consultants from the PE advisory arm of a large consultancy firm. These interviews provided initial insights into the PE sector and general structure of PE firms in Italy, and allowed us to gain access to firms in this field, where the difficulty of research access is acknowledged (Hardie and MacKenzie, 2007; King, 2008). We were successful in obtaining the collaboration of six PE firms and to identify related key informants that have significant experience in the PE field. In addition, we had the opportunity to interview three professionals from a legal firm specialised in PE agreements, to understand PE contracting in more detail. We collected data from semi-structured interviews with key informants in the PE firms. In order to triangulate our evidence where possible we also conducted some interviews in portfolio companies and we analysed formal documents, including contractual agreements, company policies and procedures (e.g. rules and behaviour policies, company statutes and bylaws), as well as company websites, company presentations, and industry association reports. In total we conducted 16 interviews over six months (see Appendix A). The interviews lasted between one and two hours. The interviews started with background information concerning the firm and the informant and then asked the respondent to describe the various phases of the relationship with the portfolio companies, the control mechanisms in place and the dimensions that they take into account when considering how to manage the relationship with the company (see interview check list in Appendix B). Almost all interviews were recorded and transcribed. For those that were not transcribed, detailed notes were taken during the interviews.

Data were first analysed with reference to the first three cases to identify relevant constructs and relationships and develop a tentative framework on how portfolio companies were managed and controlled. One important element of this process was that we allowed concepts to emerge from the data, rather than being directed by pre-defined hypotheses. We noticed common elements and differences between the cases that allowed us a continuous refinement of our framework, but we did not draw definitive conclusions until we had finished all the case analyses in order to maintain independence of the replication logic. We conducted cross-case analysis to identify similar constructs and relationships, grouping cases according to emerging dimensions that were associated with variation in control structures. Relevant emerging themes were related to the distinction between majority and minority stakes and on the presence of an entrepreneur or professional manager in the portfolio company with the corresponding implications in terms of characteristics and emphasis of control mechanisms. We fine-tuned identified relationships, revisiting the data to check whether each case suggested the same pattern, using tables and associations to foster an iterative comparative exercise. From this process we constructed a framework that explains the choice and emphasis of control mechanisms used to manage portfolio companies.

4. Evidence from the PE firms

4.1 Control mechanisms implemented by PE firms

The analysis of the evidence collected indicates that PE firms implement a wide range of control mechanisms in an attempt to support and orient portfolio company managers (Groot and Merchant, 2000; Dekker, 2004). In fact, the role of the PE firm is much more varied than simply inspecting and monitoring the activities of portfolio companies to reduce opportunistic behaviour. Rather, a primary purpose of control is to motivate opportunity search and influence decisions concerning the strategic direction of the company.

> I just think the most important thing we do is just try to educate in a way the management to do their best and to pay attention to the numbers […] and the other point is that we are trying to stimulate their minds to look for new opportunities for growth (Investment Manager, *Firm M*).

In the case of Firm F and Firm I, controls were the main way to influence the actions of the portfolio companies, more so than contractual arrangements, with positive effects on the performance of the investment.

> You can influence the course of action of the company not because you have the right, but because you have an idea, you have a proposal, you put it on the table and this is the right mind and you get two benefits. One is you get a positive news for the company, and the second is you have better trust from your partners. And whenever they have problem – my wife calls these “the Friday Night calls” […] they want to share with you the major real events of the week and they want to listen to your opinion about those events. This is a way and if

> you get this kind of confidence typically, not always but typically, the performance of the investment is much higher (Managing Partner, *Firm I*).

Evidence shows also which mechanisms are commonly adopted by PE firms to control their portfolio companies. These mechanisms are classified as contractual, outcome, behaviour or social controls, and for each of these groups a detailed list is reported in Table 2.

<Insert Table 2 about here>

PE firms define decision rights and monitor the actions of portfolio companies by means of legal ordering, which comprises the writing and enforcement of contractual agreements (financial contracting control). Common clauses placed in shareholder agreements related to exit rights (e.g. exit route, drag along, tag along, right of first refusal, redemption rights), board rights (e.g. number of seats, decision authority), voting rights, veto rights, managerial selection rights, and cash flow rights. Interestingly, although there were some variations in contracts between investments, most of the contractual clauses implemented by each PE firm were relatively standard. However, there was variation in the perceived importance of the different clauses.

Exit or liquidity rights are essential as PE firms are constrained by the limited life of the funds that they use to make acquisitions, and hence need to ensure that they have agreement with the other contracting parties about when and how the investment will be liquidated. All PE firms in our sample incorporated clearly specified exit rights in financial contracts, although the level of detail stated, notably in terms of the exit route, was particularly stressed by Firms F and C.

> We want to be clearly oriented towards a certain time horizon so the so-called liquidity clause negotiated with the parties sets out a certain time frame. Normally it's five years because our fund has an average holding period of five years for each investment. We identify possible ways of liquidating investments it could be IPO, it could be trade sale, it could be secondary sales, it could be a buy-back by majority investors, it can be a whole set of possible exit routes which are contemplated at the very beginning of the investment period. Then we need a certain degree of flexibility because we are not in control of external events (Managing Director, *Firm C*).

Control rights were important contractual specifications for all PE firms. Firm F commented on the importance of having the right to veto decisions relating to extraordinary operations (e.g. acquisitions), approval of the business plan and annual budgets, managerial selection, and investments or expenses over a certain threshold. Certain rights, such as the appointment or replacement of key managers, were often activated immediately. In majority ownership positions, Firm A typically appoints a new CEO, CFO and other key managers. Other firms preferred continuity of personnel (Firms M, F, X), and generally considered appointing or replacing only the CFO. This was especially common in situations where the company had a lack of financial expertise, as the CFO is considered critical to the success of the investment:

> Out of these [contractual controls] the most critical is having a CFO which is able to make the right dialogue with the fund. The CFO is the person which drives all the critical aspects of the company and sometimes neither the entrepreneur nor the CEO knows (Senior Partner, *Firm F*).
>
> The CFO is the real link between the company and the fund. So they must have the total trust of the fund and to do this [the CFO] must be chosen by the fund. Moreover, [the CFO] must also have the trust of the company, so it is very important that there is this alignment between the fund and the company. The CFO must be the one that connects both (CFO Portfolio Company A, *Firm M*).

Another important right is determining the non-executive board directors, as it allows PE firms to appoint specific professionals who had expertise that they felt the company required. Decision rights for specific area of expertise (e.g. international expansion, distribution channels) were often allocated to this individual. Control rights were in some cases stated contingently, typically dependent on the firm meeting financial performance benchmarks, but they were not seen to be particularly important as a contractual control, apart from instances where the firm had a significant amount of debt or additional future capital was to be provided.

However, while all these clauses represent an important way to regulate the agreement between the PE firm and the portfolio companies, the contract is considered as a tool to be enforced only as a last resort. We find evidence that the main role of contracting is in ex-ante definition of objectives and incentives, and in representing a means for developing trust, rather than being primarily an ex-post control tool.

> The main rule is never fight. Even if you lose money, you cannot fight. Because it is inefficient […] Today we have a legal fight with one of our partners in the previous investment. It's three years, we are still there, in a very preliminary discussion […] imagine, we can have the [investment fund] closed and still have the legal dispute, it doesn't make any sense (Managing Partner, *Firm I*).

> Of course it happens that sometimes they do not respect the [contractual] clauses, but I have never taken the lawyers to enforce the respect of the clauses […] the trust would have been under risk if I had used a strong approach (Senior Partner, *Firm F*).

Apart from contracting, common outcome controls implemented are regular financial reporting, participation in target setting, and incentive compensation. Often these outcome mechanisms are described in contracts, which specify the frequency with which financial reports and other performance information had to be provided to shareholders. Apart from Firm A, PE firms usually required invested companies to provide monthly financial reports. Firm A stipulates quarterly reporting, as the firms they invest in often lack the systems and personnel to provide detailed financial reports on a more frequent basis, at least initially. Generally, financial reporting tends to be quite standardized across portfolio companies, although these may be complemented by unique performance indicators that relate to the specific industry, strategy or context of the company.

> The principal tool we use to monitor financial performance is a regular formal reporting […] we have a set of standard financial reports which are provided to the company, they're customized, of course, depending on the type of business (Managing Director, *Firm C*).

Financial incentives were also seen as being critical to align the economic interests of company executives. Incentive structures for the second and third tiers of managers were implemented in some instances. There were three main incentive mechanisms. First, some of the PE firms ask company executives of the portfolio company to invest a certain amount of their own money in the firm (Firms F, I, C). This amount is calculated for instance on the basis of personal wealth or as a multiple of annual salary. Some PE firms also required the employees that are managing the investment to take an equity stake (Firms C, I). This not only incentivized the PE firm managers to "fight for that investment" but provides an initial basis for building trust – the "entrepreneur understands that you are a little bit like him" (*Firm I*). Second, short-term incentives are specified, including annual bonuses, granting of share options, and salary increases. These are tied to key financial metrics, such as turnover, profit, cash flow, and other budget and operational targets. Third, earnout clauses are implemented that provided a payment determined by whether or not, or the extent to which, the exit price of the firm exceeded a predetermined target. Another incentive mechanism, although less common, was sweat equity, which confers equity rights based on continued contributions in terms of time and effort by the entrepreneur. This is used to encourage an entrepreneur with specialised knowledge and skills, to remain with the company throughout the entire life of the investment.

A wide range of behaviour control mechanisms are also implemented by PE firms. Shareholder meetings and board meetings, typically monthly, were contractually specified in all instances, as was the right to call impromptu board meetings if extenuating circumstances arise. Management meetings and specialized committees (e.g. strategic review, human resources) were also important in many cases, as were company site visits, where PE firm managers were able to talk to lower level managers, employees, and clients.

> We sit in the board and we normally ask for a monthly board meeting. If there is a need we can have a weekly board meeting. But anyhow we normally have the right to call the board for a meeting, whatever the subject (Managing Partner, *Firm I*).

> It's important for us to visit the companies often. At least every month, once a month we have a visit at the company site, speaking with people, if it's possible speaking also with clients. This kind of stuff is very, it's very important (Senior Partner, *Firm F*).

Business planning is another key behavioural mechanism because it provides an initial agreement between the PE firm and the entrepreneur or managers as to how to set the strategic objectives and desired performance of the company over the life of the investment. Business planning also serves to define the role of the PE firm and extent of involvement in providing advisory capacity and initial financial capacity. All PE firms we interviewed are actively involved in constructing the business plan at the start of the investment – one investment manager commented that at the start of the investment 'we jump into the process […] and help them to develop the budget or the business plan' (*Firm M*). If invested companies are performing well, then the level of involvement in future reviews and adaptations is less, but typically they retain the right to veto business plan revisions. Involvement in budgeting and operational planning varies between PE firms, from the exercise of final approval to active involvement in all aspects of the planning process (e.g. determination of assumptions, costing resource requirements).

PE firms set various rules and procedures, in particular for how board meetings are to be conducted, but also in terms of boundaries around the strategic and operational activities of the company. This limits the discretion of company managers (e.g. the type of investments that they can make) without seeking formal approval.

Social controls and interpersonal relationships were also mentioned by all PE firms as being especially important for managing portfolio companies. PE firms leverage a personal relationship that starts at partner selection (i.e. the portfolio company). Appropriate partners are identified on the basis of reputation, direct past knowledge, business networks and social ties, and selected based on specific criteria for identifying investments and the related entrepreneur and management team.

> [In choosing the portfolio company] there is the size of the company, the geographical location, the sector, the quality of management. We have the hard and soft criteria of course. The hard criteria are the geographical location, sector and fundamentals. […] Then we have a full set of soft criteria, which of course encompass the quality of management, its track record of management, organisational behaviour of management, goal orientation and of course all those soft psychological sometimes philosophical elements which underlie management action (Managing Director, *Firm C*).

Partner selection can be quite protracted. The managing director of Firm F commented that forming a relationship with an entrepreneur can begin two to three years prior to an investment agreement being reached. Particularly important is the development of trust and solidifying mutually agreeable expectations between the PE firm and the entrepreneur:

> I think that it is a slow process in which you have to build trust every single day, reciprocal trust [between] yourself and the entrepreneur, and our role is to enter in confidence with the entrepreneur, to show the entrepreneur that we are not a vulture fund, we don’t want to destroy the company that he created. We do not want to, to make the extra profits by destroying his life or his family. But it’s, we try to demonstrate that, maybe doing in a different way, or giving us some governance or giving us some procedures is not only good for us but is also good for the company. So it’s a process of trust building (Senior Partner, *Firm F*).

Selecting an appropriate partner represents the starting point for building an effective relationship with the portfolio company. Continuous interaction between the PE firm and the portfolio company to jointly set objectives, address problems, make decisions and coordinate the activities , aimed at jointly setting goals, solving problems, decision-making, and carrying out activities of partnership development was noted as being important throughout the life of the investment, but particularly critical at the beginning.

> We really push for a lot of meetings in the beginning. Because you really have to build a relationship […] we have to know each other in terms of view about the company and so on. It requires a lot of effort and a lot of time but I think that must be done from day one and it is much more important than formal things (Managing Director, *Firm X*).

In this way the PE firm's members activate commitment and motivation to generate positive results from the arrangement and decrease opportunistic behaviour. They acquire knowledge on the competencies and preferences of portfolio companies and define informal communication and management practices.

4.2 Factors associated with variation and relative importance of control mechanisms

The previous section outlined the role and characteristics of the control mechanisms implemented by PE firms to manage portfolio companies. While the presence of these mechanisms was commonly observed across the PE firms, their relevance and emphasis, however, was not uniform. In this section we present the factors that emerged from our case analyses that explain variation and different emphasis of control mechanisms.[6]

One factor is whether the company is family-owned. When dealing with family-owned firms, informal communication and trust-building have greater importance. Without effective social controls, access to information and the success of efforts to guide firm decisions is limited.

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[6] A few factors that we thought might be relevant seemed to have little influence on control choice. The objectives of the PE firm – whether expansion, buy-out, restructuring, and so on – do not seem to matter because "the mechanisms are ex post all very similar, standardised with some differentiation based on the industry" (Managing Director, Firm C). In fact, the approach tends to be more from a distance when "there are very specific sectors in which you cannot understand exactly the things" (Senior Partner, Firm F). Also the level of performance does not seem to affect much the kind of control mechanisms adopted "because the performance of a company can be erratic over time" (Managing Director, Firm C).

> This idea of maximizing the monetary value of the company is something which is very different from a family company world. Emotional value sometimes comes into place […] If it's a family owned company it's more difficult because [of an] instinctive mistrust of finance people […] and instinctive reluctance to open up to a third-party (Managing Director, *Firm C*).

The method of investment – whether through an auction or a proprietary sale – is another factor. In a proprietary sale the PE firm can establish direct contact with the entrepreneur or managers. When the transaction takes place through an auction, the PE firms have limited exposure to the company and restricted access to owners and managers. Typically stricter contracts need to be implemented as it is not possible to develop strong relational ties between the parties prior to the investment taking place.

The presence of a professional intermediary in the process can also have an influence. A professional intermediary can improve information access prior to formalizing a contract and make it easier to gain the trust of an entrepreneur.

> It really can change if it's a professional, structured, sophisticated advisor that has done a lot of work ahead the time with the entrepreneur, convincing him to give enough disclosure to potential investor (Managing Director, *Firm C*).

Other factors include the level of debt of the portfolio company, which tended to influence the tightness of financial covenants included in the contract, limits on capital expenditure, and formal approval processes, and the investment lifecycle stage, which influences the extent of contact between the PE firm and the portfolio company. Interaction tends to be more substantial at the beginning of the investment period – e.g. building trust, developing shared objectives, constructing the business plan, implementing or adapting control mechanisms – and at the end of the investment when the PE firm exits the investment.

> In the initial phase it is certainly necessary that we are more present […] because we have to understand how the company works (Investment Manager, *Firm A*).

Another factor is the size of the portfolio company. Larger firms tend to have more sophisticated accounting and control structures in place, enabling more frequent access to information with greater detail.

> In certain cases, we have weekly key performance indicators but the size of the companies we deal with, normally are not so big. So with small companies, you have the problem that the organization cannot afford to produce as much information [as] you want (Managing Partner, *Firm I*).

Among all the factors identified, however, two dimensions emerged as being predominant in explaining the selection and relative importance of control mechanisms: (1) the equity arrangement between the PE firm and the portfolio company, and (2) the cognitive style of the portfolio company's management which is, in most instances, related to whether the company is managed by an entrepreneur or by a management team. These factors emerged in our cases as particularly important because they affect, on the one hand, the decision-making process taking place within the portfolio company and, on the other hand, the level of formal influence that the PE firm is able to exert.

4.2.1 The influence of the equity arrangement

The *equity arrangement* or ownership structure relates to whether or not the PE firm has a controlling interest in the portfolio company.[7] With a non-controlling interest (*minority stake*), the PE firm does not have the benefit of residual control rights (Grossman & Hart, 1986) and will tend to have a more limited capacity to implement hierarchical control mechanisms within the portfolio firm after the contract has been determined. In minority stake investments, the specification of contractual clauses is particularly important:

> Governance rules provide for a set of legal limits to the power of the majority shareholder […] so we have all these important legal limitations which you set in the shareholder agreement. And that's particularly true when you are a minority shareholder versus when you are a majority (Managing Director, *Firm C*).

In a minority position, contractual clauses need to be carefully negotiated with the majority shareholder(s). Certain control rights can be difficult to obtain as the majority shareholder (e.g. the entrepreneur) may be reluctant to give up their decision-making autonomy – "when you are a minority investor it's much harder to obtain from the majority shareholder the power to veto" (*Firm C*). At the

[7] In nearly all cases only one PE firm was involved in a portfolio company investment. For syndicated investments (i.e. multiple PE firms) that take majority ownership stakes, typically one PE firm will be the lead investor and retain most control rights.

same time, some PE firms will attempt to introduce specific contractual clauses to limit the discretion of the majority stakeholders and the related management team:

> In the contract, given that we are in minority position in the board of directors, we have the veto rights on extraordinary events, but not only that, also on ordinary management that goes beyond certain expense limits, as well as on strategic issues and the approval of the budget or the business plan which are approved with our vote (Investment Manager, *Firm A*).

Two contractual rights emerged from our analysis as necessary in most instances for a PE firm to invest as a minority shareholder. One was having access to financial and operational information in order to monitor and evaluate the performance of the company and its top managers. The second relates to the timing and route of exiting the investment. Without clearly defined exit rights, the minority partner can be stuck in the investment if a buyer only wishes to take whole or majority ownership of the company, and the majority partners refuse the offer.

> The most important aspect as a minority investor is the control of the exit route […] it's always recommended to have a very clear idea of the way you want to go about exiting and setting it very clearly vis-a-vis with the other partners (Managing Director, *Firm C*).

Exit rights may include drag-along and tag-along rights, and in some cases buy-back clauses, which ensure that if typical exit routes (e.g. trade sale, IPO) are unsuccessful, the PE firm can still exit the investment through selling their share of ownership to the majority shareholder at a predetermined price.

Although PE firms in minority positions will have access to financial and other performance information, and will often have at least one seat on the board of directors, the capacity to implement outcome and behaviour controls is otherwise limited. As such, social controls are the primary mechanisms through which PE firms influence the portfolio company. The general approach then is one that is "softer" in terms of attempting to accommodate the views and desired direction of management.

> In terms of attitude, when you are a minority investor you tend to […] accommodate more the management decisions and you have a softer stance towards managers. It's a consequence of not being the ruler of a company (Managing Director, *Firm C*).

Influence is exerted through informal relationships that PE firm develops with portfolio company managers.

> If the participation is a minority, however we must have a direct contact that we try to create, with the entrepreneur, with the CEO, to try to have a more or less continuous control on what is, say, not the ordinary administration […] but on what are strategic decisions in the company […] it can also be an informal contact with the entrepreneur, where in the phone call once a week we try to understand what is happening, what we are doing, if there is a need to go to the company, if there is a need for our presence in the company (Investment Manager, *Firm A*).

In one minority investment, Firm C wished to learn more about the projects taking place within the firm that would need to be taken to the Board of Directors for addition financing approval. Rather than voice concerns about specific projects at the Board of Directors meeting, in which they have little formal authority, they obtained information through informal contact with key managers, and provided suggestions and guidance about where the firm should be investing its resources. In contrast, with a controlling interest (*majority stake*), PE firms tend to have a more interventionist approach, and rely more on contractual and formal control mechanisms.

> When you have the majority, because you have a higher degree of responsibility, you have to have a tougher stand, a more incisive attitude towards management and with the general stakeholders of the company because you want to protect yourself from risks […] you may want to have a tougher role towards managers, you may want to implement more formal communication, formal tools towards managers (Managing Director, *Firm C*).

In majority positions, PE firms will tend to implement more rigorous financial controls and reporting procedures – "if it is a majority stake, we try to have a frequent monitoring of numbers" (Investment Manager, *Firm A*). This enables a results-based control approach, whereby managers are granted more discretion and independence but made responsible by means of performance targets, while certain boundaries are introduced through behavioural controls, such as rules, procedures and sanctions. In another portfolio company of Firm C, in which it had a majority stake, a number of critical performance issues were identified. In contrast to the informal and "soft" approach taken in the case of the minority investment noted previously, performance issues were formally detailed in the Board of Director minutes following an extraordinary meeting, together with an outline of what the CEO was required to do to turnaround the situation. Three months later Firm C dismissed the CEO and appointed a replacement. For majority investments, the right to dismiss and appoint key personnel is a primary lever for influencing the strategic trajectory and performance of the portfolio company.

> When we are a majority shareholder and we have responsibility over the management of the company we need to appoint managers. In some cases, we may retain former managers […] but definitely we go forward with new managers if we think there is need for change (Managing Director, *Firm C*).

However, the timing of the appointment of executives and managers is key because it may have an impact on the success of the transaction, given that the portfolio company may have its own specific style of management, which requires time to be modified.

> Often in family companies we have a specific, peculiar management style and the transition to professional management cannot be brutal, we don't want it to be brutal or abrupt so we ask former managers to ensure handover (Managing Director, *Firm C*).

It can be, though, very difficult to change the way in which managers operate within the portfolio companies, especially if the company is being run by the entrepreneur.

> It's difficult to change, you know? To change the habits because they were preparing, for example, quarterly income statements and no cash flows, no balance sheet. Now they are preparing a monthly package. But it took some time (Managing Director, *Firm X*).

4.2.2 The influence of cognitive style

The second factor that emerged as having a significant influence on the choice and emphasis of control mechanisms related to the individual traits of the key management of the portfolio company. This style is partly due to the fact that the portfolio company is run by entrepreneurs or managers.

> The difference [in control mechanisms] is if you talk about relation with the manager or with an entrepreneur (Managing Partner, *Firm I*).

Prior literature indicates that the way in which the company is managed can be described in terms of cognitive style. *Cognitive style* refers to an individual's preferred and habitual process for "acquiring, processing, maintaining, and using knowledge for problem solving" (Miron-Spektor et al., 2011, p. 741). Style reflects the form rather than the content of individual cognition and explains what individuals pay attention to in their environment and how they respond to change (Barbosa et al., 2007; Hayes & Allinson, 1994; Kaplan, 2008). An *entrepreneurial cognition* refers to the extensive use of heuristics and intuition in decision making (Wright et al., 2000). Individuals with an entrepreneurial cognition tend to be relatively nonconformist, have a preference for relational and experiential learning, make use of more subjective and informal decision making processes, make quick decisions based on limited information, and will enact their individual beliefs on the way the firm is structured and operates.

> If you talk to an entrepreneur, the difficult part is, even if he has the 20% of the company, he thinks that the company is his company, and he stays with that view. (Managing Partner, *Firm I*).

When the entrepreneur is the key subject in the portfolio company, the PE firm representatives focus more on broader issues of strategic advice and connections, rather than formal monitoring, decision ratification, and instituting rules and procedures.

> We do not want to drive the company ourselves instead of the entrepreneurs, we want to support entrepreneurs to do that (Senior Partner, *Firm F*).

Individuals with an entrepreneurial mindset are likely to ignore formalized controls or worse these may generate conflict and resentment towards interventions by the PE firm (Allinson & Hayes, 1996; Mitchell et al., 2007). The need for monitoring performance, however, is still necessary, particularly as much of the future value of the company is based on the tacit knowledge and understandings of the entrepreneur.

> [We] are in a minority share, but you […] have to monitor surely more because it is all in the hands of an entrepreneur […] So, in that case there, our commitment and our approach is certainly more intensive (Investment Manager, *Firm A*).

> The entrepreneur owned 60% of the company and he was reluctant to accept a formal set of reporting […] And that was really related to the nature, to the personal nature, the sort of attitude that this guy had […] so we had to accept in this specific instance a less set of formal information. Conversely we had really daily access to managers in an informal way. So we did make up for a direct formal information exchange with more informal liaisons (Managing Director, *Firm C*).

Interviewees at Firm A and Firm F both commented that they attempted to introduce some degree of formalisation, such as regular meetings and standardized financial reporting, but this is not always possible.

> We have difficulties when the portfolio company cannot produce those data. It's not able to provide us the information. This is a difficulty in controlling the firm (Investment Manager, *Firm A*).

Much of the capacity to influence decisions, then, comes about through reciprocal trust building and mutual understanding about the objectives of each party. PE firms attempt to develop close personnel relationships with entrepreneurs and seek to achieve compromise over the strategic direction of the firm and major investment decisions.

> Relation, relation. It's moral persuasion; it's the ability to convince […] if you are able to conquer the trust of the entrepreneur, he starts feeling that you are not a counterpart, you are a partner. When you are a partner, as in every partnership there is mutual trust, there is a mutual ability to influence even if you don't have the [contractual] right (Managing Partner, *Firm I*).

Contracts were still considered important control mechanisms. For instance, when much of the value of the firm is tied up in the knowledge capital of the entrepreneur, contracts are likely to include non-compete clauses. However, there were definite limits to the ability of PE firms to enforce contractual rights. Provisions such as veto rights were rarely exercised when dealing with entrepreneurs, especially when the PE firm has a minority stake.

> It allows you to create these relationships, this trust, together with entrepreneur. It is what you need, especially if you are a minority stake, because if you want to impose rules being in a minority, it doesn't work (Senior Partner, *Firm F*).

Even when the PE firm does have the contractual right to enforce a particular decision it can be problematic to do so. The managing director of Firm I explained that in one case a potential trade deal where the buyer wanted an outright purchase of the company was scuppered by the entrepreneur, even though the PE firm had all the contractual rights to enable to the sale to proceed. In meeting with the prospective buyer the entrepreneur exaggerated all the perceived weaknesses of the business and claimed how the company would cease to be financially viable without him or her being involved.

> The only way we can solve this situation is not because you have the shareholders' agreement, but because you find a mutually satisfactory agreement (Managing Director, *Firm I*).

In contrast, individuals with a *managerial cognition* tend to be more compliant and have a more professional approach with a preference for systematic, analytical and rational methods to problem solving and decision making (Allinson & Hayes, 1996; Mitchell et al., 2007). Decision making is more likely to be guided by formalised policies, procedural routines, and the use of quantified information to justify strategic actions, and as such, PE firms are able to more easily leverage these mechanisms to influence managers (Wright et al., 2000).

> If you are talking with the manager, that makes a difference. Because a manager is somebody that works for you (Managing Partner, *Firm I*).

PE firms place a greater reliance on results controls mechanisms, such as budgets and performance-based incentives, to monitor and influence the actions of managers. The development of shared expectations and objectives is also facilitated through processes such as budgeting.

> If the management is good we monitor the budgeting process from a sort of high level point of view. They present the work, we discuss about the budget assumptions. If we think it is not ok, then they go back and change it, so there is a standard negotiation between the [PE firm] and the managers (Investment Manager, *Firm M*).

The use of control mechanisms in case of managerial cognition depends on the level of autonomy provided to portfolio company managers. For PE firms in minority positions, contractual provisions, especially veto rights and control over certain decisions, are important safeguards to managerial discretion. In a majority position, although holding control rights, they tend not to be activated. Instead, the PE firm relies on the judgement of key managers, some of which they have selected.

> -[The PE firm] selects a manager and delegates to the management of the company, defines the objectives and makes resources available. From there, the manager is free to decide. There are moments in meetings in which the [PE firm representative] intervenes, since the owner has all the rights, but [they typically] try to help you without interfering in the activity. (CFO Portfolio Company A, *Firm M*).

When PE firms are dealing with a professional management team, interpersonal interactions also tend to be less intensive and formal channels of communication are more likely to be adhered to.

> We mainly go through CEO, CFO, or head of Italy or head of Germany if we have something specific, but we don't go below […] we have to respect the way the management is managing. (Managing Director, *Firm X*).

5. Discussion

Our case analyses reveal that there is a relatively common set of control mechanisms that PE firms implement to manage the relationship with portfolio companies. In contrast to the majority of studies examining PE from a financial contracting perspective, which assumes that the relationship is coordinated primarily through ex-ante contract specification and ex-post results monitoring, our analysis reveals that PE firms implement a much wider range of control mechanisms. In particular, social controls were found to play a critical role in how the PE firm attempts to influence the actions of the portfolio company. While the presence of these mechanisms are relatively common, their emphasis or importance varies depending on a range of factors – family ownership, method of investment, presence of a professional intermediary, level of debt, investment life-cycle stage, portfolio company size – although two in particular, the equity arrangement and the cognitive style of key management in the portfolio company, emerged as the primary factors associated with variation in the control structure in use.

The equity arrangement refers to whether a firm has a controlling (majority stake) or non-controlling (minority stake) interest in the portfolio company. With majority interest PE firms have significant capacity to influence the design of the control structure of the portfolio company. Control arrangements mirror closely how a parent company controls a subsidiary or joint venture, with mechanisms including defining command and authority structures, formal planning and approval processes, operating procedures, and formal mechanisms for dispute resolution (Gulati & Singh, 1998). Results based control, such as budgeting processes and incentive structures, are particularly important, providing direct mechanisms to clarify and motivate desired performance (Goold et al., 1994). These formal mechanisms reduce the need for social control processes such as intensive relational development, although replacement of personnel is important to ensure the firm has adequate technical and managerial capabilities to achieve desired objectives.

In contrast, PE firms with minority interest do not have the same ability to exert formal control. Some control rights are particularly important for minority partners, such as veto rights and access to financial information, and PE firms generally have at least one seat on the board of directors, allowing some degree of hierarchical supervision. But beyond board level interactions and certain contractual rights, influence over firm activities must be “negotiated on an ongoing basis” (Gulati & Singh, 1998, p. 793). Initial partner selection is critical as the ability to replace personnel ex-post may be limited. PE firms will invest in social interactions that build trust between managers, such as site visits, informal communications and an emphasis on advice-giving and joint problem solving in order to influence the direction of the invested firm (Dekker, 2004).

Cognitive style refers to whether key personnel have an entrepreneurial or managerial mind-set. In portfolio companies led by entrepreneurs, formal contracting can become prohibitively costly and difficult to enforce when optimal firm actions or the intentions of firm managers are based on tacit knowledge and non-codified information (Dyer & Singh, 1998; Schepker et al., 2014). Entrepreneurs will also tend to work around standardized procedures that limit autonomy and flexibility. Rather, the control efforts of PE firms focus on building trust and mutual understanding, such that exchanges were regulated through “unwritten and largely nonverbalized sets of congruent expectations and assumptions held by transacting parties about each other’s prerogatives and obligations” (Ring and Van de Ven, 1994, p. 100). Certain contractual specifications and compensation mechanisms tying the entrepreneur to the firm, such as non-compete clauses and equity-based incentives, were however considered important, particularly when their idiosyncratic knowledge and capabilities are central to the success of the organization (Arthurs et al., 2009). Financial reporting is also implemented by the

PE firm to monitor performance if not already in place, but little reliance will be placed on these systems to actively influence managerial decisions.

When the key personnel of the portfolio company have managerial mindsets, then greater reliance tends to be placed on formal contracting and results-based control structures. Individuals with managerial cognitions tend to use “accountability and compensation schemes, the structural coordination of business activities across various units, and quantifiable budgets” in making decisions and justifying prior actions (Wright et al., 2000, p. 592). Compensation based on short-term financial targets, regular financial reporting, standardized decision rules, and formalized planning procedures fit the preference of these individuals for structured work environments and analytical, systematic and fact-based decision-making (Brigham et al., 2007). Moreover, organisations led by teams with managerial mindsets are likely to have more sophisticated reporting and control structures already in place.

Based on our findings related to these two dimensions, a typology of control structures is derived, which is presented in Figure 1.

<Insert Figure 1 about here>

In transactions characterised by entrepreneurial cognition and minority ownership, PE firms have limited ability to impose formal control mechanisms, while critical information resides with the entrepreneur. They will also tend to have fewer contractual rights due to the minority stake, although clauses such as non-compete and exit rights are often a requirement for PE firm investment. As such, it is necessary to leverage on social control to influence the entrepreneur towards the achievement of objectives that are beneficial to both parties. In this situation, partner selection – choosing the right firm and the corresponding individual (entrepreneur) – is essential for the success of the investment as well as for the development of a partnership characterized by reciprocal trust. This is because the PE firm needs to exploit the strategic and business information that the entrepreneur has developed through experience and tacit understanding. At the same time, continuous interaction and support in decision making and problem solving contributes to overcoming resistance to change and encouraging the entrepreneur to seek new ways to generate growth.

In arrangements with an entrepreneurial cognition and majority ownership, PE firms will attempt to implement more formalised control structures. Companies in this quadrant are typically characterised by decision making based on personal convictions and informal routines, and the imposition of bureaucratic control mechanisms can create conflict with entrepreneurs who has an established 'way of doing things'. Yet some degree of formalisation can help the PE firm to overcome embedded rigidities and resistances to adaption, necessary to take advantage of growth opportunities. In order to alter the strategic direction of the company PE firms will often appoint key personnel in the firm, such as the CEO, and introduce more formal decision-making processes and procedures to foster greater accountability for increasing firm value. Companies in this quadrant often have unsophisticated outcome controls. In these cases the PE firm will invest in developing structures that enable more frequent and detailed performance reporting. Over time the management structure is adjusted to try to combine the strategic knowledge and operational know-how of the entrepreneur with a more formal management structure that focuses the company towards greater value generation.

In the case of managerial cognition and majority ownership, the PE firm is able to effectively rely upon an outcome-based control structure, by monitoring the achievement of financial and non-financial targets that have been agreed upon with management. The CEO and management team retain discretionary power on most strategic and operational decisions regarding how to achieve strategic objectives (Wright et al., 2001), with the PE firm intervening only when objectives are not being met or the proposed strategic plans are inadequate. As the majority owner, the PE firm will have control rights, including those to appoint and replace key personnel. The most common appointment is the CFO, who acts to ensure the trustworthiness of the information being reported. The CFO is also often the primary intermediary between the PE firm and the portfolio company, and regular interactions mean that the arrangement is not limited to a strict principal-agent approach to monitoring (Sapienza and Korsgaard, 1996; Cable and Shane, 1997).

For arrangements with managerial cognition and minority ownership, the formal control that can be exercised by the PE firm is limited. Because the ability post investment to influence managerial behaviours is limited, financial contracts play a decisive role in this case. Certain clauses are particularly important, such as selection rights, which will affect the hiring, evaluation and firing of key managers. Voting and board decision rights are also important. As a minority investment, exact specification of exit rights is a critical contractual clause. For PE firms in minority positions are limited in the number of seats that they have on the board, which is often only one. Seats are either assigned to a member of the PE firm, or the firm selects outsiders with certain competencies and expertise that they feel are necessary for company growth. PE firms typically will specify that the outside or PE firm member has rights over decisions concerning a particular strategic area (e.g. international expansion). Other decision-rights that are negotiated are usually state-contingent, for instance, transferring power to the PE firm only when performance falls below certain minimum thresholds. In order to influence the general strategic direction of the firm, PE firms frequently make use of informal communication channels, with the majority shareholder or key managers in the firm.

6. Conclusion

The objective of this work was to extend the analysis of the characteristics and contingent factors of management controls in PE settings. To achieve this aim we have departed from existing contributions in the control literature and contributed in at least three ways. First, while other ownership structures (e.g. subsidiaries) and inter-organisational relationships (e.g. alliances, partnerships) have received significant attention, we have examined PE firms as a distinct arrangement, and provided descriptive evidence of the characteristics and roles of control mechanisms within these firms. Second, we contribute to the current debate contrasting the role of the PE firms as simple financial resources providers operating 'at a distance' like investors, with the more active contribution in the support of the portfolio companies' management teams. Their role include a complex set of activities that go from the monitoring and approval of relevant decisions to broader issues of strategic direction and a focus on social exchange, interdependence and cooperation (Graebner and Eisenhardt, 2004). Third, we illustrate the importance of a wide range of control mechanisms, beyond contractual arrangements, and in particular, the importance of leveraging social controls to effectively manage portfolio companies. Finally, we developed a contingent framework to explain how the choice and relative importance of the control mechanisms adopted by PE firms is dependent on the equity arrangement and the cognition of portfolio firm managers.

One limitation of the study is that it is restricted to PE firms in a single country. As national context is likely to have some influence on the choice and emphasis of control mechanisms, future research should explore the control choices made by PE firms in other countries. Additionally, PE firms in our sample were generally focused on investments in small to medium sized companies. It may be that a less active and more transactional approach to control, reflecting conventional agency-theory expectations, is more evident in PE firms that manage deals of significantly greater size. Another factor is that across all of the active investments of the PE firms, in almost all cases there was only one PE firm involved. However, it is not uncommon for multiple PE firms to jointly invest in a portfolio company. It would be interesting to investigate how control amongst each party is organized under different conditions. Furthermore, although there were exceptions, most investments were made in

Italian companies. This may enable social control to work more effectively, especially when PE firm members are able to regularly interact face-to-face with portfolio company managers. Examining how PE firms investing in foreign companies manage their investments would be another avenue for future research. Despite these limitations, we hope this study will provide an impetus for further research into the control arrangements of PE agreements and the role they play in different economic and organizational contexts.

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Table 1
Characteristics of PE firms

	Firm M	Firm C	Firm X	Firm F	Firm I	Firm A
Structure						
Number of executives	7	5	3	20	10	14
Number of funds	1	1	2	1	3	3
Funds under management	1300m Euro	100m Euro	350m Euro	1200m Euro	200m Euro	280m Euro
Number of portfolio companies	7	3	14	16	13	11
Portfolio company industries	Consumer goods, professional services, manufacturing, petrol distribution.	Infrastructure, automotive, industrial products.	Manufacturing, professional services, food and beverage, pharmaceuticals, industrial products.	Consumer goods, industrial products, healthcare, manufacturing, maritime services, environmental services.	Industrial products, consumer goods, automotive, transportation, energy, media.	IT, industrial products and services, consumer goods, food and beverage.
Investment policy						
Minimum investment	40m Euro	n/a	10m Euro	n/a	5m Euro	10m Euro
Maximum investment	125m Euro	n/a	30m Euro	n/a	20m Euro	200m Euro
Target	Medium size companies operating in Europe. Excludes capital or industrial goods sectors.	Companies with a turnover ranging from 10 to 150 million euros in Northern and Central Italy. Excludes real estate and financial service sectors.	Companies valued from 15 to 100 million euros operating in Europe that have an international market focus. Excludes firms in highly regulated, labour-intensive or commodity sectors.	Companies operating in Italy with a turnover ranging from 10 to 250 million euros. Excludes real estate and financial service sectors.	Small to medium size companies operating in Italy. Focus on firms seeking to expand internationally.	Companies with a turnover typically ranging from 40 to 50 million euros operating in Northern Italy. Excludes real estate and financial service sectors.
Investment stage	Expansion, buyout	Expansion	Expansion, buyout	Expansion, replacement	Expansion	Expansion, replacement, buyout
Ownership position	Majority	Mainly minority	Majority and minority	Mainly minority	Majority and minority	Majority and minority

Table 2
Control mechanisms implemented by PE firms to manage portfolio companies

Formal contracting	**Outcome control**	**Behaviour control**	**Social control**
Pre-contract • Letter of intent • Due diligence • Discussions with management *Contractual clauses* • Cash flow rights • Exit rights o Specification of, or right to determine, exit route (e.g. trade sell, IPO, secondary buyout) o Drag along rights (minority shareholders required to sell) o Tag along rights (right to include minority shareholding in any majority shareholding sales) o Right of first refusal (right to purchase shares of another owner before a third party) o Buy-back / redemption rights (right to sell shares back to initial owner at a predetermined price after a specified period of time) • Managerial selection rights o Replacement and selection of managers • Veto rights o Right to veto specific managerial decisions (e.g. extraordinary operations, mergers and acquisitions, business plans,	*Reporting* • Monthly reporting (key financial and non-financial indicators) • Monthly or quarterly reporting of detailed financial statements • Free cash flow projections • Annual audits *Target setting* • Strategic target setting with clear time horizons • Budget target setting *Incentives* • Annual bonuses (e.g. cash payments, share options) • Earn-out bonuses (incentives based on performance of the firm over a specified period, e.g. profit target reached within a three year period) • Exit bonuses (based on e.g. internal rate of return, investment multiple, exit value) • Sweat equity (equity rights based on non-monetary contributions of the entrepreneur, i.e. time and effort) • Equity investment by entrepreneur or executive managers (often 'pari passu' with PE firm managers)	*Plans* • Strategic business plan development and reviews • Operational plan development and reviews *Meetings* • Shareholder meetings • Board of directors meetings • Management committees • Onsite visits *Rules and procedures* • Strategic boundaries • Planning procedures and approvals	• Partner selection o Reputation (e.g. personal networks, investment banks, local boutiques, CPAs) o Relationship developed through pre-contract interactions • PE firm managers invest their own money in the company • Frequent and open dialogue • Reciprocal trust building • Joint decision making • Informal resolution of disagreements and contractual breaches • Limited use of contractual rights

budget approval, investments exceeding a certain threshold) • Voting rights o Decision rights of shareholders specified independently of equity holding • Board rights o Number of seats assigned to different parties (e.g. shareholders, executives) o Decision rights over specific areas (e.g. international expansion) • Dispute resolution processes • Non-compete and confidentiality agreements for departing managers			

Figure 1
Primary factors influencing the choice of control mechanisms in PE firms: A framework

Ownership participation	**Cognitive Style**	**Entrepreneurial**	**Managerial**
	Minority	FINANCIAL CONTRACTING Non-compete clauses and exit rights. SOCIAL CONTROLS Partner selection based on trust and ongoing interpersonal interactions to gain access to private information and influence decisions	FINANCIAL CONTRACTING Veto rights, voting rights, and exit rights. SOCIAL CONTROLS Informal communication with key managers, as well as majority shareholders, to influence decisions.
	Majority	FINANCIAL CONTRACTING Selection rights to appoint or dismiss managers in key positions. OUTCOME CONTROLS Implementation of more frequent and standardised reports; equity-based incentives. BEHAVIOURAL CONTROLS Formalised board and committee meeting procedures and approval processes.	FINANCIAL CONTRACTING Selection rights to appoint or dismiss managers in key positions; often the CFO who acts as the primary intermediary. OUTCOME CONTROLS Strategic and annual target setting and close monitoring through performance reports. Annual and long-term performance-based incentives.

Appendix A

Interviews conducted

Firms	**Interviewees**	**Length of interviews**	**Transcription**
Consulting firm	Partner	1 hour	Notes
	Senior manager	1 hour	Notes
Firm ‘M’	Investment manager	2 hours	Transcribed
	Management team member	2 hours	Notes
	CFO portfolio company A	1 hour	Transcribed
Firm ‘C’	Managing director A	2 hours	Transcribed
	Managing director A	2 hours	Transcribed
	Managing director A	1 hour	Transcribed
Firm ‘X’	Managing director A and investment manager B	1 hour	Transcribed
	Managing director A and investment manager B	1 hour	Transcribed
	CFO portfolio company R	2 hours	Transcribed
	CFO and CEO portfolio company D	2 hours	Transcribed
	Finance director portfolio company N	2 hours	Transcribed
Firm ‘F’	Senior partner	2 hours	Transcribed
Firm ‘I’	Managing partner	2 hours	Transcribed
Firm ‘A’	Managing director	2 hours	Transcribed
Law firm	Professional A, professional B, professional C	1.5 hours	Transcribed

Appendix B

Interview check list

1. In which sector do you make investments? How did you identify the firms in which to make investments?
2. What kind of investments do you make (majority, minority, etc.)
3. What kind of strategies do you implement to create value with the portfolio companies?
4. Which resources and support are provided to the portfolio companies?
5. Which kind of agreement do you achieve before making the investment and which terms and conditions are regulated contractually?
6. Once the investment is made, which are the mechanisms employed to control and coordinate the activities of portfolio and what is their role:
    a. Selection of key managers
    b. Definition of intermediaries
    c. Business planning
    d. Reporting and performance measurement systems
    e. Incentives
    f. Communication and interaction mechanisms (frequency, subjects involved, modes)
    g. Others
7. What are the key factors that explains the differences in the relationship with portfolio companies?
8. How do you define the exit strategy?