# WHO IS THE BOSS? ENTREPRENEURIAL GOVERNANCE IN PRIVATE EQUITY INVESTMENTS IN EMERGING MARKETS

## ABSTRACT

We investigate the different forms of entrepreneurial governance in private equity (PE) investments in emerging markets. Our research design is a multicase, inductive study that uses field data to assess the full cycle of PE investments in forty companies in Brazil, a dynamic emerging economy. Our central contribution is a framework of PE investment in the presence of institutional voids. We find that PE firms can adopt three distinct entrepreneurial governance structures: growth equity, entrepreneurial buyout, and submissive buyout. We describe the main characteristics of these governance structures and discuss the key drivers that influence their adoption.

**Keywords:** private equity, entrepreneurial governance, emerging market, institutional voids, buyout, corporate governance.

## I. INTRODUCTION

Private equity (PE) firms provide funding for potentially high growth private companies in return for an equity stake (Dawson, 2011). The PE firm may be a minority investor, providing *growth equity* to the investee. The PE firm's capital is usually applied to finance specific projects or to provide liquidity to the founders with the general intention of helping them to simplify the ownership structure of the company (Zeisberger, Prahl, & White, 2017). Alternatively, the PE firm may *buyout* the investee, becoming a majority shareholder. The fundamental assumption in this case is that the current investee management team is unable to fully explore the company's potential. As a consequence, the PE firm, backed on its majority position in the investee's board of directors, selects and monitors a new top management team. For that reason, the PE buyout model is best understood not as a financing method per se but as an entrepreneurial governance mechanism (Klein, Chapman, & Mondelli, 2013). The main entrepreneurial function of PE firms is to exercise derived judgment (Foss & Klein, 2012), deciding which decision rights to delegate and to whom they should be delegated within the company that received the investment.

The pioneering market and one of the most vibrant for buyouts is the US, where the dominant target of PE firms is either public companies or spin offs of large corporations

(Lake & Lake, 2000; Zeisberger *et al.*, 2017). In emerging markets, on the other hand, the dominant target for buyouts are family-owned companies, in which the current owner lost interest and/or does not have a successor to take over. The owner decides to sell the control of the company to the PE firm. Often, the family maintains a minority equity position to benefit from the growth and operational improvements generated by the PE investor and sell that share later for a higher price. However, institutional voids exist in emerging markets (Khanna & Palepu, 1997), and family businesses can develop informal rules of trust and obligation (Khanna & Palepu, 2000; Luo & Chung, 2005; Miller, Lee, Chang, & Le Breton-Miller, 2009). The combination of these elements creates unique challenges for a PE firm to exert entrepreneurial control over its investments.

The purpose of this paper is to investigate the characteristics of entrepreneurial governance in PE investments in emerging markets. Our research design is a multicase, inductive study that uses field data to assess the full cycle of PE investment in 40 companies in Brazil, a dynamic emerging economy. This design enables a holistic view of PE investment, thus ensuring that we capture the richness of entrepreneurial governance in PE investments. Our central contribution is a framework of PE investment in the presence of institutional voids. We find that PE firms in emerging markets can adopt three distinct entrepreneurial governance structures: growth equity, entrepreneurial buyout, and submissive buyout. One of our core contributions is to describe the main characteristics of these mechanisms and to link them to the presence of institutional voids. In particular, we find evidence that PE firms that perform buyouts may decide to adopt a submissive position. Despite having a majority stake in the investee, the PE firm refrains from exercising entrepreneurial control. This finding is puzzling since it challenges the basic entrepreneurial rationale of the PE buyout model (Klein *et al.*, 2013); as such, this finding deserves to be explained by a strong prediction. Our key contribution is thus enlarging the study of private equity entrepreneurial governance in fragile institutional environments.

## II. KNOWLEDGE RECEIVED

### PE investments

Most studies in the PE literature investigate the buyout model (Tappeiner, Howorth, Achleitner, & Schraml, 2012). The buyout model refers to an investment scheme in which PE firms, usually in conjunction with a group of managers, acquire control of a company for

a limited time using not only their own money but also debt financing (Wright, Amess, Weir, & Girma, 2009).

PE firms specialized in buyouts become major players in the market of corporate control for mature firms (Castellaneta & Gottschalg, 2016). They look for opportunities in which the current owners have encountered difficulties in sustaining or improving the performance of the company, and they are unwilling to implement the changes required to make the business more efficient and more profitable (Lake and Lake, 2000). . PE firms become the majority equity holder. The classic targets of PE firms are companies that present a positive difference between their current market value and the potential value that can be generated once there is a greater alignment of interests within the company. As a result, PE investors take up positions on the board of directors of the investee and are active in making strategic decisions and in monitoring performance (Wright, 2013). Once the company has increased its market value due to better corporate governance (i.e., incentive alignment), PE firms will sell the business at a profit. Therefore, PE firms conducting buyouts can be characterized as offering dedicated services in the selection, management, and sale of investments in private companies (Taussig & Delios, 2015).

The majority of PE transactions in emerging markets, on the other hand, are minority investments in mature companies (Lerner, Ledbetter, Speen, Leamon, & Allen, 2016; Taussig & Delios, 2015; Zeisberger *et al.*, 2017). This stems from the fact that most companies that have grown during periods of rapid economic development in these markets are family businesses, which are still managed by the first or second generation of the founding families.

Family businesses are characterized by more complex decision-making processes, which are influenced not only by economic factors but also by social and emotional factors. The latter represents the company's socioemotional wealth, indicating the nonfinancial elements that meet the affective needs of the family members (Gomez-Mejia, Takacs-Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007). Since the preservation of socioemotional wealth may require the continued control of the company by the family (Gomez-Mejia et al, 2007), the owners of family businesses may be more averse to dealing with PE firms that seek control of the company (Tappeiner *et al.*, 2012). This may explain the demand for growth equity in emerging markets. On the supply side, minority

shareholding is an attractive choice for risk-averse PE firms or those willing to reduce the overall risk of their portfolio (Puche & Lotz, 2015). This behavior may stem from the presence of institutional voids in emerging markets.

**Institutional voids**

Different authors have advanced the idea that emerging economies have a multitude of institutional voids that affect the behavior and performance of firms (e.g., Chacar, Newburry, & Vissa, 2010; Cuervo-Cazurra & Dau, 2009; Hoskisson, Eden, Lau, & Wright, 2000). Khanna and Palepu (1997) identify different sources of institutional voids in emerging economies. In product markets, buyers and sellers usually suffer from a lack of information due to, for example, the underdevelopment of the communications infrastructure. In labor markets, there is a shortage of well-qualified people, while governments often make it difficult for firms to adjust their workforce to changes in economic conditions (i.e., rigidity of the labor market). Financial markets are characterized by a lack of adequate disclosure and mechanisms of corporate governance and control. Finally, Khanna and Palepu (1997) note that, despite extensive government involvement in emerging markets, these economies do not have effective mechanisms for contract enforcement.

Different strategies can be designed to overcome institutional voids. One possibility is to forge large business groups, which fulfill their affiliated units with resources that are scarce in the external markets through, for example, the financing of projects or the training of employees (Khanna & Palepu, 2000). In emerging markets, many business groups are family-owned groups. Another possibility is the creation of collaborative networks to build trust and aggregate collective resources (Boisot & Child, 1996; Mesquita & Lazzarini, 2008; Peng & Heath, 1996). Informal relationships can also supplant weak formal institutional arrangements. This is the case, for example, of social ties (*guanxi*) in China (Peng & Luo, 2000).

**Entrepreneurial governance**

We adopt the concept of entrepreneurship as an economic function, i.e., a way of thinking or acting, instead of an occupation or type of firm (Foss & Klein, 2012; Klein, 2008). To be precise, we consider entrepreneurship judgmental decision making under uncertainty (Casson, 1982; Knight, 1921). Entrepreneurial judgment is key because it is costly to trade,

thus explaining the heterogeneity of economic performance among firms (Foss & Klein, 2012).

Entrepreneurial judgement, however, is not limited to the characterization of the one-person firm (that is, the entrepreneur plus his or her alienable assets). The concept can also be applied to multiperson firms. The difference can be examined in terms of original and derived judgement (Foss & Klein, 2012). The original judgment is the "primary" form of judgment, which is implied by the ownership of the assets under uncertain conditions. Derived judgment, in turn, encompasses the decision rights delegated to employees so that the entrepreneur can take advantage of a subordinate's specific knowledge (Foss & Klein, 2012). For example, the founder of a fintech firm may delegate the judgment about legal decisions to the chief legal officer. It goes without saying that a large, complex company can be interpreted as a nested hierarchy of derived judgments, which may imply potential agency problems. More interestingly, different types of firms can be compared in terms of their entrepreneurial orientation.

Take, for instance, PE buyout firms. They are more entrepreneurial compared to publicly traded companies to the extent that PE firms are active participants in the economic decision-making process (Klein, 2008). They help to coordinate the human and capital assets under their control in the hope of achieving the maximum benefit of uncertain projects carried out by the investee (Klein *et al.*, 2013). PE firms thus perform active investor governance. However, PE managers do not become involved in the daily operations of the invested company. As a majority member of the board of directors of the investee, the PE firm acts in the selection and monitoring of the top management team. That is, its primary function is to decide which decision rights to delegate and to whom they should be delegated (i.e., derived judgment) (Klein *et al.*, 2013). Managers, in turn, receive a stake of the company's equity, are subject to strong performance incentives, and have discretionary rights to act. Under these conditions, the alignment of interests between the parties can be achieved. Not surprisingly, Bloom, Sadun and Van Reenen (2015) found that PE ownership is associated with a greater delegation of authority to plant managers and with superior management, regardless of the country in which the firm is located. What is still unclear is the extent to which PE firms exercise entrepreneurial judgment in emerging markets. We turn to this subject in the next section.

## III. METHOD

We employed a multiple-case, inductive research approach (Eisenhardt, 1989) following replication logic. This means that the cases were treated as experiments, and each case served to confirm or disconfirm the inferences drawn from the others (Yin, 1994). This approach is appropriate for our investigation because it yields a broader exploration of the research question and a better basis for theoretical insights (Eisenhardt & Graebner, 2007).

### Sample

The research setting is the private equity industry in Brazil. According to the Emerging Private Equity Association (EMPEA), despite representing 33% of the Latin America population, Brazil attracted 46% of the US$56 billion PE funds raised for the region between 2008 and 2015 (Carrera, Filgueiras, Ayres, & Romano, 2017). There are approximately 150 PE firms active in the country (GVcepe, 2008), including foreign firms, such as Actis, Advent International, Apax, Carlyle, General Atlantic, and Warburg Pincus. Well-known local firms include independent firms, such as Tarpoon, Gavea, GP Investments, and Patria (recently acquired by Blackstone), as well as bank-affiliated firms such as Kinea and BTG Pactual.

We first mapped the country's most representative private equity transactions over the last twenty years, that is, transactions involving large companies (i.e., companies with a net revenue above USD 150 million in the year of the transaction) and well-known PE firms. From this initial set, we selected those transactions whose lifecycle has already come to an end, meaning that the PE firm or the founder (or his/her descendants) no longer holds a stake in the company. With the help of a financial advisory firm, we contacted each of the owners of the companies at the time of the PE investment and invited her to be interviewed. We assembled a set of 40 cases.

Descriptive information about our sample is provided in Table 1. The 40 companies received investments from 35 different PE firms. Most investors participated in a single transaction. The companies operate in different industries, with a greater concentration in the IT and retail sectors. The average stay of investors in the companies was 5 years. The sample includes investments initiated between 1997 and 2012. All of these investments have already been concluded.

TABLE 1 - Description of sample

| | |
|---|---|
| Total number of cases | 40 |
| Number of companies according to market segment | |
| IT | 10 |
| Retail | 8 |
| Healthcare | 6 |
| Real state | 5 |
| Energy & Fuel | 4 |
| Other | 7 |
| PE Investors | |
| Total | 35 |
| Local | 21 |
| Foreigner | 14 |
| Average stay of investors in the company (years) | 5 |

**Data collection and sources**

*Interviews*

We conducted all the interviews between the last quarter of 2016 and the first quarter of 2017. Our primary respondents were the owners of the companies at the time of the PE investment. This research design has the benefit of enabling us to capture the nuances of daily business operations and the influence of the PE firm during the investment cycle. As we kept the identities of the interviewees confidential, the owners were free to describe the relationship with the PE firm during the investment period and to more frankly discuss the positive and negative aspects of the investment. However, to avoid report bias, we also interviewed a set of investors and financial assessors that were proficient in the studied PE investments.

Considering that our motivation is to extend the theory on the entrepreneurial governance of PE investments in emerging economies, our data collection efforts were focused on, but not limited to, this specific aspect. We developed a semistructured protocol. The open-ended questions in the protocol related to the following topics: transaction

motivation, allocation and exercise of decision rights, ease or difficulty of dealing with the PE firm during the investment period, and contribution of the board members and/or managers appointed by the PE firm. The interviews were focused on facts and concrete examples (i.e., 'courtroom' procedure (Eisenhardt, 1989)), lasted one hour on average, and were recorded when authorized by the interviewees. We conducted 45 interviews with a combined transcript length of 784 pages.

*Supplemental data*

We complemented the interview data with archival information about the companies and the PE firms. This information was collected from different sources, such as company websites, Capital IQ, and specialized industry publications. Because many companies did not go public after the PE investment, we were unable to collect financial data for all the companies in our sample. Nevertheless, this information helped elucidate ambiguous statements and verify interview data, where applicable. The underlying rationale was to triangulate our primary data, reviewing it from various vantage points (Yin, 1994).

**Data analysis**

Our starting point was an in-depth examination of each case through the lens of our research question (Eisenhardt, 1989). We assessed the cases individually to form our initial understanding of each case. Since our research was exploratory in nature, we did not have an a priori hypothesis or theoretical preferences. The objective was to discern the theoretical patterns and constructs in each case and with regard to our research question. We identified three distinct groups of cases that represent different entrepreneurial governance structures in PE investments.

We then turned to a cross-case analysis with the aim of identifying similarities and differences among the transactions. A focused comparison within and between the groups of cases allowed contrasts to emerge and inferences to be made. Comparisons were initially made between pairs of cases within each group. As patterns emerged, other cases from the same group were added to develop more robust causal relationships. Only then were the case groups compared. As discrepancies and agreements were observed in the emergent typology, they were investigated by revisiting the data and examining the literature. This means that to clarify our contributions, we adopted an iterative process of cycling among theory, data, and literature.

## IV. FINDINGS

Our data reveal the existence of three distinct entrepreneurial governance mechanisms in PE investments. As described in Figure 1 and in Table 2, the governance mechanisms can be identified along two dimensions: minority versus majority investments and active versus passive investor roles.

**Growth equity**

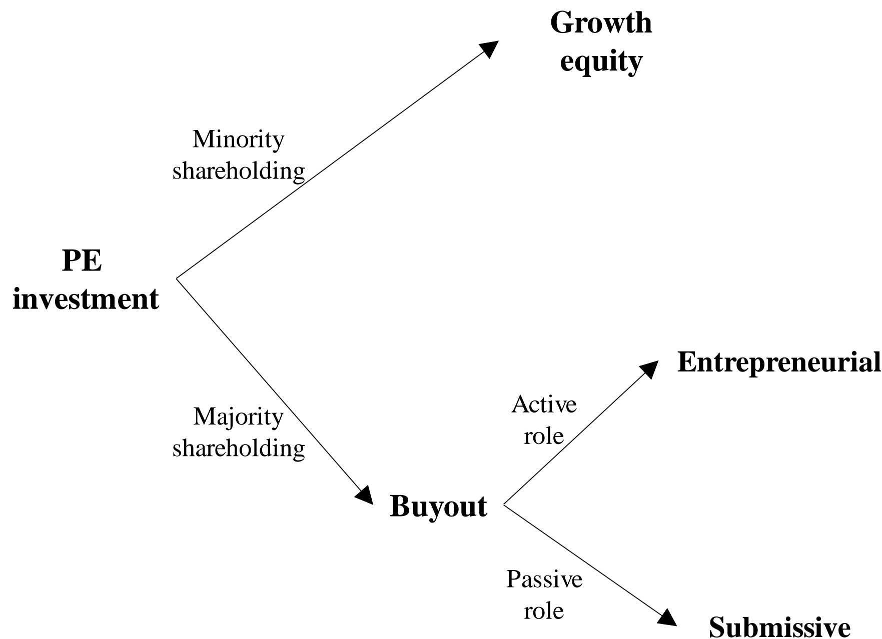
The first type of governance mechanism is the case in which PE firms are minority investors, that is, growth equity (Lerner, Leamon, & Hardymon, 2012; Zeisberger *et al.*, 2017). We have 23 cases of growth equity, of which 17 transactions were performed by local PE firms, and the average investment was $25 million.

The PE's capital is typically used for two purposes: to finance specific projects and/or to provide liquidity to the founders, helping to simplify the company's ownership structure (Zeisberger *et al.*, 2017). Many companies look for more than just capital resources when seeking a PE investor as a minority partner. Many family businesses lack the necessary resources to sustain a competitive advantage and to manage generational succession, and PE can serve as a valuable source of managerial skills and capabilities (Dawson, 2011). This is precisely the complaint of one interviewee whose company operates in the education sector; according to him, the PE firm was not very proactive in helping with new ideas or new points of view.

PE minority investors can influence the investee's resource profile by increasing its assets, competencies and attributes (Wood & Wright, 2009). Specifically, the PE firm can assist the investee in capital structuring and capital market issues. One company from the retail sector, for example, states that the PE firm has brought discipline, capital structuring and insight into the decision regarding the correct timing to make the company's IPO. One company from the industry machinery sector, in turn, states that the main contribution of the PE firm was the discipline that the company adopted in accounting and financial reporting. The support provided by the PE can also boost the investee's network in commercial circles. As one interviewee from the education sector says, the PE firm has opened many doors for the company in the market to obtain large contracts. Another company that operates in the real state sector also emphasizes this aspect when it states that

*The investor inserted us into a very rich ecosystem. They put us on the map. With the investor's contribution, the market gives you more credibility and looks at you with different eyes.*

FIGURE 1. PE investment: types




In a context of minority shareholding, the PE firm's entrepreneurial influence is naturally limited. PE investors usually do not have majority voting rights. Therefore, they cannot make decisions without reaching an agreement with major shareholders. Decisions about changes in operations, governance or acquisitions must be made jointly (Puche & Lotz, 2015). Consequently, a minority investment will generally be less radical in changing the operating dynamics of a business since the relationships among stakeholders are maintained (Zeisberger *et al.*, 2017).

To mitigate their lack of entrepreneurial influence, minority PE firms seek a good fit with their major partners. Put differently, the minority investors try to establish a close connection with the majority partner (Puche & Lotz, 2015). This can occur through the deliberate search of companies for PE firms that have ways of thinking and acting in accordance with their expectations. An example is a respondent that operates in the IT sector, who states that the company had a clear vision of what it wanted with a minority partner. The same occurred with another company also from the IT sector, which projected in advance the

type of relationship it wanted to have with the investor and then sought an appropriate partner. Accordingly, it seems important from the outset that the PE minority investor understands the motivations of the majority shareholders and ensures that they are aligned with the firm's investment thesis, its expansion prospects, and its plans for change (Zeisberger *et al.*, 2017). However, cases of misalignment between PE firms and investees are common. One company that operates in the real estate sector, for example, says that, in the fifth year of investment, there was a misalignment between the parties in relation to the investment perspective: the PE firm was pushing for new product launches, while the founders wanted to maintain a slower pace of growth. This impasse immobilized the company and forced the exit of the PE firm. Another example of misalignment is a company from the health care sector. The interviewee observes the following:

*The relationship with the investor was very different from what I imagined. Weak management, no goal. They took the productivity scheme out of the company. Very slow in the decision-making and execution of the growth plan.*

TABLE 2. Entrepreneurial governance in PE investments

| | Growth equity | Buyout | |
|---|---|---|---|
| | | Entrepreneurial | Submissive |
| PE shareholding position | minority | majority | majority |
| Investor role | passive | active | passive |
| Number of cases | 23 | 7 | 10 |
| Transactions carried out by local PE firms | 17 | 5 | 4 |
| Average amount invested per transaction (USD) | 25 MM | 50 MM | 55 MM |
| Business rationale of the transaction | Financing of specific projects<br>Provide liquidity for the investee<br>Source of managerial skills and capabilities | Current owners of the company face difficulties in sustaining or improving the performance of the company | Current owners of the company face difficulties in sustaining or improving the performance of the company |
| Key entrepreneurial | Alignment of expectations | Selection of top executive officers | Strategy design |
| Drivers | Trust | Strategic Design | Trust |
| Constraints imposed by institutional voids on the PE firm's entrepreneurial ability | Lack of knowledge about the local market and the industry of the investee may cause misalignment of expectations and prevent the building of trust | Industry-specific knowledge and informal networks may be concentrated in the founder and top management team of the investee | Informal rules established within the investee create a more personalistic character, with strong employee loyalty |

The most important aspect of the description above is to realize that there was a misalignment between the style of the PE firm and the expectation of the company's founder. The emergence of frustration is then inevitable.

In addition to the alignment of expectations, there should also be trust between majority shareholders and investors; otherwise, stalemate situations may arise (Puche & Lotz, 2015; Tappeiner *et al.*, 2012). The founder of an energy and fuel company observes with enthusiasm that the PE firm has left him free to run the company. In times when there were differences of opinion between him and the PE firm, it was always possible to reach a consensus. Another company that operates in the healthcare segment also indicates building a relationship based on trust with the PE investor. According to the interviewee, the relationship during the investment period was good because the investor showed concern about the business itself, not just the financial return. Certainly, this attitude has created a bond of trust between the investor and the founder and the managers of the company. Something similar seems to have occurred in an IT company, which indicates that there was always consensus on the board of directors.

Trust is an important component because it allows the PE firm to exercise a greater degree of discretion in its actions or at least enables it to put into the discussion the issues it considers important. Thus, the PE firm's degree of entrepreneurial action within the invested company increases. When trust is broken, however, the firm loses much of its ability to play an entrepreneurial role. Apparently, this was the case with another energy and fuel company when expressing its disappointment with the new representative hired by the investor:

*The relationship with the PE investor was good only in the first two years. After this period, the relationship was very troubled, especially with regard to the new representative appointed by the investor. He only collaborated on the issues that were formalized in the contract. He was sitting at his desk in the US and did not know anything about Brazil and the company's market.*

Indeed, the lack of knowledge of the PE firm in the local market and in the industry of the investee is a strong constraint on the entrepreneurial ability of the PE investor. It may generate a misalignment of expectations between the parties and may prevent the building of trust. Such a result is magnified in the presence of institutional voids. In line with the literature on emerging economies (Hoskisson *et al.*, 2000; Huang, Luo, Liu, & Yang, 2016;

Peng & Luo, 2000), our data provide evidence that companies seeking to navigate weak institutional environments develop informal networks of relationships within their industry. This makes it more difficult for the PE firm to understand and operate in the investee market. However, it comes as a surprise that, in our sample, there are 14 growth equity transactions in which the PE firm did not even change the company's CFO (ten of these transactions were performed by local PE firms). This is quite unusual. The CFO is the person that communicates the financial results to the PE investor and works through capital structure issues. Even minority PE firms increasingly require specific experience for the CFO role, and they tend to exert influence in the selection process, although the ultimate decision usually belongs to the CEO of the company (Shaw, 2017).

**Entrepreneurial buyout**

In the entrepreneurial buyout model, the PE firm is a majority shareholder and plays an active role in selecting the top executive officers and designing the strategy of the investee. In our sample, 7 cases correspond to this configuration. Of this total, five transactions were carried out by local investors and two by foreign PE firms.

In just three cases, all the executive officers of the investee were replaced. An example is a company which operates in the real estate segment. The company was a family business with several family members involved in management. After receiving the investment from a foreign PE firm, the entire executive board was replaced by professional managers. The overall assessment of the PE firm was positive. However, the same did not occur in the other two companies. One complained that investor underestimated the importance of business knowledge and risk management. This same aspect is mentioned by the other founder:

*The investor made changes very quickly and without consistency, such as the change of all executives and in business strategy*.

The potential risk is that the description above is seen as a mere discomfort of the company's founder with the loss of control over the company (Wasserman, 2017). Although this emotional component cannot be neglected, it must be weighed against the ability of the founder to analyze the company's performance. Acting in a market characterized by institutional voids, the founder is potentially able to perceive the strategic mistakes of the PE firm more quickly. This is a central aspect.

According to the ‘traditional’ PE rationale, the managers of an investee will not be replaced by new managers if, and only if, their individual performance is of high quality, and they are in line with the new philosophy of work brought by the PE firm. In these cases, the PE firm uses its derived judgment, thus deciding to keep the original managers in the company and to delegate to them certain decision rights. However, we found other reasons for the nonreplacement of managers by the PE firm. On the one hand, emerging markets, such as Brazil, are characterized by the low supply and high cost of finding top managerial talent (Ready, Hill, & Conger, 2008). On the other hand, and more importantly, industry-specific knowledge and informal networks are relevant assets in emerging markets (Taussig & Delios, 2015), and these tend to be concentrated in the founder and top management team of the investee. That is, investors recognize that it makes sense to retain professionals who are already adapted to local circumstances and therefore have a deeper understanding of the local market (Ahlstrom & Bruton, 2006; Leeds & Sunderland, 2003). Our data suggest that this is a reason behind the importance of maintaining in the company a considerable part of the original executive team. This fact, however, represents a limitation of the PE firm's ability to replace executive officers, thus representing a restriction of its entrepreneurial control.

In the majority of the cases in our sample, few senior management positions have been changed after the investment. Executive officers nominated by PE firms performed positively (i.e., were said to contribute to the company's growth) in three cases. One case is a company which operates in the retail sector. The company received investment from a local PE firm that appointed a new CEO and a new CFO, but did not appoint a representative to the board of directors of the firm. The founder remained with the company during the investment period and recognizes that the new managers contributed to the professionalization and growth of the firm. The same is reported by another founder, who notes that even minor conflicts with the managers appointed by the PE firm have been resolved in a consensual, peaceful manner. Regarding the performance of the PE firm's representatives on the board of directors, in only one case did the founders evaluate the performance as positive. The interviewee emphasized the contribution of the PE investor in structuring the company in a more professional way, even if there were frictions in the relationship.

The PE firm's knowledge of the investee market is a relevant factor for the success of the buyout investment. As a corollary, majority PE firms operating in emerging markets cannot restrict their action to reading financial reports, observing performance from a distance, and attending periodic meetings of the board of directors of the investee (Leeds & Sunderland, 2003). PE firms should strengthen the corporate governance practices of the investee and restructure its management without necessarily changing the entire executive team. This task is not simple. The existence of institutional voids creates adaptation difficulties, and our data indicate that such difficulties may exist even for local investors, if they do not have the specific knowledge and the network of specific relationships in a certain industry. The founder of one company, for example, indicates that the PE firm made the investment at a time when the company was implementing a new business plan. However, the investor chose to dismiss the people who were responsible for drawing up and implementing the plan, weakening the company's competitive position. Another example is a company which operates in the retail sector and received investment from a foreign PE firm. The investor changed all of the firm's executive officers, apparently disregarding the fact that the firm operates in a segment where relational ties with suppliers are remarkably important.

**Submissive buyout**

Along with the entrepreneurial buyout and growth equity models, there is the unlikely situation of a submissive buyout. In this case, although the PE firm is a majority shareholder of the investee, it does not exert entrepreneurial control. In our sample, there are 10 cases of submissive buyout, with 6 cases involving foreign PE firms (Table 2). In four cases, the PE firms did not appoint any new members of the management team, and in five cases, they required the change only of the CFO, which is a typical growth equity request.

This situation is puzzling to the extent that the PE firm is a majority shareholder of the investee but behaves as if it had invested in a growth equity deal. One hypothesis is that the PE firm simply abdicates its entrepreneurial control over the company because it understands that institutional voids are so severe that it would be useless, or even disastrous, to try to change the management of the company. Five interviewees mentioned that the PE investor did not understand the business of the company. This creates some frustration and frictions. One of these interviewees mentioned that the new board members did not

understand the business, and it appeared to him that the PE investor itself did not trust them. This is at least a paradoxical situation.

However, the severity of the institutional voids may just be a part of the reason behind the submissive behavior of the PE firm. Our data indicate that the investees who have a submissive PE investor are those with a stronger family culture and strong founder influence. Although the presence of family firms is not exclusive to emerging economies, the existence of institutional voids places an emphasis on the set of informal ties that the founder of the company is able to create. This is also true for the building of informal family norms within the company (e.g., trust, obligation), which stand in for weak formal institutions (Khanna & Palepu, 2000; Luo & Chung, 2005; Miller *et al.*, 2009). In emerging markets, family norms of trust and authority may become more prominent in reducing the asymmetry of information between the owners of the company and the top management team (Luo & Chung, 2013) and in creating a close association between the company and its employees to overcome the shortage of managerial talent (Miller *et al.*, 2009).

Informal norms established within the family business ultimately represent the creation of a more personalistic character within the company. For example, it is common for managers to be hired, compensated and promoted on the basis of particular criteria other than professional expertise (Schulze, Lubatkin, Dino, & Buchholtz, 2001). Therefore, owner-managers may be less willing to follow formalized people-management practices (Carney, 2005). This can generate intense employee loyalty (Miller, Minichilli, & Corbetta, 2013), and such loyalty is not automatically transferred to the PE investor. This seems to be a key factor. The PE firm depends on the founder of the company and/or on the family CEO to the extent that they give the firm the internal legitimacy to operate and interfere with strategy and operations.

On the other hand, owners of family businesses operating in environments with institutional voids tend to rely less on external financing (Khanna & Palepu, 2000). This may give them less incentive to consider the interests of external stakeholders (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). It goes without saying that the founders are not always able or willing to understand the change in their role that the investment in PE brings. Take, for instance one founder who explicitly argues that

*From time to time, investors wanted to get into the operation, but I would not let them, and the board of directors supported me.*

This argument is eccentric if examined outside the context described above. Another interesting example is a founder who noted that, "despite his warnings", the PE investor has not kept its promise not to interfere too much with management and not to change the company's strategy. The founder of another company argues that the only friction in the relationship with the PE investor was generated by the CFO appointed by the PE firm, but this was solved with his resignation. Interestingly, the CFO was the only manager appointed by the PE firm in this company.

Alignment and trust between the founder and the PE investor may mitigate the frictions brought about by the perception that the PE firm has little knowledge about the business. For instance, one company which received capital from an international PE firm mentioned that there was some friction in the beginning of the relationship, because the PE investor did not understand the business and the Brazilian environment. However, as they always talked and exchanged ideas, the deal was great for both parties.

A lack of trust is problematic. Take, for instance, the comments of a company in which the original PE investor sold its equity to another PE investor:

*It was a good relationship at first, but it was all very fast. The PE firm sold to another company, which had 70 partners around the world. We got lost and did not know the new investor.*

In most cases, very similar to the growth model, entrepreneurs recognize that PE investors bring other contributions besides capital: a focus on financial performance, professional management, and financial operations. The following arguments of a business owner illustrate this situation:

*The investor helped with private placement in the 2008 crises. However, the investor did not demonstrate knowledge about the company's market.*

In the scenario of a lack of specific knowledge and the existence of institutional voids, the PE firm would evaluate the investment bearing in mind that the management team will remain in the company. In this circumstance, the PE firm may become submissive to the minority shareholder, keeping the former family CEO even in the buyout model. Obviously, as stated by industry experts, this configuration holds while the PE firm realizes the

possibility of a gain in its investment through its indirect influence on the strategy design of the investee.

## V. DISCUSSION

As mentioned, PE firms perform an entrepreneurial action indirectly by selecting which decision rights regarding the investee will be delegated and who will exercise those decision rights (Klein *et al.*, 2013). In other words, PE firms carry out their entrepreneurial action by means of derived judgment (Foss & Klein, 2012). Our data indicate, however, that the PE's derived judgment is restricted in emerging markets due to the existence of institutional voids and the predominance of family-owned companies, even in the case of equity growth.

Institutional voids in emerging economies influence companies' behavior and performance (Chacar *et al.*, 2010; Cuervo-Cazurra & Dau, 2009; Hoskisson *et al.*, 2000; Peng, Sun, Pinkham, & Chen, 2009). Because they create difficulties regarding access to input, labor and capital markets, institutional voids affect both companies' prospects for growth and their ability to give life to new ideas. Specifically, the search for and selection of management talent is more difficult (Ready *et al.*, 2008), which places a constraint on the PE firm's ability to change the managers of the investee. This, however, is only part of the issue. In emerging markets, tacit market knowledge and informal ties tend to be important resources that leverage firm performance (Taussig & Delios, 2015). Since such resources are embedded in the founders and the top management of the company, these people are more difficult to replace. The issue becomes even more complex in companies with a strong family culture. In this type of business, senior executives tend to have an even higher degree of tacit knowledge, such as unwritten rules and informal culture. This can be a major constraint for newcomers in the company (Gomez-Mejia, Nuñez-Nickel, & Gutierrez, 2001; Hall & Nordqvist, 2008; Miller *et al.*, 2009, 2013).

Consider the entrepreneurial buyout model. We have seen that, in most cases, even when the PE firm has a majority share and plays an active role in the investee, it does not replace all the executive officers. This may be a consequence of the fact that poor performers remain in their executive positions because they are proficient at navigating the institutional obstacles of the local market (Taussig & Delios, 2015). From an entrepreneurial perspective, this suggests that the existence of institutional voids acts as a limitation on the PE firm's

ability to replace the top management team of the investee and to make decisions that oppose the will of the minority shareholder, which was the former family owner. Put differently, institutional voids may restrict the PE firm's ability to fully exercise derived judgment. As the institutional void becomes more acute, the PE firm may find itself less and less able to make changes to the company's management. At the extreme, the PE firm becomes a hostage to the minority shareholder and to the current top management team of the invested company because it has no knowledge of the institutional obstacles of the local market and it lacks legitimacy within the structure of the family company. As there is no room for any change of executive officers, the PE firm may choose to play a role as a passive investor even when it has a majority shareholding, i.e., a submissive buyout.

We summarize these findings in three propositions:

*Proposition 1. PE firms that invest in emerging markets are more likely to have constraints on their entrepreneurial ability.*

*Proposition 2. PE firms that invest in emerging markets and do not have specific knowledge about the business are very dependent on the current management team and try to retain it after the investment.*

*Proposition 3. PE firms that invest in family businesses in emerging markets and are very dependent on managerial teams tend to be submissive to the founder of the company and/or the family CEO because the PE firm will need their support to build internal legitimacy.*

## VI. CONCLUSION

Many family companies in emerging markets may benefit from a PE model because they need to improve governance, operational processes and professionalism. This generates many value creation opportunities for PE firms. However, to succeed in emerging markets, PE firms, especially international firms, must be flexible to adapt the traditional buyout model to the constraints of their entrepreneurial ability. It is important to recognize that, because of institutional voids, it will often be necessary to retain the majority of the current management team. Since the management team will probably be loyal to the founder and the founder may have informal ties to the business community, PE firms quite often will have to engage in the submissive buyout model. Ignoring this fact may create value destruction. Even when PE firms change the CEO, if the new CEO is not endorsed and supported by the

founder, she may face many difficulties with regard to being respected by the company's employees and the business community. This creates a need for trust between the business founder and the PE firm, and the trust must begin before the deal is closed. The company and business prospective may be excellent; however, in the absence of trust between the investor and the business owner, the PE firm will most likely be better off if it does not invest in the company. Therefore, an implication for PE managers is that, independently of the governance model, they must select the entrepreneur very well before making the investment decision. Fit and trust are key for a successful partnership.

In addition, to succeed in emerging markets, international PE firms will need to hire local PE talent that understands the specificities of the country. Local PE professionals will be better positioned to develop trust between the fund and the business founder. Many international PE firms open offices in emerging markets, make some unsuccessful investments and, after a while, decide to leave the country.

Our study raises many interesting questions for future research. First and foremost, this article highlights the fact that the nuances about PE buyout and growth models are not black and white. Minority PE investors can sometimes be as active as – or even more active than – buyout investors. We believe that this is a promising research agenda on its own.

In addition, family firms are a dominant business form not only in emerging markets but also in European countries (Dawson, 2011). PE investors can contribute to family firms with capital along with professionalization, governance and other necessary resources to growth. Even if the context of our analysis is emerging markets, many of the issues discussed apply to family businesses in developed countries. We assumed that the three different governance models are particular to emerging markets, but do they hold in developed countries as well? Do entrepreneurs of mature companies in emerging markets retain specific knowledge that makes it harder to remove them from the company management?

Another research question that deserves further investigation is the impact of different governance models on company performance. How effective were the PE firms in implementing value creation actions in the investee? What are the characteristics of the firm and of the partnership that increase the chances of superior performance? Did the improvements last after the PE firm left the company?

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