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The institutional determinants of private equity involvement in business groups—The case of Africa

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ABSTRACT

This study examines the governance attributes of post-IPO (initial public offering) retained ownership of private equity in business group constituent firms in contrast to their unaffiliated counterparts, in 202 newly listed firms in 22 emerging African economies. We adopt an actor centered institutional-theoretic perspective in rationalizing institutional voids and the advantages of maintained governance by both business angels (BA) and venture capital (VC) private equity. Our findings reveal private equity retain higher post-IPO ownership in business group constituents compared to unaffiliated firms and that this is inversely moderated in the context of improving institutional quality – where this is particularly strong in case of foreign VC as opposed to domestic VC or BA. Our result adds to the literature on multifocal corporate governance mechanisms and the institutional determinants of private equity investment.

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1. Introduction

Business groups are hybrid organizational forms comprised of a number of nominally independent firms. These firms are intrinsically bound together through a range of "hard" ownership-based control mechanisms (e.g. concentrated voting rights) and "soft" socialization measures (e.g. clan and familial affiliation of top management), where business group constituent firms collectively adhere to common group-wide strategies (Khanna & Rivkin, 2001). Despite the importance of business groups in emerging markets there is a lack of literature on business group expansion; specifically on how the constraints of a limited internal capital market necessitate external capital infusions by predominantly private equity (Khanna & Rivkin, 2001).

In this paper we analyze the interplay between the institutional context and the corporate governance role of private equity retained ownership in post-IPO (initial public offering) business group structures. By developing a new institutional-theoretic approach we address the role of formal institutions on the conduct of firms based in Africa. We argue that Africa is a particular rich research context given the exceptionally high variation in institutionally quality across the continent, with this ranging from the weakest formal institutions worldwide (Transparency International, 2014) to some national governance frameworks being on a par with Western Europe (see Hearn & Piesse, 2013; Hearn, 2014)).

Prior research has emphasized that one of the main advantages of business groups in emerging economies is their ability to mitigate institutional voids (Khanna & Yafeh, 2007). The vulnerability of firms to such institutional voids can be reduced by forming business groups with internally coordinated group-wide managerial labor, product and capital markets, paralleled by accentuated control across the group. The functioning of such internalized markets is underscored by extensive socialized control amongst group constituents (Khanna & Rivkin, 2001). Socialized control commonly reflects powerful underlying sociological traits within indigenous society, such as familial or clan affiliation, and provide a different rationale for group formation rivaling conventional arguments based on institutional voids. This is further exemplified by the often intractable nature of powerful family groups within state institutional architecture, prevalent to many emerging economies (Claessens, Djanko, & Lang, 2000; Khanna & Yafeh, 2007; Khanna & Palepu, 2000). Thus private equity investors into business group constituent firms must contend with the socialized control over the business group by the controlling owner. The complexity of such control is aggravated by the opaqueness of formal institutions offering protection of property rights.

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We contribute to the nascent comparative corporate governance literature (see Aguilera & Jackson, 2003, Aguilera & Jackson, 2010) in developing an actor-centered institutional-theoretic perspective. Specifically, we apply this perspective by focusing on the interaction between outside private equity and controlling business group entities within focal IPO firms.[1] Our perspective is particularly useful in rationalizing the co-existence of multiple governance frameworks within a single national context. This implies that we use theoretical concepts such as institutional path dependence (see North, 1990, 1994) and mutually reinforcing complementarities (see Aoki, 2001; Millgrom & Roberts, 1995). The perspective is also particularly applicable in Africa where European-colonial transplanted formal institutions are often incongruous with informal institutions rooted on feudal clan-based political economies – eschewing collectivism and communitarian notions as well as religious norms based on egalitarianism and uniformity. The perspective provides our theoretical basis for evaluating the corporate governance options available to private equity post-IPO. Such corporate governance options are a transactions cost trade-off between retained ownership – leading to more intrusive social participation within the business group constituent firm – or alternatively with lower level of ownership a greater reliance on state-level institutional architecture and consequently higher reliance on legally mandated performance covenants. The trade-off between these two alternatives centers on transactions costs – themselves a function of the differences in bounded rationality between outside private equity and dominant business group controlling entity where these are shaped by institutions.

Using a unique hand-collected and comprehensive sample of 202 IPOs undertaken across Africa from January 2000 to January 2014 we find empirical support for our hypotheses that private equity post-IPO ownership is higher in business group constituent firms than in their unaffiliated counterparts. This association is inversely moderated by institutional quality. The moderating effect is found to be much stronger for foreign VC than for domestic VCs.

The rest of this paper is organized in six sections. In the next section below, we outline the theoretical justification behind our study and hypotheses. In the section thereafter we provide an overview of African stock markets, private equity and institutional frameworks, followed by a section in which we outline the data. Next we define the variables used in study and the modeling techniques. In a further section, we discuss the empirical findings. In the closing section, we summarizes the key findings and discuss the implications and the limitations of the study.

2. Theory and hypotheses

While business groups are constellations of firms under the control of a dominant entity – usually a family but also state, banks (e.g. Japanese keiretsu), corporate, informal or individual interests – all subordinate firms commonly adhere to a joint group-wide strategy (Khanna & Rivkin, 2001). The extended group is a hybrid organizational structure – where its coordinated strategy between constituents infers it falls outside the classical boundary of the firm yet within the scope of frictionless markets (Williamson, 2000). In past literature the main arguments rationalizing the formation of business groups are based on deficiencies in state-level financial and legal architecture and/or a weak institutional environment leading to prohibitive transactions costs (Williamson, 1998, 2000). Such weaknesses commonly arise from a lack of efficient intermediaries in external markets for products, labor and capital (Khanna & Yafeh, 2007). Such inefficiencies lead to a necessity in internalizing the intermediation function of these markets through a better-performing group-wide resource coordination system.[2]

Past research (Khanna & Palepu, 2000; Khanna & Rivkin, 2001) indicates that religious and familial altruism can provide the social "glue" binding the business group members together, as these institutions[3] employ socialized control mechanisms across the wider group. This "glue" is also shown by the fact that within the business group there is commonly a complex managerial coordination system – with resource allocation being made in accordance to social status and within-group institutionalized rules of action (Ocasio, 1999). The institutionalized nature of this social cohesion promotes trust between group members, enhancing group-based social capital. The institutional-theoretic argument above rationalizes business group formation in terms of networks-based trust that helps to circumvent institutional voids. This argument based on institutional complementarities (Aguilera & Jackson, 2003) alludes to broader mutually reinforcing institutional elements (Aoki, 2001; Millgrom & Roberts, 1995) that originate from the deeper societal matrix. Overall the institutional perspective places considerable emphasis on the inherent social nature of business groups.

In order to enhance the efficiencies associated with resource provision in internal capital markets, business groups often take over and internalize a specialized financial services firm, such as a commercial bank or VC entity (Khanna & Palepu, 2000). Business group expansion – either through additional diversification of activities or calving i.e. the formation of subordinate founder-led groups from within the parent group structure – stretches financial resources and necessitates the raising of outside private equity capital. Group-constituent firms are in a particularly strategically advantageous position in being able to leverage on the wider group reputation or brand in facilitating trust and to attract external investment (Khanna & Rivkin, 2001). Trust is instrumental in their attainment of credibility in contracting (Khanna & Palepu, 2000; Khanna & Rivkin, 2001). African IPO firms' access to private equity investors is at a low absolute level but still essential for capital infusions to augment provision by internal markets.

A critical dimension in capital market intermediation is the intertemporal dimension of investment, which draws on the relative longevity of investment time horizons of actors. Large extended family entities – particularly in emerging economies with minimal, if any, state social welfare provision (Levy, 2008) – are largely motivated by intergenerational transfer of capital. Thus in diversified groups investment horizons associated with internal capital markets may be significantly longer in focusing on long-term value and the social significance of a constituent firm's operations than those of outside private equity investors. The longer horizons are especially prominent in the operations of group-wide internal markets, where a combination of investment over multiple periods and shareholder tunneling appear together with mechanisms such as transfer pricing and expropriation used to redistribute capital around group members (Claessens, Djankov, Fan, & Lang, 1999, Claessens et al., 2000; La Porta, Lopez-de-Silanes, Schliefer, & Vishny,

[1] Such an actor-centered perspective encompasses the institutional formal versus informal dichotomy of North (1990, 1994), elements of Williamson's (1998, 2000) transaction cost economics – itself an offshoot of the institutional literature, and notions of isomorphic conformity in organizational structure of DiMaggio and Powell (1983). These provide the basis of nascent comparative corporate governance literature of Aguilera and Jackson (2003).

[2] Emerging economy business groups are typically diversified across industries and attract a market valuation premium for this – where the opposite would be true for such diversification in developed economies (Khanna & Yafeh, 2007). The emerging market premium assists business groups in attaining geographical and industry risk diversification – where sector concentration otherwise renders firms vulnerable to the significant macroeconomic and policy instability ubiquitous to many emerging economies. Such group-based diversification of cash flow also contributes to a group-wide income smoothing and to a more efficient allocation of the group-based internal capital markets.

[3] In this context we refer to North's (1990) dichotomous definition of institutions being formal and informal. The former refers to formal governmental, political, legal mechanisms while the latter refers to norms, social values, religious ideals and other deeper sociological notions and behavioral norms.

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