ALTERNATIVE MODELS OF GOVERNANCE

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ALTERNATIVE MODELS OF GOVERNANCE

- Among public companies, governance features are imposed by regulators, listing exchanges, and capital-market pressure.
- However, other organizational structures exist:
  - Family-controlled businesses
  - Venture-backed companies
  - Private equity-owned companies
  - Nonprofit organizations
- The governance features of these firms will reflect the issues they face regarding purpose, ownership, and control.

1. FAMILY-CONTROLLED CORPORATIONS

- Family-controlled businesses are those in which a founder or founding-family member maintains a presence as shareholder, director, or manager.

  (+) Large ownership position aligns interests with minority investors.

  (+) Long-term orientation (see the company as their "legacy").

  (+) Vigilant oversight of management, strategy, risk, and compensation.

  (-) Might exert disproportionate control relative to ownership stake.

  (-) Might extract private benefits at the cost of minority shareholders.

  (-) Might be excessively risk-averse.

Percentage of large corporations that are family-controlled:

- Emerging markets: 60%
- Europe: 40%
- United States: 30%

McKinsey & Co. (2014)

1. FAMILY-CONTROLLED CORPORATIONS

Family-controlled corporations tend to:

- Exhibit superior long-term performance, especially when the founder serves as CEO.
- Maintain better employee relations, stronger culture.
- Be less prepared for CEO succession, make worse selection choices.
- Demonstrate higher earnings quality.
- Exhibit less transparency, engage in higher levels of insider trading.

Anderson and Reed (2003); Mueller and Philippon (2011); Pérez-Gonzáles (2006); Ali, Chen, and Radhakrishnan (2007); Anderson, Duru, and Reeb (2009)

2. VENTURE-BACKED COMPANIES

- Venture capital (VC) firms:
  - Provide initial and early-stage capital to small, high-growth companies.
  - Focus on rapidly changing industries where potential returns and risk are high.
  - Reduce risk by investing in a diversified portfolio (a few highly successful investments offset a large number of losses).
- Venture capital funds:
  - Structured as a limited partnership.
  - Capital is committed for 10-years.
  - Capital is returned to investors when companies are sold or go public (IPO).
  - VC firm receives percent of the profits ("carried interest").

VENTURE CAPITAL SUMMARY STATISTICS

	1993	2003	2013
NUMBER OF VC FIRMS	370	951	874
NUMBER OF VC FIRMS RAISING $ THIS YEAR	93	160	187
VC CAPITAL RAISED THIS YEAR ($ BN)	4.5	9.1	16.8
VC CAPITAL UNDER MANAGEMENT ($ BN)	29.3	263.9	192.9
AVERAGE VC FUND SIZE TO DATE ($ M)	40.2	94.4	110.3
VC INVESTMENTS BY STAGE			
SEED	17.2%	1.9%	3.3%
EARLY STAGE	15.7%	18.3%	33.5%
EXPANSION	51.0%	49.7%	33.2%
LATER STAGE	16.1%	30.1%	30.0%
PERCENTAGE OF IPOs VC-BACKED	N/A	37.1%	47.9%

Thomson Reuters (2014)

2. VENTURE-BACKED COMPANIES

- Board of directors
  - Tightly controlled: 4 directors, 2 of whom are members of VC firm.
  - Low independence (56% of directors); CEO rarely serves as chairman (15%).
  - No formal audit, comp, or governance committees until run-up to IPO.
- Executive compensation
  - Heavily weighted toward equity-based awards.
  - Prior to IPO, CEO holds 15% of equity, top five managers 26%, total directors and officers 63%.
- Antitakeover protections
  - Remain tightly controlled following IPO.
  - 77% staggered board, 15% dual-class shares, 69% restrict shareholder rights.

Wongsunwai (2007); Daines and Klausner (2001); Proskauer (2015)

2. VENTURE-BACKED COMPANIES

Venture-capitalists tend to positively impact the firms they invest in:

- Contribute to the "professionalization" of start-ups by replacing founder with outside CEO, introducing stock options, and influencing HR policies.
- Encourage innovation, investment in research, and deal activity.
- Demonstrate higher earnings quality.
- Positive effects are most pronounced among companies backed by "high-quality" VC firms.

Hellman and Puri (2002); Celikyurt, Sevilir, and Shivdasani (2014); Hochberg (2012); Klausner (2013); Wongsunwai (2007); Krishnan, Ivanov, Masulis, and Singh (2011)

3. PRIVATE EQUITY-OWNED COMPANIES

- Private equity firms are privately held investment firms that invest in businesses for the benefit of retail and institutional investors.
- Tend to target mature companies that generate substantial free cash flow to support a leveraged capital structure.
- Following acquisition, the target undergoes a complete change in management, board, strategy, and capital structure.
- If successful, the private equity firm sells the company back to the public or to a strategic or financial buyer.
- The private equity firm earns a carried interest and returns the remaining proceeds to investors.

3. PRIVATE EQUITY-OWNED COMPANIES

PRIVATE EQUITY SUMMARY STATISTICS

	1985-1989	1990-1994	1995-1999	2000-2004	2005-2007	1970-2007
COMBINED ENTERPRISE VALUE	$257 BN	$149 BN	$554 BN	$1,055 BN	$1,563 BN	$3,616 BN
NUMBER OF TRANSACTIONS	642	1,123	4,348	5,673	5,188	17,171
LBOs BY TYPE						
PUBLIC TO PRIVATE	49%	9%	15%	18%	34%	27%
INDEPENDENT PRIVATE	31%	54%	44%	19%	14%	23%
DIVISIONAL	17%	31%	27%	41%	25%	30%
SECONDARY	2%	6%	13%	20%	26%	20%
DISTRESSED	0%	1%	1%	2%	1%	1%
TYPE OF EXIT						
BANKRUPTCY	6%	5%	8%	4%	3%	6%
IPO	25%	23%	11%	10%	1%	14%
SOLD TO STRATEGIC BUYER	35%	38%	40%	38%	34%	38%
SOLD TO FINANCIAL BUYER	13%	17%	23%	31%	17%	24%
SOLD TO LBO-BACKED FIRM	3%	3%	5%	7%	19%	5%
SOLD TO MANAGEMENT	1%	1%	2%	1%	1%	1%
OTHER OR UNKNOWN	18%	12%	11%	8%	24%	11%

Kaplan and Strömberg (2008)

3. PRIVATE EQUITY-OWNED COMPANIES

- Board of directors
  - Small: 5 to 7 directors, heavily represented by insiders.
  - Closely involved in strategic and operating decisions.
  - Require more time than public boards (54 days v. 19 days, per year).
- Executive compensation
  - Lower salary but higher total pay opportunity than public company CEOs.
  - CEO equity stake in company doubles following sale to PE firm.
  - Performance targets shifted from qualitative to profitability measures.
  - Equity awards contain a mix of performance and time-vested awards.
- Capital structure
  - Debt-to-equity ratio triples following acquisition (25% to 71%).

Acharya, Kehoe, and Reyner (2008); Leslie and Oyer (2009); Cronqvist and Fahlenbrach (2013); Guo, Hotchkiss, and Song (2011)

3. PRIVATE EQUITY-OWNED COMPANIES

Private equity owners have an uncertain impact on the firms they invest in:

- Tend to outperform publicly traded companies.
- Are aggressive in redirecting investment from less productive to more productive activities.
- Still, it is unclear the extent to which returns are driven by operating improvement, rather than increases in leverage and tax reduction.
- Research is mixed on how private and public equity returns compare on a risk-adjusted basis.

Phalippou and Gottschalg (2009); Harris, Jenkinson, and Kaplan (2014); Guo, Hotchkiss, and Song (2011); Acharya, Gottschalg, Hahn, and Kehoe (2013); Davis, Haltiwanger, Handley, Jarmin, Lerner, and Miranda (2014)

4. NONPROFIT ORGANIZATIONS

- Nonprofit organizations operate in a wide range of activities, including:
  - Education
  - Social and legal services
  - Arts and culture
  - Health services
  - Civic, fraternal, and religious organizations.
- Tax-exempt under rule 501(c) of the Internal Revenue Code.
- Have a stakeholder (rather than shareholder) orientation.

4. NONPROFIT ORGANIZATIONS

NONPROFIT SUMMARY STATISTICS

	U.S. TOTALS 2012
REGISTERED NONPROFITS	1.4 M
PUBLIC CHARITIES, 501(c)(3)	1.0 M
FINANCIAL INFORMATION	
TOTAL REVENUES	$1.65 T
TOTAL ASSETS	$2.99 T
BREAKDOWN OF CHARITIES	
ARTS, CULTURE, HUMANITIES	9.9%
EDUCATION	17.1%
ENVIRONMENT, ANIMALS	4.5%
HEALTH	13.0%
HUMAN SERVICES	35.5%
INTERNATIONAL AFFAIRS	2.1%
PUBLIC, SOCIAL BENEFIT	11.6%
RELIGION-RELATED	6.1%

McKeever and Pettijohn (2014)

4. NONPROFIT ORGANIZATIONS

- Board of directors
  - Large: 16 members.
  - CEO rarely serves as chairman.
  - Directors often have significant fundraising obligations.
  - Audit committee not required.
- Executive compensation
  - Significantly lower than for-profit companies ($130,000 median).
  - Comprised of salary and cash bonus.

BOARD ATTRIBUTE	U.S. AVERAGE 2012
NUMBER OF DIRECTORS	16
NUMBER OF MEETINGS PER YEAR	7
NUMBER OF COMMITTEES	5.5
AUDIT COMMITTEE	72%
DUAL CHAIR/CEO	3%
CEO NONVOTING DIRECTOR	40%
CEO NOT ON BOARD	46%
DIRECTORS REQUIRED TO DONATE	75%
DIRECTORS REQUIRED TO FUNDRAISE	42%
FEMALE DIRECTORS	45%
ETHNIC MINORITY DIRECTORS	18%

BoardSource (2012)

4. NONPROFIT ORGANIZATIONS

Governance quality varies significantly across organizations:

- Many board members do not fully understand their obligations as directors.
- Many do not understand strategy, mission, and performance of the organization.
- Many nonprofits lack formal governance processes (external audit, internal controls, succession planning, board evaluations).

Nonprofits with weak controls are more likely to exhibit agency problems (e.g., understate or shift costs to appear more efficient).

Stanford University, BoardSource, and GuideStar (2015); Krishnan, Yetman, and Yetman (2006); Krishnan and Yetman (2011)

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