

## TAPPING THE LIABILITIES' SIDE - AUSTRIAN EVIDENCE FOR PRIVATE EQUITY INVESTOR INVOLVEMENT, GROWTH AND THE INTERNATIONALIZATION OF FIRMS

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### ABSTRACT

*This paper aims to close one of the most persistent gaps in international business (IB) and strategic management (SM) research by advocating a systematic extension of our research perspective to a more finance-based "liabilities' approach". As such, it responds to the recent work of prominent scholars such as Agmon (2006) and Bowe, Filatotchev and Marshall (2010). We challenge the prevailing "finance follows" mindset and – using Private Equity (PE) investors as an illustrative example – we demonstrate how an integrated approach may improve existing theories and open up entirely new avenues of research. We present confirmatory as well as exploratory findings on the impact of investors, suggesting that a company's ownership not only determines a company's financial strength but also has a number of less obvious implications for growth and internationalization. Our findings suggest that investors may be a strategic asset and can serve as catalysts for a company's growth at several levels of involvement.*

**Keywords:** private equity, investor involvement, ownership, internationalisation, strategic finance

### TAPPING THE LIABILITIES' SIDE OF INTERNATIONAL BUSINESS

Maria Tereza Leme Fleury opened the 2010 Academy of International Business Conference, quoting Tatiana Kostova's call for a reassessment of the applicability of contemporary IB (international business) theories in the face world in crisis.

Her words indicate one of the most persistently neglected areas in contemporary international business (IB) and strategic management (SM) research. For decades, mainstream research extended deep into the details of a company's assets but ignored the financial ramifications of international business

incorporated on the liabilities' side of the balance sheet. Strategic, organisational, knowledge based, as well as social and cultural resources were integrated in a rich set of theories and analysed in a self-reinforcing cycle that became increasingly impractical. While these topics undoubtedly play a pivotal role in a firm's strategy, it is questionable whether their academic dominance *vis-à-vis* financial resources is justified by modern corporate reality. By concentrating on the application of resources, contemporary research often ignores the source and sometimes even the availability of financial assets, implying a perfect interchangeability of capital. This one-sided approach traps research in an antiquated neoclassical business world: an implied theorem of irrelevance.

Following the meltdown of the financial markets, economic reality has outpaced researchers, and the "*liabilities' side of the balance sheet*" has impressively reclaimed its status in corporate boardrooms, leaving formerly successful internationalisers – companies and nations alike – desperate for financing. In a highly stylised depiction, Figure 1 illustrates the academic disregard of the liabilities' side as envisaged by the author.

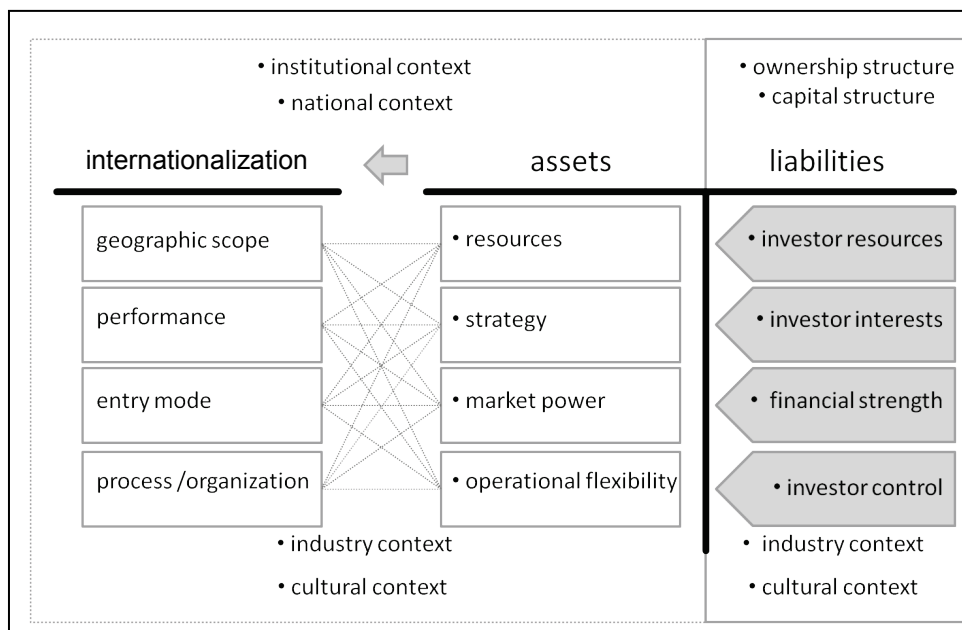


Figure 1. The academic disregard of the liabilities' side of the balance sheet

## **PRIVATE EQUITY AS AN EXEMPLARY APPLICATION OF THE LIABILITIES' PERSPECTIVE**

Other fields of research, such as financial economics and entrepreneurship, have long provided empirical evidence on the firm-level impact of investors. Acharya, Hahn and Kehoe (2009), Smith (1990), Weir and Laing (1998) and Bottazzi and Da Rin (2002) have found significant but sometimes contradictory impacts of private equity (PE) investors on firm-level profitability and growth. Other researchers, such as Amess, Girma and Wright (2008), Davis Haltiwanger, Jarmin, Lerner and Miranda (2008), and Boucly, Sraer and Thesmar (2009), have described the specific effects of PE on remuneration and job creation. Hellmann and Puri (2002) have identified a professionalisation effect of PE investors, and Lerner et al. (2008) conclude that PE investors may spur corporate innovation. PE studies relating to firm-level internationalization and strategy are scarce. Peneder, Schwarz and Jud (2006, p. 44) estimate an 11.4% annual export growth superiority of PE-financed companies in an Austrian sample. Lockett, Wright, Burrows, Scholes and Paton (2008) offered evidence that PE monitoring and value-added services are directly related to export intensity. In a similar vein, Fernhaber and McDougall-Covin (2009) suggested that the link between internationalization and performance may be moderated by the reputational and knowledge resources of investors. While these studies are groundbreaking in their contributions, "*...considerable interest remains in understanding in greater depth the nature of engagement and involvement of PE houses with portfolio companies and providing more robust evidence on how these relate to value creation*" (Acharya et al., 2009, p. 38).

This paper is structured to address this interest. The first section introduces a comprehensive, literature-based model of PE investor involvement. The second section builds on the results of a comprehensive study carried out among Austrian PE-financed companies; while the study included large sample confirmatory analysis, the focus of this paper will be on the results of the exploratory survey. Finally, we return to a liabilities' perspective of IB and show how these findings have implications for contemporary IB and SM research.

## **A MODEL OF INVESTOR INVOLVEMENT, FIRM GROWTH AND INTERNATIONALIZATION**

PE investors are highly specialised intermediaries funding companies with high risk and high yield potential. Their primary function *is to finance* the growth of a portfolio company (PC) (H<sub>1</sub>). PE investors distinguish themselves from other types of investors because they aim at maximising the exit value of the companies they invest in through intensive *monitoring* (H<sub>3</sub>) (Lerner, 1995;

Robbie et al., 1997), growth-orientated *incentive* and *governance structures* (H<sub>2</sub>) (Kaplan & Strömberg, 2004), and *value added services* (VAS) (H<sub>4</sub>) (Busenitz, Fiet, & Moesel, 2004; Hellmann & Puri, 2002). For the purposes of the explorative survey, these four areas of intervention were integrated into a holistic model of PE involvement, and a total of 13 proposed involvement-effect hypotheses were generated.

The first area of involvement – *finance* – is best illustrated in Teece's statement (1997, p. 521) that "*what a firm can do in short order is often a function of its balance sheet*". Although it may appear fatuous, the statement perfectly stresses the broader aim of the paper. However, exploring the liabilities' perspective requires a deeper look into the specific properties of the finance provided. The presence of PE financing will have an indirect effect on the financial standing of the company. The higher equity-to-assets ratio resulting from the PE investor will enable the firm to borrow additional debt or mezzanine capital (H<sub>1a</sub>). Scholars such as Bottazzi and Da Rin (2002) and Shane and Cable (2002) have also provided evidence that PE investors have a positive certification effect on shareholders and creditors alike (H<sub>1b</sub>).

Furthermore, PE investors provide financial expertise, improving capital structure and working capital management (H<sub>1c</sub>). The improved equity base will also extend management's capabilities for strategic manoeuvring and reduce risk aversion (H<sub>1d</sub>).

There are several reasons why these effects will be even more pronounced in a company operating in an international context rather than a domestically focused company because the additional risks associated with entering foreign markets increase investment uncertainty (Hill, Hwang, & Kim, 1990; Johanson & Vahlne, 1977; Moser, 2009). Furthermore, geographic and cultural distances in international business increase information asymmetry (Mäkelä, 2004). Of course, capital-intensive market entry strategies will regularly exceed the debt financing capabilities of SMEs. Therefore, all 13 involvement hypotheses were formulated separately with regard to their contribution to domestic and international growth.

A second set of propositions was called *contractual governance* and relates to the contractual aspects of the agency relationship in PE finance. In a number of papers, Rosenstein analysed the PE investor's board representation and contractual covenants involved (Rosenstein, 1988; Rosenstein et al., 1990 and Rosenstein et al., 1993). By implementing growth-oriented incentive structures such as staged financing and management equity participation (H<sub>2a</sub>) (Holmstrom & Milgrom, 1991), the interests of principal and agent are aligned, and therefore, the cost of the double-sided moral hazard situation specifically associated with

PE may be reduced (Houben, 2002; Kaplan & Strömberg, 2004). Of course, in addition to these positive incentives, PE investors regularly acquire a controlling share of the company, and they insist on interventionist contractual covenants if the company does not achieve certain performance milestones (H<sub>2b</sub>) (Hellmann, 1998). Despite the rich literature on governance, few papers relate PE corporate governance to its effect on firms' internationalization. Smolarski and Kut (2009, p. 39) provided evidence that firms with staged PE investments show higher export sales growth than those with stand-alone investments, and George, Wiklund and Zahra (2005, p. 230) concluded that external owners decrease risk aversion and thus promote internationalization.

The third set of propositions, *monitoring*, is closely linked to contractual governance. Venture capitalists spend approximately 50% of their time monitoring their investments (Gorman & Sahlman, 1989, p. 241). As acknowledged by numerous authors, PE monitoring may go far beyond purely financial monitoring (Lockett et al., 2008; Rosenstein et al., 1993), thus imposing continuous growth orientation on the company (H<sub>3a</sub>). Monitoring also creates better information flow, promotes the development of know-how and encourages a pro-active, value-based management (H<sub>3b</sub>) (Lockett et al., 2008). However, at present, the empirical evidence linking monitoring and a firm's performance is conflicting. While MacMillan, Kulow and Khoylian (1989) provide evidence for a positive relationship, Wijbenga, Postma and Stratling (2007) demonstrate that excessive reporting requirements may have a detrimental effect on a firm's performance. Lockett et al. (2008) made a first attempt to relate monitoring to internationalization and found a positive relationship.

Finally PE investors often claim to provide *value added services* (Busenitz, Fiet, & Moesel, 2004; Lange et al., 2001; Sorensen, 2007). Existing literature on the matter has mostly drawn on the *resource-based view*, analysing resources such as the following:

1. International strategy formation (H<sub>4a</sub>) (Kotha et al., 2001)
2. International know-how and experience (H<sub>4b</sub>) (Bloodgood et al., 1996; Fernhaber & McDougall-Covin, 2009; Higashide & Birley, 2000; Reuber & Fischer, 1997; Shepherd & Zacharakis, 2002; Shepherd et al., 2003)
3. Reputation (H<sub>4c</sub>) (Fernhaber & McDougall-Covin, 2009)
4. Relational capital and networks (H<sub>4d</sub>) (De Clercq & Sapienza, 2006; Zahra et al., 2007)
5. International human capital formation (H<sub>4e</sub>) (Zahra, et al., 2007)

Lindsey (2008) provided evidence that PE investors can open up opportunities for strategic alliances due to their certification effect. Mäkelä and Maula (2005, 2006) apply an institutional perspective and conclude that embedding an investee

in a global investor's network subjects the PC to isomorphic pressure, thus influencing internationalization. An important and well-documented aspect of investment behaviour in this connection is the international syndication of investments between two or more investors (Brander et al., 2002; Mäkelä, 2004).

While the model itself will certainly require further theoretical development and conceptual modelling, the task of empirical testing is not the intention of this paper and will not be addressed further. Conversely, the model should serve as an explorative impetus to identify new avenues of research on the liabilities' side.

## **METHOD, CONFIRMATORY RESULTS AND EXPLORATIVE FINDINGS OF THE MODEL**

In June 2010, a research project was initiated to assess PE investors' contribution to a firm's growth and internationalization within a sample of Austrian PE investments. The project undertook a quantitative, *confirmatory impact* study among later stage buyouts using matched control groups. Several OLS and Heckman two-step regressions were carried out to control for sample endogeneity. Companies were matched according to location, their primary and secondary NACE Rev. 3 industry classification, sales, and employment, using the Amadeus database. Primary performance data was obtained from a commercial credit agency (KSV 1870) and from various business databases. Overall data coverage of approximately 70% was achieved over a 10-year period. In addition to the database match we adopted a second matching method referred to as *respondent-match*. In this approach we asked the PE-financed companies to identify their most comparable competitors. The *respondent-matching* process permitted the research project to control for more latent and less tangible characteristics in the matching process and allowed us to validate the results from the database matching. Table 1 shows the compound annual sales and employee growth rates for the subject PE companies from 2000 to 2010 and compares the same figures for the two control groups and the overall Austrian economy.

The sales growth differential is significant and even more pronounced after controlling for sample endogeneity using a Heckman two-step regression model. We believe that this surprising fact results from a reverse selection bias. While most studies recognise the favourable endogeneity caused by the PE investor's decision to finance high-potential companies, few authors consider that a reverse selection may take place on the side of potential PCs who may refuse to take on a PE investor. Contrary to the selection of the PE investor such a reverse selection may lead to an underestimation of the true impact of PE investors. A similar observation is made by Bertoni et al. (2010, p. 3) in an Italian sample of PCs.

Overall, the results suggest that PE investors have a positive impact on firm growth and thus confirm the role of the liabilities' side in business performance.

Table 1  
*PE companies' sales and employee growth compared to control groups*

	PE	DB Matches	RE Matches	Overall economy
CAGR_SALES	9.04 % p.a.	4.93% p.a. 0.052*	3.94% p.a. 0.06*	2.93% p.a. 0.001**
CAGR_EMP	3.85% p.a.	1,99%p.a. 0.187	0.53% p.a. 0.09*	0.99% p.a. 0.012**
N	109	109	56	n.a

Notes: Level of significance reported: \* $p < .1$ ; \*\* $p < .05$ ; \*\*\* $p < .001$

This conceptual paper will focus, however, on the theoretical implications of an accompanying *explorative survey* conducted among PE-financed companies in cooperation with the *Austrian Private Equity and Venture Capital Organization* (AVCO). Companies were asked to rate the perceived impact of PE investors following the model of investor involvement, and a response rate of nearly 30% was achieved. While the relatively small absolute sample size does not allow for confirmatory factor analysis or structural equation modelling, it does provide very interesting explorative insights into the complexities of the liabilities' side of internationalization.

Introductory questions about the overall contribution of PE investors to internationalization and growth received clear and significantly positive reactions from the respondent firms. Using five-point scales, all propositions of the model were rated by the respondents with respect to PE investors' effect on domestic growth and on internationalization. Table 2 displays the mean assessments of the respondents.

In a purely domestic context, the results indicate that the perceived contribution of the PE investor is mostly limited to the *finance* function, i.e., for providing financial resources and financial know-how and for opening up new sources of capital. Neither *governance* nor *monitoring* by the PE investors was perceived to have a significant contribution to firm growth. However, it is important to note that perceived impact may not necessarily correspond to actual impact in such instances. Contrary to existing research (Hsu, 2004; Puri & Zarutskie, 2008) and PE publicity, the value-added services of a PE investor were largely considered an impediment to a firm's growth by the respondent companies. PE investors' reputation and industry knowledge were even reported to have a significantly negative effect on firm growth within the sample of

Austrian firms. Some firms, especially family buyouts, have also explicitly complained about the negative effect of PE investors on domestic shareholders due to the transition from family-owned to investor-owned business. This finding is consistent with the notion of a very negative attitude towards PE investors in Germany and Austria. Respondents voiced similar reservations about the industry knowledge contributions of PE investors in a domestic context because PE investor knowledge was perceived as unhelpful and even detrimental to a firm's performance when combined with a PE investor's ability to impose its will on the company.

Table 2  
*Explorative results of the investor involvement model*

Area of Involvement	Hypothesis	Perceived effect on domestic growth	Perceived effect on internationalization
H <sub>1</sub> : Finance	H1a: equity provision	+ 0.649**	+ 0.892**
	H1b: access to additional debt	+ 0.757**	+ 0.838**
	H1c: financial know-how	+ 0.324	+ 0.649**
	H1d: financial flexibility and risk aversion	+ 0.649*	+ 0.486*
H <sub>2</sub> : Contractual governance	H2a: positive financial incentives	+ 0.054	+ 0.297**
	H2b: interventionist control rights	- 0.216	+ 0.189
H <sub>3</sub> : Monitoring	H3a: increased reporting and controlling	+ 0.351	+ 0.405**
	H3b: professionalisation of management systems	+ 0.270	+ 0.514**
H <sub>4</sub> : Value added services	H4a: strategy expertise	- 0.027	+ 0.541**
	H4b: industry know-how and experience	- 0.568*	+ 0.162
	H4c: reputation	- 0.892**	+ 0.027
	H4d: personnel management	- 0.054	+ 0.135
	H4e: network access	+ 0.351*	+ 0.595**

Perceived impact was measured using scales from -2 (very negative effect) to +2 (very positive effect). Values represent the mean response. Significant impacts were corrected cumulative alpha error in multiple testing using the Holm-Bonferroni procedure (Holm, 1979, p. 65).

One central finding of the paper and an empirical justification of the liabilities' perspective on international business is that the perceived contribution of the PE investor in the domestic context differs significantly from an internationalization domestic context. All measures, including contractual governance and



monitoring, showed positive contributions, and nine of these measures showed significant positive contributions. In contrast to their primary role as financiers in the domestic context, PE investors seem to contribute to and act as catalysts for internationalization by setting incentives, providing network contacts, offering management competence and, of course, making available the capital to internationalise more aggressively.

Non-parametric tests showed that the two effects seem to be unrelated in at least four of the propositions. This finding provides strong justification for integrating PE investor involvement in internationalization research. Of course, the PE investor is only one element of a company's liabilities' side. Family businesses, highly leveraged companies and companies within a conglomerate structure will have completely different sets of incentives and resources, and these companies may therefore show very different internationalization behaviour.

Another interesting finding is that high-performing companies reported greater satisfaction with PE investors' contributions regarding the *finance*, *governance* and *monitoring* functions. Evidently, low-performing companies perceive investor involvement beyond the *finance* function as interventionist interference and an impediment to performance. Conversely, high-performing companies consistently rated the PE contribution regarding *value added services* as lower than their less successful counterparts. These results suggest that the role of PE investors differs not only between the domestic and international contexts but also between different portfolio companies. It seems that needs and expectations regarding *value added services* are not consistent across portfolio companies.

A number of further in-sample regressions were undertaken to further explore the possible determinants of the effect of PE investors on internationalization, and the main hypotheses regarded syndication, investor provenience and the size of the stake held by the PE investor. One interesting finding, although not statistically significant, is that foreign investors seemed to have a more positive effect on firms' internationalization. Another interesting finding is that syndicated investments seem to have a significantly stronger effect on sales growth, but the limited data does not allow testing for reverse causality yet. The results of the in-sample regressions are displayed in Table 3.

The overall fit of the models is rather low with the employment model explaining an adjusted 45% in employment growth and the sales model explaining 43% of the sales variance. However, the aim of the model was not to construct a predictor model for sales and employment growth but to determine the influence of several variables.

Table 3  
In-sample regression models on employment and sales growth

Impact	Model 1 (CAGR_EMP)		Model 2 (CAGR_SALE)	
Variable	Coefficient B	(Sig.)	Coefficient B	(Sig.)
(Intercept)	8.353	.110	13.907	.229
Syndication	1.729	.353	8.315**	.033
Majority_Share	-1.221	.493	-.874	.819
Domestic_Foreign	2.791	.238	-4.550	.273
EBIT <sub>t-1</sub>	.171**	.002	.159**	.013
SALES <sub>t-1</sub>			.414***	.000
EMPLOYMENT <sub>t-1</sub>	.263***	.000		
IND_1	-1.919	.617	-11.187	.343
IND_3	3.676	.284	-5.666	.486
IND_4			-11.110*	.062
IND_6	1.386	.663	3.350	.638
IND_25	6.444**	.049		
IND_26	1.386	.663	-13.280*	.085
IND_28	3.167	.270	-8.252	.250
IND_2x	.654	.791	-1.459	.820
Entry_Year_Cen	-1.772**	.043	-2.526	.114
Duration	-1.525*	.056	-.990	.463
Age	.005	.817	-.038	.287
N	109		109	
R <sup>2</sup>	.668		.617	
Adjusted R <sup>2</sup>	.447		.432	
ANOVA Sig.	.011**		.002**	

Notes: Level of significance reported: \* $p < .1$ ; \*\* $p < .05$ ; \*\*\* $p < .001$ . Dependent variable (CAGR\_EMP): compound annual growth rate of employment. Independent variables: Syndication = Dummy more than one PE investor, Majority\_Share = Dummy total synd. PE ownership > 50%, Domestic\_Foreign: Dummy for min. one foreign PE investor, EBIT<sub>t-1</sub> = EBIT in year before PE investment, SALES<sub>t-1</sub> = Sales growth in year before PE investment, EMPLOYMENT<sub>t-1</sub> = Employment growth in year before PE investment, IND\_1-2x = Industry dummy classification acc. NACE Rev.2, Entry\_Year\_Cen = year of entry by first PE investor (centred variable), Duration = duration of PE involvement, AGE = age of company in years.

In addition to syndication's positive effect on sales, the results strongly support the selection hypothesis. All variables  $t-1$  are highly significant, suggesting that characteristics of the companies prior to PE investor entry may explain a large part of their later growth. PE investors thus may capitalise on superior selection skills. The results also stress the importance of controlling for sample endogeneity in PE impact research.

Even though the results may be preliminary and exploratory, the study has broad implications for IB and SM research. These implications will be discussed in the following section.

## **DISCUSSION AND IMPLICATIONS OF THE STUDY**

The exploratory results presented in this paper suggest that the source of finance plays an important role in firms' internationalization and domestic growth. A PE investor must meet the individual requirements of the financed firms with respect to their specific set of resources and governance. It is important to note that all of these results may not be transferable to other institutional contexts and apply only to the Austrian sample.

The study has implications for *PE management*. The notion of reverse selection, for example, questions the PE managers' role in selecting the right companies for investment and stresses the importance of convincing the right companies to accept investment. In continental Europe, PE funds face fierce criticism in the public media. However, PE investors' reputations are crucial to winning the confidence of potential investees. More effort must therefore be put into actively managing, creating value for and communicating value to the financed companies. For *financed companies*, the results suggest that, despite fierce media criticism, companies may gain from an active investor's presence, maximising their growth potential. The heterogeneity of investor involvement and contribution found in the study further underscores the importance of strategic selection of the PE investor by the investee company. To sum it up, companies should take to heart the famous words of Friedrich Schiller (1798):

*So test therefore, who join forever // If heart to heart be found  
together! // Delusion is short, remorse is long.*

However, the primary aim of the paper was not to address PE practice, but to argue for a more holistic view of internationalization in IB and SM research. By analysing PE investors, this paper showed that PE investors may act as catalysts for, and active contributors to, firms' domestic growth and internationalization.

## **BROADER IMPLICATIONS FOR THE IB AND SM RESEARCH AGENDA**

The paper has implications on at least three different levels of the IB and SM research agenda. First, the model should be tested and validated in numerous *international and industry contexts*. Researchers should consider factors like the effect of national policies and regulations, industry, culture and institutions on investor-investee interaction and its outcome. It is important, for example, to acknowledge that internationalization, from our perspective, is no longer determined by a two-sided cultural, political, geographic and economic distance relationship within a specific industry, but involves three contextual actors/institutions (namely investors, company executives and host country institution/customers). Even more important from a financial perspective, the link between risk, finance and internationalization must be addressed. The broad spectrum of public guarantees and incentives for internationalization, for example, is a strategically valuable component on the liabilities' side of the balance sheet that has been widely ignored but has significant practical importance for internationalising firms.

Secondly, research should look further into *investor heterogeneity*. Such differences may, for example, stem from the different geographical provenance of investors (Bhaumik et al., 2009; Lockett et al., 2002; Manigart et al., 2000; Pruthi et al., 2003; Sapienza et al., 1994; Sapienza et al., 1996) or from investor specialisation in certain industries (Munari et al., 2006; Norton & Tenenbaum, 1993). Local investors' involvement, for example, may affect transaction costs and uncertainty in a firm's internationalization, influencing the choice of market entry strategy as a consequence (Anderson & Gatignon, 1986; Brouthers, 2002; Brouthers & Brouthers, 2000; Hennart, 1988).

Finally, research on the effects of PE financing should incorporate more sophisticated measures of *firm internationalization and performance* to enable IB and SM research to tackle the complexities of a post-crisis business reality. Or, as Bowe (2010, p. 435) recently augured in the special edition of *International Business Review*:

*...linking finance and IB research provides fertile ground, not only for testing existing theories but also for developing newer ones, these endeavors are likely to greatly enrich the insights obtained.*

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