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Private equity and corporate governance: managing Brazilian SMEs

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Private equity and corporate governance: managing Brazilian SMEs

Estêvão Teixeira Latini, Joaquim Rubens Fontes-Filho and Eric L. Chambers

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Abstract

Purpose – *This paper aims to identify the effectiveness of private equity and venture capital (PE/VC) funds in promoting best practices of corporate governance in small and medium enterprises (SMEs) committed to PE/VC partnerships, in an institutional environment characterized by ownership concentration, lack of support for minorities' shareholder rights, and limited outside sources of finance for SMEs.*

Design/methodology/approach – *Based on the literature related to similar work and context as in Eastern Europe and South Africa and best corporate governance practices developed for Brazil, the authors developed a list of aspects associated to practices related to SMEs. This list was submitted to 15 specialists, and the resulting compilation produced a list of 49 items that were submitted to a sample of 78 respondents to evaluate the relative importance of each item. Finally, a survey comprised of 70 entrepreneurs and managers of SMEs with investments from PE/VC funds evaluated the situation of their companies before and after forming a partnership with the fund.*

Findings – *The study provides evidence that PE/VC funds play an important role in promoting best practices of corporate governance in invested SMEs, which contributes to development of the institutional environment and SMEs access to outside sources of finance.*

Originality/value – *The study contributes empirical evidence to the role played by PE/VC funds and their influence on corporate governance practices.*

Keywords *Venture capital, Corporate governance, Brazil, Emerging markets, Small and medium enterprises, Private equity*

Paper type *Research paper*

1. Introduction

Analyses conducted by the OECD (2003) evidenced that Latin American countries share key characteristics related to publicly traded companies within their national borders, such as ownership concentration, defined control and financing needs. Although this context may represent an active oversight of management, which reduces agency problems, it proves difficult for such companies to access outside sources of finance.

This challenge to access external financing sources is especially problematic for small and medium enterprises (SMEs) and entrepreneurial ventures operating not only in Latin America, but also in other developing regions, where they often lack sufficient access to funding sources (Mitter, 2012) and are subject to deficiencies in the institutional environment related to minority investor protection, which reduces the interest and guarantees of most institutional investors. According to Parisi *et al.* (2009), the lack of regulatory protection against minority shareholder wealth expropriation represents a major impediment to the development of many emerging markets.

Besides the limitation of national public securities markets and the nature of the institutional environment, international investors and lenders demand effective corporate governance practices, especially for non-listed companies, most of which depend heavily on private

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equity and venture capital (PE/VC) or the global banking system for business expansion and growth. However, PE/VC funds recognize the necessity for their investments in firms, commonly known as portfolio companies, to develop best practices of corporate governance and management improvements, which suggests that they are associated with developing best practices in their investments. Recent research based on US and EU data has acknowledged the role played by PE/VC funds in improving governance practices and operating performance of portfolio companies (Kaplan, 2009).

Based on the definition for corporate governance proposed by Zingales (2008), as a complex set of constraints that shape the *ex post* bargaining over the quasi-rents generated by a firm, we may understand the relationship between PE/VC funds and portfolio companies as a problem related to the design of these constraints. This implication stems from concentrated ownership systems, as found in Brazil, which raise problems resulting from widespread expropriation of private benefits of control (Coffee, 2005). Even more than controlling agency problems and *ex post* bargains, the relationship between PE/VC and SMEs must consider that investment value derives from entrepreneurial capabilities put forward by the owners and managers of SMEs, so that the PE/VC fund must retain key persons and avoid curbing their entrepreneurial capabilities when drawing up terms of the investment contract.

In this sense, as an alternative to the traditional principal-agent conflicts discussed in classical corporate governance literature, the PE/VC-SME relationship resembles a principal-principal problem, similar to the one identified by Young *et al.* (2008) as a major concern of corporate governance between controlling shareholders and minority shareholders for listed companies in emerging economies, or a stewardship relationship, characterized by a pro-organizational and trustworthy partnership (Davis *et al.*, 1997).

In applying these alternative theories to the case of Brazil, a large emerging market economy, we hypothesize that PE/VC funds play an effective role in promoting best practices of corporate governance in portfolio companies, as an *ex post* action to control other principals and management, to assure an environment conducive to entrepreneurial motivation, innovation and initiatives.

To thoroughly classify the portfolio companies of the participating PE/VC funds in this study, Brazilian SMEs were identified by annual gross revenues from a collection of firms and defined by the classification standard mandated by local economic development policy (BNDES, 2011). This adopted classification grouping segments small businesses as firms with annual gross revenues between approximately $1.3 million (R$2.4 million) and $8.5 million (R$16.0 million), medium enterprises as firms with annual gross revenues between $8.5 million and $48.0 million (R$90.0 million), and medium-large enterprises as firms with annual gross revenues between $48.0 million and $160.0 million (R$300.0 million).

A weighted model of corporate governance best practices for SMEs was developed and applied to a focused survey of entrepreneurs and managers of SMEs receiving investment capital from PE/VC funds in Brazil. The chief executive officer (CEO) survey asked participants to assign and adopt mechanisms related in the model before and after the investment. Since the weighted model was developed by a large group of specialists, the research study contributes to a better understanding of the role played by PE/VC funds in enhancing the institutional environment for equity investment and shares a practical tool that PE/VC managers and SME owners could utilize for improving the corporate governance practices in their portfolio companies and simplify financial audits and reviews required by investors.

2. PE/VC funds and the promotion of best practices of corporate governance

Private equity is broadly defined as the investment in the stock, equity ownership, of companies that are neither listed nor quoted on public stock exchanges. This form of investment is characterized by low liquidity, long-term returns, and an asymmetry of company information, which yield private equity investors higher rates of return to

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compensate for higher risk as compared to traditional investments in public equity and corporate debt (Fraser-Sampson, 2007).

Private Equity also describes the industry in which investment fund managers raise, invest and employ capital in equity ownership of companies across many industries into two distinct alternative investment asset classes, namely ''private equity'' and ''venture capital'', on behalf of institutional investors and wealthy individuals. The principal difference between these asset classes derives from the stage of development in which a company is described in its company lifecycle, where ''private equity'' investments are more narrowly defined as investments in mature companies in the growth or later stages of the lifecycle and ''venture capital'' investments in developing companies in the early stage of the lifecycle. This study reflects PE/VC within the Brazilian context while holding agreement with both domestic and international classifications that identify stages based on the company lifecycle. The separation between private equity and venture capital as distinct alternative investment asset classes is also commonly recognized by industry participants, including fund managers, public policy agents, and entrepreneurs (GVCEPE, 2012).

Studies exploring the role of PE/VC managers concluded that these institutional investors have adapted in past decades to deal with novel agency problems arising from the PE/VC-entrepreneur relationship (Arthurs and Busenitz, 2003; Sahlman, 1990) by employing effective mechanisms in environments characterized by a high degree of uncertainty and information asymmetry (Berghe and Levrau, 2002; Hellmann and Puri, 2002; Hochberg, 2004; Millson and Ward, 2005; Shleifer and Vishny, 1997; Wongsunwai, 2007).

According to Zong (2005), PE/VC managers develop corporate governance practices with a more proactive, but less formal, approach than listed companies that drives the effects of financial performance and venture reputation favorably for stakeholders (Berghe and Levrau, 2002; Hellmann and Puri, 2002; Millson and Ward, 2005; Shleifer and Vishny, 1997).

Berghe and Levrau (2002) stress that dynamic economic environments in which portfolio companies are embedded have little effect on the monitoring mechanism, used by activist investors during Shareholders' Meetings, given as an *ex post* action. Generally, these companies require alternative actions to deal with information asymmetry between principals and agents exacerbated by the early-stage of development and greater uncertainty related to these firms, leading to higher overall risk.

The PE/VC monitoring process is distinguished by three complementary models (Berghe and Levrau, 2002; Hellmann and Puri, 2002; Hochberg, 2004; Shleifer and Vishny, 1997; Wongsunwai, 2007):

1. Pre-investment agreements.
2. Board of directors (BoD) participation.
3. Company management interaction.

The ''pre-investment agreements'' model utilizes cumulative rights obtained by the Fund throughout the contract to provide a comprehensive perspective of ownership rights and capital protection, commonly called the shareholders' agreement, given the risk profiles of portfolio companies. These provisions ensure veto rights on relevant corporate actions, such as debt assumption and adjustment mechanisms, or earn-out clauses, to equity participation according to future performance of the portfolio company and prior to joint sale, passive (tag-along) or forced (drag-along).

In the ''BoD participation'' model PE/VC managers occupy seats on the governing board of the portfolio company; however, their roles extend beyond supervision of the company's management. They are obligated to play a larger and active role on various issues, such as executive recruiting, compensation, evaluation of mergers and acquisitions, management systems, tax assessments and financial audits aiming at greater disclosure and transparency (Berghe and Levrau, 2002; Bottazzi *et al.*, 2004; Kelly, 2007; Masulis and Thomas, 2009; Wright *et al.* 2009; Zong, 2005).

The ‘‘company management interaction’’ model describes PE/VC managers desire to monitor portfolio company performance through active interaction with executives and frequent visits to operating locations in an effort to support in firm strategy implementation, to hire consultants, and to review short-term borrowing and trade negotiations (Bottazzi *et al.*, 2004; Kelly, 2007; Wright *et al.*, 2009; Zong, 2005). Zider (1998) concludes that members of PE/VC managing bodies allocate approximately 25 percent of their time to advising and assisting executives of their portfolio companies.

Another relevant practice developed by PE/VC managers is the design of executive incentive packages aligned with established deadlines for realizing investment gains in the sale of portfolio companies and remuneration sourced from achieving operational goals (Bottazzi *et al.*, 2004; Kelly, 2007; Masulis and Thomas, 2009; Millson and Ward, 2005; Wright *et al.*, 2009; Zong, 2005). This alignment encourages the executive, as agent, to adopt and execute value-creating strategies on behalf of the firm in lieu of maximizing their own self-interests. Traditionally, executives enact stock option plans, driven by short-term and aggressive performance targets based on economic value added (EVA) and other management metrics, within the designated time horizon to exercise the acquired stock options (Bottazzi *et al.*, 2004; Kelly, 2007; Masulis and Thomas, 2009; Millson and Ward, 2005; Wright *et al.*, 2009; Zong, 2005).

However, the effectiveness and implementation of these mechanisms vary greatly depending on the competence and experience of the manager, the legal and regulatory environment affecting the portfolio company (La Porta *et al.*, 1999), and the entrepreneur’s commitment to developing value additive corporate governance practices. Despite the contractual mechanisms, monitoring, and incentives developed by PE/VC managers, a series of effective governance questions are often observed in this relationship, due to entrepreneurs’ limited knowledge of best governance practices and weak quality control and reporting by portfolio companies.

3. PE/VC in Brazil and emerging economies

A typical PE/VC-SME relationship in advanced economies supports the assumption that entrepreneurs are committed to fund performance in terms of contract requirements and governance mechanisms, in so that corporate governance development becomes an organic and gradual process, with low potential for agency conflicts (Arthurs and Busenitz, 2003; Berghe and Levrau, 2002; Bottazzi *et al.*, 2004; Hellmann and Puri, 2002; Hochberg, 2004; Masulis and Thomas, 2009; Millson and Ward, 2005; Kelly, 2007; Wongsunwai, 2007; Wright *et al.*, 2009; Zong, 2005). In contrast, in emerging economies PE/VC funds face additional challenges, such as fewer qualified entrepreneurs, limited management competencies, and inadequate regulation and legal infrastructure (Hassan, 2010). As a consequence, PE/VC managers must formulate innovative success strategies within those contexts.

PE/VC funds operating in emerging economies close deals within a different context, characterized by smaller and often less formal companies, typically entrepreneur or family-based ownership, with greater financial capital constraints within firms, relatively small capital markets and under an institutional environment offering less protection for investors. This context imposes significant restrictions for firms to access financial capital for their expansion, particularly equity finance, and contributes to forging a culture unsupportive of co-investment partnerships and, to a lesser degree, of formal managerial routines.

According to Wright *et al.* (2009), studies on emerging economies have acknowledged heterogeneous groups of principals whose interests and objectives do not coincide, with the persistence of dominant shareholders who may attempt to obtain private benefits of control. As a consequence, the primary agency problem in this environment is related to the expropriation of minority shareholders by the controlling shareholders, and principal-principal conflicts emerge as a paramount issue related to corporate governance in this context (Young *et al.*, 2008).

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Klonowski (2006) and Millson and Ward (2005) conducted surveys highlighting main problems facing PE/VC in Eastern Europe and South-South economies, respectively. Millson and Ward (2005) developed a methodology to quantify the relative importance of specific attributes on the relationship considered by PE/VC manager implementation effectiveness for investment decision-making. A survey was then taken where 27 industry professionals were ranked according to perceived importance by respondents, which displayed computed results in a multivariate analysis in order to obtain the relative weight of each of the six criteria or attributes of the lists. The experience and accomplishments of the executives received half of the total weight, equaling the sum of all other criteria.

Based on the work of authors such as Berghe and Levrau (2002), Klonowski (2006) conducted a survey with 133 Eastern European PE/VC professionals to rate the impact of 20 governance criteria, using a Likert scale. The responses, treated using factor analysis, identified three constructs associated with governance issues in the sector:

1. Pre-investment decision considerations.
2. Monitoring and operational controls.
3. Conducting value-additive activities.

The work by Millson and Ward (2005) and Klonowski (2006) convey PE/VC managers' concern for fundamental corporate governance principles in emerging economies beyond that of the traditional agenda of PE/VC manager agenda found in advanced economies, which concurs with the findings of La Porta *et al.* (1999). This and similar research converge on the relevance of addressing issues on related party transactions, private use of firm assets, appointment of unqualified members to executive positions, representation and independence of the BoD to enact guidelines in the shareholders' agreement, regulatory compliance, transparency and quality of financial reporting, and involvement of the manager in formulating strategic and operational leverage on behalf of the portfolio company.

As introduced in the previous section, PE/VC may play a significant role in promoting good corporate governance in emerging economies. Notably, investments in portfolio companies are highly concentrated in SMEs. In contrast to the PE/VC landscape of the USA or UK, PE/VC managers in emerging economies are less likely to remove the company management and executives, less extraordinary circumstances. In emerging economies, a predisposition to owners and managers working together as steward with the objective of improving the portfolio company is observed, so as long as a better capacity to influence, monitor, and control the firm exists. Subsequent to the investment cycle of approximately ten years, PE/VC funds often prefer portfolio companies to pursue an initial public offering (IPO) exit strategy, where equities are sold for an appreciated fair market value to the investment amount made at the time of acquisition or co-investment partnership. This is the underlying driver for promoting development of best practices of corporate governance in portfolio companies operating in emerging economies.

An examination of the Brazilian PE/VC industry narrates the gradual development and maturation of the industry over a three-decade period beginning in the 1970s and, more recently, accelerating into one of the fastest growing and most mature PE/VC markets among the Brazil, Russia, India, and China (BRIC) group of leading emerging economies (Klonowski, 2011). However, a lack of industry data limited the number and depth of empirical studies in Brazilian PE/VC literature until 2006 (De Carvalho *et al.*, 2012). Ribeiro and De Carvalho (2008) were the first to outline an empirically based description of the size and structure of the Brazilian PE/VC industry. These distinct size-structure characteristics indicated that, while the industry is small relative to the overall size of the Brazilian economy, its growth was a key driver in accelerating regional IPO activity, where trade sales to corporate and strategic buyers had been the far dominant exit strategy for realizing investment returns. Structurally, the industry is heavily concentrated both geographically and in terms of committed capital; however, fund managers evenly disperse their portfolio company investments across nearly all industry sectors (Ribeiro and De Carvalho, 2008). A review of the five-year period between the close of the first PE/VC investment cycle in 2004

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and the onset of the global economic recession in 2009, shows that the size of the Brazilian PE/VC industry grew substantially, by nearly 50 percent per annum, reaching approximately $36.1 billion in committed capital in 2009 (De Carvalho *et al.*, 2012).

Other empirical studies of the Brazilian PE/VC industry have primarily aimed to analyze public market phenomena indirectly related to the implementation of corporate governance best practices by PE/VC managers on portfolio companies prior to, during and immediately after employing an IPO exit strategy. Specifically, studies have compared PE/VC backed IPOs against non-venture backed IPOs by the degree in which PE/VC managers monitor and influence earnings management through the IPO process (Gioielli and De Carvalho, 2008), and by the relative performance of stock market returns observed on the São Paulo Stock Exchange (BOVESPA) (Minardi *et al.*, 2013).

Minardi *et al.* (2013) suggest that PE/VC managers influence corporate governance practices within portfolio companies by certifying the quality of Brazilian IPOs, upon entry into the capital markets. Two distinct explanations to this phenomenon are drawn:

1. *Superior execution* – PE/VC managers effectively execute strategic/operational improvements and managerial competence, implement corporate governance standards and professionalization, and hire talented teams of executives to portfolio companies.
2. *Superior selection* – PE/VC managers skillfully select, through the sourcing and due diligence phases of the investment process, portfolio companies that have attained best corporate governance practices and nurtured highly competent executive teams.

Where the literature has explored the relationship between large PE/VC backed companies and non-PE/VC backed companies in the context of public markets' response *vis-à-vis* the IPO process, our study aims to extend on existing literature by providing the first description of key aspects in corporate governance effectiveness between Brazilian PE/VC management organizations and SMEs, distinct from public equity and capital markets data.

4. The context for corporate governance, PE/VC and Brazilian SMEs

Over the past ten years, several changes occurred in the Brazilian context regarding the ownership structure of portfolio companies, access to sources of finance, and corporate governance practices. As identified in previous studies (Rabelo and Vasconcelos, 2002; Zeidan and Filho, 2012), firms were controlled by the state, local family-owned business groups and affiliates of multinational corporations through the late 1990s. Agency conflicts were often found between controlling and minority shareholders, and between the controlling shareholders themselves.

Domestic capital markets did not represent a significant source of finance (Rabelo and Vasconcelos, 2002). The weaknesses of the institutional environment favoring the existence of significant private benefits of control and expropriation of minority shareholders, and the boards had no significant role in governance (Leal and De Oliveira, 2002). As pointed out by Araujo and Esposito (2004), the concentrated ownership structure of Brazilian companies was the main reason for many governance problems.

Since 2002, however, it is possible to identify a significant improvement in this context, due to factors such as political and economic stability of the past decade, the influx of international investments in the capital markets, improvements in the institutional environment resulting from the strengthening of oversight institutions' markets, dissemination of best practices of corporate governance, and strengthening of the ''Novo Mercado'', the special segment of listed companies which have the highest standard of corporate governance requirements. These factors resulted in a surge in IPO activity between 2004 and 2007. Thus, according to the Brazilian stock exchange data, between December 2001 and December 2010, the market capitalization has grown almost tenfold, from $185.0 billion to greater than $1.5 trillion, and over 23 percent were qualified into the Novo Mercado (BM&FBOVESPA, 2012).

These developments, which occurred not only in Brazil but also in several Latin American economies, can be considered distinct from earlier progress that occurred elsewhere, since they were not intended to extend the protections of a dispersed shareholder, but improve investor security and reduce the abuse of power in an environment of highly concentrated ownership. It is significant to note that these improvements in the context of governance has been reflected in the academic publications of these countries, since the descriptive orientation of the early research on governance moved toward deeper understanding of the impact of governance reforms and market responses (Harris, 2009).

However, institutional maturation and rapid development in the stock exchange were not sufficient to facilitate access to the resources of stock exchanges for SMEs, with only three companies currently listed in Bovespa Mais, the designated listing segment formed for small firms[1]. According to a survey by the Brazilian Service of Support for Micro and Small Enterprises (SEBRAE), only 6 percent of the nearly 4.2 million Brazilian companies are classified as SMEs. This classification is based on annual gross operating revenues and according to the SEBRAE criterion of a formally structured enterprise having 19 or more employees on staff. At almost 93 percent, the vast majority of Brazilian companies are classified as microenterprises with fewer than 19 employees. However, SMEs account for about 30 percent of formal job creation in Brazil and operate mainly in the service (80 percent) and industrial (14 percent) sectors. In terms of regional focus, approximately 75 percent of these companies are located in the South and Southeast regions of the country, and are predominantly structured as family-owned or controlled enterprises (SEBRAE, 2005).

The survey evidenced that most of these companies are relatively new, with clearly defined ownership and highly dependent on a controlling entrepreneurial figure that frequently exercise executive authority. This results in higher barriers in the process of succession and formalization of infrastructure management within these organizations, since its operations are highly dependent on a centrally dominant figure (SEBRAE, 2007). Thus, sustainable and perpetual growth of these organizations ultimately involves a process of developing improvements to existing corporate governance practices coupled with strong control mechanisms. While SME motivations relating to governance should align with those of large companies, effective implementation of these mechanisms is often subject to portfolio company budget constraints, which result in increased bureaucratic procedures, decreased independent advising during implementation phases, and failure to hire auditors for improved financial control and transparency.

In the past decade, Brazilian companies have had a growing need for external financing through capital markets and partnership agreements with PE/VC managers. This shift has pressured portfolio companies to acquire knowledge of minimum corporate governance requirements demanded by capital providers. Consequently, PE/VC funds have begun to play a critical role in the development and institutionalization of better corporate governance practices in Brazil. The motivation of PE/VC managers directly relates to the investment goals to achieve greater relative valuations and returns from portfolio companies than competing PE/VC managers, either by mitigating risks associated to executive succession or implementing operational improvements that drive sustainable growth and competitive advantage.

Despite the growing relevance of Brazilian PE/VC, few studies address the relationships between fund managers and entrepreneurs. Existing literature analyzes the context of pre-IPO portfolio companies and the public offering process in public equity markets. Furthermore, this focus on public equity research and corporate governance has risen since performance management and control *vis-à-vis* the listing segments on the BOVESPA was adopted, and involvement of PE/VC managers in the public offering process has become more prevalent (Gioielli and De Carvalho, 2008).

In their comprehensive assessment of the evolution of Brazilian corporate governance between 2004 and 2009, Black *et al.* (2012) evaluated corporate governance best practices of PE/VC sponsored IPOs and non-sponsored IPOs along six key aspects of their Brazil Corporate Governance Index (BCGI): board structure; ownership structure; board procedures; shareholder rights; related party transactions; and disclosure.

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Based on an analysis of their 2009 survey of 24 PE/VC sponsored IPOs and 28 non-sponsored IPOs, they found that board procedures was the only characteristic that significantly differentiated PE/VC backed firms from non-PE/VC backed firms, where PE/VC backed firms scored modestly higher. Key differences in procedures were related to PE/VC backed firms' ability to create and implement systems that evaluate performance of the CEO and other directors, and to enact specific bylaws to govern the BoD.

Complementary to the BCGI developed by Black *et al.* (2012), our study explores the ''PE/VC Effect'' as it relates to salient aspects in Brazilian corporate governance. However, we also cover attributes not previously evaluated, such as emphasis on the role of the chief financial officer (CFO), executive incentive policies related to formal variable compensation and stock options, professional management procedures, and formalization within firms. Furthermore, we offer added depth to such elements as the separation of CEO and chairman roles related to board structure; and shareholders' agreement legitimation and protection of tag-along/exit rights, related to shareholder rights. In contrast to the work of Black *et al.* (2012), this study is focused on the ''PE/VC effect'' on SMEs, our sample of private firms comprises of smaller enterprises rather than large companies, as reflected in the BCGI.

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5. Methodology

We define effectiveness of the PE/VC funds in promoting good corporate governance as the increased SME adoption of best practices of corporate governance, as proposed by existing Brazilian codes and agreed-upon through weighted criteria ranking process by a panel of industry specialists. We followed a two-step methodology to assess the quality of corporate governance practices of Brazilian SMEs before and after the sale of ownership interests in portfolio companies by a PE/VC fund.

In the initial step, we compiled a list of best practices of corporate governance, based on our literature review and guidelines proposed by the Brazilian Institute of Corporate Governance (IBGC). We then submitted this list to a group of 15 corporate governance experts for review and conducted individual in-depth interviews, from which a final list of 49 criteria associated with 12 key issues emerged. Finally, this list was submitted to a panel formed by 78 Brazilian PE/VC fund managers that weighted the items according to relevance to assess the corporate governance practices of SMEs. This assisted in the design of the survey instrument and assured its content validity.

In the second step, following a pilot study, we surveyed entrepreneurs and managers of SMEs that received investment capital from PE/VC funds. The sample organizations examined in this study were classified according to annual gross operating revenues, based on the methodology used by the Brazilian Development Bank (BNDES). The sample of this research was restricted to SMEs with annual gross revenues not exceeding $160.0 million (R$300.0 million), as classified by the BNDES, of PE/VC investment for a period not less than one year, and regulated by the Brazilian Securities and Exchange Commission (CVM) instructions No. 209 and No. 391, which provides guidance on the operation of PE/VC funds. This sample represents approximately 40 percent of PE/VC fund investment in the country (GVCEPE, 2008)[2].

We used a web-based survey application to support data collection activities that occurred between January and March of 2011. We retrieved 70 questionnaires and, depending on the nature of the data, used the Mann-Whitney and Kruskal-Wallis non-parametric statistical tests to detect differences between groups.

6. Results

The distribution of the results obtained from the weights of selected criteria of the governance model proposed in this paper reveals the absence of a standard and convergent governance approach sought by fund managers. Note that approximately 80 percent weight of the criteria surveyed had ''zero weight'' assigned by at least one of the

professionals interviewed, confirming the heterogeneity of the governance models pursued in these ventures. This dispersion of perceptions attributed to the model criterion, can be partially explained by the degree of maturation of the PE/VC industry in Brazil, where most of the fund managers are still managing their first investment cycle, and the distinguished profile of the PE/VC professionals coming from other sectors such as management consulting, commercial and investment banking, academia, etc.

The criteria considered as priorities by entrepreneurs and managers relate to:

- tag-along rights and feasibility of a fair value exit (while minority shareholder);
- installation and standardization of information provided to the BoD;
- experience and involvement of the CFO in strategy formulation;
- performance of independent audit;
- scope of BoD and executive board competencies and duties;
- degree of formalization of the venture; and
- agents' incentives policy.

These results reflect managerial concerns regarding the legal and regulatory framework of the domestic PE/VC industry. From the perspective of these managers, it is observed that the governance agenda of Brazilian SMEs is far from addressing the core concerns highlighted by IBGC[3] and BOVESPA[4] governance codes, as it relates to aspects such as separation of CEO and Chairman positions, presence of independent directors, and installation of BoD advisory committees.

According to Table I, the average occurrence of the criterion to the proposed model increased from 23 percent to 68 percent after PE/VC-SME partnership formation, particularly with the rate of installation of the BoD, which is considered the main vehicle for managers seeking to add value to ventures. However, the plurality of Board composition, including relevant minority shareholders and independent directors, remains a critical challenge for managers in part by budgetary constraints and the level of exposure to directors, given the higher risk profile of these companies. The prediction of shareholders rights in the pre-investment agreements and venture's bylaws, evident in about 80 percent of the sample, confirms the significance of these agreements in mitigating agency conflicts in the ventures' and managers' concerns regarding legal aspects of the controller-minority shareholder relationship in Brazil.

Subsequent to forming the PE/VC-SME partnership, annual independent audits were conducted across the entire sample, with ''Big Four''[5] professional service firm audits conducted in 80 percent of the ventures analyzed. However, only 73 percent of the sample participation in the independent audit process is appropriately subordinate to the BoD and not exclusively to the CEO, which highlights the minimal involvement of the Board in planning and evaluation of this process. The success of this process is directly related to the development of managerial and financial reporting standards in nearly all firms (96 percent), indicating its relevance in monitoring ventures.

Although the origins of corporate governance theories are based on the separation of ownership and control, this process proves to be extremely complex in SMEs, where heavy dependency on the active participation of a controlling entrepreneurial figure, or key person, that frequently exercises executive authority. Therefore, yielding fewer successes in dissociating the CEO and Chairman positions in this sample. As alluded to earlier, the criterion related to ''Advisory committees'' had the worst level of development among the areas analyzed.

Table II summarizes the mean ratings obtained by the weighted average of each governance criterion, segmented into three surveyed categories:

1. revenues;
2. number of relevant shareholders; and
3. PE/VC-SME partnership duration.

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Table I Governance model and criterion development before and after PE/VC-SME partnership formation

Themes	*Criteria*	*Average weight (%)*	*Survey Before (%)*	*Survey After (%)*
Board of directors (BoD) (12.7%)	Installed board of directors (BoD)	3.0	32	100
	Indication of directors by relevant minority partner (≥5% of shares)	1.5	7	70
	Participation of independent directors	1.8	14	63
	Monthly face-to-face meetings of the BoD	1.4	14	82
	Symmetric information submission among all board member classes (controllers, minority and independent)	1.9	39	98
	Higher approval quorum for main governance themes of the company	2.0	27	95
	Management's previous analysis and formal proposal of matters submitted to the BoD	1.2	21	91
Shareholders agreement legitimation (11.1%)	Bylaws rights of minority shareholders prediction	3.1	16	86
	Prediction of minority shareholders rights on the Shareholders Agreement (''SA'')	2.9	13	86
	Bylaws sanctions predictions against shareholders in cases of SA noncompliance	2.6	13	82
	Bylaws sanctions predictions against shareholders in cases of Bylaws minority shareholders rights noncompliance	2.4	13	63
CFO (7.7%)	CFO with relevant corporate experience (prior to joining the company)	2.6	52	89
	CFO with relevant corporate experience hired by recommendation/approval of the Fund Manager and/or minority shareholders	2.9	23	79
	CFO participation in strategy formulation and on BoD related advisory committees	2.2	41	91
CEO x Chairman (5.4%)	Assignment of CEO and Chairman positions by distinct professionals	1.8	34	66
	Bylaws prohibition of concurrent positions of CEO and Chairman by the same professional	1.3	11	29
	Bylaws delimitation of powers between the executive management board and the BoD	2.4	30	88
Management professionalization (8.1%)	Formalization of financial limits of authority for contract/payments of the executive board and the BoD	2.4	36	98
	Hiring management and strategy formulation consultants	0.9	43	73
	Formal succession policy for key executives of the company	1.2	2	27
	Successor's identification for the main executives of the company	1.2	7	23
	Formal policy to regulate the assignment of family/controller shareholders related members to executive/managerial positions	2.4	18	48
Incentive policy (8.3%)	Formal variable compensation (''VC'') policy for profit sharing and bonuses	1.6	45	77
	Formal VC policy including an objective and transparent evaluation system, assigned to the executive body[a]	2.5	34	79
	Formal VC policy including an objective and transparent evaluation system, assigned to all employees	2.0	29	59
	Formal policy for distribution of stock options for key executives	2.1	7	38
Tag-along and Exit (9.7%)	Full tag-along right (100%) to minority shareholders[a]	5.8	21	91
	SA provision for minority shareholders fair exit rights, regardless of exit of the controlling shareholder	3.8	18	86
Independent audit (9.7%)	Annual independent audit[a]	3.0	52	100

(*Continued*)

Table I

Themes	Criteria	Average weight (%)	Survey Before (%)	Survey After (%)
	Annual independent audit by ''Big Four''	2.1	32	88
	Independent audit rotation within less than 5 years (as stated in CVM 308/1999)	1.0	20	59
	Independent audit subordination of the BoD	1.4	27	73
	BoD participation in the independent audit scope of work	1.0	16	41
	BoD annual evaluation of independent audit process	1.3	14	57
BoD advisory committee (4.7%)	BoD advisory committees installation	1.5	4	41
	BoD audit committee installation	1.1	2	20
	Bylaws provision for BoD advisory committees	1.0	5	45
	Advisory committees composition including independent/external members (non-executive and non-directors)	1.1	4	25
Financial reports (8.8%)	Standardized management reports to BoD including main key performance indicators[a]	3.1	34	96
	Submission of management reports request by directors at least one week prior to BoD meeting	1.7	20	77
	Advisory committees review of related management reports prior submission to BoD	1.4	13	54
	Submission of monthly Financial Statements to BoD and shareholders[a]	2.5	45	86
Degree of formalization (7.3%)	Adoption of enterprise resource planning (''ERP'') system	3.1	55	84
	Formal policy to regulate the hiring of service providers as companies (single-employee company)	2.2	21	50
	Internal accounting	2.0	48	64
Related parties (''RP'') transactions (6.7%)	Formal policy regarding RP transactions, including criteria and management controls over RP transactions	1.9	18	70
	Formal mandatory abstention of potentially conflicted Directors at BoD voting regarding related party hiring	1.7	20	55
	Formal policy regarding lending and borrowing mutuals/loans with shareholders	1.6	14	59
	Formal mandatory abstention of potentially conflicted Directors at BoD voting regarding mutuals/loans with/to shareholders	1.4	14	48
Total/Average[b]		100.0	23[b]	68[b]

Notes: [a] denotes five criteria with greater discrepancy than other sample item criteria; and [b] denotes criteria average occurrence rate of the sample

It is observed that PE/VC-SME partnerships provide a significant impact on the average governance rating of the full sample from only 16 to 72 percent after the formation and development of these partnerships.

An analysis of the composition of ratings obtained following partnership reveals that high priority themes classified by managers as board of directors, shareholders' agreement and mechanisms of protection for minority shareholders are significantly developed from about 25 percent to over 75 percent in the sample, irrespective of category. This breakthrough shows the critical nature that this factor attributed to these themes by PE/VC fund managers.

Issues relating to incentive policy, professional management, and treatment of related parties, with considerable relevance to the developed governance model, still have an intermediate level of development, about 60 percent, but are increasingly becoming the future key issues to be addressed more effectively by managers. The presence of Board's Advisory Committee was not identified in almost any of the portfolio companies before partnership formation, and remains nascent even after formation, corresponding to only about 50 percent of portfolio companies with revenues over $53.3 million (R$100.0 million).

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Table II Statistical significance of governance rating increase among categorical variables					
Category	*Segments*	*No.*	*Mean rank*	*Test statistics*	*Total*
Annual gross revenues	$10.7 million to $26.7 million (R$20.0 million to R$50.0 million)	25	19.8	Chi-Square	12.840
	$26.7 million to $53.3 million (R$50.0 million to R$100.0 million)	11	34.6	df	2
	Greater than $53.3 million (Greater than R$100.0 million)	20	36.0	Asymp. Sig. (*P*-value)	2%
PE/VC-SME partnership duration	Up to 1 year	13	30.0	Chi-Square	0.371
	Between 1 and 2 years	14	26.3	Df	2
	Over 2 years	29	28.9	Asymp. Sig. (*P*-value)	83%
Relevant Shareholders (≥5%)	1 shareholder	4	23.0	Chi-Square	0.507
	2 shareholders	17	28.5	Df	2
	More than 2 shareholders	35	29.1	Asymp. Sig. (*P*-value)	78%

Note: Test statistics were performed at the Kruskal-Wallis test for grouping variables: Annual Gross Revenues, PE/VC-SME Partnership Duration and Relevant Shareholders (≥5%)

Theme development was statistically significant at a 1 percent level of confidence for the entire sample; some exceptions that prove to be significant only at 5 percent and 10 percent, only four firms within the category of portfolio companies with only one relevant shareholder (only four firms). Annual gross revenues was the only variable whose correlation with governance development was statistically significant at 5 percent, despite the theoretical assumptions discussed in the study, regarding the influence of the categorical variables selected as to the development of corporate governance, as shown in Table II.

The results obtained from the sample of portfolio companies surveyed support the central hypothesis proposed, as shown in Table III, illustrating that PE/VC managers are effective sponsors of governance mechanisms in SMEs in which they hold relevant interest, although it is essential to emphasize the distinctive profile of the entities in this sample in relation to the population of Brazilian SMEs, where these portfolio companies have undergone a rigorous selection process by managers prior to being considered suitable for receiving PE/VC capital contributions. Therefore, the success rate and speed of implementation for best governance practices highlighted in this sample are likely significantly better than expected in typical Brazilian SMEs.

7. Conclusion

The motivation for this paper was to investigate the role played by PE/VC funds in promoting best practices of corporate governance in SMEs in which they invest and form partnerships. PE/VC represents an important and growing source of financial capital for companies in an environment characterized by limited access to funding, particularly for SMEs. The adoption of best practices of corporate governance is very important in countries like Brazil where firm ownership structure is highly concentrated, and governance practices are rooted in a patrimonial organizational culture. These factors are becoming even more critical for SMEs, as the Brazilian capital markets and regulatory-legal framework applicable to this business segment makes governance mechanisms paramount for protecting the rights of minority shareholders against expropriation by controlling shareholders.

Previous studies have shown that governance principles adopted by PE/VC, comprised of close relationships between fund managers and portfolio companies, suggested the industry to be an effective inducer of the development process of these principles, as compared to firms that have not received PE/VC investment, supporting our central hypothesis that PE/VC funds should likewise have a similar role in Brazil. In line with those studies, the research presented in this paper extends the benefits from PE/VC participation toward promoting governance for Brazilian SMEs.

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Table III Governance rating composition before and after PE/VC-SME partnership formation

			Mean development: level of governance themes by category (0%-100% of theme)											
Sample	*Number of companies*	*Category mean rating (%)*	*BoD (%)*	*Legitimacy of SA (%)*	*CFO (%)*	*CEO x Chairman (%)*	*Mgmt. Prof. (%)*	*Incentives Policy (%)*	*Tag-along and Exit (%)*	*Ind. Audit (%)*	*Advisory Committees (%)*	*Financial Reports (%)*	*Degree of Formalization (%)*	*Related Parties (%)*
Before pe/vc-sme partnership														
Full	56	16	24	14	38	27	22	28	20	32	4	31	43	17
Annual gross revenues (prior year)														
$10.7m to $26.7m	25	10	21	9	26	17	11	22	23	19	0	20	19	10
$26.7m to $53.3m	11	14	18	12	35	33	21	27	13	32	3	25	67	2
Greater than $53.3m	20	29	30	20	55	36	36	36	20	49	8	48	61	32
PE/VC-SME partnership duration														
Up to 1 year	13	24	27	23	61	43	26	16	8	22	7	31	60	18
Between 1 and 2 years	14	17	25	11	30	23	23	33	26	35	0	35	49	23
Over 2 years	29	17	23	10	29	19	18	38	25	34	5	31	37	14
Relevant shareholders (≥5)														
1 shareholder	4	15	2	0	25	0	13	24	0	0	0	16	61	7
2 shareholders	17	19	25	6	36	32	24	24	12	35	1	33	49	10
More than 2 shareholders	35	20	26	19	41	28	22	30	26	34	5	32	38	21
After PE/VC-SME partnership														
Full	56	72*	87*	80*	86*	67*	59*	63*	89*	78*	33*	84*	68*	58*
Annual gross revenues (prior year)														
$10.7m to $26.7m	25	67*	83*	74*	82*	59*	49*	53*	86*	75*	17*	83*	53*	47*
$26.7m to $53.3m	11	81*	90*	76*	80*	69**	66*	66*	91*	86*	44*	91*	89**	62*
Greater than $53.3m	20	81*	90*	89*	93*	75*	66*	74*	91*	76*	47*	82*	76**	70*
PE/VC-SME partnership duration														
Up to 1 year	13	75*	93*	80*	92*	73***	71*	57*	95*	71*	40*	76*	71	56*
Between 1 and 2 years	14	72*	82*	67*	83*	58*	53*	63*	80*	75*	22*	89*	85*	67*
Over 2 years	29	81*	88*	87*	84*	67*	55*	69*	93*	81*	31*	84*	63*	48*
Relevant shareholders (≥5)														
1 shareholder	4	70*	84*	75*	100*	47**	56**	56	75**	86**	5	84*	68	39**
2 shareholders	17	71*	88*	82*	82*	67*	55*	66*	82*	72*	42*	82*	75**	52*
More than 2 shareholders	35	75*	87*	79*	86*	69*	61*	62*	94*	79*	32*	86*	65*	63*
Theme weight (governance model)			12.7	11.1	7.7	5.4	8.1	8.3	9.7	9.7	4.7	8.8	7.3	6.7

Notes: * denote statistical significance at 1 per cent at the Mann-Whitney U test for governance rating increase; ** denote statistical significance at 5 per cent at the Mann-Whitney U test for governance rating increase; *** denote statistical significance at 10 per cent at the Mann-Whitney U test for governance rating increase

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We explored concerns raised in earlier studies, such as information transparency and managerial competence (Ribeiro and De Carvalho, 2008) and evaluated issues addressed in recent studies, such as factors of dysfunctional boards, limitations in the enforceability of legal rights, and lack of protection for minority shareholder rights (Klonowski, 2011; De Carvalho *et al.*, 2012). Managerial attributes, related to the prospects of ''superior execution'' and ''superior selection'' by PE/VC fund managers relative to non-sponsored firms (Minardi *et al.*, 2013), were also considered in our assessment. Our study extends existing literature dedicated to the ''PE/VC effect'' on Brazilian corporate governance and offers additional insights into the relevant themes of ''board structure'' and ''shareholder rights'' (Black *et al.*, 2012). Moreover, we incorporate descriptive elements not evaluated in earlier studies, such as the strategic role of the CFO, agents' incentive policies, professional management, and formalization within firms. Most importantly, this study complements the literature by providing an empirical base for Brazilian corporate governance and PE/VC-SME research.

The findings of this study indicate the development of effective governance mechanisms in most themes analyzed, with emphasis on composition and performance of the BoD and protection of minority shareholders rights, and reflects the difficulties related to the separation of CEO and Chairman roles, the installation of BoD Advisory Committees and leadership succession processes within organizations. The results support the main hypothesis proposed in the research, showing that PE/VC funds effectively promote good governance mechanisms in SMEs in which they have a relevant interest, where for all themes analyzed there were significantly positive change with capital inflow of funds into business ventures.

Nevertheless, the results reveal the absence of a homogeneous pattern of governance sought by PE/VC managers. This heterogeneity of priorities can be partly explained by the degree of maturity of the PE/VC industry in Brazil, still nascent, and a profile indicating varied professional experience of Brazilian managers. According to these managers, the governance agenda of Brazilian SMEs is far from aligning with the issues posed by most accepted best practices of corporate governance, such as separation of the roles of CEO and chairman and installation of board advisory committees.

We stress that the mechanisms related to the BoD had a successful deployment, although its composition did not contemplate the participation of minority and independent directors in the entire sample. In contrast, we observed a high incidence of minorities' rights on pre-investments contracts, mainly related to tag along exit agreements, confirming the concern of PE/VC managers with the legal aspects of the relationship between controllers and minorities' shareholders in Brazil.

With regard to monitoring exercised by the boards of portfolio companies, we found evidence that there is a clear concern for quality and standardization of management and financial reporting, fundamental to annual independent audit procedures, and the presence of a fund-appointed CFO, with effective participation in strategic decision-making for the company and responsibility for ensuring that managerial decisions taken by the board are effectively implemented and add value to the company.

Moreover, it was observed that other issues, such as agent incentives (i.e. stock options), decoupling of CEO and chairman, existence of a succession plan, related party disclosures, exercise of executive positions by members related to controlling families, founders or entrepreneurs, did not show a similar rate of implementation as previously mentioned criteria.

It is necessary however to highlight the distinctive profile of the firms in this sample in relation to the total population of Brazilian SMEs. We note that these companies have gone through a rigorous search and selection process by PE/VC managing bodies prior to being considered eligible to receive PE/VC investment. Thus, the success rate and speed of implementation of best governance practices evidenced in this sample are likely significantly better than expected in other SMEs, and the endogeneity bias should be considered for future studies.

The dissemination of best corporate governance practices among SMEs is a fundamental development in the Brazilian context. Despite numerous IPOs that occurred between 2004 and 2007, which dissolved the historical ownership structure based on family businesses, state-owned enterprises and subsidiaries of multinationals, the Brazilian capital markets and its financial resources are still inaccessible to SMEs. The establishment and spread of best corporate governance practices in SMEs promoted by PE/VC management organizations, supplemented the formation of Bovespa Mais and other initiatives by the BOVESPA to strengthen this grouping segment, may represent a significant contribution to the growth of SMEs in the country and, in the near future, increase the total number of listed companies.

Notes

1. BOVESPA MAIS is a special listing segment of the São Paulo Stock, Mercantile and Futures Exchange, the BM&FBOVESPA, that aims to foster the growth of small and medium-sized companies through capital markets, which enables smaller firms to sufficiently finance growth and strengthen corporate governance practices (www.bmfbovespa.com.br/cias-listadas/empresas-listadas/BuscaEmpresaListada. aspx?Idioma = pt-br).
2. For detailed statistics and analysis specific to the Brazilian private equity and venture capital industry refer to research publications and census reports produced by the Center for Private Equity and Venture Capital Studies (GVcepe) based in the São Paulo School of Business Administration of the Getulio Vargas Foundation (www.gvcepe.com).
3. The Brazilian Institute of Corporate Governance (www.ibgc.org.br) is an organization solely dedicated to promoting corporate governance in Brazil. It is the leading driver of practices and discussions on the subject in the country and releases the Code of Best Practice of Corporate Governance (currently in its fourth edition).
4. The São Paulo Stock, Mercantile & Futures Exchange, the BM&FBOVESPA (www.bmfbovespa.com.br), is the leading public market security exchange in Brazil. The organization issues listing rules, which promote best practices in corporate governance, to be applied to publicly-held companies for the trading of their securities on the premium listing segments of the exchange: Novo Mercado (translated as ''New Market''), Level II, Level I and BOVESPA MAIS. These rules establish differentiated listing requirements to be followed by listing companies, their senior managers and controlling shareholder.
5. The Big Four global professional service firms are PricewaterhouseCoopers (PwC), Deloitte, Ernst & Young (EY) and KPMG.

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