



UNIVERSITETET I AGDER

# **The impact of private equity on firms in emerging markets: evidence from Ghana.**

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## **DECLARATION**

We hereby declare that this master thesis is by our own effort and that, to the best of our knowledge, it contains no material previously published by another person(s) nor material submitted by any person(s) to the University of Agder or another university for the award of any degree, except where we have duly made acknowledgement in the text.

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## **LIST OF ABBREVIATIONS**

PE	Private Equity
ROE	Return on Equity
OLS	Ordinary Least Squares
GDP	Gross Domestic Product
GVCTF	Ghana Venture Capital Trust Fund
EMPEA	Emerging Market Private Equity Association
APEVCA	African Private Equity Data Tracker
IFC	International Finance Corporation
EVCA	European Private Equity and Venture Capital Association

## **FOREWORD**

The master thesis is a requirement towards the completion of a Master of Science in Business Administration at the University of Agder with specialization in International Management. The thesis is written on the topic; “the impact of private equity on firms in emerging markets: evidence from Ghana”. Specially we seek to find out how private equity funding impact recipients’ overall financial performance and how through corporate governance mechanisms such financial performance may be affected.

We include reflective notes which is in line with the three broad themes (internationalisation, innovation and responsibility) of University of Agder. The themes are deemed important for Business Administration’s professionals. With the reflective notes, each one of us touches on how our topic and the main findings relate to the broad themes; internationalisation, innovation and responsibility. The reflective notes can be found in appendix III.

## ABSTRACT

In the last decade, most emerging markets have been associated with new investment opportunities and some growth prospects that attract private equity (hereafter, PE) investors. Regions with growing interest of PE investments include Africa and Asia. Research on PE impact on recipient firms in developed economies are voluminous and has proven that PE plays a remarkable role in firms' success. Until now, such performance implications on firms in emerging markets are limited in study. Our study focuses on the impact of PE funding on financial performance of firms in emerging markets using Ghana as a case. Using data from both the investors and fund recipients of PE, we empirically assess how the presence and ownership stake of PE investors affect financial performance of recipient firms. We also investigate the influence of post-investment corporate governance mechanisms on the overall financial performance of the recipient firms. We find that, PE backed firms have relatively higher returns on equity (ROE) and growth rate than listed firms though the differences are not statically significant. Also, we find that recipient firms with higher PE ownership stake have high ROE and growth rate than recipient firms with lower PE ownership stake. These findings recapitulate that, though PE investment significantly affects the performance of recipient firms positively, the PE industry is still at a growing stage and young in most emerging markets hence long-term benefits of PE investments would take time to be realized. We also find that PE recipient firms that involve the founders in management irrespective of the stake acquired by the PE investors outperform listed firms in terms of ROE. Finding on the board size of the recipient firms proves that, large board size affects ROE negatively. We therefore conclude that infusion of PE funds, through minority or majority stake, invariably, has a positive influence on recipient firms' financial performance but higher stake enhances such stimuli. Also, corporate governance mechanisms play a major role in enhancing the positive relationship between PE and financial performance of recipient firms. Our findings are robust and they are empirically and theoretically supported. The findings should however be generalized with caution. This is because, as literature suggests, performance improvements that result from PE may take time to be realized and institutional context may also limit the generalisability of the finding among emerging markets that have vast institutional differences from Ghana.

Keywords: Private equity, corporate governance, emerging markets, financial performance

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## **CHAPTER ONE**

### **GENERAL INTRODUCTION**

In this master thesis, we investigate how PE funding affects the financial performance of recipients in emerging markets through corporate governance mechanisms. There is a growing body of academic research on private equity (PE) funding and firm performance in developed economies. Some studies suggest that corporate governance mechanisms and legality have impact on PE performance (Cumming et al, 2004;2006; Bruton et al, 2010). Hence, we believe that such performance stimuli may also exist in emerging markets and may affect the financial performance of the PE recipient firms. In this regard, we seek to answer the following questions: Does PE funding affect the financial performance of recipient firms in emerging markets? Also, how can corporate governance mechanisms affect the financial performance of PE recipient firms? Despite the capital imbalance that is predominant in emerging markets in terms of PE fundraising and investment, there is the need for additional financing as there is continual positive economic growth rates for emerging markets from limited partners point of view (Groh et al, 2011; Klonowski, 2013). According to Emerging Market Private Equity Association (EMPEA), (2016), fund managers raised US\$7.0 billion for emerging markets focused PE fund and deployed US\$4.9 billion across all emerging markets in the first quarter of 2016. Although there has been a constant decline recently in PE fundraising and investment across emerging markets, such markets could offer many opportunities (International Finance Corporation (IFC), 2016). The infusion of PE funding and its impact on recipient firms may come with some questions for fund managers and policymakers. For fund managers and limited partners, the obvious questions should be, can they provide much benefits to the recipient firms? Policymakers such as governments and other organisations in the industry will usually be concerned with, is there the need for PE funding at all? Thus, in the end when our study has provided answers to these questions, they will be of importance to policymakers, limited partners including pension funds, fund managers, recipient firms and the PE industry as a whole.

To help offer explanations, this study is based on the following theories; agency theory, corporate governance, institutional theory, and transaction cost theory. Classical publicly traded companies are characterised by the separation of ownership from control. Agency theory seeks to offer explanations to this separation as it may lead to poor performance. The poor performance could be as a result of agency problems which occur when difference exists

between the interest of top managers and that of owners (shareholders) of a company. Good corporate governance is imperative to improve companies' performance when ownership is separated from control. Agency problem is common between recipient firms and fund managers due to information asymmetry (Kaplan Stömberg, 2003). Investors' representation on boards and their active involvement in recipients' management activities can help reduce the agency problem and increase performance. Through managers' co-ownership and relative few board members, PE helps align the interest of entrepreneurs and fund managers which improves performance of recipient firms (Wruck, 2008; Jayhun, 2016).

Although PE funding is projected to present recipients with superior performance, such efforts may be thwarted in markets with weak institutions. Institutions are said to be the rules of the game and companies play by it (North, 1990). When the political, social and economic structures of a country are good, uncertainties are reduced which facilitates good interactions (Bruton et al, 2004). Inadequate investor protection, legal and regulatory framework largely explain most of the problems encountered by PE investors in emerging markets (Leeds and Sunderland, 2003). Therefore, effectiveness of corporate governance mechanisms depends on both the institutional frameworks and enforcement of laws in the host country (Munisi, Hermes & Randøy, 2014; Luio, Chao & Yang, 2016).

PE in emerging economies could offer many opportunities despite current turmoil in global markets.<sup>1</sup> Cumming et al (2008), suggest that governance and the institutional framework of countries do affect PE performance. The expertise and board representation by PE investors also yield superior performance (Kaplan & Stromberg, 2003). According to Wruck (2008), it is not only fund manager's expertise and board representation, which lead to superior performance but also entrepreneur involvement/ co-ownership by management play a major role. As most of these findings were from developed markets, we seek to find out whether they can be replicated in emerging markets context? Most studies on PE in emerging markets (both on country basis and/or geographical blocs) tend to be theoretical based and review of literature but not on empirical studies. (see, Groh, 2009; Klonowski, 2011; Charvel, 2012; Klonowski, 2013). Hence empirical research focusing on how PE impact recipient firms' financial performance in emerging markets remains unanswered. Also to the best of our knowledge, how corporate governance can impact the financial performance of recipient

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<sup>1</sup> <http://www.ifc.org>

firms are limited in literature. We seek to fill these gaps by answering the following research questions:

1. How does Private Equity funding affect financial performance of firms in emerging economies?
2. How does corporate governance affect the financial performance of recipient firms of private equity in emerging economies?

Providing answers to these research questions is of utmost importance. This is because the effect may be different from those experienced by developed markets and may have implications for emerging markets. First, the study it will help fill the identified gap in literature relating to the impact of PE funding on recipient's performance through corporate governance mechanisms. Second, the study will help provide empirical evidence on the effect of PE funding on firms emerging markets. This is because the effect may be different from those experienced by developed economies and may have implications for emerging economies.

We employ hand-collected cross-sectional data as at 2015 from Ghana. Given the unknown status and relatively small nature of Ghana's PE industry, a purposive sampling was used. Therefore, only the list of firms provided by the Ghana's VCTF (Venture Capital Trust Fund) was included in the survey to avoid the tendency of using false information from "legally unrecognised" PE fund managers. The study surveyed the entire population of 5 fund managers and 28 investee firms recognised by the VCTF. We also use listed firms on the Ghana stock exchange as comparable where the financial performance measures of PE recipients were matched against that of the listed firms.

The main variable of study is an accounting measure of performance; return on equity. We use a mixed methodology in analysing the data. By quantitative method we employ a bivariate correlation test and regression analysis. Subsequently we adopt qualitative techniques by summarizing themes from the interviews conducted.

We find that PE funding has influence on overall financial performance of recipient firms. The ownership stake owned by PE investors has a positive significant impact on financial performance. The involvement of founders in management as corporate governance proxy, also strongly influences the financial performance of the recipient firms positively. Conversely, board size as another corporate governance proxy, has negative relationship with

PE recipient firms' financial performance. The findings are also consistent with the summary of themes from both fund managers and recipients. Thus, we may conclude that the PE and recipient firms' performance enhancement stimuli found in developed markets also exist in emerging markets but subjected to small board size and founder involvement in management. These findings are theoretically and empirically supported. However, the ability to generalise the findings to other emerging markets may be limited given the small sample size of recipients used in the analysis.

We organise the rest of the study as follows. The relevance and background for the study are presented in chapter two. Chapter three focuses on the theories underlying our research, previous studies on the topic and the conceptual framework for the study. Chapter four deals with the data as well as the sampling and data collection techniques. Chapter five focuses on the research methodology where we present the procedures and methods for analysing the data. In chapter six, we present the findings from analysing the data. We discuss the findings of the study in chapter seven. Finally, we end the study in chapter eight where we present summary of findings, recommendations, suggestions for further studies and some limitations.

## **CHAPTER TWO**

### **BACKGROUND AND RELEVANCE OF THE STUDY**

#### **2.0 Introduction**

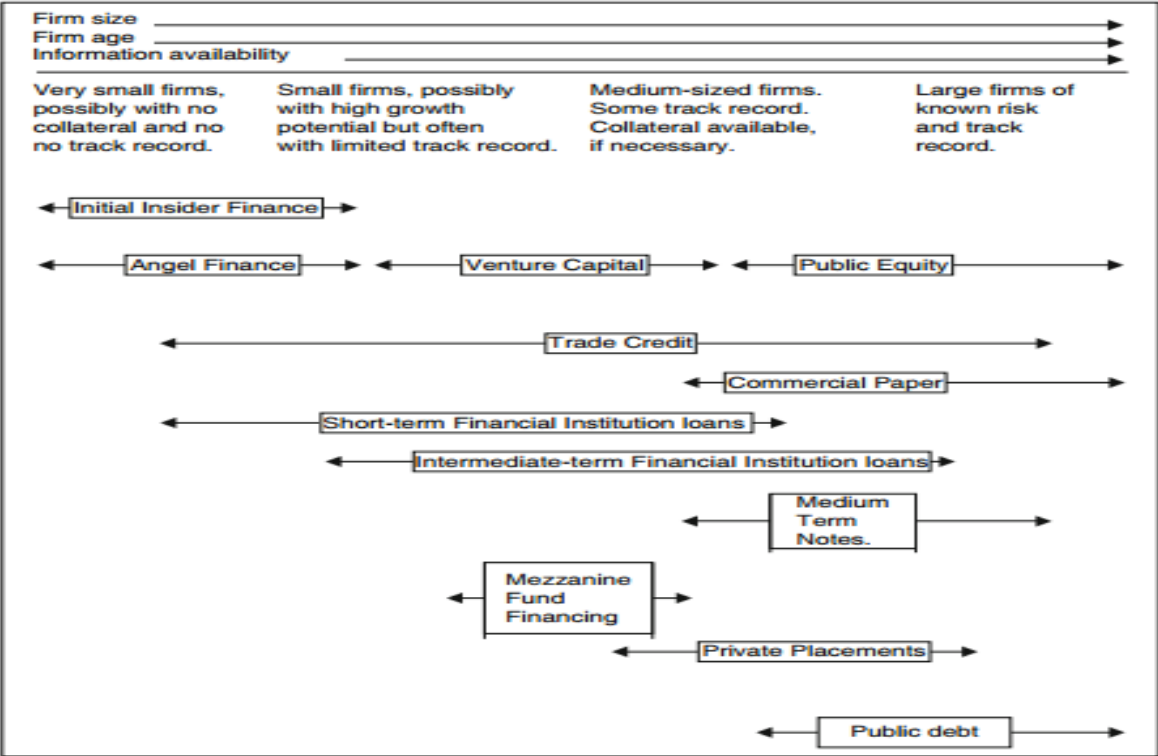
In this chapter, we discuss the relevance and general background of the study. We also justify why such a study is undertaken as well as the motivation behind the study. We also touch on some important topics relating to Ghana, the country of analysis. Finally, we touch on the gap that we seek to fill with this research and elaborate on some peculiar issues related to the study.

#### **2.1 Financial life cycle of firms**

Start-ups have difficulties in sourcing external finance because of information opacity (Huyghebaert & Van de Gucht, 2007). The most important and commonly used sources of finance therefore are personal savings of the firm owner, and finance from friends and family (Ullah & Taylor, 2007). But in most time, due to the limited capital availability especially in emerging market, firms are not able to exploit their potentials and discontinue operations in extreme cases (Cressy, 2006). Berger & Udell (1998) contributed to the discussion of firm growth and funding sources with their growth continuum and finance model as shown in Figure 2.1. Venture capital and PE funding may be the next most desirable source of capital after the owners' seed capital. PE and ventures capital funding come with less stringent requirements than banks and stock markets (Berger & Udell 1998).



**Figure 2.1: Financial Life Cycle of Firms**



**Source: Berger and Udell (1998)**

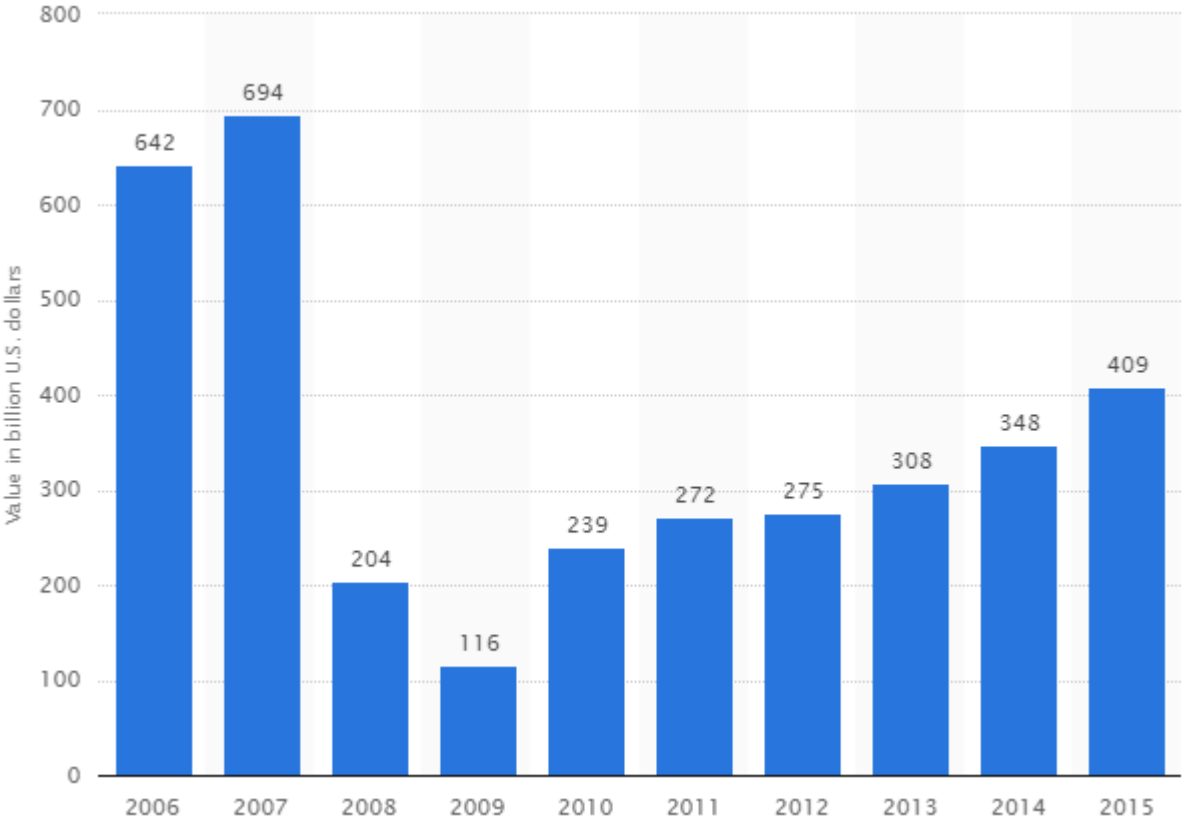
**2.2 Global private equity**

PE and venture capital as a financial model was first developed in the United States in 1946 and has achieved significant success in its implementation (Ribeiro & Carvalho, 2008). PE and venture capital have then been used interchangeably as their distinction is usually blurred (Wright et al., 2005). We would therefore be using them interchangeably in this research. PE has been defined by international bodies such as EMPEA and EVCA as the provision of equity funding to non-listed firms with high growth potentials ranging from a medium to long term horizons (Meles et al., 2014). According to Meles et al. (2014, p. 203), “venture capital and buyout, strictly speaking, are subset of PE and refers to equity investments made for the launch, early development or expansion of a business”. PE serves as an important source of funding for start-ups, private middle-markets, financially distressed firms, as well as public firms in need of buyout financing (Penn et al, 1997; Bruton & Ahlstrom, 2003). PE funding usually comes from institutional and retail investors, high net worth individuals, pension funds and insurance companies (Bruton & Ahlstrom, 2003) as well as development finance institutions who promote small and medium enterprises development in developing countries (Leeds & Sunderland, 2003; Casey, 2014). Pension funds and insurance companies tend to be

the largest investors in the PE industry (Gilligan & Wright, 2014) due to the long-term nature of their funds held in trust of their fund owners. Eid, 2006; Kaplan & Stromberg, 2009; Naidech, 2013; Fang et al, 2015 therefore categorised PE funding into limited partnerships (partners with passive role by supplying only capital) and general partners (partners take active role and usually act on behalf of limited partners in deal selection, execution, monitoring and exiting making them liable for all debts of the partnership). It is the norm for the general partner to provide at least 1 percent of the total capital and the fund typically has a fixed life, usually ten years (Kaplan & Stromberg, 2009). According to Leeds & Sunderland (2003), the cycle of PE is driven by the constant urge to figure out a profitable exit within a certain time frame. These exits can be done through secondary buyout, sale to a strategic investor and initial public offering (which according to empirical studies is the preferred option as it maximises the value of firms). The essence of PE as an investment vehicle and a spur for economic growth (Bruton, Ahlstrom, and Yeh, 2004; Sapienza, Manigart, & Vermeir, 1996; Achleitner & Klöckner, 2005; Kaplan, 1989; Lichtenberg & Siegel, 1990; Wright, Thompson, & Robbie, 1992; Jeng & Wells, 2000) has increased PE transactions worldwide (both in developed and emerging markets).

From Figure 2.2, the total value of PE-backed buyout (PE investments) deals worldwide reached it peaked in the year 2007 but a drastic decline in 2008 and 2009. This has been mainly attributed to the global financial crisis which bedevilled most nations in 2008 (Meles et al., 2014). The industry however started picking up from the year 2010 with total buyout transactions of 239 billion US dollars. However, it can be said the growth was at a relatively slow rate. Total PE investment transactions globally amounted to 409 billion U.S. dollars in 2015 where we see a significant turnaround in the industry (Statista, 2015).

**Figure 2.2: Value of private equity-backed buyout deals worldwide from 2006 to 2015 (in billion U.S. dollars)**

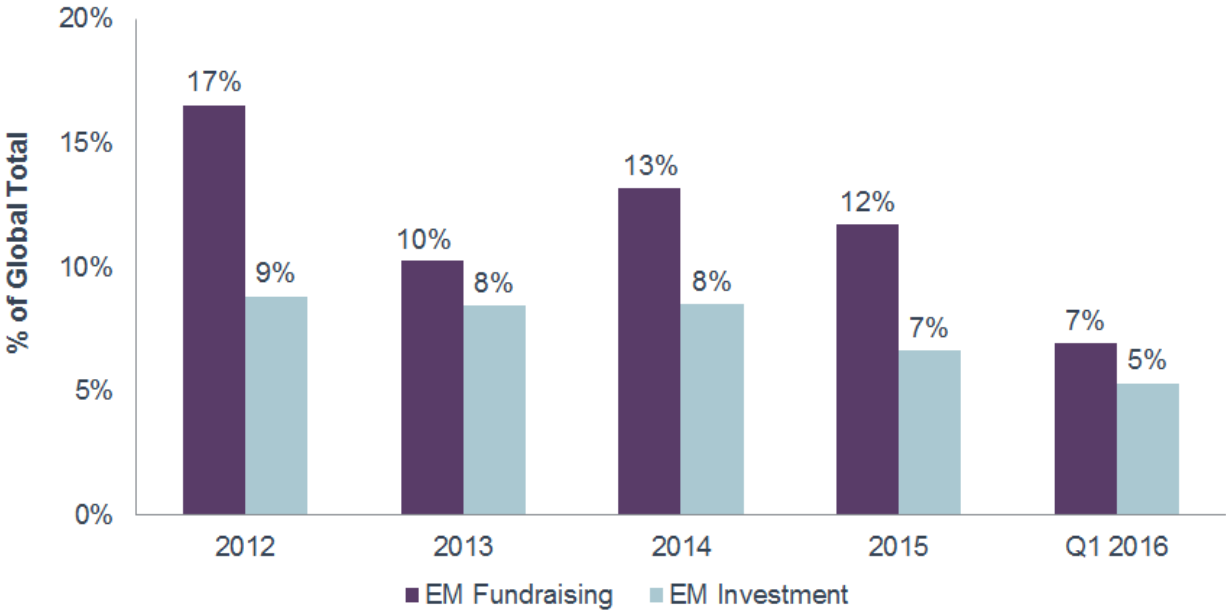


Source: Statista, 2015

**2.3 Private equity in Emerging markets**

Although the economic outlook for developed countries seems uncertain, some emerging economies presents some growth prospects (Klonowski, 2013). Despite the current decline in PE fundraising and investment across emerging markets, such markets could offer many opportunities (IFC, 2016). The robust development of PE in emerging markets is underscored in key statistics. According to EMPEA’s 2016 first quarter Emerging Markets Private Capital Industry Statistics, fund managers raised US\$7.0 billion for emerging markets focused private funds in the first quarter of 2016. This shows a drop of 30% from the first quarter of 2015. Also, fund managers deployed US\$4.9 billion and completed 341 investments, corresponding to a decline of 20% and 9% respectively across all emerging markets. Based on 2015 data, PE penetration (expressed as a ratio of private equity investment to GDP) in emerging markets is around 0.15 which is relatively low compared to the developed PE regions (U.K ;1.98 and U.S; 1.45).

**Figure 2.3: Emerging Market (EM) Private Equity Fundraising & Investment as % of Global Total**



**Source: EMPEA Industry Statistics, 2016: p 12**

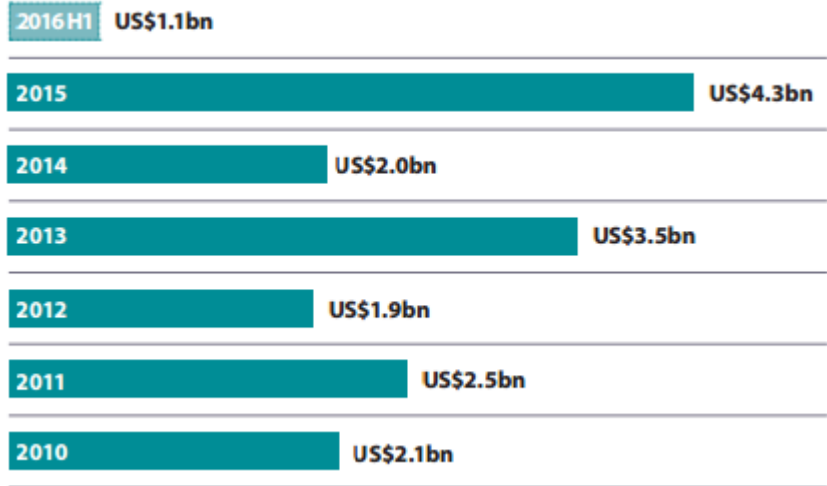
Notwithstanding the capital imbalance that is predominant in this region in terms of PE fundraising and investment, from limited partners point of view, there is continual positive economic growth rates for emerging markets and hence there is the need for financing. (Groh et al, 2011; Klonowski, 2013). According to Klonowski (2013), although there is a slowdown in overall economic development of emerging markets in recent years, GDP growth in these markets exceeds those in developed markets by a significant amount. Thus, emerging markets offer global investors the opportunity to diversify their global portfolios, to generate higher returns as well as participate in the economic turnaround of the world economy. Weak legal systems for investor protection, low corporate governance and weak capital markets in emerging economies are the dominant factors affecting capital attraction and investment activities in these countries compared to those of advanced economies (Leeds & Sunderland, 2003; Groh, 2009; Makhene, 2009; Klonowski, 2013).

The PE industry is set to transform emerging markets, markets which have already gone through their initial "teething" problems (Klonowski, 2011). There is therefore the need to advance research in PE in emerging economies to assess as to how best good corporate governance mechanisms can help improve the anticipated returns in the region. Our study will have practical implications for fund managers, investors and recipient firms.

### 2.4 Private equity in Africa

Most countries in Africa are bedevilled with generally shallow, inefficient capital markets and nascent stock exchanges (Bruce & Piesse, 2013) and PE could be the perfect asset class for investors in the continent.<sup>2</sup> Investors are confident that, Africa remains a strong growth opportunity and more attractive in terms of PE investment<sup>3</sup>. In effect, African PE markets have grown exponentially in terms of fundraising during the past decade despite their history of roller coaster in the past six years as depicted in the figure below.

**Figure 2.4: Total value of Africa Private Equity fundraising, by year of final close, US\$bn**



**Source: APEVCA; African Private Equity Data Tracker, (2016- first quarter; p 1)**

There has been ups and down in the value of fundraising in the continent. Figure 2.5 shows a 19% growth in 2011, a reduction of 24% in 2012, a rise of 84% in 2013, a reduction of 43% in 2014 and a tremendous increased rise of 115% in 2015. All thing being equal, the US\$1.1bn funds raised in the first quarter of 2016 signifies only 2% growth in 2016 (if quarterly funds raised remains constant throughout the year). The projection for funds in 2016 and 2017 were relatively lower due to the; current uncertainty around African emerging markets, low commodity prices and depreciating local currencies (APEVCA report, 2015). Notwithstanding the ill projections, Boston Consulting Group (BCG) in their 2016 report on PE in Africa stated that “African continent remains ripped and will continue to offer higher returns on private investments”. There is a growing presence of large funds and principal

<sup>2</sup> Boston Consulting Group private equity report, (2016). Why Africa remains ripe for private equity  
<sup>3</sup> (Ernst & Young, industry report on private equity in Africa, 2016)

investors which has broaden the market, thus making it relatively easier for existing investors to divest as compared to the past twenty years<sup>4</sup>. On exits, an average of 40 exits by PE funds was witnessed in 2013, 2014 and 2015 compared to an average of 29 in the previous five years (APEVCA report, 2015). Leeds and Sunderland 2003; Lieber, 2004; Gompers & Lerner; 2004 and Weber, 2006, on exits argued that, PE cycle is driven by the constant urge to figure out a profitable exit within a certain time frame hence increasing exit opportunities in PE market is a sign of a good investment. Buttressing this with investors quest in seeking quality deals all over the continent has triggered the interest of equity investors in other non-traditional PE investment destinations especially in West and East region of the continent.<sup>5</sup>

Effort has been made by both government and non-governmental agencies in improving the investment climate especially in; Tanzania, Botswana, Kenya, Uganda, Ethiopia, Rwanda, Ghana, Côte d'Ivoire, Senegal and Mali.<sup>6</sup> Nevertheless, the investment environment in these emerging markets are still not without challenges. PE firms continue to struggle with lack of quality deal flows, human capital challenges, lack of sophistication in potential acquisitions and portfolio companies partly due to institutional inefficiencies and unstable macro-economic factors (APEVCA, 2015). Largely, we say the picture of PE in Africa's emerging economies is positive and investors are optimistic about favourable returns.

In our case, we focus on the western region of the continent which has gained more attention of investors. BCG private report (2016) stated that, West Africa will be the most attractive investment destination in the few years. Figure 2.6 depicts a survey by Deloitte on investors' confidence and attractiveness of the countries in West Africa.

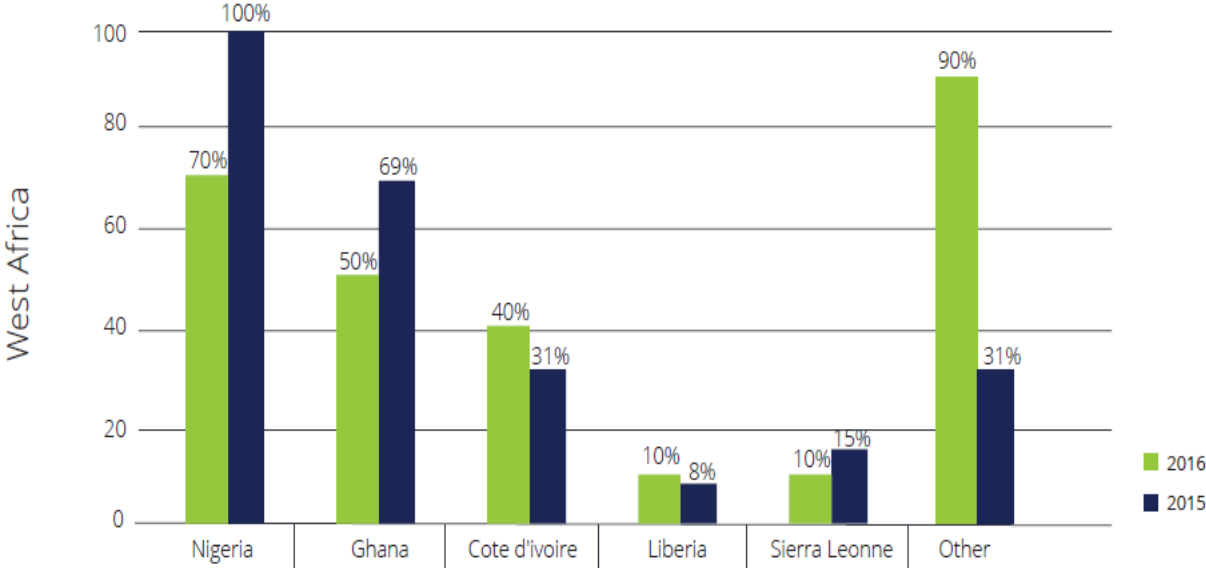
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<sup>4</sup> African Private Equity and Venture Capital Association (APEVCA) report, 2015.

<sup>5</sup> Deloitte Africa private equity confidence survey, (2016)

<sup>6</sup> World Bank Report on Ease of doing business in East and Sub-Saharan Africa, (2017)

**Figure 2.5. Country focus for 2015 and 2016 (Private equity investors percentage score on investment destinations attractiveness in West Africa)**



**Source: (Deloitte Africa private equity confidence survey, 2016.)**

Nigeria, Africa’s largest economy was the most favourite country but has been consistently lowered in terms of growth forecast by the IMF (International Monetary Fund) due to the decline in oil prices and the political instability which has negatively affected the country’s investment attractiveness (APEVCA 2016). Investors focus may be shifting to other countries such as Ghana as shown in figure 2.6 being the next best investment destination in the region. This can be attributed to Ghana’s political stability, abundant natural resources, growing consumer market which enhancing investment diversification and consistency of returns (Deloitte Africa PE confidence survey, 2016). Moreover, there is limited flow of international and syndicated PE capital coupled with the absence of angel investors and inefficient stock market (VCTF, 2015). Thus, it can be concluded that there is a big space in the country for foreign PE investors (Gatsi & Nsenkyire, 2010). These opinions confirm the position of Ghana among her peers in terms of investors’ confidence but certain perennial questions remain unanswered. Will the increased levels of confidence and capital deployment by PE investors impact the financial performance of recipient firms positively? Or are investors concerned about their higher returns? And, what are the opportunities in these countries for western based investors that are unidentified and/or unexploited?

### **2.5.1 Overview of the economy of Ghana**

The analysis under this section is based on our field work and the empirical findings of the U.S. Department of State's Investment Climate Statements in Ghana from 2010 to 2016 which observed the Ghanaian economy empirically from various angles. Ghana until recently when the country's GDP growth rate slowed in 2015 to 3.9 %, was among the world's fastest growing economies. The country's high dependence on the exportation of primary commodities (including; gold, cocoa, oil and other agricultural products) makes the economy highly vulnerable to commodity price shocks. Ghana's economy deteriorated between the years of 2013 and 2016. Inflation hit 19.2% in the first quarter of 2016 (the highest since early 2010) and the Ghanaian currency (cedi) has been depreciating since 2013 (lost almost 32 percent of its value in 2014 and slid another 15 percent in 2015). Unemployment stood at 5.2% as at 2014 (Ghana Statistical Service report, 2015). To stabilize Ghana's struggling economy, various credit facilities have been extended to the country with the aim of boosting firms at the start-up and growth stages. The three-year \$918 million extended credit from the IMF in 2015 is an example. On the negative side, this shot Ghana's debt to GDP rising ratio above 70 percent. On energy and productivity, the nation suffered severe power outages in 2015 which extended to the ending of 2016 and has negatively affected businesses especially the small and medium enterprises in the private sector.

Prospects for Ghana's economy look brighter despite current macro-economic challenges. Hinging on positive outcomes from the oil sector and the IMF fiscal consolidation program, Ghana's macro-economic indicators are beginning to stabilize. Private sector productivity is expected to increase as processes to meliorate the power outage issues are on track. Backed by a strong services sector performance, Ghana's economy grew by 4.9% during the first quarter of 2016 which was higher than the 4.1% recorded in the first quarter of 2015. The inflation rate which was hovering around 18% in the first quarter of 2016 fell to 16.7% in July and has been the lowest since March 2015. The GDP growth rate is projected to reach around 7.5% by 2018.<sup>7</sup> Also, capital markets and portfolio investment are gradually evolving<sup>8</sup>

The current government administration acknowledges Ghana's yawning fiscal deficit and lack of availability of capital for potential private start-up businesses and sees infusion of foreign funds through PE investment as a necessity in enhancing economic growth. Ghana offers

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<sup>7</sup> <http://www.worldbank.org/en/country/ghana>

<sup>8</sup> U.S. Department of State's Ghana's Investment Climate Statement (2015)



investors a business environment with features such as a stable and predictable political environment, non-discrimination against foreign investors, free-floating exchange rate regime and guarantees that investors can transfer profits out of Ghana, investment laws that protect investors against expropriation and nationalization, and lower degree of corruption than that of some regional counterparts. Among the promising sectors are agribusiness, financial sector, education, food processing, downstream oil, gas, and minerals processing, as well as the energy and mining-related services subsectors. Overall, the investment climate in Ghana is relatively welcoming to foreign investment as well as enhancing firm's performance of both foreign and local business, especially compared to other countries in the sub-region<sup>9</sup>. However, burdensome bureaucracy (e.g. stringent local content regulations in the petroleum sector), costly financial services, under-developed infrastructure, ambiguous property laws, frequent power and water cuts, and an unskilled labour force are the main factors that hinder the growth of both foreign and private businesses in Ghana (U.S Department of State's Ghana's Investment Climate Statement, 2015).

### **2.5.2 Legal and institutional environment of Ghana vis à-vis corporate governance**

In assessing firm performance, the importance of legal traditions for corporate governance and economic growth in a country cannot be denied (Andreas, 2012). Ghana, been colonised by the British has a common law and customary law as basic legal systems on which all investment transactions are based. Common-law countries have the strongest legal protection of minority shareholders, while investor protection is weakest in French civil-law countries (Hoskisson *et al.*, 2004; Lerner and Schoar, 2005 and La Porta *et al.* 2000). However, it has been observed that, differences and similarities between specific countries should be explained considering additional factors than the legal traditions only (Andreas, 2012). In Ghana, the regulatory framework for an effective corporate governance practice in Ghana is contained in the Companies code 1963 (Act 179), Securities Industry Law 1993 (PNDCL 333) as revised by the Securities Industry (Amendment) Act, 2000 (Act 590) and the listing regulations, 1990 (L.I. 1509) of the Ghana Stock Exchange. Corporate governance and minority's interest protection is strong in listed firms but weak in unlisted firms leading to increase in agency cost and increasing dispute resolution at commercial courts (Agyemang & Castellini, 2015). Although it may be somewhat less, in Ghana there is evidence of government intervention in the court system and the courts being slow in disposing of cases

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<sup>9</sup> U.S Department of State's Ghana's Investment Climate Statement (2015)

(U.S. Department of State's Ghana Investment Climate Statements, 2015). Corruption in Ghana is comparatively less prevalent than in other countries in the region<sup>10</sup> but remains a problem as few American firms operating in Ghana have identified corruption as the main obstacle to foreign direct investment in the country (U.S. Department of State's Ghana Investment Climate Statements, 2015). Nevertheless, Ghana's track record of political stability and a relatively, reliable legal system results in dispute resolution processes that benefits foreign investors, in comparison to other countries in the region (U.S. Department of State's Ghana Investment Climate Statements, 2015).

### **2.5.3 Private equity industry in Ghana**

As in most emerging markets, Ghana's SMEs serves as the backbone of the economy. It has been estimated that SMEs comprise about 90% of all businesses in the country. Yet access to capital has been consistently cited as the major challenge faced by African SMEs (Aryeetey, 1994) and SMEs in Ghana are no exception. The typical challenge is access to long term source of finance in terms of equity as funds from Banks and other Non-Bank Financial institutions are short term in nature. This therefore makes the sustenance of capital intensive sectors very critical. Over the years, the government has shown commitment through various financing programmes such the Export Development and Investment Fund (EDIF) to help salvage the perennial problem of access to finance for SMEs. These have however faced challenges such as strict regulations and lack of market support.

Following the unsuccessful nature of most of the SMEs financing programmes, the government thus implemented the suggestion given by some Development Financial Institutions and local investors to help pass a formal legislation for financing schemes and help develop the supporting market infrastructure. This led to the passage of the Venture Capital Trust Fund Act (Act 680, 2004) with seed funding from the government through the National Reconstruction Levy and Act also allows the fund to source additional funding from private investors<sup>11</sup>. According to Venture Capital Trust Fund (VCTF) 2016 annual report, it has invested into 48 portfolio companies using a total of USD 14,213,454 of the venture's committed capital. The activities of the Trust Fund have boosted the role of PE in the country which promoted the influx of additional funding for SMEs both locally and overseas. Locally, the financial sector (e.g. Databank, Fidelity Bank, State Insurance Corporation) has

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<sup>10</sup> Transparency international Corruption Perceptions Index (2016)

<sup>11</sup> <http://reports.weforum.org/social-innovation-2013/06-the-venture-capital-trust-fund-ghana/>

appreciated the role of PE by making availability equity funding to companies. Foreign investors have also been increasingly active in the country with majority of them without any physical present (local offices). However, a few have physical present in Ghana by way of regional offices such as Aureos Capital and Kingdom Zephyr African Management. The foreign fund managers without local presence include Blackstone Group and Warburg Pincus who invested in an oil exploration firm known as Kosmos Energy and Actis International who made an invested in Accra Mall, a project estimated at USD 30 million. With regards to the foreign capital investments, most of them are geared towards the financial sectors. The later part of 2013, saw Abraaj Group buying a majority stake in Ghana Home Loan, a mortgage firm and in 2014 Petra Trust, a leading pension firm in Ghana received funding from Leapfrog.

## **2.6 Private equity in Emerging markets research**

There is a growing research in PE investment. Most of these studies have focused on; the portfolio performance of fund investors in the industry in general (e.g. Bruton et al, 2010; Wruck, 2008; Hearn & Piesse, 2013), PE in general as catalyst for economic development in emerging economies (e.g. Eid, (2006 and Groh (2009), PE fund raising and investment analysis in the geographical blocks of emerging markets (Babarinde, 2012; Klonowski, 2013) and PE in specific countries in the emerging market regions (eg. Charvel, 2012; Klonowski, 2011; Ribeiro & Carvalho, 2008).

Most of these researchers have focused on the PE industry and corporate governance implication in the US and the UK while such research in emerging and developing economies such as Africa and Asia remains scanty, review based and less significant compared to those on developed economies except Hearn & Piesse (2013) and Leeds & Sunderland (2003). However, we deem it necessary that more research must focus on emerging economies in Africa as “the continent remains ripped and will continue to offer higher returns on private investments compared to similar investments in developed western economies” (Boston Consulting Group, 2015).

With the limited amount of research on PE in emerging economies, most focused on a top-down approach where researchers study the gross portfolio performance overtime amid corporate governance issues. Exited investments through initial public offerings are also usually considered. This situation however like Kaplan & Schoar (2005) opined is because of

the lack of availability of data because PE industry is largely exempted from publicly disclosing their activities. Thus, to the best of our knowledge there is no such research which has used a bottom-up approach on the interrelation between the impact of corporate governance implication on PE funding and the performance of recipients. Hence drawing on Ghana's PE industry and using; agency theory and transaction cost theory, and institutional theory, we seek to provide an empirical evidence of the impact of PE investment on recipients. Recipients drawn from Ghana will serve as generalisation for recipients in emerging economies in Africa. Indeed, this will help fill the knowledge gap. Moreover, it will guide practitioners and other players in the PE industry to assess their projected confidence in the emerging economies.

## **2.7 Chapter Summary**

Notwithstanding the predominance of capital imbalance in emerging markets in terms of PE fundraising and investment, limited partners opine that there is the need for financing as there is continual positive economic growth rates for emerging markets. Although research in PE is constantly being advance, studies focusing on the impact of PE funding impact performance in emerging economies remains unanswered as well as how corporate governance can impact private performance of recipient firms to the best of our knowledge. The relevance of our research is in two-folds. First, it will help fill the identified gap in literature relating to impact on PE funding on recipient's performance through corporate governance mechanisms. Second, it will help provide empirical evidence on the effect of PE funding on recipients' financial performance in emerging economies.

## **CHAPTER THREE**

### **THEORY AND PREVIOUS FINDINGS**

#### **3.0 Introduction**

In this section, we present the basic theories underlying our research as well as some empirical findings relating to the study. We would also present our research hypotheses and finally end with a conceptual framework for this research.

#### **3.1 Theories**

As theories provide researchers the opportunity to explain some occurrences and phenomena, we would basically rely on the following theories to offer explanations for our research; agency theory, transaction cost theory and institutional theory. We would also discuss corporate governance in this section.

##### **3.1.1 Agency theory**

An indispensable and the most common concept in the context of PE is the phenomenon of information asymmetry between the investor and the entrepreneur or managers of firms (Kaplan and Stömberg, 2003). Kaplan and Strömberg (2004) opined that, agency problems are the major source of tension between PE investors and entrepreneurs. Their finding is in line with the classic theory of agency including Stiglitz, 1974 and Grossman & Hart, 1983. These scholars opined that, there is a potential for conflict between the agent and the principal who both seek to maximize the task for their respective benefits. The cost associated with these agency problem is known as, agency cost (Shapiro, 2005; Jensen & Meckling, 1976). Jensen & Meckling, (1976) grouped these cost into; “the monitoring expenditures by the principal, the bonding expenditures by the agent, and the residual loss”. This apprise investors to recognize costs related to separation of ownership and managerial control in the PE equity industry. In the context of PE investments, the principal, can be generalised as the limited partner who invests capital in a project that is carried out by the general partner as agent, or the general partner whose project is carried out by the entrepreneur as agent (Raphael, 2011). Elaborating on these three types of agency relationship with respect to PE, Bygrave & Timmons (1992) and Cumming & Macintosh (2003) stated that, once ownership of the project is shared with the investor, both general partners and entrepreneurs as agent have an information advantage and an incentive to not always act in the best interests of the investor. In the quest of mollifying the effect of agency theory and it related cost, Spremann (1990)

classified agency theory into three main categories; adverse selection, moral hazards, hold ups and adverse selection.

Adverse selection occurs in markets or contracts where one party cannot differentiate between the good versus bad quality of the other due to asymmetric information (Spremann,1990). In the PE investment arena, two main scenarios explain this problem (Raphael, 2011). Kaplan and Strömberg (2004) and Gompers (1996) elaborated this in the following sentences. In PE funding, competition among entrepreneurs for equity funds pushes them to present optimistic forecast of favourable returns and gargantuan growth projection for their business whilst withholding negative information that can potentially if uncovered, ruin their attractiveness for the funds. General partners, also in the quest to signal their ability of bringing recipients to the capital market sooner than other older PE firms, and moreover to establish a reputation, they fail to embark on background checks on the new recipient firms.

The second and third categories of agency are; moral hazard and holdups. Moral hazard was first identified by the economist and philosopher Adam Smith in his book “The Wealth of Nations” (Smith & Garnier, 1838). Spreman (1990) articulated that this problem can arise in two ways; when an agent uses hidden information and/or hidden action at the blind side of the principal to increase their own utility at the detriment of the principal’s best interest. A private equity investor, as the principal, cannot monitor fully the behaviour of the agent but only examine the firm’s most pressing goals and ultimate success. Different control system such as pre-contractual screening of potential investments and post-contractual monitoring and incentive-settings are array of governance mechanisms that investors in their capacity as principals use to allay most of the latent agency problems (Kaplan & Strömberg, 2004; Koryak & Smolarski, 2008). But Milgrom and Roberts (1992) stated that, the cost of perfect monitoring is typically greater than the return from the employees perfectly monitored effort. Jensen and Meckling, 1976 suggest that, the higher and tighter the level of monitoring, the higher the costs incurred and hence, investors aim at keeping monitoring costs as low as possible. Hence, there is nothing like and would never be a perfect control mechanism in organisations (Merchant & Van der Stede, 2007). This suggest that, governance mechanisms including board composition and founder involvement may play critical role in aligning investors and owners interest as well as overall performance of PE recipient firm. Holdup occurs when agent through systematic approaches use gaps and deficiencies in contracts (Raphael, 2011). The opportunistic behaviour of the human nature and human not been

immune to bounded rationality will naturally make future contracts incomplete in one way or the other. Agents in their selfish interest reveals their previously hidden intentions and call for renegotiation as soon as investors deploy the initial funds and after sunk costs have been incurred (Spremann, 1990). From the agency theory perspective, the equity investors can and may outline complete contractual agreement. But as Fama & Jensen, (1983) opined, full contract formulation and enforcement may exceed the benefits secured from the agent's tasks.

### **3.1.2 Corporate governance**

Agency problems and governance move in tandem with the former being a pulling string on the latter as highlighted in the discussions of the preceding categories of agency theory (Thomsen, 2008). Separation of ownership and control leading to agency problems makes corporate governance mechanisms a necessity (Fama & Jensen, 1983; Thomsen, 2008). The intertwined relationship between these phenomena is dated back to the work of Adam Smith in his book "The wealth of Nations", he observed that "the directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company" (Smith & Garnier, 1838, p. 311) and hence a good governance is often needed as a counteragent to this problem (Thomsen, 2008). When investors finance a firm, they conventionally obtain certain rights that are generally protected through the enforcement of regulations and laws (La Porta et al., 2000). But Jensen and Meckling (1976) and Hart (1995) state that, principal and agent interest could diverge even during legal enforcement, and investors protection through legal systems may turn out to be ineffective. Expropriation of investors by the controlling management can therefore be extensive. La Porta et al., (1998) state that investors face risk, and sometimes near certainty that the returns on their investments will never be materialize in inefficient institutional environment. PE investors must therefore be on the edge of implementing extra controls to supplement the legal investor protections available which are to some extent country, institutional and industry specific (La Porta et al., 2000). The presence of equity investors on the recipient company's board could therefore potentially align the interest of managers and that of investors (Berger et al., 2009).

On the contrary, García-Herrero & Santabárbara (2008) had an opposite opinion on the presence of investors on the beneficiary firm's board.

### **3.1.3 Transaction cost theory**

This theory forms part of the new institutional economics together with agency theory and property rights (Saam, 2007). After Oliver E. Williamson outlined the main determinants of transaction cost in his seminal book "Market and Hierarchies" in 1973 (Williamson, 1975), transaction cost economics has become an imperative in the study of management and organizations (David & Han, 2004). Williamson (1991) argued that, transaction cost theory is the 'core theory' of strategy and hence other increasing phenomena should be subsumed (Groenewegen & Vromen, 1996; David & Han, 2004), Scholars including Groenewegen & Vromen, 1996; Moran & Ghoshal, 1996; David & Han, 2004 has contributed to theory regarding the empirical validity and applicability of the theory in international business and cross border- activities. Williamson (1973) opines that, transaction cost exists mainly because of uncertainty, and opportunism, though bounded rationality is involved as well. It exists when true underlying circumstances relevant to the transaction, or related set of transactions, are known to one or more parties but cannot be costlessly discerned by others. Transaction cost theory and agency cost theory and corporate governance are inseparable in the context of investment (David & Han, 2004). From the discussion of these three theories, it can be deduced that; (a) Transaction cost theory is an alternative variant of agency cost, understanding governance assumptions. That is transaction cost governance frameworks are based on the net effects of internal and external transactions, rather than contractual relationships with shareholders. The corporate governance problem of transaction cost theory is the effective and efficient accomplishment of transactions by firms but not the protection of ownership rights. (b) Transaction cost theory and agency theory essentially deal with the same issues and problems but agency theory focuses on the individual agents and transaction cost theory focuses on the individual transactions. Search and information costs, bargaining and decision costs and policing and enforcement costs are situation under which transaction cost may occur (Leeds & Sunderland 2003)

### **3.1.4 Institutional theory**

"Institutions are the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction" (North, 1990, p. 3). Institutions contribute immensely to locational advantages, the second component of the well-known ownership-



location-internalization (OLI) paradigm which explains the pattern of foreign direct investment (Dunning,1998; Meyer & Nguyen, 2005). Scholars including Scott (1987), Williamson (1995) and Shirley (2005) state that, these rules of the game are both formal and informal elements made up of economic, political and social institutions put in place to structure and promote an enabling environment in which people and businesses prosper. Efficient institutions reduce uncertainties and establish stable structures that facilitate interactions thereby reducing both transaction and information costs (Bruton et al., 2004; Kingsley & Graham 2017). In places where institutions increase the certainty that contracts will be honoured and property protected, individuals will be more willing to specialize, invest in sunk assets, undertake complex transactions and accumulate and share knowledge North (1990; Williamson, 2000). Implicitly, agency cost is minimal and governance becomes lenient in firms operating in countries rooted in quality institutions. Investors knowledgeable about the host country's institutional build-up therefore is indispensable prior to negotiations and funds commitment. Also, Bell et al. (2012) adds that, the larger the institutional knowledge gap, the higher the liability of foreignness and the additional cost of doing business in the host country. Scott (1995) and Bruton et al. (2004) emphasis that institutional components are categorised into; regulatory, normative and cognitive aspects and in sum, shapes all activities of an originations.

Laws and sanctions regulating firms and individual's behaviour in an environment are classified as the regulatory elements (North, 1990). These regulatory institutions are based on legal philosophy, degree of legal protection for investors, law enforcement and the nature of capital market system in respective countries and therefore differs around the world (Bruton, Fried, & Manigart 2005). Leeds and Sunderland (2003) cited inadequate investors protection and legal and regulatory framework as the major reasons for the problems encountered by PE funds entering emerging markets. Therefore, the development of PE industry in emerging economies is undoubtedly affected by the level of investor protection regulations (Bruton et al., 2005; Kingsley & Graham, 2017). This can be buttressed with the assertion of Bruton et al., (2003) stating that, PE industry development in a country is due not only to the existence of laws but also to their strict enforcement.

The normative aspect of institution are the derivational actions, acceptable behaviour and values from professional standards that are propagated through training and constant practice (DiMaggio, 2001). Many players in the PE industry in emerging economies have studied and

worked in Western institutions where they received their training and hence, normative practices in the PE industry in emerging economies are strongly influenced by Western ideas (Bruton, et al., 2002). Wright et al., (2005) state that, venture capital companies from United States entering foreign markets adapts their way of working to certain degree. This buttress the dominant normative logic of PE as a financial model originating from the United States with its strong values and norms (Bruton et al., 2005) but also implies that, host countries environments are equally imperative.

Bruton et al., (2004) define cognitive element of institutions as the constraints concretized in traditions that are subconsciously accepted as rules and customs, and commercial conventions that develops over time through social interactions among the various participants which shape their notions of what is appropriate and conceivable behaviour. Relevant elements impounded in the definition that are of greatest concern for PE investors are the differences in the cognitive value and roles placed on entrepreneurship and social networks respectively (Bruton et al., 2005). Raphael, (2011) suggests that, the differentiating factor between the United States and some European countries is the status attached to entrepreneurship. While entrepreneurs with US traits are held in high regard (characterised with high rewards for success and low punishment for failure), in European countries entrepreneurs are typically seen as opportunists. (success does not necessarily confer high status and failure has major negative implications) Raphael, (2011). On social network, Raphael, (2011) opines that, connections between business people in most European countries are stronger than in the U.S. and even stronger in Asia. Ascribed entrepreneurship roles and network-based financing connections, is known to have an influence on managerial behaviour and performance of equity investment (Chen, 2002).

Implementation of effective corporate governance mechanisms will reduce agency problems through effective monitoring. This enhance transparency and the accountability of decision-making processes which turns to improve corporate performance (Munisi, Hermes & Randøy, 2014). Studies including Allen et al., (2005, 2012) show that, legal institutions by themselves fail to explain problems with corporate governance. Munisi, Hermes & Randøy, (2014) opine that, the effectiveness of corporate governance mechanisms depends on both the institutional framework and legal enforcement. Considering the nature of PE investment and the characteristics of emerging economies, the interplay of the above theories discussed

undoubtedly would serve as a stepping stone on which the impact of PE investment in emerging economies can be assessed (Meyer & Nguyen ,2005).

### **3.2 Empirical findings from previous research**

#### **3.2.1 Private equity stake and recipients' performance**

Empirical literature assessing the effects of PE on firm performance overlaps with studies that assess the impact of leveraged (Battistin et al., 2013). Since the highly leveraged hostile takeovers took over several public companies in the United in 1980s, the effects of PE investments have been lively debated. Considerably, PE investment has changed since the 1980s, extending their scope from leverage buyouts that entail almost the acquisition of a majority stake, to minority investments as well. Lerner et al., (2009) and Kaplan & Stromberg (2009) commented on the non-trivial role played by minority investments.

Kaplan & Stromberg, (2009) commented on the rising importance of minority investment types of deals and speculated that, the 2008 economic crisis will lead to a substantial growth of buyout related interest rates, and hence will increase minority stakes in PE investment. Lerner et al. (2009), sampled worldwide completed PE deals from 1984 to 2008 where minority investments accounted for 72.7% of transactions, and were largely predominant in venture capital (99.5%), growth capital (99.3%), public equity (98.9%), private placement (59.9%), other PE-backed acquisitions (56.8%), and almost completely missing was LBOs-majority stake (0.9%). According to Lerner et al. (2009), growth capital and private investments in public equity (i.e. value investments that were almost completely undertaken by means of minority stakes) accounted for 23.4% of all PE-backed transaction. Studying the relationship between firm performance and investment stake is therefore a necessity.

Notwithstanding the widespread occurrence of minority deals, as well as their relevance in the activities of PE firms, the empirical evidence on their effects is still scanty (Battistin et al., 2013). Moreover, to the best of our knowledge, none of these studies focused on emerging markets. Chen et al. (2014), focus on 123 minority investments in publicly held targets carried out from 1990 to 2006 in the US and found only weak evidence that minority investment increases firm profitability. Battistin et al. (2016), sampled 90 majority and 101 minority targets investments undertaken by PE investment in Italy between 1995 and 2004 confirmed that, PE investments contribute to the value generation of portfolio companies through the

promotion of growth more than through restructuring and control seeking measures. They therefore concluded that, (I) target firms experience strong growth in sales and profitability but there is a strong evidence that the effect is way larger in minority investments (ii) where PE complements but not substitute the previous ownership and also backs existing corporate board rather than substitute them through minority deals, minority investments clearly outperform majority investments in terms of profitability. Boucly et al., (2011) studying a large sample of PE-backed LBOs undertaken in France from 1994 to 2004, find that firms experience significant sales and profitability growth after the PE deals, similarly to what one would expect ex-ante for minority and majority targets. Therefore, whether majority and minority targets perform differently after the deal is still an empirical matter worth of investigation. On governance measures, Boucly et al., (2011) opine that, both minimum and maximum investment affect board composition with majority deals having significant effect. It may well be that, variations in performance are mediated by important changes in the board. In the hindsight, the effect of majority investment on the boards doesn't come as a surprise. Empirical studies on leverage buyouts, that forms the most part of majority deals including, Gou et al., (2011) and Acharya et al. (2012), show that PE tends to have significant effect on the board. Whilst the evidence about PE effect on target governance controls is not strikingly surprising, to Battistin (2016), minority investments perform better than majority investments, although understandably, majority investors actively involved in management and board structures. These findings in one way or the other, are in line with the prediction of Kaplan and Stromberg (2009): PE investments can create value at the company level without having full control of targets, thanks to their experience in operational engineering.

### **3.2.2 Founder involvement in management and firm performance**

Private firms are usually owned and managed by a small, concentrated group of shareholders (Cumming et al., 2007). This may point to the immense role that founders can play to impact financial performance of PE recipient firms given the close nature of the industry. However, there is limited research on how the active involvement of founders in PE funding recipients' management may impact performance especially in emerging markets. The analysis in literature concerning founder-management and firm performance can also be extended to the PE industry as done by Randøy et al. (2013), where the authors used Microfinance institutions. Randøy et al. (2013), assessing the impact of entrepreneur-CEOs in Microfinance institutions (MFIs) using a sample size of 295 suggest that entrepreneur-managed MFIs are associated with greater financial sustainability and lower cost. The finding

by Randøy & Goel (2003) is in line with a study conducted by Adam et al (2009) to understand the relationship between founder-CEOs and firm performance. Fahlenbrach (2009), sampling 2,327 unique firms and 3,633 CEOs in the US finds that founder-CEO firms have higher firm value and stock performance than non-founder-CEO firms. Daily & Dalton (1992), show no significant difference between founder-managed firms and professionally managed firms. They however note that “it may be that the alleged relationship between founder-managed and professionally managed firms and corporate performance is more complex than has been implied” (Daily & Dalton, 1992 p 31). Wruck, (2008) emphasises that co-ownership by top management helps increase the profitability and overall financial performance of firms. This is because from the agency cost and corporate governance perspectives, the interest of investors, management and/or founder will be aligned to promote superior performance.

Literature including Schulze et al., 2002; Morck & Yeung 2003; Howorth et al., 2004 and Scholes et al., 2007 recognize that private firms’ ownership and control structures can introduce agency problems. Private ownership and owner management may limit external control causing owners to adopt behaviours that are not economically motivating (Batistine et al., 2016). Owner management is driven by personal preferences or taste of owners which in the end harm themselves as well as those around them (Schulze et al. 2001). Schulze et al., (2002) cites such harmful actions of owner-management as; the use of owner-manager position to assist friends and families or to refuse change in business model because this would threaten the status quo (Batistine et al., 2016). According to Dawson, (2011), these problems are characterised with private firms, where tendency to nepotism and willingness of owner to retain ownership control at all costs is high.

To the further side of the effect, PE investment enhance entrepreneurship and promote strategic innovation (Markides 1997; Wright et al., 2001) in firms where such opportunities cannot be achieved under current ownership (Britiatine, 2016). According to Randøy & Goel (2003), founder-led firms are associated with low agency cost which may be exploited for strategic purposes. The low agency cost as shown in literature and the overall motivation that entrepreneurs/founders bring on board may account for the significant association found between founder involvement in management and firm performance. However, the study of how founder involvement impact performance in the PE industry remains scanty if there is

any at all to the best of our knowledge. The extension of such analysis to the PE industry may however be of utmost importance given its closed nature.

### **3.2.3 Private Equity, Corporate governance and performance**

In assessing corporate governance mechanisms on the performance of recipient firms we focus much attention on board size. This is because board size will naturally be in conformity with other board structure characteristics such as proportion outside directors, number of committees etc. Also, given the close nature of the PE industry, the study of the association between board size as an attribute of board structure and recipients' performance may be in the right direction.

Many are the research works on how the structure and effectiveness of board of directors affect performance of firms. However, as noted by Yermack (1996), empirical works on board structure usually overlook board size effect on performance but rather concentrate on proportion of outside directors, stock ownership by directors and chief executive's influence. This motivated Yermack study on the relationship between board size and performance using a panel data set of 452 large public corporations in the U. S showing a negative relationship between board size and firm value. His result is in line with other recommendations from Lipton & Lorsch (1992) and Jensen (1993) who advocate a limit on board size. The reason usually cited for the negative relationship is that small groups make better and effective decisions that large because of increased complexities in communication and coordination. Eisenberg et al. (1996), conducted similar research using a sample of 900 small Finnish firms to assess the extent to which the negative relationship between board size and performance holds for small firms. As noted by the researchers this was necessary as different factors may account for the board size and structure in the two class of firms. Most importantly the agency problem affecting board size and structure may not be prevalent in smaller firms. However, their findings were consistent with earlier research works still indicating a negative relationship between board size and performance in smaller firms.

In the PE industry, we extent the analysis of Eisenberg et al. (1996) to it on the premise that the recipient firms tend to be small. According to the authors, the negative association between board-size and performance can exist although smaller firms tends to have less separation of ownership and control than in large firms. This is usually the case in most

recipient firms as the founder tends to the CEO or actively involved in the running of the business.

Communication and coordination problems emanating from agency problems may be present in PE firms if fund managers or founders choose suboptimal board structures. Most importantly large board size goes in accordance with large proportion of outside directors. Research have shown that outside directors tend to favour the interest of shareholders affecting the overall performance of firms (Hickman, 1992; Yermack, 1996). A plausible explanation can be the one given by Eisenberg et al (1998) suggesting owners choose boards that will meet their preferences. That is there the tendency for fund managers to choose members to join the board since they will meet their preferences.

“Private equity firms combine significant and concentrated share ownership with effective board oversight, thereby reuniting the corporate risk-bearing and governance functions that are separated when companies go public. And the results of such changes in ownership and governance have been impressive” (Wruck, 2008, p 12). The author seems to suggest that PE firms ensure good corporate governance mechanism for the ultimate performance of firms. Theoretically, it is argued that PE can improve the operations of supported firms by reducing agency costs (Jensen 1986, 1989). Jayhun (2016) opines that PE adjusts managers’ incentives to meet the interests of executives such that, improvements in the operating performance of firms benefits both parties. General partners close monitoring of the firms in which they have invested by actively joining the board of directors and taking part in proceedings reduce agency cost (Kaplan & Stömberg, 2003).

Indeed, numerous research works have not only focused the relationship between corporate governance mechanism and firm performance using PE firms over the years but also on factors impacting the governance of PE firms. Cumming et al. (2008) investigating governance using investments of venture capitalists in 3848 portfolio firms in 39 countries from North and South America, Europe and Asia from the years 1971 to 2003 found that cross-country differences in legality have a significant impact on the governance structure of venture capital investments. The control rights in PE firms by means of board representation tends to be natural related to legality (Kaplan & Strömberg, 2003). Again, returns have shown to be greater in countries with stronger legal conditions (La Porta et al., 1998; Cumming and Walz, 2004). This emphasises the importance of the legal environment as a catalyst for external corporate governance mechanisms (Cumming et al., 2008). Cumming et

al. (2006) conducting an extensive analysis on 468 PE investments from 12 Australasian countries provided a consistent evidence that PE companies are more likely to achieve IPOs in countries with a superior environment.

### **3.3 Research Hypotheses**

We present our research hypotheses in this subsection

#### **3.3.1 Private equity stake and firm performance**

Considering the evidence discussed in the empirical finding of minority and majority stake in PE investment and owner-management, we align these two categories of investment stake with the agency theory, corporate governance, and institutional theories to determine how the effect of PE on firms varies with regards to minority and majority stakes. Battistin et al., (2016) propose that, (i) In majority investment, the reduction of agency cost is associated with an “institutional” superiority of PE investors as owners and they radically adjust firm’s strategic direction and also substitute the existing owners. (ii) In minority investments, the investors resources complement existing owners and in this case, reduction of agency costs may manifest through investors acting as active minority shareholders, monitoring controlling shareholders’ behaviour and their commitment to value creation. They add that, there is difficulty in predicting the net effect of the substitution of incumbent owners with majority investment representatives on entrepreneurship and strategic resources because as the investor brings in additional resources, those delivered by existing owners are less valued and lost within a short period. Achleitner et al., (2008) stated that, investors’ expertise is likely to be in areas such as financial engineering, management information systems, and strategy development. In minority investment, drawing on institutional theories, these investors expertise are augmented by the existing owner’s knowledge regarding the host country’s environment and possibly relevant industry and firm-related matter (Batistin et al., 2013).

Moreover, through majority investment, investors provide intensive oversight of their recipient firms operating in countries with weak institutions (Holderness, 2003). This is done through both board participation, informal visits and involvement in key strategic decisions in countries where institutional and regulatory framework is generally inefficient (Holderness, 2003; Maury & Pajuste 2005). Advocates note that majority stake provides superior form of governance, while opponents depict them as an illusion to transfer value from entrepreneurs to corporate raiders at the expense of the long- term growth and profitability of recipient firms



(Battistin et al., 2013). We therefore expect the differential effects of minority and majority stake to be stronger in emerging economies where institutional effects play critical role in business success. Though Common-law countries are ascribed with strongest legal protection of minority shareholders (La Porta et al., 2000), in Ghana, relatively, corporate governance and minority's interest protection is strong in listed firms but weak in unlisted firms leading to increase in agency cost and increasing dispute resolution at commercial courts (Agyemang & Castellini, 2015). On the other hand, the maximum stake a private investor could invest is 49.9% of the market value of the firm. Thus, the threshold of 50% majority is not applicable and we ascribe majority and minority status based on how high or low the shares acquired by PE investors are. These empirical findings, coupled with the national characteristics of Ghana, lead us to formulate the following hypothesis:

*H<sub>1</sub>: There is a positive relationship between private equity investment and performance of the recipient firms.*

### **3.3.2 Private equity, founder involvement in management and recipients' performance**

We now investigate how the involvement of founders/entrepreneurs in the management of PE firms can impact recipients' performance. Previous research works on the involvement of founders/entrepreneurs and founding family in management show that such firms are associated with superior performance (e.g., Randøy & Goel, 2003; Adams et al., 2009; Fahlenbrach, 2009). We believe such analysis in literature concerning founder-management and firm performance can also be extended to the PE industry. The positive impact of founders on firms as previous literature suggests may be explained from the social and human capital that founders might have built over time. This is because an entrepreneur starts a business by building networks and accumulating resources which are key to the survival of the business. The entrepreneur/ founder also carries the overall direction and innovation surrounding the business. Thus, when PE investors come on board their human and social capital augment that of founders and in a whole, enhance performance of the firms.

Randøy & Goel (2003), suggest that founder-led firms are associated with low agency cost which may be exploited for strategic purposes. According to Cumming et al (2007), private firms are usually owned and managed by a small, concentrated group of shareholders and could have lower pre-investment agency costs. Theoretically, it is also argued that PE can improve the operations of supported firms by reducing agency costs (Jensen 1986; 1989).

Thus, from agency perspective, the small concentrated nature of shareholding with active close monitoring help reduce agency cost to increase the performance of recipients. On the other hand, the institutional framework existing in a country may serve as hindrance to benefits discussed. Cognitive element of institutions including subconsciously accepted rules and customs as defined by Bruton et al., (2004) can harm firm performance. In countries like Ghana where favouritism and nepotism is an acceptable norm there is the tendency for private ownership and owner management to limit external control causing owners to adopt behaviours that are not economically motivating (Batistine et al., 2016). The founder may favour people for example appointing directors onto the board which can be detrimental to firm's performance leading to aggravation of the agency problem.

However, we argue that the overall motivation and willingness to succeed attitude of founders/entrepreneurs should supersede any desire to engage in nepotism or favouritism (Randøy et al., 2013). Hence, we hypothesize:

*H<sub>2</sub>: There is a positive relationship between founder management and performance of recipient firms.*

### **3.3.3 Private equity, board size and recipients' performance**

The effectiveness of corporate governance mechanisms depends on both the institutional framework and their enforcement (Munisi, Hermes & Randøy, 2014; Luio, Chao & Yang, 2016). This may be in the right direction as the enforcement of laws depends on how the institutions in a country functions. Moreover, fund managers close monitoring of the firms in which they have invested by actively joining the board of directors and taking part in proceedings reduces agency cost (Kaplan and Stömberg, 2003). Munisi & Randøy (2013), find that the corporate governance index score has a positive and significant association with the companies' accounting performance (ROA). Kajola (2008) argues that firms should ensure a limit on their board size. PE backed firms typically have relatively few board of directors (usually five to eight) (Wruck, 2008). Therefore, the PE corporate governance model implies small boards for superior performance. In developing our next hypothesis, we follow Yermack, (1996, p 189) argument that "firm value depends on the quality of monitoring and decision-making by the board of directors, and that the board's size represents an important determinant of its performance". Ribiero et al. (2008), opine that PE as a model was started from U.S to most emerging markets and invariable the structures underlying its success will

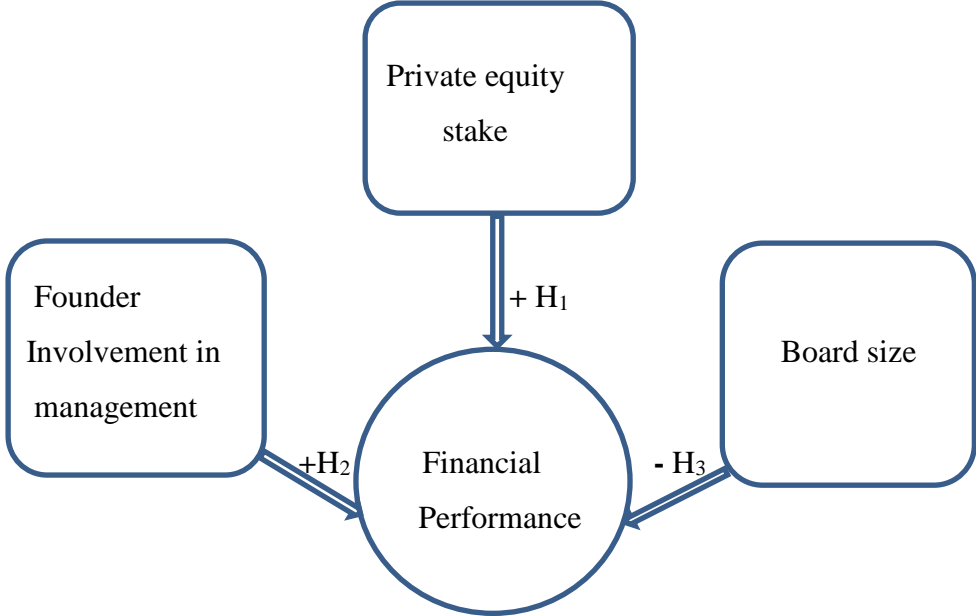
be different from these emerging markets. Their argument may be correct considering the lack of transparency and difficulty in doing business in these countries. Given the different institutional context in both developed and emerging countries, the dilemma now is whether the findings of negative association between board size and performance (see Lipton & Lorsch 1992; Jensen, 1993; Yermack, 1996; Eisenberg et al., 1998) will still be present in emerging countries and most importantly Ghana, the country of analysis. Thus, we formulate the following hypothesis:

*H<sub>3</sub>: There is a negative relationship between the board size of private equity recipient firms and financial performance.*

**3.4 Conceptual framework**

Based on agency, transaction cost, institutional and corporate governance theories, as well as the empirical findings discussed above, we present the conceptual framework for the study. The framework is based on the relationships established by the research hypotheses (H<sub>1</sub>, H<sub>2</sub> and H<sub>3</sub> in the section. The framework is shown in Figure 3.1.

**Figure 3.1: Conceptual framework**



*Source: Authors' own construct*

### **3.5 Chapter summary**

In this chapter, we presented the main theories which the study is based on. We also reviewed and commented on previous empirical finding on the research topic. Finally, we ended with the hypotheses for the study.

## CHAPTER FOUR

### DATA

#### 4.0 Introduction

In this chapter, we describe the data for the research as well as the sampling and data collection procedures. Again, we discuss the validity and representativeness of the data.

#### 4.1 Data source and sample description

Data may be obtained from two main sources; primary and secondary sources. “Primary data refers to information obtained first-hand by the researcher on variables of interest for the specific purpose of the study whereas information gathered from sources that already exist is a secondary data” (Sekaran & Bougie, 2013, p 113). We employ both primary data and secondary data sources for this cross-sectional analysis on the impact of PE funding on financial performance of recipient firms. Despite primary data sources being our focus to obtain real field data, secondary sources also played eminent role

Because of the relatively small number of active PE fund managers in Ghana and the unknown status of some of investment advisors as at the time of the study, purposive sampling technique was used in this study. According to Agyemang & Castellini (2015), at the beginning of 2013, 91 investment advisors had been licensed by the Securities and Exchange Commission of Ghana but their operational status as at 2015 was unknown mainly because the Securities Industries Law, 1993 (PNDCL 333) does not capture PE or venture capital investments Therefore, only the list of firms provided by the Ghana’s Venture Capital Trust Fund was included in the survey to avoid the tendency of using false information from “legally unrecognised PE fund managers. The study surveyed the entire population of 5 fund managers and 28 investee firms recognised by the VCTF shown in below (Table 4.1) with a 100% response rate. However, cleaning of the data for missing information, outliers and inconsistencies resulted in 23 recipient firms. Detailed descriptive statistics and discussion of the impact of PE on these firms are presented in chapter 6.

Thompson (1999) posits that, sampling technique in qualitative or mixed study is guided by the need to select subjects and data possible to produce robust, rich and unfathomable levels of appreciation but not strictly by the need to generalise about something. Bleijenbergh, 2010; Mills et al., 2010; Fletcher & Plakoyiannaki 2010 opine that, sampling for studies using a case as evidence is about suitability, objective and access to adequate information rather than

general representativeness as in the case of pure quantitative research. This study used the purposive sampling technique where legally recognised firms were selected to provide rich evidence. To mirror the image of how PE funding has impacted firms in Ghana rather than conjecturing and accepting what is supposed to have taken place with regards to theories on the relationship between firms' performance and PE investment in emerging markets, this technique was used. The survey covered financial performance of the recipient firms as at the year 2015 and the corporate governance mechanism employed by the fund managers in the recipient firms. Prospects of the entire PE industry and investment environment in Ghana were also explored.

**Table 4.1 List of Private equity fund managers, recipient firms and industry focus**

	<b>Fund Managers</b>	<b>Recipient Firms (Ltd firm)</b>	<b>Industry Focus</b>
<b>1</b>	Gold Venture Limited	<ol style="list-style-type: none"> <li>1. Caltech Venture</li> <li>2. Graphic Colour</li> <li>3. Villa Monticello</li> </ol>	<ol style="list-style-type: none"> <li>1. Agro-processing</li> <li>2. Digital printing</li> <li>3. Hospitality</li> </ol>
<b>2</b>	Bedrock Venture Capital Financing Limited	<ol style="list-style-type: none"> <li>1. Allied Cocoa</li> <li>2. Elsa</li> <li>3. Scientellect</li> </ol>	<ol style="list-style-type: none"> <li>1. Manufacturing</li> <li>2. Agro-Processing</li> <li>3. Agro-Processing</li> </ol>
<b>3</b>	Ebankese Fund Limited	<ol style="list-style-type: none"> <li>1. Builders Accessories</li> <li>2. GH Housing</li> <li>3. Pentfield Schools</li> <li>4. Redrow Developments</li> <li>5. Rising Sun school</li> <li>6. Wenchi Rural Bank</li> </ol>	<ol style="list-style-type: none"> <li>1. Manufacturing</li> <li>2. Real Estate</li> <li>3. Education</li> <li>4. Real Estate</li> <li>5. Education</li> <li>6. Financial Services</li> </ol>
<b>4</b>	Activity Venture Finance Company Ltd	<ol style="list-style-type: none"> <li>1. African University College of Communications</li> <li>2. EKA Processing</li> <li>3. Immanuel School</li> <li>4. J&amp;Q</li> <li>5. Natural Scientific</li> <li>6. Vestor Oil</li> </ol>	<ol style="list-style-type: none"> <li>1. Education</li> <li>2. Agro-Processing</li> <li>3. Education</li> <li>4. Manufacturing</li> <li>5. Healthcare</li> <li>6. Manufacturing</li> </ol>
<b>5</b>	Fidelity fund II Financing	<ol style="list-style-type: none"> <li>1. Diagnostic Centre</li> <li>2. Emerald Properties</li> <li>3. LaGray</li> <li>4. Process &amp; Plants GH.</li> </ol>	<ol style="list-style-type: none"> <li>1. Healthcare</li> <li>2. Real Estate</li> <li>3. Healthcare</li> <li>4. Real Estate</li> </ol>

**Table 4.2 List of Firms on the Ghana Stock Exchange used as control group**

<b>Listed Firms (Limited)</b>	<b>Industry Focus</b>
1. African Champion Industries	Manufacturing
2. Aluworks	Manufacturing
3. AngloGold Ashanti	Mining
4. Ayrton Drug Manufacturing	Healthcare
5. Benso Oil Palm Plantation	Agro-processing
6. CAL Bank	Financial Service
7. Camelot Ghana	Digital printing
8. Clydestone Ghana	Financial service
9. Ecobank Ghana	Financial service
10. Enterprise Group	Financial service
11. Fan Milk	Manufacturing
12. Ghana Commercial Bank	Financial services
13. Ghana Oil Company	Oil & Gas
14. Golden Star Resources	Mining
15. Guinness Ghana Breweries	Manufacturing
16. HFC Bank (Ghana)	Financing services
17. Mechanical Lloyd Company	Automotive
18. Mega African Capital	Financial service
19. Pioneer Kitchenware	Manufacturing
20. PBC	Agro-processing
21. PZ Cussons Ghana	Manufacturing
22. Sam-Woode	Digital printing
23. Societe Generale Ghana	Financial services
24. SIC Insurance Company	Financial services
25. Standard Chartered Bank Ghana	Financial services
26. Starwin Products	Healthcare
27. Total Petroleum Ghana	Oil & Gas
28. Transaction Solutions Ghana	Financial Services
29. Trust Bank (The Gambia)	Financial Services
30. Tullow Oil	Oil and Gas
31. Unilever Ghana	Manufacturing

#### **4.2 Data collection techniques**

Two sources of data collection techniques were used to gather data: archival records and semi-structured interviews. This multi-approach technique was used to maximise the series of hard-to-get available quantitative and qualitative data from the recipient firms and fund managers. These techniques enhanced the data credibility, served as an edge for triangulation among the two methods and gave a differing view about the subject matter as well

compensating for their intrinsic weaknesses. Hence the strength of archival records and semi-structured interview techniques in primary and secondary data collection were fully exploited. Archival records were first examined before the interview sessions to acquire historical backgrounds of the firms. Patton (1990, p. 245) posits that archival records' "analysis provides behind-the-scenes look at the program that may not be directly observable and about which the interviewer might not ask appropriate questions". Lincoln & Guba (1985, p. 27) buttressed this by viewing archival records as: "a stable source of information that may accurately reflect situations that occurred at some time in the past and that they can be analysed and re-analysed without undergoing changes in the interim". Prior to the interview section, annual reports, publications, press releases, periodical reports by the VCTF on the portfolio companies were monitored to get the snap shot on the performance and governance mechanisms in the recipient firms.

Goulding (2002), posits that, in a more realistic manner, a case study made of partly/fully qualitative research must use a face-to-face, semi-structured, open-ended, ethnographic, in-depth conversational interview. The justification is that it has the possibility to produce rich and comprehensive accounts of a person's experience. Face-to-face interviews were conducted with investment managers of the fund managers who later help reveal the identity of their recipient firms. The management/owners of recipient firms were further contacted for interviews at their respective business premises. Respondent groups were not influenced by each other and hence information gathered were given at their free will without duress. During the interview session, relevant and interesting developments cropped up that were not available in the archival records and others which in one way or the other contradicted the information in the archival data. The interviews took the structure of semi-structured interviews and was conducted in English and Twi (the widely spoken local language in Ghana). Interviews were tape-recorded and further notes were taken. In the context of this study, the interview session allowed the interviewees to articulate themselves in a more candid manner and defined the PE industry in Ghana not only as answers to the questions posed but from their own viewpoint.

#### **4.3 Data representativeness, validity, reliability and authenticity**

As stated in the data source section, the study surveyed the legally recognised firms in the PE industry in Ghana by the GVCTF which consisted of 5 fund managers and 28 recipient firms with a 100% response rate. To ensure data credibility and reliability, geniuses and



consistency in accounting methods and figures reported in the financial statements of the recipient firms, only financial statements audited independently by certified auditing firms were used in computing their profitability measure (ROE). Furthermore, to ensure authenticity of financial statement used for the analysis, we gathered the financial reports from three sources; the recipient firms, the fund managers and the VCTF reporting on the same year under review for the same companies. For the control group, financial statements of 31 publicly traded companies were extracted from archives of Ghana stock exchange to access their performance in terms of profitability (Table 4.2). The computed profitability measure (ROE) of these listed companies were also cross-checked with archival data provided by Wall Street Journal<sup>12</sup> on these listed companies. Detailed descriptive statistics and discussion of the data of the recipient firms are presented in chapter 6.

#### **4.4 Chapter summary**

Given our research objectives and with the purposive sampling method, archival records and semi structured interviews were used in collecting both secondary and primary data respectively. We created a Storehouse of information from the given sample which we believe is a true representation of the population that is needed to achieve the aim of the study and ensure generalisability of our findings.

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<sup>12</sup> <https://www.wsj.com>

## **CHAPTER FIVE**

### **METHODOLOGY**

#### **5.0 Introduction**

This chapter focuses on the research methodology for our work. We provide a detailed discussion of the techniques and procedures that will be followed to analyse the data. Thus, the process we will go through to measure concepts and answer the research questions.

#### **5.1 Operationalisation and measurement of concepts**

The “reduction of abstract concepts to render them measurable in a tangible way is called operationalising the concepts” Sekaran and Bougie (2013, p. 200). Operationalisation thus help to make concepts measurable to test hypothesized statements and have answers to the research questions. The main concepts in this mixed method research include; corporate governance and PE financial performance. We select specific measures for the various concepts based on previous empirical studies.

##### **5.1.1 Independent and dependent variables**

The dependent variable for answering our research questions is a measure of firm profitability as found in literature especially we follow Bruton et al. (2010) for the first research question and Yermack, (1996); Eisenberg et al., 1998 for the second research question. The independent variable for the first research question is equity stake of investors’ in recipient firms. We use corporate governance variables as independent variables to help answer the second research question; board size and a dummy for founder involvement in management.

##### **5.1.2 Control variables**

In this study, we include controls in our analysis as found in literatures relating to PE research and corporate governance (Yermack, 1996; Eisenberg et al., 1998; Bruton et al., 2010). The controls are firm specific in nature. They are age of the firm, size (log of total assets) and industry of operations. However, given our small sample size we add one control variable at a time. In Table 5.1 below we explain or identify the measures for the variables; dependent, independent and controls. The expected relationship between the dependent and independent variables are presented in table 5.2

**Table 5.1: Explanation of variables**

<b>Variables</b>	<b>Explanation/Measure</b>
<b>Private Equity Variables</b>	
Private equity stake	Fund managers' equity stake in recipient firms
Amount invested	Amount invested by fund managers in recipient firms
Private Equity	Identity of the five fund managers
Origin of funds	A dummy variable with value of (1) if funding is sourced locally and value of (0) if funding is a combination of both local and foreign sources
<b>Performance Variables</b>	
Growth rate	Annual percentage change in sales (revenue)
ROE	Return on Equity (Net profit as percentage of total shareholders' equity)
<b>Corporate governance variables</b>	
Founder management	A dummy variable with value of (1) if the entrepreneur is part of management and value of (0) if the entrepreneur is not part of management
Private equity on board	Number of private equity investors representation on recipients' board.
Board size	Number of directors on the recipients' boards
<b>Firm specific variables</b>	
Size	Log of total assets
Age	Number of years the firm has been in operation
Industry	A dummy variable with value of (1) if the firm operates in the financial services industry and value of (0) for otherwise
Number of employees	Recipient firms total number of employees as at 2015

**Table 5.2: Expected relationship between dependent and independent variables**

<b>Independent variable</b>	<b>Expected Dependent variable (ROE)</b>
<i>Private Equity variable</i>	
Private equity stake	+
<i>Corporate governance variables</i>	
Founder involvement in management	
Board size	+
	-

**5.2 Data analysis techniques**

To access the impact of PE funding on recipients we adopted a mixed methodology. A concurrent mixed method procedure is used. This strategy characterised an attempt to cross validate and confirm findings within a single research work using two different methods (Creswell, 2003). We therefore apply both quantitative and qualitative techniques in analysing our data. Given the limited sample size, we believe the integration of both methods will help enrich and triangulate our findings and interpretations. The data analysis begins with a descriptive statistic to help familiarise ourselves with the dataset and various variables relating to the recipient firms. Descriptive statistics is said to be a useful way of summarising a dataset and the simplest means of statistical analysis (Fisher & Marshall, 2009).

The first stage of the analysis is focused on answering the first research question. To assess the impact of PE on recipient firms, we explore t-test, bivariate correlation and regression models. To assess if there is significant difference between PE firms’ performance and that of listed firms, we perform an independent t-test. This involves comparing the means of the performance variables and for such analysis sample t-test is appropriate (Sekaran & Bougie, 2013). The bivariate correlation analysis is used to study the association between PE variables and performance variable. The focus here is to measure the extent of the association which

will argue the univariate analysis. We also conduct a linear regression test where our dependent variable is ROE with PE stake as the only independent variable. The limited sample size places restrictions on our ability to include more explanatory variables. We control for firms' specific effects one at a time. We also present summary of themes from the interviews related to PE performance. The use of bivariate correlation and linear regression are the quantitative techniques adopted to answer the second research question. In the regression analysis, ROE is the dependent variable with board size and a dummy variable for founder involvement as the independent variables. We also add controls for firms' specific effects. The transcribing of recorded interviews and summarizing themes will also offer further explanations to the findings from the quantitative data analysis techniques.

**5.3 Regression equations**

In this section, we present the equations for our regression analysis. We conduct the regression analysis with nine regression equations controlling for firm specific effects.

- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>PE\_stake<sub>i</sub> + β<sub>2</sub>Size<sub>i</sub> + ε<sub>i</sub>.....(1)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>PE\_stake<sub>i</sub> + β<sub>2</sub>Industry<sub>i</sub> + ε<sub>i</sub>.....(2)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>PE\_stake<sub>i</sub> + β<sub>2</sub>Age<sub>i</sub> + ε<sub>i</sub>.....(3)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>DM\_Founder\_Mgt<sub>i</sub> + β<sub>2</sub>Size<sub>i</sub> + ε<sub>i</sub>.....(4)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>DM\_Founder\_Mgt<sub>i</sub> + β<sub>2</sub>Industry<sub>i</sub> + ε<sub>i</sub>.....(5)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>DM\_Founder\_Mgt<sub>i</sub> + β<sub>2</sub>Age<sub>i</sub> + ε<sub>i</sub>.....(6)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>Board size<sub>i</sub> + β<sub>2</sub>Size<sub>i</sub> + ε<sub>i</sub>.....(7)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>Board size<sub>i</sub> + β<sub>2</sub>Industry<sub>i</sub> + ε<sub>i</sub>.....(8)
- ROE<sub>i</sub> = β<sub>0</sub> + β<sub>1</sub>Board size<sub>i</sub> + β<sub>2</sub>Age<sub>i</sub> + ε<sub>i</sub>.....(9)

Where;

ROE = Return on equity, PE\_stake =Private equity investors' stake in recipient firms and  
 DM\_Founder\_mgt = Founder involvement in management

**5.4 Test of assumptions**

This section focuses on testing the assumptions underlying OLS regression. These include; multicollinearity, autocorrelation and heteroscedasticity.

### 5.4.1 Multicollinearity

There is exist the problem of multicollinearity if the independent variables in a model are highly or perfectly correlated. Multicollinearity issue arises because two or more independent variables contain the same information which will affect the predictive ability of the model (Sarstedt & Mooi, 2014). We test for this by generating a correlation matrix and Variance Inflation Factor (VIF) for the independent variables. The correlation matrix for the three equations is shown in table 5.3 while the VIF for the independent variable are presented in appendix i.

**Table 5.3 Correlation matrix**

	PE_stake	Board_size	D_Founder_age	Size	Industry	Age
PE_stake	1.0000					
Board_size	-0.3647	1.0000				
D_Founder_age	0.4118	-0.4183	1.0000			
Size	-0.4239	0.2513	-0.1708	1.0000		
Industry	-0.1087	0.5447	-0.2919	0.1492	1.0000	
Age	0.4727	-0.1588	0.3954	-0.0154	0.2206	1.0000

Hair et al (2010), opines that there is the problem of multicollinearity when the correlation value is greater than 0.9. From the table, the highest value is the correlation between board size and industry with a corresponding value of 0.5447. Therefore, since none of the correlation values is above 0.9 we conclude that there is the absence of the problem of multicollinearity. Also, turning to the VIF values, it shows multicollinearity is not a problem. By this we follow the suggesting given by (Sarstedt & Mooi, 2014) that a tolerance of below 0.10 indicates that multicollinearity is not a problem.

### 5.4.2 Test for heteroscedasticity

When errors of a linear model have, unequal spread or variance it results in the problem of heteroscedasticity which can lead to biased estimates if not corrected (Gujarat, 2003). To test for this, we use Breusch-Pagan test in Stata with a null hypothesis of a constant variance. The results are presented in table 5.4 below where the p-value in bold indicates the presence of

heteroscedasticity. Thus, we reject the null hypothesis for model ii and adopt a robust standard error approach to correct for the problem as found in literature (Sarstedt & Mooi, 2014).

**Table 5.4: Results for Breusch-Pagan test for heteroscedasticity**

Regression equations	X <sup>2</sup>	p-value
1	0.47	0.4941
2	0.72	0.3958
3	0.00	0.9766
4	2.52	0.1124
5	2.87	<b>0.0900</b>
6	4.55	<b>0.0328</b>
7	2.10	0.1469
8	1.26	0.2625
9	0.68	0.4090

### 5.4.3 Test for autocorrelation

The problem of autocorrelation exists in a linear regression model when the errors are dependent of each other. That is the errors tend to be correlated for any two observations (Sarstedt & Mooi, 2014). This problem also leads to inefficient estimates. We test for this by using Durbin-Watson test with a null hypothesis of no autocorrelation. The results are presented in Table 5.5. As before the p-values in bold indicate the presence of autocorrelation. Hence, we perform the analysis by using robust standard errors (Sarstedt & Mooi, 2014).

**Table 5.5 Durbin-Watson test for autocorrelation**

<b>Regression equations</b>	<b>Durbin-Watson d-statistic</b>
1	<b>0.719863</b>
2	<b>0.6694711</b>
3	<b>0.9272898</b>
4	<b>0.6220839</b>
5	<b>0.4997218</b>
6	<b>0.7723961</b>
7	<b>0.5198684</b>
8	<b>0.5246112</b>
9	<b>0.7412004</b>

### **5.5 Robustness check**

Using growth rate as dependent variable in first research question we perform further analysis on how PE impact financial performance of recipient firms. We also check the robustness of our board size effect results by extending the analysis to include listed firms. By so doing we seek to get an overall view in Ghana considering its legal status and institutional framework.

### **5.6 Chapter summary**

In this chapter, we explained the operationalisation of concepts and the techniques for analysing the data. We employ a mixed methodology approach where qualitative and quantitative techniques is to be used. By quantitative methods, we employ t-test, bivariate correlation and OLS regression techniques.



## **CHAPTER SIX**

### **PRESENTATION OF FINDINGS**

#### **6.0 Introduction**

The results of the statistical models used in analysing the data are presented here which will help in answering the research questions.

#### **6.1 Descriptive statistics**

This section presents summary characteristics of both PE recipient firms and listed firms in the dataset. Table 6.1 report the descriptive statistics of the dependent and the independent variables of the study.

Regarding the financial variables from the dataset, 7 out of the 23 PE recipient firms and 11 out of 31 listed firms achieved negative return on equity. On average the ROE of the PE recipient firms is 12% with the maximum 74% and minimum -80%. The story of negative returns was not evitable for the listed firms as the maximum, minimum, and average returns on equity are 112%, -104% and 5% respectively. Also, on average, the return on asset for both PE backed firms and listed companies were -16% and 6% respectively with the later having maximum of 94% and minimum of -28%, and maximum of 25% and -400% minimum for the former. Financial performance from the dataset proves that PE investors earn almost twice as the return equity investor earn in on the stock market. A t-test in chapter five will explain how significant the difference is.

In terms of age of the firms, on average, a PE firm is about 13 years old while its listed counterpart is about 38 years old. The maximum and minimum age of both PE firms and listed firms are; 31 years and 6 years, and 91 years and 7 years respectively. Also, the longest PE fund investment was 8 years with a minimum of 1 year and average of 4.6 years. The average value of assets held by PE firms in the dataset is US\$ 2,279,770 with US\$30,174 and US\$9,615,164 been the least and highest value of assets respectively. Listed firms have an average of US\$ 936,138,045 and the minimum and maximum asset base of US\$589,110.46 and US\$11,347,800,000 respectively.

The vast difference in the ages and asset base of PE firms and listed firms points to the fact that, most of the PE firms are at their growth stages. This is manifested in the PE growth rate

of 18% which is 6% higher than the growth rate of listed firms. Per the interview with the fund managers, it was revealed that, around 90% of exited deals yielded three folds of the of the amount invested. Considering the growth cycle of firms and the; age, asset, investment years and growth rate in the PE firms in the dataset, the negative and low returns of some PE firms may not imply poor performance but probably future returns for the current and immediate past investments may manifest in higher positive returns and act as turnaround for the least performing firms.

Whilst listed firms operate in ten different industries, the five PE fund managers in the dataset manage firms in 8 different industries with each firm employing an average of 61 employees, with 250 and 3 employees as maximum and minimum number of employees respectively. On the source of PE funding, local funds constitute majority (75%) of the total funds managed by the 5 general partners in the dataset and the combination of both local and foreign sources constituted the minority (25%). None of the PE investments was solely backed by foreign funds.

Turning to the share of ownership, in Ghana, legally, PE investors cannot own above 49% of the recipient firm. In the dataset, PE investors on average take ownership stake of 28%, minimum stake of 5% and maximum stake of 45%. The averages for the founder management dummy gives an indication that most founders of the PE backed firms play crucial role in the management processes since the ownership stake restriction invariably makes all investments minority. In the dataset, 65% of the sample firms have their founders being engaged in the management of the firms and 35% being the vice versa. The board size of the PE firms ranges between a maximum of 8 and a minimum of 3 members with an average of 5 while board size of listed firms ranges between a maximum of 11 and a minimum of 5 members with an average of 8. In addition to the attractiveness of Ghana highlighted in the previous section, overall, the variables in the dataset suggests that the PE industry in Ghana is young, small, very attractive and to an extent mimics the typical characteristics of the ignition stages of PE in most emerging markets. From the PE players' perspective, we consider the Ghanaian economy as a market with many investment opportunities.

**Table 6.1: Descriptive statistics for private equity recipient firms**

Variables	Obs.	Std. Dev.	Mean	Minimum	Maximum
<b>Financial performance variables</b>					
ROE	23	0.12	0.32	-0.8	0.74
Growth rate	23	0.18	0.30	-0.55	0.68
<b>Corporate governance variables</b>					
Board_size	23	5.26	1.10	3	8
DM_founder_mgt	23	0.65	0.49	0	1
<b>Private equity variables</b>					
PE_stake	23	0.28	0.11	0.05	0.45
DM_Origin_funds	23	0.26	0.49	0	1
<b>Recipients specific controls</b>					
Age	23	13.17	5.76	6	31
DM_Industry	23	0.04	0.21	0	1
Size	23	2,279,770.00	2,436,803.00	30,174.10	9,615,164.00

**Table 6.2: Listed firms' summary characteristics**

Variables	Obs.	Std. Dev.	Mean	Minimum	Maximum
<b>Financial performance variables</b>					
ROE	30	0.05	0.42	-1.04	1.12
Growth rate	30	0.11	0.33	-0.72	0.78
<b>Corporate governance variables</b>					
Board_size	30	8.3	1.73	5	11
<b>Listed firms' specific controls</b>					
Age	30	38.37	19.84	7	91
DM_Industry	30	0.40	0.50	0	1
Size	30	936,138,044.79	1,912,897,199.54	589,110.46	11,347,800,000.00

## 6.2 Private equity and recipient firms' performance

First, we assess the performance of PE firms by univariate t-test analysis and augment it with a regression analysis.

### 6.2.1 Results of t-test

The aim of the t-test is to compare the means of the two independent groups in this research. By comparing both listed and PE firms we seek to find out if there is a significant difference between their performance and an independent t-test allows that. The null hypothesis for this test is that there is no significant difference between the performance of the samples.

**Table 6.3: Results of t-test**

Variables	Means		t-statistic	p-value
	Listed firms	PE recipient firms		
ROE	0.04695	0.1216	0.7036	0.4849
ROA	0.05761	-0.1622	-1.3271	0.1904
Growth rate	0.1116	0.1812	0.7885	0.4340

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

From the above table, we find no significant difference between the performance of PE funded firms and listed firms. Considering the growth cycle of firms and response of the interview, PE fund managers were confident in high future returns for the current and immediate past investments. We therefore presume that, the lack of significant difference between the performance of PE funded firms and listed firms may change considerably in the next few years.

**Table 6.4: Results of correlation test between ROE, private equity stake and growth rate**

We follow the rule of thumb below in the interpretation of the correlation analysis; below 0.30 indicates a weak relationship, between 0.30 and 0.49 shows a moderate relationship and above 0.49 indicates a strong relationship between the studies variables (Sarstedt & Mooi, 2014; Cohen, 1988).

Variable	ROE	PE_stake	GR_2015
ROE	1.0000		
PE_stake	0.4456	1.0000	
GR_2015	0.2622	0.3937	1.0000

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

The results from the table above shows no strong statistically significant correlation between the variables. We however, observe a positive moderate association between PE stake and

ROE. PE stake also has a positive moderate association with growth rate. These associations, in line with our expectations was not overwhelming. Though the fund managers admitted during the interview sessions that they play imperative roles in financing, operations, strategies and governance activities of recipient firms, the legal restriction on the private ownership stake (maximum of 49%) in the country do limits such influences to a certain extent. Therefore, to draw a conclusion on a solid relationship, we use regression analysis in Table 6.5 in the next section to help answer the extent of association between the PE stake and ROE.

## 6.2.2 Results of regression analysis

**Table 6.5: Results for the effect of private equity stake on financial performance of private equity recipients**

	ROE	ROE	ROE	ROE
PE_stake	0.240 (2.16)**	0.207 (1.69)	0.233 (2.15)**	0.185 (1.45)
Size		-0.026 (0.68)		
Industry			-0.439 (1.47)	
Age				0.161 (0.90)
_cons	0.469 (2.72)***	0.770 (1.61)	0.478 (2.84)***	0.013 (0.02)
$R^2$	0.18	0.20	0.26	0.21
F-statistic	4.65**	2.49	3.54**	2.71*
$N$	23	23	23	23

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

Regressing ROE on PE stake without any controls, PE stake has significant influence on performance at 95% confidence level. Controlling for size, industry and age separately, we again continue with another regression of ROE on private equity stake. However, PE stake has significant effect on performance only when we controlled for industry. Both size and industry have shown negative relationships but have no significant influence on the relationship between PE stake and ROE. Age shows a positive relationship with performance but also not significant. Notwithstanding the relatively small sample size of the study, this result confirms the first hypothesis of the study of the positive relationship between PE investment stake in the recipient firms and their financial performance. We also observe that,

the relationship between PE stake and ROE in the bivariate analysis is consistent with the regression analysis. Cross verification of the results with interviews conducted with both the fund managers and recipient firms further validates the results in the regression analysis. “Private equity investors undoubtedly have enhanced our performance in various respect, and with our arching need in seeking repairs to our over indebted balance sheet, we would love to give more stake to them but the legal clause of 49% maximum is a limitation” an entrepreneur confirmed<sup>13</sup>. This attests to the significant influence that PE stake has on performance of recipient firms which almost 90% of the respondents from the recipient firms agreed during the interview session.

### 6.3 Corporate governance and overall performance of private equity recipient firms

In analysing how corporate governance affect performance of PE recipient firms we performance a bivariate correlation test and regression analysis. As noted earlier the small sample size limit our ability to add all the control variables at a time. We therefore regress each control variable one at a time. We first present the results of the correlation test followed by the regression analysis.

#### 6.3.1 Results of correlation test

**Table 6.6: Results of correlation test between ROE and Board size/Founder\_Mgt**

Variable	ROE	DM_founder_mgt	Board size
ROE	1.0000		
DM_founder_mgt	0.5136***	1.0000	
Board size	-0.6408***	-0.4070	1.0000

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

From Table 6.6 above we observe a significant high association between ROE and the corporate governance variables. The involvement of a founders in management has a strong positive association with ROE which is significant at 99%. Board size also has a strong negative association with performance which indicates that an increase in one will lead to a decrease in the order. But the most important question is the direction of causation, which is a very critical question that correlation analysis cannot answer. We will therefore turn to the regression analysis to help answer that. Board size also has negative moderate association

<sup>13</sup> All quotes used are transcribed recordings from our interviews conducted with fund managers and recipients

with the involvement of founder in management variable. This is to be expected as firms with huge board sizes invariably tend to be bigger ones and the founder or entrepreneur may no longer be part in running the affairs of the company.

The results of the bivariate analysis are largely to our expectations but it will be premature to draw conclusions based on only associations. We will therefore focus on the next section about regression analysis.

**Table 6.7: Regression result for board size effect on recipients' performance**

	ROE	ROE	ROE	ROE
Board size	-1.014 (3.89)***	-0.960 (3.60)***	-1.014 (3.36)***	-0.949 (3.74)***
Size		-0.291 (0.98)		
Industry			-0.000 (0.00)	
Age				0.212 (1.66)
_cons	1.784 (4.14)***	2.092 (3.92)***	1.784 (3.62)***	1.150 (2.04)
$R^2$	0.42	0.45	0.42	0.49
F-statistic	15.10***	8.02***	7.19***	9.56***
$N$	23	23	23	23

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$



**Table 6.8: Result for the effect of founder involvement on recipients' performance**

	ROE	ROE	ROE	ROE
Founder_mgt	0.340 (2.74)**	0.317 (2.53)**	0.308 (2.36)**	0.292 (2.06)*
Size		-0.368 (1.12)		
Industry			-0.256 (0.84)	
Age				0.122 (0.72)
_cons	-0.100 (1.00)	0.415 (0.88)	0.068 (0.63)	-0.374 (0.95)
R <sup>2</sup>	0.26	0.31	0.29	0.28
F-statistic	7.52**	4.43**	4.06**	3.94**
N	23	23	23	23

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

From the two tables, above, four distinct types of regression were performed for each independent variable. This as noted earlier, is largely based on the limited sample size at our disposal. Firstly, we regress ROE on both independent variables without any controls. We continue with a regression of ROE on the two independent variables separately while controlling for size, industry and age in each case.

The results above show that board size has significant influence on performance at 99% confidence level respectively in all the regression analyses performed. Founder involvement in management on the other hand is significant at 95% confidence level in all the analyses except when controlling for age for which it becomes significant at 90% confidence level. Board size has a negative relationship with performance while founder involvement has a positive relationship with performance. These results to some extent provide support for both H<sub>2</sub> and H<sub>3</sub>. Although our sample size is small for any strong conclusion, we believe it is consistent with the bivariate analysis as well our interviews with fund managers. Almost all the fund managers indicated the immense role attitude of entrepreneur or promoter has on the recipients' performance. Thus, where the attitude of the founder is questionable the fund managers must take drastic measures to salvage the situation. "...We found one instance where the promoter who was also the chief executive had proven beyond reasonable doubt

that he is not the person to take the firm to level that we anticipated so we asked him to step down or stop committing funds to the investment” noted one fund manager. One plausible explanation for the positive relationship between performance and founder involvement is the overall motivation that entrepreneurs bring on board bearing in mind that their returns at the end of the day is linked with the survival and performance of their firm in the long run. The negative relationship between board size and performance may also be because of the complexities in large numbers. Also, small board invariably will reduce coordination cost, increase the speed at which decisions are made.

Concerning the control variables, size and industry show negative relationships with ROE for both independent variables. Age on the other hand shows positive relationship with ROE when ROE was regressed on both board size and founder involvement in management. Yet none of these control variables show any significant results.

#### **6.4 Results for robustness check**

As indicated in section 5.5 we check for robustness of our results to research questions one and two. For question one, we regress growth rate on PE since some studies have shown that PE is associated with increase in growth rates (e.g., Boucly et al.; Battistin et al. 2016). The results are shown in the table presented in appendix ii (a).

We find significant positive relationship between growth rate and PE stake. The confidence levels are 95% without controls as well as when controlling for industry of operations. These are in line with our earlier results when ROE was used as the dependent variable. However, the positive relationship between growth rate and PE stake is at a confidence level of 90% when controlling for size. The result is also consistent with the bivariate correlation test where we observe a moderate positive association between growth rate and PE stake.

To check the robustness of our regression results on how board size has a negative relationship with ROE, we extend the analysis to include listed firms on the Ghana stock exchange. Here we add all the three control variables and controlled for 2015 growth rate in the second regression analysis. From the table in appendix ii (b), we observe at a 95% confidence level, there exist a negative relationship between board size and ROE. The 95% confidence level is the same with or without growth rate as a control variable. The results are consistent with earlier correlation and regression analysis in the PE industry. Here, age tends

to be the only significant control variable in the board size effect analysis. This presupposes that the performance of recipients is higher for old firms than for young firms. We believe this is the normal thing because young firms usually embark on investment activities which reduces their accounting performance although their growth rate and operating performances will be high.

## **6.5 Chapter summary**

We presented the findings in this chapter. On financial performance, we find that PE investment has a significant positive impact on recipient firms' performance but there is no difference between the performance of PE firms and listed firms. Also, the proportion of the PE stake held by private investors positively affect the financial performance of the recipient firms. These findings still hold even after controlling for firms' specific characteristics; size and industry. These findings are largely according to our expectation. On governance mechanism, we find that, the involvement of a founders in management has a strong positive relationship with ROE with a high significant level. Board size also has a strong negative relationship with performance.

## **CHAPTER SEVEN**

### **DISCUSSION OF FINDINGS**

#### **7.0 Introduction**

We discuss the findings of the study as presented in the previous chapter while relating them to the underlying theories and previous research works.

#### **7.1 Private equity and overall performance of recipient firms**

We measure overall financial performance in terms of profitability and efficiency. The discussion on the explored association between PE investment and recipient firms' performance are as follows:

Firstly, we compare the performance of PE recipient firms and listed firms. The descriptive statistics presented in the previous section reveal that on average, PE investors earn above twice as the return on equity investors earn from listed firms. However, the t-test reveals no significant difference. Also, the PE backed firms exhibit higher growth than listed firms. On growth, the results show that recipient firms are relatively younger than the listed firm and hence the difference is not over-striking. The bivariate correlation analysis explores a positive moderate association between PE stake and ROE. Also, PE has a positive moderate association with growth rate. A further regression of ROE on PE stake with and without controls (size, industry and age) proves that PE stake has significant influence on performance of recipient firms. This finding is consistent with Meles et al. (2014) and Jain and Kini (1995) findings that, PE-backed firms outperform other firms. Also, the finding is in line with the studies of other scholars (Kim & Cho 2009; Ueda 2004 and Kaplan & Strömberg, 2009; Boucley et al. 2011 and Chunj 2011). These scholars observed that, through PE recipient firms significantly improve their returns and efficiency.

This finding has a phenomenal resource implication as one recipient noted "...for the past three years, considering the difficulty in raising funds from banks and financial institutions, we have relied heavily on PE funding to keep the business running". "The entrepreneurial firms do confirm how our involvement has enhanced their performance not only through fund committed but also through our managerial and operational advice, strategic involvement and governance systems" a fund manager noted. Again, an entrepreneur noted that "...currently, our financial performance has improved more than a competitor-who is a friend and started

operations in the same year as we did and apparently with similar resource challenges. But I do attribute this success to the PE funds infusion which graced our innovative ideas” In this regard, PE investment facilitates the commercialisation of entrepreneurial ideas and growth of financially distressed firms through fund manager’s dynamic expertise, networks, knowledge and other skill-sets which are instrumental in the beneficiary firms’ performance. In a practical perspective, an example is of PE ability to improve the operations of firms through what the Private Equity Council, (2015) classified as the 4Cs: capabilities, clarity, culture, and capital. Previous finding including Kaplan & Schoar (2005), Hoskisson et al. (2013) and Klonowski (2011) argue that PE funding is concomitant with expertise and knowledge that enable recipient firms achieve superior performance. Our findings therefore support the argument of these scholars and confirms that, PE investors and fund managers having accumulated specific industry knowledge and expertise tends to provide detailed and professional guidance to recipient firms. This creates value and also enhances financial performance of recipient firms.

Secondly, we measure how the stake of ownership acquired by PE investors affect the overall financial performance of recipient firms. The correlation analysis shows no strong statistically significant association between ROE, growth rate and PE stake. PE stake however has a positive moderate association with growth rate. A further regression of ROE on PE stake with and without control (industry) still confirms the positive significant relationship between PE stake and recipient firms’ performance. These relationships, to our expectations was not overwhelming. From transaction cost perspective, our finding supports the assertion that, transaction cost is reduced by more efficient institutions (Williamson, 2000) and where institutions are inefficient, majority stake provides a superior form of governance (Battistin, 2006).

Although the fund managers admitted during the interview sessions in playing imperative roles in financing, operations, strategies and governance activities of recipient firms, the legal restriction on the private ownership stake (maximum of 49%) in the country may limit such influences to a certain extent. Cross verification of the results with interviews conducted further validates the results in the regression analysis. “Private equity investors undoubtedly have enhanced our performance in various respect, and with our arching need in seeking repairs to our over indebted balance sheet, we would want to give more stake to them but the legal clause of 49% maximum is a limitation” an entrepreneur noted. Also, “...with respect to the relatively weak and inefficient legal protections for minority interest in the country, we

prefer having a higher stake of ownership in the recipient firms to enhance governance and oversight and reduce agency cost” a fund manager noted. These findings attest to the significant influence of institutions restricting PE investments in the country. Almost 90 percent of the PE firm respondents confirmed during the interview session that, they need to enhance their oversight mechanisms to curb agency problems and that would be possible only through acquiring higher stake. Based on this finding we therefore accept hypothesis H<sub>1</sub>.

Altogether, we observe that the PE funding influences overall financial performance positively. Also, ownership stake has a positive significant relationship between PE stake and recipient firms’ performance hence we accept H<sub>1</sub>. Considering the legal limitation of the maximum ownership stake, it is difficult to predict the net effect of this positive significant relationship between PE stake and recipient firms’ performance should the threshold of ownership increases. Perhaps such relationship might change. In the next section, we proceed to reflect on the findings related to board size and founder management as corporate governance proxies.

## **7.2 Corporate governance and private equity performance**

As mention earlier, the second objective of this study is to assess corporate governance impact on the performance of PE recipients’ by using board size and the involvement of founder in management as measures for corporate governance. We observe consistent results from the use of correlation and regression techniques. Also, the findings are in line with the interviews conducted with PE fund managers and recipients.

We analyse how the involvement of the founder/entrepreneur in management affects performance. The result from this analysis is also consistent with both correlation and regression analyses. Also, the positive relationship between founder involvement and performance is in line with the views shared by fund managers. In effect, we are saying that the involvement of founders in running of firms or the co-ownership by top managers has positive impact on the performance of recipient firms. The finding is consistent with the PE model for corporate governance in developed countries which highlights co-ownership by top management and founder involvement (Wruck, 2008). The author further emphasises that co-ownership by top management help increase the profitability and overall financial performance of recipients. The result is also in line with the other empirical research works on how entrepreneur-CEOs/ founder-led firms impact firm performance in other industries

(e.g., Randøy & Goel, 2003; Adams et al, 2009; Fahlenbrach, 2009; Randøy et al, 2013.). We could explain this relationship using agency theory. From the agency and corporate governance perspectives, the interest of investors, management and/or founders will be aligned to promote superior performance. This is because the concentrated nature of ownership and management in recipient firms will help lower agency cost to promote superior performance (Randøy & Goel, 2003; Cumming et al., 2007). A fund manager opined that, "...most recipient firms are family-owned business which were ran to suit the preference of the owners". Therefore, fund managers must ensure that their interest and that of the recipients are aligned to impact firm performance. Moreover, the innovation and ideas behind these recipient firms are borne by the founders which will drive the firm to its anticipated level. Also, the founders may have established links and networks which may be sustaining the business operation, hence their continual involvement in management may be critical. Thus, in a way the attitude of founders has an impact on overall performance. As noted by one fund manager, "...we found one instance where the promoter who was also the chief executive had proven beyond reason doubt that he is not the person to take the firm to level that we anticipated so we asked him to step down or stop committing funds to the investment". Based on this finding we therefore accept hypothesis H<sub>2</sub>.

Concerning board size effect, we find a negative relationship between board size and performance. The finding is in conformity with that of Jensen (1993), Yermack (1996) and Eisenberg et al. (1998). Most importantly, in the context of PE, the finding is consistent with the suggestion given by Wruck (2008) that smaller board size have a positive impact on performance. The result therefore implies that recipients can achieve superior performance (ROE) when they ensure a smaller board size. We believe that various reasons may account for this relationship especially when it comes to the PE industry. Ghana as a common-law country generally should emphasis the protection of minority especially when it comes to private investments. However, the institutional lax persisting in the country makes it difficult for fund managers to protect their interest without any pragmatic actions. As a fund manager noted, "...there is no specific law regulating the PE industry". It is therefore prudent for investors to ensure that they are represented on the board of recipient firms. Fund managers may also insist on the appointment of independent directors on the board. The board representation and the inclusion of independent directors may have implications from agency theory. As Eisenberg et al., (1998) suggest, the agency problems resulting from board size may reduce in firms with smaller boards

It has been noted that, large board size is associated with increased coordination cost, communication difficulties and increased exploitation power for the CEO/chairman of the board (Lipton & Lorsch, 1992; Yermack, 1996). Thus, the presence of a large board size will affect the ability of directors to efficiently and effectively monitor top management. This invariably may cancel out the important impact that board existence has on firm performance. A smaller board will allow directors to familiarise themselves with each other for effective and efficient discussions from their deliberations (Lipton & Lorsch, 1992) which helps improve the firm performance. In the PE industry, Wruck (2008) suggests five to eight members, however, we believe this may be too large for Ghana's (and some emerging markets) PE industry given the smaller nature of the recipient firms. Hence putting all together, we find a negative relationship between board size and return on equity, we therefore accept hypothesis H<sub>3</sub>. Perhaps as shared by all the interviewed fund managers, "the private equity industry is very small and still in its embryonic stage", therefore the board size effect will change when the industry grows or the effect will persist no matter the stage the industry will find itself in.

The findings of our study are robust and empirically supported across the various quantitative and qualitative techniques used in analysing the data.

### **7.3 Chapter summary**

PE funding positively influences overall financial performance of recipient firms. Also, the ownership stake owned by the PE investors has a positive significant impact on the financial performance of the recipient firms. The involvement of founders in management strongly influence the financial performance of the recipient firms positively. Conversely, large boards mar PE recipient firms' financial performance. These findings are theoretically and empirically supported.



## **CHAPTER EIGHT**

### **SUMMARY OF FINDINGS, CONCLUSION, IMPLICATIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH**

#### **8.0 Introduction**

Most emerging markets present new investment opportunities and some growth prospects that attracts PE investors. There has therefore been a growing interest in most emerging markets by PE investors. Although studies on PE have been well advanced in developed economies, there is limited focus on PE implications for emerging markets firms. We conduct our study on PE and corporate governance implications for emerging markets using Ghana as a case study. Our research focuses on how PE funding impact overall financial performance of recipients in emerging markets as well as how corporate governance affects such performance. The study fills an important gap in literature relating to impact of PE funding in emerging markets. It provides empirical evidence on recipient firm's financial performance and how corporate governance mechanisms do affect such performance. We adopt a mixed methodology in analysing the data.

#### **8.1 Summary of findings and conclusion**

We find that, PE backed firms have relatively higher ROE and growth rate than listed firms though the differences are not statistically significant which is partly limited by our small sample size and the corresponding low level of statistical power. Recipient firms with higher PE stake have high ROE and growth rate than recipient firms with small PE ownership stake. We also find that PE recipient firms that involve the founders in management irrespective of the stake are highly efficient in terms of ROE. Another finding on the board size of PE recipient firms supports the argument that, large board size influences financial performance negatively. We therefore conclude that infusion of PE funds, through minority or majority stake, invariably, has a positive influence on recipient firms' financial performance and higher ownership stake enhances such stimuli. Also, corporate governance mechanisms play a major role in enhancing the relationship between PE and recipient firms' financial performance. Our findings are robust and as well, they are empirically and theoretically supported.

## **8.2 Implications**

Our findings have important policy and practical implications for policymakers and the players in the PE industry. Firstly, policymakers should be aware of the trend of PE investors interest in acquiring majority stake and match it with the unlimited demand for the limited supply of capital in Ghana. Considering the institutional inefficiencies and limited protection of minorities in the country, acquiring a smaller proportion of recipient firms could unsettle some investor. Investors may worry that minority stake would leave them without enough influence on the recipient firms. Therefore, there is a tendency for PE investors to offset the risk of not having full control by forcing firms to accept low valuation on the stake they put up for sale. In effect, investors may generate high return at the detriment of recipient firm's long terms growth and profitability. These have strong implications for; policymakers in the institutional context (amendment of the maximum stake threshold and the enhancement of institutional efficiencies) and the investors and the recipient of funds in the context of PE (enhancing long term success of firms and stakeholders which is the spearheading relevance of PE as a financial model)

The implication for the board size effect is that PE investors must be weary of the need to seek more board representations and appointment of more outside/ independent directors as means of curbing agency problems. Recipients' must adopt a board size which is in line with their firm size. The size of the board must not be increased at the blind side of recipients' financial performance. Finally, founder management variable and its relationship with recipient' financial performance may also have implications for the PE industry. There is the need for investors to consider the overall motivation that founders bring on board and its effect on firms' financial performance. Founders/entrepreneurs must therefore be given the opportunity to actively get involve in the management to help ensure the continuity of innovations and inventions. However, there must be a limit to the founders' involvement as there is the tendency for some founders to seek their own personal interest which may mar overall performance.

## **8.3 Limitations of the study**

It is a fact that every research work is not without certain limitations, and our research is not an exception. An important limitation that needs not be overlooked is the small number of recipient firms used as a sample for the study. Given the lack of database for the PE industry

in Ghana, the sample used may not be a perfect representation of PE recipients in the country. This may affect the generalisability of our findings for other emerging markets.

#### **8.4 Recommendations for further studies**

The findings of this study paves way for further studies to be undertaken. A longitudinal research may be conducted, where the impact of the PE funding on recipients is assessed over time. This may be worthwhile as financial performance may change overtime. The explanatory variable such as PE investors stake may also change as the years go by as well as the corporate governance variables. Longitudinal studies would be able to detect PE effects over a period of time hence such studies are encouraged for future studies.

Again, using non-recipient firms of PE as a matched sample will set the pace for a new direction of analysis. By comparing these two distinct firms, it will help ascertain the extent to which PE adds value to their recipient firms.

Moreover, similar study on this topic could explore more explanatory variables. Other corporate governance variables such as board composition, board independence and performance rewards for senior managements. When assessing overall performance, the inclusion of amount invested as explanatory variable may also be worthwhile. This is because, PE funding comes with both financial and human resources and thus the amount invested will help assess how the financial resources brought in by the investors do affect recipients' performance.

Finally, similar study could be conducted with data from different country or countries to help test the reliability and validity of the findings of this study.

#### **8.5 Chapter summary**

In this chapter, we came out with conclusions from the discussion of our findings. Implications of the findings were also presented for policymaker and the PE industry as a whole. Certain limitations of the study were also presented and we also set the agenda for further research.

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## APPENDICES

### Appendix I: VIF result

Variable	VIF	1/VIF
Industry	1.00	0.998153
PE_stake	1.00	0.998153
Age	1.40	0.715490
Board_size	1.40	0.715490
DM_Founder_mgt	1.28	0.780538
Age	1.28	0.780538

### Appendix II: Results of robustness checks

#### Robustness check: Regression of growth rate on equity stake

	GR_2015	GR_2015	GR_2015	GR_2015
PE_stake	0.230 (2.23)**	0.202 (1.77)*	0.234 (2.26)**	0.1401 (1.24)
Size		-0.022 (0.63)		
Industry			0.266 (0.93)	
Age				0.261 (1.65)
_cons	0.515 (3.21)***	0.777 (1.74)*	0.509 (3.16)***	-0.268 (0.54)
R <sup>2</sup>	0.19	0.21	0.22	0.29
F-statistic	4.96**	2.61	2.90*	4.04**
N	23	23	23	23

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

**Robustness check: Further analysis of the effect of board size on financial performance of both listed and private equity firms**

	ROE	ROE
Board size	-0.533 (2.04)**	-0.527 (2.02)**
Size	-0.011 (0.45)	-0.008 (0.32)
Age	0.209 (2.59)***	0.188 (2.28)**
Industry	0.082 (0.64)	0.861 (0.67)
GR_2015		0.180 (1.11)
_cons	0.611 (1.83)*	0.590 (1.77)*
$R^2$	0.19	0.21
F-statistic	2.82**	2.52**
$N$	54	54

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$



## **APPENDIX III**

### **REFLECTIVE NOTES**

Written by: **Prince Baah-Peprah**

#### **1.0 Introduction**

In this reflective note, I present the findings and conclusion of this thesis and touch on the issues relating to the themes: innovation, responsibility and internationalization.

#### **2.0 Summary of thesis findings and conclusion**

The main theme of the study is “the impact of private equity (PE) on firms in emerging markets: evidence from Ghana”. The study used a multi-approach data collection techniques to collect primary and secondary data and adopted a mixed methodology in analysing the impact of PE on financial performance of recipient firms. The study finds that, PE backed firms have relatively higher return on equity (ROE) and growth rate than listed firms. The study further revealed that, recipient firms with higher PE ownership stake have significant higher ROE and growth rate than recipient firms with small PE ownership stake. On governance mechanisms, the study used founder management and board size as proxies to investigate how corporate governance affects the financial performance of the recipient firms. It was found that, PE recipient firms that involve the founders in management irrespective of the PE ownership stake are highly efficient in terms of ROE. It was also found that, large board size influences ROE negatively. Based on these findings, the study concluded that, infusion of PE funds, through minority or majority ownership stake, invariably, has a positive influence on recipient firms’ financial performance but higher stake enhances such stimuli. Also, corporate governance mechanisms enhance the positive relationship between PE and financial performance of recipient firms but subject to small board size and founder involvement in management.

#### **3.0 Innovation**

A long-standing controversy exist as to whether PE enhances the innovative ideas of entrepreneurs in the long run. Critics argue on the grounds of “myopia” and suggest that PE investors sacrifice the long-term value-adding expenditures such as R&D in the quest of smoothing earnings within the life time of their investments (average of five-to-seven-year).

Though ROE is positively related to PE according to this study, the relationship can be partly ascribed to the owners' adapted innovation strategy prior to the PE funds infusion. Also, the firms' financial performance might have been influenced by innovation strategy introduced by PE investors in commercializing the existing entrepreneurs' innovative ideas. The relationship between the two is often simultaneous and tricky to conclude without empirical studies. Generally, PE (venture capital) investors do nurture innovation in start-ups. This can be witnessed in the increasing number of born-global firms in developed markets. Most studies on PE in developed market confirm that, based on the ownership stake acquired by PE investors as well as their industry knowledge of entrepreneurs' core business operations, they install innovation processes such as; idea generation and evaluation processes, prototyping, testing, validation, and commercialization. But this association may not directly be replicated in emerging markets considering the vast difference in developed and emerging markets' institutions and economic development. For example, a typical evidence of institutional inefficiency was revealed during the interview sessions when respondents in pharmaceutical sector expressed their concern on the lack of sufficient protection of intellectual property rights such as patent (which is an outcome of investors' toil and sacrifice of short-term returns for investments in R&D). Also, particularly in small firms in markets with weak institutions (most emerging markets), uncertainty and informational gaps may affect innovative investments since it is difficult to curb agency problems such as moral hazard and information asymmetries. Implicitly, I assume that, PE is well suited form of funding in nurturing and financing innovative young firms in markets where institutions are efficient.

Therefore, innovation in firms in emerging markets should be a strategic priority of policymakers regarding institutional changes. But these changes should be accomplished without diluting the founders' ownership stake. As this study confirms, founders' original innovative ideas are imperative and their involvement in strategic decisions significantly influences financial performance and growth. This been said, the institutional changes could be achieved by establishing collective organizations such as technological centres that promote collaborative innovation and generic R&D programs among entrepreneurs and PE investors. I suggest that, policymakers of emerging markets could establish organisations solely responsible for intensive scrutiny of business plans of potential start-ups. A pool of attractive start-ups may then be made available to the public. With that, PE investors (local and foreign) and general partners with high-tech innovative ideas could identify suitable firms where they can deploy their competences and enhance both innovation and profitability.

#### **4.0 Responsibility**

PE as a financial model has been accustomed with the role of funding start-ups, private middle-markets, financially distressed firms, as well as public firms in need of buyout. But, PE investors have been severely criticised for exploiting recipient firms especially in emerging markets. Critics argue that, investors through strict corporate governance mechanisms gain excessive power and thereafter engage in firms stripping and quick flips that are detrimental to the firms' success in the long-run. Presumably, various actions implemented by PE investors are not solely because of their selfish interest of earning higher returns within the life time of their investments. These strict corporate governance mechanisms on the other hand, could be direct responses to the intuitional environment in the host country as well as the peculiar characteristics and behaviour exhibited by recipient firms during post-investment period. Most firms especially in less developed markets are entangled with unnecessary operating peripherals in their supply chain that add no value. An example in our case is a family firm that prior to PE funding, found it difficult to change a supplier and lay off redundant employees just because of family ties.

I therefore assume that investors strict oversight mechanisms cut cost and largely enhance financial performance which in a whole benefit all stakeholders. Nevertheless, I suggest that, the investors should not serve as a disability to recipient firms by focusing on their short term returns but should facilitate initiating phases of entrepreneurship in firms and further back them to go through their growth cycles. Suggestions on institutions such as those proposed in the innovation section would be useful here as well to enable PE fulfil its spearheading responsibility of funding financially distressed firms and nurturing young innovative firms.

#### **5.0 Internationalization**

Emerging markets account for a significant proportion of the global population and hence have become critical nodes in the global economic system. Therefore, growth of firms in these markets has a significant influence on international business. A critical factor marring the performance of firms in emerging markets is inadequate capital. Deducing from the concept of born-global firms, entrepreneurs in emerging markets with innovative ideas that are appealing to international investors and customers can turn their ideas into a commercialized concept and sell beyond their local boundaries if adequately funded. International PE investors therefore play an eminent role by enabling local firms gain access to international networks that catapult them beyond their local markets. Start-up firms aiming to step above bootstrapping stage, eyeing to sell their products and services globally and

subsequently get listed through initial public offerings (IPOs) must therefore subject themselves to; transparency, integrity and accountability as these factors boost foreign PE investors' confidence in firms. Emerging market firms engaging the services of internationally reputable accounting and audit firms would be a step in the right direction to source international PE funds and sell their products and services without boundaries.

## **Reflective note**

**by:** Priscilla Serwaah

### **1.0 Introduction**

By this reflective note, I seek to discuss the findings of the master thesis in relation to the three broad themes of University of Agder, which are internationalization, innovation and responsibility. Firstly, I will present the findings of the study.

### **2.0 Summary of thesis findings and conclusion**

This study was conducted on the topic: the impact of private equity (PE) funding on recipient firms in emerging economies. The study sought to assess how PE funding affect the financial performance of recipient firms and how through corporate governance mechanisms such financial performance of recipients may be impacted. An analysis of the data through both quantitative and qualitative methods showed that PE funding has a positive influence on recipients' financial performance when the investors have a higher equity stake in recipients' businesses. By corporate governance, it was revealed that the involvement of the founders of the recipients' in management activities do affect recipient' financial performance positively whereas a larger board size mars the financial performance of recipient firms. In conclusion, the acquisition of higher equity stake by PE investors impact recipients' financial performance positively. Again, through effective and efficient corporate governance mechanisms PE funding would enhance recipients' financial performance.

### **3.0 Internationalization**

Private equity funding may be seen as a tripartite relationship between limited partners, general partners (fund managers) and recipients. Although technically both limited partners and general partners are together the investors, I will be focusing much attention on the general partners as they have closer relationships with recipients and the limited partners tend to be 'just' providers of funds.

Thus, as fund managers (general partners) source funding from limited partners for onward investment in recipient firms, they may face challenges when it comes to the financial markets. The fundraising activities of fund managers in emerging economies are usually inadequate for onward investments. Hence most fund managers depend on other foreign sources of funding. Indeed, PE investment is projected to increase in emerging economies and the inadequate sources of local funding will force fund managers to compete with other

sectors to seek funds overseas. Foreign sources of funding may come from donor agencies and individuals and development financial institutions. Microfinance industry could be a key competitor for fund managers in the sourcing of foreign funds. Thus, the extent to which fund managers ensure efficiency, effectiveness, transparency, sanity and sustainability in their activities will determine their ability to raise more funds overseas. By acquiring higher stakes in recipients' firms, fund managers can effectively and efficiently monitor the businesses and drive it towards achieving superior performance as suggested by this study and other research works.

### **3.0 Innovation**

Private equity involves providing funds to unlisted firms who are usually small-scale business. The investors thus acquire equity stake in the recipient firms'. However, the equity position acquired by the investors may serve as a hindrance to potential small-scale businesses. From the interviews conducted one fund manager noted that "... most businesses tend not to appreciate the fact that it is good to owe say 10% of a bigger pie than to keep a small pie to yourself 100%". There is the notion among such businesses that when one receives funds from PE investors, it will pave way for the investors to take over his/her business. I therefore believe that for PE investors to affect changes in more businesses in emerging economies and their respective countries, they could offer more debt capital. According to corporate finance literature, debt holders may also be seen as owners of a firm. This is because in times of bankruptcy total ownership will go to debtholders. Such innovative meaning of funding recipients will make available to them cheap means of long term funding compared to bank loans which are usually short term in nature. The provision of more debt capital by the investors may be organised in a similar way as equity capital where investors bring professionalism, expertise and other resources needed to achieve superior performance. Effective monitoring and control may also be achieved using debt covenants which will either restrict certain activities of recipients or mandate them to undertake certain activities.

### **4.0 Responsibility**

Private equity funding comes with financial, human and other resources to improve recipients' financial performance. There is usually a time limit of at most ten years at which the investors will sell out their equity stake through initial public offering, buy-outs etc. In the hindsight, there is the tendency for investors to be only interested in high returns prior to exit

without caring about recipients' performance after exiting and in the long. This is an ethical challenge which if it persists at the back of fund managers' minds will affect the overall sustainability of recipient firms. Fund managers may undertake high risk investments which will be only beneficial in the short term. It therefore beholds on investors to deliver not only high returns but also leave a positive impact on those who benefit from their funds and expertise. This study shown that recipient firms achieve superior financial performance when founders/entrepreneurs are involved in management. I believe this may be a means of curbing the ethical challenge raised. By so doing the interest of investors seeking high returns are aligned with the founder/entrepreneur's wish of achieving both superior performance and sustainability of his/her business.