

DEPENDENT OR INDEPENDENT? THE PERFORMANCE CONTRIBUTION OF BOARD MEMBERS IN ITALIAN VENTURE-BACKED FIRMS

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Abstract

In this paper we tested the relationship between the IRR and the corporate governance choices of 87 Italian closed-end funds for the management of 698 private equity operations carried out from 1999 to 2003. In particular, we looked for information about the role of independent directors and their ability to stimulate firm growth and the closed-end funds final return, compared with the performance of dependent directors. We found no differences in the performance of venture-backed firms due to the presence of independent members in the board of directors, and concluded that this does not influence final results.

Keywords: IRR, independent member, corporate governance, closed-end fund, venture-backed firm performance

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1. Purpose

The finance literature shows that firm performance is related not only to market trends and competitive positioning, but also to corporate governance. The composition of the board of directors and the internal rules of governance directly affect firm performance. For that reason, regulators in many countries have established laws to promote effective corporate governance rules. Independent directors, i.e., board members not nominated by the owners, are recognized to provide additional value by promoting effective corporate governance. Several empirical studies have shown that the presence of independent directors (IND) positively affects firm performance. Internal codes, private bodies of rules within stock exchanges, and public authorities also promote the use of IND. In many countries, the profile of the IND is clearly defined by law and by rules.

Where firm performance has a great impact on public opinion and/or the number of stakeholders is huge (i.e., with listed companies, private equity-owned firms, state-owned firms, etc.) the use of independent directors is very developed in several European Union countries. In 2002, the British government commissioned an investigation of the role and effectiveness of independent directors on the boards of British firms. The report's key recommendations included the following:

1. At least 50% of board members should be independent.

2. The tenure of IND should be restricted to no more than two three-year terms.
3. IND should not hold options on company shares.

However, because of the diffusion and the use (or abuse) of that figure, it is necessary to investigate what effect IND has on firm performance.

The private equity sector represents a good potential area for investigating this phenomenon because of the potential for IND to promote fair corporate governance rules within the boards of venture-backed firms, and the impact of these firms' performance on the portfolio of private equity funds. Considering the increasing resources flowing into the private equity funds trough in all European countries, it becomes crucial to understand—for the evaluation of efficiency of the market—if IND are a profitable solution to improve or maximize the internal rate of return of closed-end funds investments. New evidence from these investigations could influence public authorities and regulators to clarify or re-designed the body of rules within IND and spur owners and management to make more efficient use of the IND's services within their boards.

2. Literature Review

A number of theories of board behavior have been developed over a long period of time. A brief review of these is given by Stiles and Taylor (2001), who identify three main bodies.

The Agency Theory focuses on the agent-principal relationship to further the understanding of the governing board. The agency relationship (or agent-principal framework) is a contract under which one or more persons, the principals, engage another person, the agent, to perform some services on their behalf. This involves delegating authority to the agent. Agency Theory incorporates important assumptions about managerial behavior being self interested, such as moral hazard and evincing bounded rationality. According to Gompers, Ishii, and Metrick (2003), the theory regards the board of directors as an instrument of control. Cronqvist, Henrik, and Nillson (2003) focused on the role of agency cost in controlling minority shareholders.

The Stewardship Theory proposes that there is no conflict of interest between managers and owners and that to be successful the organization requires a structure that allows coordination to be achieved most effectively. Muth and Donaldson (1998) found that the Stewardship Theory—in contrast to the Agency Theory—recognizes a range of non-financial motives of managers found in the occupational psychology literature. Examples include need for advancement and recognition, intrinsic job satisfaction, respect for the authority, and the work ethic.

The rise of the Stakeholders Theory, according to Gay (2002), was prompted by the growing recognition by boards of the need to consider the wider interest of society.

Gay lists the essential premises upon which the Stakeholders Theory rests, as shown by Jones and Wicks (1999):

(1) The firm has relationships with many stakeholders that affect, and are affected by, its decisions. The theory is concerned with the nature of these relationships in terms of both processes and outcomes and focuses on managerial decision-making.

(2) The interests of all legitimate stakeholders have intrinsic value, and no set of interests is assumed to dominate the others. Demsetz, Harold, and Villalonga (2001) show the presence of multiple goals within stakeholders' structure, according to the Stakeholders Theory.

Following and testing the above-mentioned theories, several studies have attempted to investigate the relationship between board composition and company performance, either in different countries or among specific types firms, such as publicly-owned, fast-growing, venture-backed, or family-owned firms. La Porta, De Silanes, and Shleifer (1999) went through a broad recognition. Anderson and Reeb (2003) pay specific attention to the family-owned case and to the role of board members not linked to the controlling family, finding specific evidence towards firm performance. Villalonga and Amit (2004) deepened the focus on family-owned firms, testing the relationships among

performance, rules of governance, and composition of boards. Faccio and Lang (2002) examine corporate governance rules with specific attention to institutional investors inside boards.

Researchers and studies on the private equity sector also pay attention to corporate governance structure and to the usage of IND. The corporate governance scheme is relevant for investors when it can improve the performance of the owned firm. The debate on closed-end funds and their management of venture-backed firms starts with Gompers and Lerner (1996) and moves through empirical evidence, almost all related to the US market, such as that provided by Gompers and Lerner (1998; 2000), Gottschalg, Phalippou, and Zollo (2003), Hellmann, Lindsey, and Puri (2004), and Kaplan and Schoar (2004). In a very recent work, Lerner, Schoar, and Wong (2005) deepen the characteristic of the board of directors of venture-backed firms to have specific evidence to drive investor choices within a long-period investment horizon. However, there is still no hard evidence defining the true performance profile of IND.

Fich and Shivdasani (2004) approached the theme of the IND from an economic viewpoint, looking for a relationship between busy outside directors and firm performance. In particular, they studied the question of whether having directors serving on several boards would affect financial and output performance. In fact, the common view among investors and policy advocates is that serving on numerous boards can result in overstretched directors who may not be effective monitors of any board. The results that Fich and Shivdasani obtained are not very clear because, on the one hand, companies with a majority of busy outside directors show significantly lower market-to-book ratios and weaker operating performance¹, but on the other hand, the presence of directors who hold more than one directorship was not more likely to occur in firms that are performing poorly. For this reason, these authors concluded that boards relying heavily on outside directors that serve on several boards are likely to experience a decline in their quality of corporate governance, even if the "measure" is firm-specific.

Belkhir (2004) investigates the relationship between board size and performance in a sample of banks and savings-and-loan holding companies. Contrary to theories predicting that smaller boards of directors are more effective, he found that increasing the number of directors in banking firms does not undermine performance. In particular, he thinks that performance and corporate governance are not as closely linked as previous studies declare (Lipton and Lorsch, 1992; Jensen, 1993) and that the number of directors is the effect of performance and not the

¹ Gompers, Ishii, and Metrick (2004) obtained the same findings using their "governance index."

contrary. In any case, Belkhir's results show that there is no negative relation between board size and performance in banking.

Adams and Mehran (2005) studied in depth the relationship between on the one hand, board size and composition and, on the other hand, Tobin's Q in banking firms, and found a surprising result: a non-negative relationship, which is contrary to the evidence for non-financial firms. As did Belkhir (2004), even these authors concluded that the connection between governance and performance in the banking industry is particular and has no correlation with other industries².

Bhagat and Black (2001), starting from the assumption that that a "monitoring board," composed almost entirely of IND, is an important component of good corporate governance, analyzed a wide sample of US firms and found no supporting evidence for this conventional wisdom. In particular, firms with more independent boards do not perform better than other firms in the long term.

Nevertheless, the authors do not suggest a return to the 1960s, when boards were insider-dominated and usually passive, but recommend that investors should not complain if companies experiment with departures from the current norm of a "supermajority independent" board with only one or two inside directors. A board with, for example, six IND, four inside directors, and one affiliated director, instead of nine IND and two inside directors, might bring subtle benefits. IND will still numerically dominate the board and can take appropriate action in a crisis.

Rowe and Davidson III (2002), studying the case of closed-end funds, concluded that the evidence that board composition influences financial performance is not very strong and depends on the definitions of financial performance and board composition as well as the type of econometric model utilized. Given this extremely weak relationship, it is difficult to establish that the relationship between board composition and financial performance is endogenous, even if some results suggest that financial performance influences board composition and that, for this reason, it appears that poor financial performance for closed-end funds causes the funds to increase the proportion of IND to boost their growth.

Prasanna (2005) investigated whether board independence has any influence in maximizing the value of some Indian firms. The empirical analysis did not produce evidence to confirm this relationship, but the author concluded that all these kinds of studies must be made over a very long period and in particular not during the phases of implementation of corporate governance reforms.

3. Testable hypothesis

The basic purpose of the present paper is to determine whether the presence of IND, which is well developed through venture-backed firms, is better able to spur firm performance than the presence of dependent members (DIP). Starting from this distinction, the aim is to demonstrate that the presence of IND has a strong positive effect on firm performance, while conversely the presence of DIP negatively affects performance. That is because DIP depend on the owner and their presence is not an effective tool of corporate governance.

Starting from here, the research hypothesis is defined as follows:

H1. If in the board of a venture-backed firm there are IND, their presence positively affects the firm's performance. The greater the number of IND, the more strongly this relationship subsists.

The main reason that should be so is that the main goal for a private-equity firm is not the internal rate of return but others. To reach other goals it is necessary to have deeper and more effective control over the board of a venture-backed firm. That is the reason they use DIP on their boards.

4. Data and methodology

Our empirical investigation will use a very articulated database of information about the Italian private equity market. The data were collected through questionnaires sent to 58 Italian private equity firms managing 87 closed-end funds. All the firms which responded and put the data at our disposal also signed an accord of non-disclosure of the data themselves if used namely. None of the companies studied is totally dedicated to start-up financing; however, startup financing investment is a minor part of certain closed-end funds portfolios. This is a traditional characteristic of investment firms in Italy and most other European countries, except the UK. The time period was 1999-2003, or 5 years of observation. The number of investments we examined was 987. From these 987 we extracted 698, representing all the investments started and closed through exit way or write-off in the study period. We did not consider private equity firms and funds born after 1999.

The quality and the originality/importance of data has to be qualified as follows:

1. Such a huge database doesn't officially exist in Italy.
2. The period 1999-2003 covers the topic period of Italian closed-end funds history because before 1999 there were very few investment funds. The first such investment was dated 1995.

² See also Hellman, Lindsy, and Puri (2004).

For all private equity firms investigated, we had at our disposal the following information:

1. The structure of ownership and of the boards of administration.
2. The number of funds and their amounts.
3. The balance sheet.

For each closed-end fund we had at our disposal the following information:

1. The number and typology of each single investment (balance sheet of the firm, dimension of the investment, characteristics of the sector of activity).
2. The structure of the board of administration, with the name and profile of each person sitting on the board.
3. The internal rate of return of the investment itself.

The people sitting on boards of directors were classified as independent or not and their names were matched with three official databases in order to determine how many other positions they held as members of administrative boards in other firms or institutions.

4. Empirical findings

Among 698 investments, we discovered 316 IND cases and 382 DIP cases. These data are extremely interesting and show the importance of IND in Italian venture-backed firms. In fact, in 45.72% of the whole sample, there are board members not directly linked with the financial institution that makes the financial intervention. We think that this finding is consistent with the private equity business

and the value that reputation and autonomy have in the development of relationships and funding actions. Moreover, recall that private equity is also a skill-based business and the choice of IND could be to compensate for a lack of competencies or expertise inside the financial institution. Table 1 shows the average IRR of the 698 investments, or the whole sample. As can be seen, there is no difference between the two sub-samples, and even the statistical Z-test shows no discrepancy. From an economic point of view this finding is extremely important, as it confirms that the presence of IND is not enough to improve performance for private equity investment. We use both total and yearly IRR because the length of private equity investments varies among firms and within objectives. For example, a turnover or leveraged buy-out operation has a very different time horizon compared with an early-stage financing operation. For a closed-end fund, this result implies that the reason for the use of dependent or independent human resources is not an intention to achieve future better performance, as an investment taken care of by IND will not necessarily be able to bring a greater return. Returning to the hypothesis of this paper, we demonstrated that the presence of IND does not affect venture-backed firm performance.

In order to understand the disparity between the extensive use of IND among private equity firms and the limited resulting economic and financial return, we made a deep analysis of this phenomenon, looking for a relationship between IND and exit ways, holding periods, and numbers of people sitting in the board of administration.

Table 1. Total and yearly average IRR

The IRR, or investment gross internal rate of return, is calculated by comparing the cash flows of all operations. The yearly IRR is an elaboration of the gross IRR and allows us to compare the performance of all investments whatever the length. Z is the result of the statistical Z-test utilized to judge differences among data samples.

	Total IRR	Yearly IRR
IND	33.79%	11.43%
DIP	34.93%	11.87%
Total sample	34.41%	11.67%
$Z = 0.467164$		

Table 2. Exit ways of the investments studied

The exit way is the strategy used by a closed-end fund to shut down its involvement in the firm. All data reported are measured on a number scale and not on a value scale to reduce biases due to differences among the different average values of each exit way cluster.

	IND	DIP
TRADE-SALE	85.44%	90.31%
IPO	7.91%	3.93%
WRITE-OFF	6.65%	5.76%

Table 3. Holding period and number of people belonging to the board of directors

The holding period represents the number of months in which the fund participated in the equity of the firm. The average number of people sitting in the board takes into account both executive and non-executive directors and chairman.

	IND	DIP
Average holding period (in months)	34.10	34.21
Average number of people sitting on the board of directors	5.99	6.05

With reference to the connection between the exit way used by private equity operators and the kinds of members on the boards, we used a simple two-type classification:

1. We identify as write-offs all cases where the investment fails and the firm goes to bankruptcy.
2. We identify as initial public offerings (IPO) all cases where the firm reaches the stock market independent of the choice of the closed-end fund either to sell or maintain shares.

Outside this classification, we identify as trade-sale the remaining cases where the exit strategy is the trade of the participation between the private equity operator and other financial investors or entrepreneurs.

Table 2 shows that an IPO as exit way is most probable if the board of administration includes an IND. Although the exit strategy could not be fixed with certainty at the entry date, private equity operators tend to use IND if they foresee the opportunity to reach the stock market. This choice is in accordance with the need for autonomy and monitoring activity that stock markets require of firms, because an outside member can ensure better satisfaction and involvement owing to his lower

potential for conflicts of interest. Moreover, the presence of an IND improves a closed-end fund's reputation and standing. The employing of this individual is well exploited in these situations because the IPO is the exit way that assures the greatest visibility to the firm and to the financial institution.

We assumed that the choice of an IND rather than a DIP was linked either to the holding period of the investment or to the size of the board of directors. In fact, the larger the board, the greater the visibility and reputation required for a director to have a significant voice in management matters, and only an IND would be able to guarantee this. As regards the time horizon of the investment, we thought that the longer the period, the greater the skills needed, and for this reason we expected a strong relationship between the holding period and IND.

Table 3 show that our hypotheses were wrong, as IND are not selected in accordance with these characteristics: in particular, the IND and DIP data are strictly similar, which could mean that closed-end funds do not pay attention to this element that depends on other variables such as the firm's corporate governance system or the investment qualities.

Table 4. Average investment size and IND vs. DIP

The investment size was calculated for each investment and not for each firm, in order to reduce biases attributable to dimension, sector, or age. The kind of investment is related back to the clusters proposed by the European Venture Capital Association.

(in €millions)	IND	DIP	TOTAL
EARLY STAGE	0.97	1.00	0.98
EXPANSION	3.67	3.83	3.76
BUY-OUT	15.88	15.83	15.85
TURNOVER	7.77	8.46	8.17
TOTAL	6.59	6.90	6.76

Table 5. Use of IND and DIP by kind of investment

Firms in which both INDs and DIPs are present, are twice counted, so compare in either columns of the table.

	IND	DIP
EARLY STAGE	16.14%	16.75%
EXPANSION	52.85%	50.00%
BUY-OUT	25.63%	27.23%
TURNOVER	5.38%	6.02%
TOTAL	100.00%	100.00%

Tables 4 and 5 summarize our findings for the Italian markets. We assumed that the choice of an IND rather than a DIP depended on the size of the investment or on the kind of private equity contribution to the development of the firm.

Concerning to the average size of the investment we did not find results that could support the relationship with the presence of IND. The preference for DIP or IND seems not be related to the amount funded. Nevertheless, we noted that the

average investment for a buy-out managed by an IND is two and a half times the size of the average investment, while for the same operation managed by a DIP the financial institution is inclined to fund an amount just little higher than double the average. From a management point of view, this could mean that for operations calling for precise and distinct skills such as a buy-out, closed-end funds prefer to entrust themselves to connoisseurs and, for this reason, look for them outside their organization,

especially when the amount funded is high.

However, we do not think this element in fact has a substantial effect on the final judgment, because the sources funded by a closed-end fund are related to the characteristics of the operation that must be designed or of the firm requiring subsidies. For this reason, having no data to support a deeper analysis, it might be concluded only that these results are associated with the elements that made up the sample.

As for the effect of the kind of investment, we find no differences between IND and DIP. Practically speaking, this aspect is not central enough to elicit separate approaches for selecting either IND or DIP. Moreover, this means that closed-end funds prefer to derive skills and expertise internally for all the types of operations that they might face during their life.

5. Conclusions and Further Research

Corporate governance practices and firm performance are themes that drew the attention of researchers during the last decade because of an increase in the number of audit scandals and unexpected defaults. Moreover, the existing empirical studies, which often do not agree, generally are not able to support the hypothesis that financial market operators think that better corporate governance must be related to better firm performance, and thus, better-governed firms should perform better than worse-governed firms.

In this paper we looked at a particular aspect of corporate governance and we studied in detail the role of IND in venture-backed firms. Our aim was to show whether this role is common and whether it is apt to improve the performance of closed-end funds. In fact, we think that a closed-end fund or manager decides whether to choose an independent person (IND) or a dependent (DIP) person for an organizational, supervisory, or monitoring function based on the skills, expertise, and competencies of the counterparty. For this reason, we expected our research to demonstrate a very strong connection between the presence of IND and the IRR of the investment.

We made up a highly articulated database

drawn from information about the Italian private equity market, involving 58 private equity firms managing 87 closed-end funds, for a total of 698 investments that were opened and closed in the period 1999-2003. We found that 45% of the whole sample showed an IND presence on their boards, but, contrary to our expectations, there were no correlations between IRR and IND. In Italian venture-backed firms, the presence of IND did not seem to stimulate the firm growth, nor that they worked less effectively than DIPs, but only that, for a closed-end fund, the use of IND could not ensure a final excess-return. Owing to these findings, we made a deeper analysis concerning the reason for this use, looking for connections between IND, DIP, and investment characteristics. Among these investigations, we found only two differences between the effects of IND and of DIP. The first related to the exit strategy expectation, and the second related to the amount funded and the skills required for certain types of investments. In fact, our sample showed that the presence of INDs is greater when closed-end funds predict an IPO as the exit strategy, probably due to the higher reputation and visibility effects of IND board members. On the other hand, for operations calling for precise and distinct skills, such as buy-out, financial institutions appeared to prefer INDs to DIPs when the amount funded was much higher than average.

We think that much more research is required to explain this surprising situation. We suggest an initial analysis looking for differences inside the IND group, because it is reasonable to assume that not all IND operate in the same manner, and this might aid in discovering the authentic reasons for their involvement. Next, we conclude that a closer study of IRR is needed in order to confirm the independence—or lack of connections—between the private equity and the stock and bond financial markets. Third, we think that the sample of all investments must be disaggregated among Small and Medium Enterprises and large firms, family and non-family firms, and staged and non-staged financial supports, in order to determine the significance of the counterparty organization and corporate governance.

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