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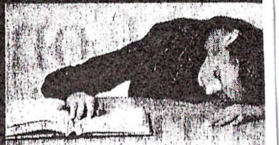

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# Pvt equity funds' role in improving corporate governance

Sumant Batra

INDIA is becoming a powerful magnet for private equity investment. The regulators are maintaining a close vigil on the private equity (PE) funds as mostly the investments are routed through tax heavens with little information disclosed about the investors. The policymakers perceive PE funds as short-term investors who typically exit the market in three to five years after making profits, having no long-term interest or commitment in the market. The public perception is no different.

Studies, however, establish that private equity investors can play an important role in emerging markets. Besides fulfiling the capital need of small and mid-size companies, which can not access funds from public market, the PE funds play a meaningful role in the life span of the investee company by bringing international experience, wealth of knowledge, strategic advisors and providing access to new customers, suppliers and business opportunities.

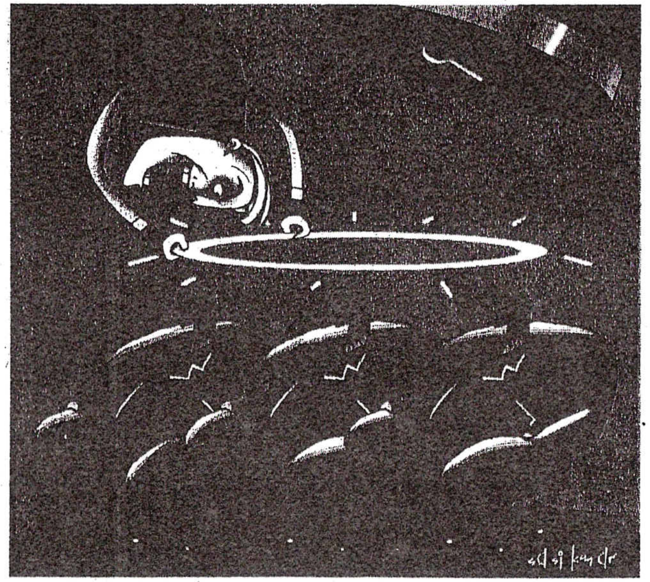
Policymakers across the world are beginning to recognise the role of PE funds in improving the corporate governance practices of non-listed companies. It is now well-acknowledged that PE managers are uniquely positioned to play a catalytic role in promoting sound governance practices and raising corporate governance standards of the companies they invest in or deal with because of their investment size, term and the positions held in board and management. They address the corporate governance issues from the stage when they meet with management to consider an investment to the time when a complete exit from the investment is made.

**LENDING STRENGTH**

**Unlike other shareholders, activist hedge funds and private equity could help strengthen corporate governance practices. They have incentive to make use of their shareholder rights**

The contribution of PE funds in improving corporate governance, in fact, starts at pre-investment stage without even there being any formal role in the company. The sheer possibility of their positive decision to invest is enough to influence management on governance-related issues through the assessment, questions and feedback made by PE managers. The due diligence carried out by PE funds helps in identifying corporate governance weaknesses of the company. Sometimes, putting the house in order is made a condition precedent for considering investment. Selection process reinforces good governance as well-governed companies get rewarded with investment, while others face rejection.

The role assumes a more formal and direct form after investment has been made because of the status as investors, and invariably, as board participants. PE managers engage in a wide variety of governance activities, ranging from customary exercises — such as validating management's business plan, counselling management on making the board more effective, or improving financial reporting and disclosure — to unusual undertakings, such as investigating financial irregularities or assisting management in corporate restructuring or acquisitions. The role is even stronger in a buyout or majority stake acquisition, where PE managers exercise not just influence but substantial control over a company's governance matters. The engagement becomes intense when PE funds take conscious decisions to invest in companies with poor governance due to commercial reasons but backed by confidence and understanding with the management that the corporate governance landscape must change for better.



**IN TANDEM**

**Policymakers and PE funds ought to work together for the betterment of corporate governance. The PE funds should create a platform to share their global experience and knowledge.**

PE funds use the investment transaction documents to make the management of the investee company agree to legal covenants requiring specific, time-bound governance improvements. The terms are generally inspired from the provisions of company law and international best practices. In practice, it is not the legal terms but the education and know-how of the benefits of corporate governance which drives the change for the better. Improvement in performance acts as an icing on the cake.

OECD has concluded on basis of available evidence that activist hedge funds and private equity could help strengthen corporate governance practices since they have incentives to make active and informed use of their shareholder rights, something which other shareholders might not have. Activist hedge funds generally do not seek to control or to own a company but to influence its policies from a position of strength arising from a significant ownership of shares in the target company (much larger that a normal mutual or pension fund) and through the ability to attract other investors to their cause. Their demands may include changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans, all of which are normally regarded as corporate governance issues.

Besides the investee company, the PE funds benefit the other companies in the market which can see the visible benefits of good corporate governance. They are inspired to introduce similar practice which, in turn, helps them in attracting investment and reducing the cost of capital besides getting better value for their shares.

It is important that the policymakers and PE funds work together on the corporate governance reform agenda. The PE funds must engage actively in the corporate governance debate, awareness building and work with the stakeholders in improving corporate governance landscape of non-listed companies. The PE funds should produce an effective platform to share and disseminate their international experience and wealth of knowledge of corporate governance. Their developmental contribution will assist in recognition of their true potential and help gain friendship of the gate keepers (regulators) who may be more considerate in their guidelines providing for foreign direct investment.

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