Entrepreneurial Orientation In Management Buy-Outs And The Contribution Of Venture Capital

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Abstract	This paper focuses on the development of entrepreneurial orientation (EO) after a management buy-out (MBO) and on the role played by venture capital firms in enhancing EO. It presents results of two exploratory case studies of divisional buy-outs with regard to their EO and the areas where the venture capital firm (VC) has been of greatest help. We discuss their contribution to elements of the EO of the buy-out firm. The key output is expected to be a better understanding of the functioning and operations of the VC with regard to their contribution to the EO of the firm after an MBO. This will also benefit the management team that seeks venture capital support to improve the firm's economic performance by using its upside potential.	
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ENTREPRENEURIAL ORIENTATION IN MANAGEMENT BUY-OUTS AND THE CONTRIBUTION OF VENTURE CAPITAL

Hans Bruining and Mike Wright [1]

This paper focuses on the development of entrepreneurial orientation (EO) after a management buy-out (MBO) and on the role played by venture capital firms in enhancing EO. It presents results of two exploratory case studies of divisional buy-outs with regard to their EO and the areas where the venture capital firm (VC) has been of greatest help. We discuss their contribution to elements of the EO of the buy-out firm. The key output is expected to be a better understanding of the functioning and operations of the VC with regard to their contribution to the EO of the firm after an MBO. This will also benefit the management team that seeks venture capital support to improve the firm's economic performance by using its upside potential.

Keywords: venture capital; governance; entrepreneurial orientation; management buy-outs

INTRODUCTION

Buy-outs have traditionally been viewed as involving firms in mature sectors with few investment demands and low growth prospects (Jensen 1989). However, the main rationale for buy-outs has shifted from cost reduction and strategic reorientation in mature sectors to creating value in technology sectors through product development and innovation (Wright et al. 2000,2001). A shift is occurring in the buyout market from downside protection in deals led by LBO associations to VCs that look for the upside potential of firms. The market is moving to find added value in deals, because auctions increase deal prices and fund providers are looking for higher returns. Research from the US, UK and Continental Europe shows that buy-outs are often followed by increase in (new) product development (Zahra 1995; Wright et al. 1992; Bruining 1992). In the US, traditional LBO associations have been joining forces with VCs for this reason.

Many VCs label themselves today as long term committed and active shareholders that have a 'buy-and-build' strategy. In our view long term committed venture capitalists have a focus on value creation in the business and supply additional capital for internal growth and/or acquisitions. Being an active investor implies a need for development of in-house technical expertise about the business and management support and creates prospects for VCs and buy-out firms to link (Wright et al. 2000). In contrast to studies that highlight the role of the venture capitalist in start-up firms, research about how the role of the venture capitalist (VC) fits into this newer growth orientation in management buyouts is lacking. This article aims to fill this gap by analysing the entrepreneur-venture capitalist relationship in two mature buy-out firms in order to obtain insight concerning where and how the VCs commitment contributes to the entrepreneurial practices in the MBO firm. The study examines the questions: how do MBOs improve their entrepreneurial orientation (EO) and to what extent does the venture capitalist contribute to the EO of the buy-out firm?

Our theoretical framework uses the EO concept of Lumpkin and Dess (1996:152) which conceptualises the relationship between entrepreneurial practices and firm performance. We highlight the role of the venture capitalist as a long-term committed and active shareholder and

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extend conceptualisation of how environmental and organisational variables impact the EO-performance relationship in the context of buy-outs.

The structure of this article is as follows: after defining an MBO, we link the MBO to the EO framework and highlight the VC role along the EO dimensions. We explain our research methodology and data gathering in the following section. From two case studies we analyse the role of the VC after the MBO and its potential to contribute to the EO of the firm. In a comparative analysis of the case studies we explain differences in the way VCs arrange post-investment assistance. In the last section we draw the major conclusions of this study.

MANAGEMENT BUY-OUTS

An MBO involves members of the incumbent management team acquiring a significant equity stake as individuals with institutional support in order to control the company (Robbie and Wright 1996).

The structuring of a buy-out involves the introduction of significant equity incentives for the entrepreneurs involved, together with substantial external funding and active monitoring by investors (Jensen 1993, Wright et al. 1994) in order to control agency costs. The emphasis in buy-outs in the US has typically focused on the debt providers who provide substantial amounts of leverage. However, in Europe venture capital firms play a major role in funding buy-outs. In the UK, for example, the vast majority of buy-outs with a transaction value above £5 million involve venture capital finance (CMBOR, 2001). In the Netherlands, the value of private equity backed buy-outs amounted to €3,457 mn in 1998 and € 4,463 mn in 1999 (CMBOR, 2000) (Table 1).

MBOs backed by venture capital lead to significant changes in a firm's ownership composition, and can contribute to subsequent growth and changes in strategy, organisational structure and entrepreneurial practices (Reid 1996, EVCA 2001). This is especially the case in those MBOs which are not traditionally perceived as an organisational efficiency tool to streamline processes and decrease unit costs (Wright et al. 2000).

Extensive screening by venture capitalists at the time of investment appraisal places considerable emphasis on the entrepreneurial skills of the managers leading a proposed buy-out or buy-in (Robbie and Wright 1995). VCs that have a reputation to provide capital for growth, use long term incentives to encourage process or incremental innovation by managers and show good understanding of the industry and business in the post-investment period, will attract most of these deals. The extent to which VCs are able to enhance EO in their investees is the subject of this article.

[Insert table 1 about here]

CONCEPTUAL MODEL OF ENTREPRENEURIAL ORIENTATION

To focus on the involvement of the VC in promoting the entrepreneurial upside potential of an MBO firm, we use the EO model of Lumpkin and Dess (1996:152). We define the EO dimensions and show how these link to MBOs. We also identify the range of areas where the VCs are more likely to intervene in the various elements of the model.

EO-Dimensions

EO highlights practices, decision-making styles and methods managers use to let firms act entrepreneurially and offers an opportunity to examine where the VC contributes to enhancing the firm's upside potential. Lumpkin and Dess (1996) argue that an entrepreneurial firm is any firm that engages in an effective combination of five dimensions. First, innovativeness is the tendency of an organisation to engage in and to support new ideas, novelty, experimentation and creative processes that result in new products, services or technological processes. In this study we include in this definition incremental product/service innovation because this also opens windows of opportunity for the firm. Second, proactiveness involves the process of anticipating and acting on future needs by seeking new opportunities, introducing new products ahead of competition, and strategically eliminating declining operations. Third, competitive aggressiveness is a firm's propensity to outperform industry rivals in the marketplace. Fourth, risk taking, is the degree to which managers are willing to make large and risky resource commitments. Fifth, autonomy is the extent to which a team or an individual in the firm is free to bring forward and implement a vision or an idea.

These process dimensions are intermediate factors between external (environmental) and internal (organisational) variables that drive firm performance and lead to 'new entry', the essential act of entrepreneurship. At the firm level, new entry involves actions initiated by the firm to promote upside potential and the strengthening of competitive advantage. As such, the EO concept offers an additional explanation for performance improvement following buy-out that goes beyond agency cost arguments involving efficiency improvement to protect the firm against downside risks (Phan and Hill 1995). In buyouts which need at least some innovation, environmental and organisational factors play an important moderating role in enhancing the EO of the firm.

Environmental factors

Several environmental variables moderate the entrepreneurship-firm performance relationship. The EO-firm performance relationship is positively/negatively moderated by the extent of hostility in the firm’s environment. It is wellknown that managers pre-MBO face investment restrictions from HQ because their firms are peripheral to the product line of the parent company (Wright et al. 2001). This decreases the possibilities of responding entrepreneurially to market development. After the buy-out this situation is reversed. The same can be argued for the other environmental factor dynamism. This variable expresses the extent to which the needs of customers change and the extent to which technology changes. Pre-MBO, buy-out firms, if they are peripheral to the core business of the parent, are not allowed to have growth-oriented strategies and organisations. This conflict between subsidiary management and HQ is often an indication that a buy-out may be appropriate (Bruining 1992, Wright et al. 2001).

Other environmental factors in the model are heterogeneity and technological sophistication. The first expresses the diversity in customer needs and expectations, thus offering a firm many or few opportunities for additional innovation and market development. Heterogeneity can enable firms to apply lessons learned in one market to other markets. Technological sophistication is indicative of more demand for new technologies.

Organisational Factors

Knowledge about the interaction between organisational factors and EO-dimensions is crucial for understanding the dynamics of the buy-out firm and the possible supportive role of the VC. A significant share of MBOs divested from parent companies face changes to a more growth-oriented *strategy* and in the process of strategy formulation. Instead of obeying orders from headquarters that block innovation and investment in order to optimise goals of the diversified parent company, the buy-out managers have discretionary power to decide what is best for the business and how the business plan can be carried out most profitably for themselves as a firm (Wright, et al. 2001).

The distance between policy and implementation becomes significantly shorter, because of the remarriage of ownership and control (Alchian and Demsetz 1972). It is likely that the new owner-managers show higher levels of commitment to the implementation of a growth oriented strategy than before the MBO. In turn, this is likely to change the organisational <u>culture</u> to one that is more entrepreneurially driven. Other organisational factors that stimulate efficiency and decentralisation after buyout are the decrease in both size and complexity of the <u>organisational structure</u> (Phan and Hill 1995). Top managers experience more immediate freedom and independence, which enables more flexible decision-making, more delegation, quicker action and easier consensus among manager/owners and shareholders (Bruining 1992). This creates greater room at the firm level for the autonomy dimension of EO. Buy-outs typically involve increased levels of external funding. The costs of servicing debt and fixed dividend commitments act as a discipline to allocate <u>resources</u> to operations with the strongest cash flow and eliminate unprofitable operations. Finally, the <u>experience</u> of incumbent senior management is a crucial basis for their ability to act entrepreneurially.

This commitment to EO by the incumbent management is crucial to the development of a joint venture relationship with the VC that will contribute to achieving the growth objectives of the buy-out.

<u>VCs and Entrepreneurial Orientation</u>

In principle, VCs can make a contribution to the entrepreneurial orientation of their investees through the support they provide following investment. Previous literature suggests that VCs investing at early stages emphasise market growth and uniqueness of products rather than demonstrated market acceptance as in later stage investments (Elango et al. 1995). Amason et al. (1994) shows that VC involvement increases as the need arises. This is more likely in riskier, earlier stage deals. Supportive of this are the findings of Sapienza et al. (1994) that frequency of interaction depends on the degree of the CEO’s venture experience, the venture’s stage of development and the degree of technical innovation.

Macmillan et al. (1989) find that the highest degree of involvement of the VC concerns acting as ‘sounding board’ together with obtaining alternative sources of equity financing, interfacing with equity group, monitoring financial performance and obtaining alternative sources of debt. Gorman and Sahlman (1989) stresses the consultancy nature of the role VCs play in their investment. Littler and Sweeting (1989) observes that VCs provide access to networks among suppliers, customers, competitors and backers. Venture capitalists may provide significantly more value added if they control the board and if they have operating rather than purely financial expertise (Rosenstein, et al. 1993). The contribution of non-executive directors may vary quite considerably (Sweeting and Wong 1997). Sahlman (1990) in comparing LBO associations with venture capitalists, notes that executives in the former assume control of the board of directors and are less likely to assume operational control than venture capitalists investing in new ventures.

Venture capitalists, especially in Europe, may also invest in management buy-outs. Among the few studies to consider the role of VCs in MBOs, Wright et al (1992) report that 30% of the buy-out managers considered VC involvement very helpful. While some 62.3% of buy-outs introduced new products as a result of the greater freedom of the buy-out, the study does not reveal how the VCs enhanced these entrepreneurial measures. In a study of management buy-ins (MBI)[1], Robbie and Wright (1996) show that the efficacy of direct board representation varies from a proactive stance and protection of their financial position to not being able to justify further investment because of spending a disproportional amount of time and cost to achieve satisfactory restructuring. Hatherly et al. (1994) suggest that relationships between VCs and CEOs of buy-out firms be best characterised as a joint venture. The relationships of trust, openness and mutual support that prevail are arguably important in facilitating VC/CEO interaction on non-routine issues. A recent study by Wright et al. (2001) identifies different types of buyouts and suggests that different types of financial investor may have different roles to play in monitoring. In the more traditional highly leveraged buyouts, LBO associations may be more appropriate as they are adept at financial monitoring. In contrast, in buyouts requiring some limited form of investment and innovation (revitalisation buyouts) or involving major entrepreneurial innovation (entrepreneurial buyouts) venture capital firms may have a greater role to play as there is a need for technical as well as financial monitoring skills.

This review suggests that while buy-outs have traditionally been seen as requiring less investor involvement than earlier stage investments, some MBOs may have significant entrepreneurial opportunities that require greater involvement by VCs. In particular, VCs may have an important role to play in developing the EO dimensions of buy-out firms.

The EO model also suggests that VCs' involvement is required in accumulating and applying knowledge of sector specific environmental factors such as technology, dynamism, hostility and the heterogeneity of markets in order to take appropriate pre- and post-investment decisions. Alliances with venture capital funds may be an important route to gain early access to developments emerging from the fast moving Internet and communications sectors.

With respect to organisational factors, compared to the relationship with head office before the buy-out, greater interaction is expected to take place between the board of directors, key managers and the VC. Monitoring by VCs, together with substantial management equity stakes, are expected to be primary factors in meeting the costs of servicing external finance and in taking entrepreneurial actions associated with the generation of enhanced cash flow. The VC may play a key role in scrutinising the expertise of management, with only those able to develop the newly independent firm likely to be acceptable as equity holding insiders to the VC (Robbie and Wright, 1996).

The next section explains the research methodology and data gathering process adopted in the study in order to address these issues.

METHODOLOGY AND DATA GATHERING

The empirical evidence is based on two detailed case studies. A two-stage research approach was carried out during 1998. After piloting a questionnaire in three MBOs, supplemented with face-to-face interviews, information was first gathered information from CEOs by questionnaires (available from the author on request). The questionnaire contained 5-point Likert scale questions with regard to external and organisational factors that may affect the relationship between EO and buy-out performance. The questions referred to the period of two years before and two years after the MBO. The MBOs selected had 50-100 employees and the deal prices varied between Dfl 5-10 million. The firms were divested by their Dutch parent companies by means of an MBO. Choosing MBO firms from the period 1992-1995, allowed sufficient time for the operational, organisational and strategic consequences of the change in ownership to be implemented. Another criteria for selection was that the firms had to be venture capital backed by leading Dutch VCs, all of whom are experienced in financing buy-outs. These VCs were involved from the very start of the MBO and have representatives who are chairmen of the supervisory board, guaranteeing that they are well informed about the likely development of entrepreneurial practices and their relationship with the CEO.

The operationalization of the variables in the conceptual model was based on measures taken from the widely used studies of Miller (1983) and Covin and Slevin (1986 and 1989). After completion of the questionnaire more detailed face-to-face interviews were conducted with the CEOs. Other sources of information used included magazines, product development brochures, annual reports and, in one case, the flotation prospectus. This approach was adopted as a more appropriate instrument for capturing the complexity of the managerial, entrepreneurial and organisational changes taking place following the transfers of ownership (Green 1992). Full reports of the case studies were sent for comments to the CEOs.

This exercise laid the basis for the second part of the research. The EO profiles of the CEOs were subsequently sent for comments to the representatives of the respective VCs, who included the chairmen of the supervisory board and the investment manager[2]. Interviews were conducted with both to triangulate views about changes in the EO profile following buy-out (Eisenhardt, 1989). Post-MBO both VC representatives remain in contact with each other and receive the same financial information. In addition to the EO-questionnaire, a second set of questions, based on the work of Rosenstein et al (1993) and Mitchell et al (1999), was used in face-to-face interviews to focus on the venture capital firms' practices and their specific information requirements in the operational and strategic monitoring of the investee (checklist available from author on request). This enabled identification of the areas where venture capitalists gave assistance to the CEO and his management team to act more entrepreneurially.

MBO firms were selected that showed strong differences with respect to VC's governance system, exit strategy and the voting position of management based on their equity stakes. In case study 1 the VC used a dual governance system, had a majority equity stake and was aiming at a trade sale exit. In case study 2, the VC used no dual governance, had a minority equity stake and was aiming at exit through a flotation. Using information from these two distinct cases we expect to highlight the role of the VC along all EO dimensions more transparently (Eisenhardt 1989). Coupled with within-case analysis we also carried out cross-case comparisons.

CASE STUDY RESULTS

For each case, this section first presents a synopsis of its main features and, based on information post-MBO, identifies the changes in dimensions of EO, and the VC's role post-MBO along these changes and dimensions. Second, a cross-case comparison is developed to analyse differences and similarities in the contribution of the VCs to the EO of the buy-out firms.

Case study 1

<u>Synopsis</u>

Company 1 is a pet food manufacturer with Dfl 60 mn turnover and 60 employees, it exports 90 percent of its products to the expanding markets for pet food in Scandinavia, Germany, Belgium, Spain, Portugal and Greece. Company 1 was bought by its management team for Dfl 8.5 mn in 1995 from the parent company Cebeco-Handelsraad, a large co-operative firm producing vegetables, flowers, breeding and food. Alpinvest, which was recently acquired by NIB-Capital and which has 41 percent of its total investment portfolio of Dfl 300m invested in MBOs/MBIs, backed the company. The firm's target rate of return for MBOs is 15-40 percent on an annualised basis. The pet food producer belongs to the mid-range size of Alpinvest investments. Alpinvest owns 43 percent of the shares, another large Dutch VC, NPM Capital also has 43 percent, whereas a minority (14%) is owned by the CEO, the financial controller and the director of production. At the time of the buy-out the financial leverage measured by equity to total assets was 42%. Seven years after the buy-out the firm was sold in 2001 to Profima, one of Europe's largest pet food producers. Alpinvest and NPM Capital distinguish between an investment manager who does the deal and a supervisory board member taking care of operational post-investment activities. However, the investment managers receive the same financial information about the firm as the member of the Supervisory Board and stays in contact with the latter. Alpinvest's representative is the chairman of the supervisory board and has a background as a consultant and entrepreneur in the industry. From the very start of the MBO, a modest 6 percent dividend was paid, indicating a longer-term investment attitude of the VC firm to let Company 1 first repay the debt and allow investments to improve the business, without neglecting the reward for the new shareholders. After paying off the amount of debt and amortisation of "goodwill" the payout of dividends increased. The following sections discuss EO dimensions, environmental and organisational factors and the contribution of the VC to developing EO as outlined earlier with respect to this case.

<u>EO Dimensions</u>

The companies parent CEBECO paid little attention to Company 1's new product ideas because pet food was peripheral to its main focus on vegetables and flowers. This changed after the MBO, as management became more <u>proactive</u> in both product development and rationalisation. The company started developing new products on its own. The trend towards humanising animals created ample opportunity for increasing quality and product margins. This increased the firm's <u>proactiveness</u>. The company as a small player had to act smart in its efforts to differentiate and develop new products. The ENMAX exhibition in Chicago became an integral part for the product innovation program of the firm. Active search for new opportunities required an increase in expenditures for research and development by more than 50 percent. After the MBO the firm renewed its equipment for the production of varying percentages of fat in order to anticipate healthier animal snacks for the whole animal life-cycle without adding colouring agents. One of its new successful products was the puppy-snack. This is evidence of strengthening <u>innovativeness</u>.

Following the MBO there was an increase in <u>autonomy</u> at the workgroup level. Pre-MBO the CEO as subsidiary director was responsible for the marketing, production and financial decisions at the operational but not the strategic level. This changed after the MBO but he was forced to listen to younger ambitious specialists in the fields of marketing and nutrition of which he lacks understanding.

Management became more <u>willing to take risks</u>. Top management developed a strategic focus on RandD, indicating a preference for projects which could yield relatively higher added value (ROI) and thus a higher return on investment than was the case before the MBO. A high price/quality strategy was adopted that signalled the firm's increased <u>competitive aggressiveness</u>. The role of marketing changed. The marketing department had to obtain orders from superstores and convince them of the healthier status of the company's products, and had to be more active in gathering product ideas from the industry itself. In dealing with the competitors after the MBO the company typically seeks to avoid competitive clashes, targeting peripheral markets, e.g. the Finnish market where it succeeded in becoming market leader within six months of the MBO.

Environment

In order to differentiate oneself in the pet food industry, technology is a key factor. Products and the related technologies become obsolete rather quickly, because of the need for frequent innovations involving healthy pet food products. Consumer tastes are fairly easy to predict but competitor actions are becoming more unpredictable. Although hostility is not seen as a threat for survival in the short term, the danger of price competition remains in the home market.

Organisational Factors

Before the MBO management did not focus on the firm's core competencies and its objectives. After the MBO, the management developed a clear strategy, mission and vision as a niche-player in order to grow internally in the expanding markets for pet food. Ideas for new products now originate more from visits to important international industry conferences such as the Chicago pet food exhibition. The RandD function is crucial to creating a strong position by changing the food ingredients needed in a timely manner. The firm now takes a longer-term perspective for planning its future growth. Investment proposals are carried out on the basis of own cash flows, indicating the need for profitable growth and attractive payout figures on which realistic budgets can be made.

More things had to be done after the MBO by the same amount of people, causing a need to delegate by installing self-managing teams. After the MBO, communication developed more intensively between the management team and employees because management was forced to adopt the latest developments from RandD and marketing. Despite his autocratic style of leadership, the CEO changed his attitude towards the RandD and marketing function, whereas before the MBO he considered this primarily as a cost. Several innovation working groups and quality platforms were installed with regular meetings. These groups determined the direction for product development. Ideas for product development are developed during brainstorming sessions between teams of workers and management. In this sense the organisation became flatter and adopted a stronger results oriented attitude towards work. However, the planning of capital expenditures as well as the use of operational budgets are examples of the drive for tight centralised financial control after the MBO and thus the need for more formalisation.

After the MBO the company began to imitate new products launched by international leading pet food firms such as Hills in the US. It also started it own new product development. Compared to its competitors, time to market has been reduced from nine to approximately six months, because after the MBO the firm has targeted foreign niche markets to minimise the problems of price competition in its home market. By hiring engineers from the Agriculture University of Wageningen the firm was able to anticipate the new technological developments necessary to produce improved animal food for these niche markets. The emphasis on the top quality pet food segment of the market required increasing efforts to qualify for international standards organisation (ISO) certificates and the more recently acquired Hazard Analysis Critical Control Point. New quality control procedures were introduced. The drive for tight cost control after the MBO resulted in better control of costs and working capital. E.g. accounts receivable decreased by 17% (e.g. Dfl 580.000). These kinds of activities enable the firm to undertake investment in contrast to before the MBO.

While top management considers that it has the same degree of experience compared to pre-MBO, there have been important changes in management development. E.g. the supervisory board has been very constructive in developing the focus of the CEO from a predominant emphasis on the bottom line to broader more professional management. It is notable that not all disciplines are represented in the management board of Company 1. The sales manager and the nutritionist are both not formally part of the management team, but attend on request. The director of finance also became the director of human resources in the post buy-out period. Most of the employees are not rewarded in relation to performance. However, besides equity stakes the CEO and his financial controller and deputy directors of production enjoy profit related payments. In 1996 bonuses amounted to approximately Dfl 150,000 each. Top management is clearly better incentivised than before the MBO.

Net profit as a percentage of sales of Company 1 improved dramatically after the buy-out in 1995 (Table 2). The divestment of the Soya business decreased sales but not the firm's profitability. In 1995, the year after the MBO, a substantially higher level of net profit was reached due to the higher margin strategy. In 1997 net profit decreased with 20% because of increased input prices reduced profit margins. In 1998 this situation was reversed.

[Insert Table 2 about here]

VC and Entrepreneurial Orientation

The VC contributed to developing proactiveness by approving and stimulating the implementation of a value added strategy. With regard to another aspect of proactiveness the VC also played an important advisory role in discussions about decisions to cut unprofitable activities. He actively suggested that the firm invested in a non-stop production process facility, to decreased its workforce (5 people) and divested the Soya beans unit, thus rationalising production in order to realise higher margins.

The VC played an important role in promoting innovativeness since, in the period immediately following the MBO, it reviewed the quality of the RandD plans several times a year. Later on, because of the satisfactory results, the involvement of the VC decreased to once a year, and focused on the status of projects. The VC stimulated Dfl 1 million of investment in management information systems. These systems included the introduction of barcodes and software packages as well as systems covering the understanding, control and distribution of information.

The VC played an important informal role in stimulating the development of autonomy since at the VC's instigation, a process was introduced whereby proposals were initiated by the marketing manager and ratified and monitored by management and the VC. The VC approved the direction of the marketing plan, paying particular attention to pricing and sales forecasts, which was important in achieving financial control of the strategy.
A characteristic of this case was the intervention of the VC in the sales strategy following the MBO. This happened during 1997 when Company 1 faced downward pressure on product margins due to higher purchase prices of raw material that could not be passed on to customers. An extremely important consequence was that the investment program based on internal finance was endangered. The management board and the VC in the supervisory board discussed whether to stop the investment program and accept the lower margin on sales or to keep the investment program in operation and focus sales effort at the higher price/quality segment of the market. The VC succeeded in convincing the buy-out team of the usefulness of a higher added value strategy for Company 1 and in maintaining a focus on sales effort aimed at the higher price/quality segment. In this way, the VC also contributed to increasing management’s willingness to take

risks. Moreover, with the help of the VC the attention of management shifted from mere price to more quality driven competition.

This evidence indicates that he VC stimulated the entrepreneurial practices initiated after the MBO in order to control the projected economic performance of the venture. The intervention by the VC in Company 1's business strategy corrected the actions of top management team in a timely manner. In this case the management had to learn to carry out a new value added strategy and re-allocate resources in order to anticipate effectively trends in technology, markets and specific dangers such as increased price competition. RandD sources from own cash flow, product development and marketing plans, management information system, leadership style of the CEO, delegation and performance related rewards for the buy-out managers are seen as enablers of developing appropriate levels of EO and involved the VC from the start of the MBO.

Case study 2

Synopsis

Company 2 is a manufacturer of Computer Aided Design (CAD) and Computer Aided Manufacturing (CAM) systems and creates one-stop solutions for the carpet, printed textiles and woven fabrics industries. It develops, manufactures and markets dedicated software and services for textile design, colour matching, colour separation, fabric simulation, 3D presentation and production of textiles. Turnover is Dfl 13 mn of which 70% is exported. Besides these systems the firm is also a producer of Geographic Information Systems for municipalities. The company operates in a relatively young niche market where technology is changing very fast and price-competition is very fierce. With headquarters based in The Netherlands, offices in the UK, France and the US with a worldwide agent network Company 2 positions itself to market and sell its products on a worldwide scale.

The company was backed by Gilde Investment which is based in Utrecht and is one of the leading investment banks in the Netherlands. From its buy-out fund 74 percent is invested in MBOs totalling approximately ƒ300 mn. Company 2 belongs to the middle range class of Gilde's investments with a target rate of return between 20-30%. The total amount of equity invested in Company 2 by Gilde was ƒ 5-mn equity, giving it a minority stake of 36%. Top management and 20 employees hold a majority stake of 64%. The financial leverage measured by equity to total assets was 24% at the time of the buy-out. The firm was bought for an undisclosed sum from the receivership of HCS Technology, which went bankrupt in 1992. In this case the investment manager of Gilde is also chairman of the supervisory board and is an experienced financial consultant in the IT sector. Six years after the buy-out, the intended flotation was realised in 1998. The following sections discuss EO dimensions, environmental and organisational factors and the contribution of the VC to developing EO as outlined earlier with respect to this case.

EO Dimensions

Reducing the time from the initial stage of product development to final production is essential for competitiveness in Company 2’s market. Before the buy-out, Company 2 was not capable of seizing these opportunities and offering one-stop solutions. After the MBO, the firm increased its efforts to search for new opportunities, and proactively developed new business opportunities in existing and related markets. At the same time, contracts with suppliers were renegotiated and catering costs were decreased by about 60%. People not able to work in an independent company left. Another example of looking for chances to be ahead of the competition, was the acquisition of a French firm specialised in certain weaving techniques, which was used to acquire and develop further new technology and to increase market share in France.

Post-MBO product developments demonstrated the firm's innovative focus on improving communication, networking and multi-media solutions in computer graphics technology and textile technology. The successful launch of new CAD/CAM software Tuft/NT to produce complex carpet designs also demonstrates innovativeness. Further examples of new products are the shrink-wrapped Fashion Flash software, DesignCom software for using design data in other applications and NedGeoDatawarehouse to store geographical and alphanumerical data. Since the MBO the number of software developers has increased from 20 to 30 (25 percent of the total staff) and substantial investments were made in RandD development (between 7 and 10 % of its annual revenues). After the MBO there was more room for bottom-up communication and quick decision-making, resulting in a richer stream of business proposals with regard to acquisitions and equipment from the business units, thus stimulating autonomy regarding entrepreneurial initiatives. There was a shift towards more flexible use of formal rules and procedures in the firm.

There was a major change in competitive aggressiveness. Company 2 aims to be first with initiatives in the market with substantial lowering of prices. The marketing stance is encapsulated in the advertising slogan: 'We would have released our windows/NT based software sooner, but we were too busy leaving our competition behind!' Marketing has become important to determine the strategic direction of the firm and generates more products than before the MBO.

Indicative of more *risk taking* following the MBO was the venture set up in the US. This was a very expensive lesson because this venture failed. After the failure of the start-up, the chief financial officer was given more authority to calculate risks of the firm's strategic decisions. From then on investment opportunities to expand in familiar niches were selected in Europe. After the buy-out Company 2 acquired several companies to expand into the carpet and the printed textile market in the UK, France, Belgium and in its home market.

Environment

Software production technology changes quickly and marketing practices must constantly be adapted to communicate better with industrial customers in order to forecast demand and consumer tastes adequately. Despite the strong price competition for CAD/CAM applications in the carpet industry world-wide and the dynamic environment, the CEO of Company 2 perceives a decrease in threat to survival of the firm, because after the MBO the company invests its own cash flow in its own future, instead of in a financially distressed parent company.

Organisational Factors

The financial distressed parent company stifled innovation and investment. After the buy-out the most significant changes occurred in the process and speed of strategy formulation. The longer-term profitability of investments became more important than shorter-term returns. After the MBO the company formulated a mission statement for the development of textile CAD/CAM and GIS Systems. With regard to the former it aims to become the leading supplier of one-stop solutions for all market areas in the textile CAD/CAM market, by providing the most comprehensive product line, state-of-the-art PC/Windows/NT-based technology, a high level of support and competitive prices on a world-wide scale. In the field of GIS systems, the firm strives to be market leader in integrated 'organisation-wide' GIS solutions for municipalities in The Netherlands, based on an open-systems concept, universal system integration capabilities, turnkey solutions, a full-service concept and partnerships with users of its systems. The firm became the leader after the MBO in the niche markets involving carpets and printed textile, strengthening its market focus and enlarging its product range. The emphasis is now on standard quality and low prices in order to increase market share, whereas before the MBO the focus was on low prices.

After the MBO in 1992 Company 2 acquired several companies to expand in the US, the UK, France, Belgium and in its home market. The acquisitions were internally financed and concentrated on the standard quality segment.

The company organised itself after the MBO into two independent strategic business units, Textile and Geographic Information Systems. Two-way-communication within each strategic business units have increased and the layers of organisation have decreased after the MBO. In contrast to before the MBO, these SBUs meet separately with top management, and if necessary with the VC to evaluate ideas. Instead of painful discussion with the parent company, whose main product line was copiers, the company's culture supports the open expression of novel ideas after the MBO, in contrast to the situation beforehand where the CEO was forced to slowdown new business proposals because the directors of the financially troubled parent were not willing to invest in businesses they did not know

Without the financial limitations imposed by its former parent and with savings on overhead of approximately Dfl 500,000 a year (2% of its sales revenue) and fewer restrictions on financial resources, the firm has experienced more freedom to make investments. After the MBO personnel are better incentivised. Twenty key managers now have equity stakes. Half the employees (40) of the sales department received a refined performance related reward system and all employees of Company 2 are given a performance-related bonus in their salary. This relationship was also intensified through arrangements made on an individual basis for those who show ambition to develop certain parts of the market abroad (e.g.Turkey). Other aspects of performance related pay are aimed at enhancing product development. Employees earn a bonus when they keep product development and maintenance time within certain limits.

The CEO and the CFO have experience with all business functions, but not all disciplines are represented in the management board. The SBU managers of GIS and Textile CAD/CAM, responsible for respectively marketing and sales, project engineering, product development and customer support, as well as the HRM manager are not formally part of the management board, but attend on request. The characteristic of the top management team remained the same as before the MBO. The CEO was seen in general as a charismatic leader with a strong influence on Company 2 employees.

The years immediately following the buy-out showed the strongest increase in EBIT as % of sales. Despite the failed start-up investment in 1995 in the US it is clear from Table 3 that Company 2 showed improved performance post-1992. However, sales growth during 1995-1998 was not spectacular.

[Insert Table 3 about here]

In 1998 the company was successfully floated on the NMAX stock exchange. In 2000 the textile and apparel and E-commerce activity are suffering lower demand and tough price competition as a result of market saturation.

<u>VC and Entrepreneurial Orientation</u>

The VC supported the firm's increased efforts to proactively develop new business opportunities in existing and related markets. In 1995 the VC assisted the CEO to start an IT company in the US and led a consortium of investors to finance that investment. In the stressful period of reorganising the existing firm due to a sharp fall in profit in 1995 and starting a company abroad the VC was actively involved in advising management. With respect to greater autonomy, the VC has monthly talks with business unit management, indicating scope for informality. As strategy was not very coherent at the time of the MBO, an INSEAD professor was asked to join the Supervisory Board at the request of the VC to advise on how to address this problem.

With respect to decision-making information used in Company 2, the VC did not directly intervene in daily operations. Prior to the buy-out, the operating decision-making information used internally and reported to the VC came from marketing and sales. Subsequent to VC involvement, operating decision information was required with regard to finance and personnel. The VC is involved with the operations of the firm through the monitoring of financial information, but its involvement extends further to include the development of strategic decision-making information about acquisitions, product development and marketing actions. The VC's networks are used extensively for advising management. The VC assisted closely in making acquisition decisions, carrying out five acquisitions in Europe. To implement the marketing strategy the VC was assisted by a Flemish venture capitalist who took an equity stake in the major competitor Sofis, based in Belgium, in order to block competition. Other tasks where the VC showed commitment were counselling for product development and marketing programs, but also in stressful situations during an IT start-up in the US and early reorganisation following the buy-out firm, and last but not least the preparation of flotation. These services enhance most of the EO dimensions of the firm.

With respect to the existing carpet and cartography niche markets the VC confirmed the CEO's entrepreneurial approach, but assessed the CEO's vision as too narrow in scope to realise diversification opportunities in technology related markets. The VC tried to create awareness for the relatively small market size and the slow pace of long-term growth and undertook efforts to renew this strategy. However, the lack of a hierarchical relationship, resulting from the minority shareholding of the VC, limited powerful interaction with top management. The CEO and the VC looked at proposals but did not find anything worthwhile to invest in. According to the VC the CEO was too risk averse in this respect. This was largely due to the fact that in the first two years the VC was the only member in the supervisory board representing a minority shareholding. Therefore the VC could neither provoke action nor promote dynamism to convince others of the right course of action.

COMPARISON OF EO IN COMPANIES 1 AND 2

In both cases we found evidence of actions on the part of the VC to realise long-term benefits. Management and the VC of Company 1 decided to pay a moderate annual dividend of 6 percent from the start and concentrated on repayment of debt and preparation of the firm for a trade sale. In Company 2, the VC supported the CEOs initiatives for a start-up and required payment of a dividend above a 25 percent return on equity. After a period of growth, the VC prepared the company for floatation. In both firms the VCs were shareholders for a six or seven-year period, demonstrating that they were relatively long term-committed shareholders. Both cases pre-MBO are firms not central strategically to their parents and therefore deprived of investments for innovation and renewal purposes. Using the categorisation of Wright et al. (2000), Company 1 can be identified as a revitalisation buyout as it involved process and incremental innovations while Company 2 is an entrepreneurial buyout involving strategic innovation.

The extent to which the VCs showed a similar pattern of activities in both companies that enhanced the EO of the firms will now be discussed. Table 4 summarises the different VC governance characteristics and effects found in the case studies.

In both companies major interventions by the VC took place during the buy-out. At Company 1 the intervention by the VC to adhere to the strategy of value adding convinced the CEO and was successful in contrast to the efforts of the VC in Company 2 to broaden the CEOs view of the market scope of the firm. In Company 1 this likely increased commitment in the inter-organisational relationship between the VC and the CEO. (Carnevale and Isen 1986), producing more innovative solutions. For Company 2 this appeared only valid at the start of the MBO, as shown by the launch of the new IT-firm in the US. This failure might have increased the risk aversion of the CEO, because in the years following the MBO, he became reluctant to change the market scope of the firm. Affective commitment in the relationship may have become more problematic from that moment on. Both findings appear to be consistent with the respective influence of VCs on the CEO's leadership styles. In Company 1 the problematic authoritarian style of the CEO changed in order to integrate the contribution of specialist managers' to product- and market development. In Company 2 the strong charismatic leadership of the CEO did not generate potential successors from within the firm.

In Company 1 the VC brought in an experienced entrepreneur in the food industry as a business consultant, whereas the VC of Company 2 is a financial specialist in IT business. Both are experienced in developing strategies with the board of directors, but the former possesses more awareness of operational details. The absence of an external specialist at Company 1 in the field of strategy and implementation in contrast to Company 2 supports this observation. Convincing people on the basis of one's own qualities may increase mutually affective commitment in the post-investment relationship between CEO and VC and emotional attachment to the organisation in the long run. Post-investment relationship building between the VC and CEO may prosper more from attention to operational rather than financial detail (Rosenstein, et al. 1993).

Another finding which has a likely impact on the relationship between the CEO and the VC is the hierarchical position of the parties to each other based on the size of their equity stakes. In the case of Company 2 the VC had a minority shareholding in the firm and had to wait until flotation when the CEO sold his equity before the firm's strategy could be adapted. The VC lacked hierarchical power to control top management. However, concrete proposals to invest in other markets were also absent. In Company 1 the VCs had a majority equity stake and were able to supervise the necessary changes before the exit of the firm. At the time of the trade sale exit of Company 1 the CEO retired.

[Insert Table 4 about here]

The VCs differ also in the way they organised post-investment assistance. In both cases, post-investment involvement went beyond financial control. The VC in Company 1 appointed an independent supervisory board member. He had his own personal and legal basis for giving advice in the interest of all the firm's stakeholders. Neither of the VCs can give him orders, although he works closely with them. His fee is paid by Company 1 in contrast to the fee of the VC representative in Company 2, which is paid to Gilde. The latter, therefore, does not have such an independent position for its supervisory board member. The VC representatives in Company 1, i.e. the investment manager and the supervisory board member, get the same contractual data, only the latter specialises in face-to-face communication with the CEO. The investment manager stays in close contact (a half day per quarter) with the CEO and the supervisory board member, but continues to search for new deals. This situation is different for the VC in Company 2 that prefers to have its own people on the Supervisory Board. Here the representative monitors contractual data and performs a sounding board function in addition to his role in looking for new venture capital investments.

CONCLUSION

This paper has sought to analyse how buy-outs improve their EO following the change in ownership and how VCs contribute to this process through the development of post-investment relationships. The paper also sought to validate the EO-model in the context of MBOs.

The case studies show that buy-outs do occur where entrepreneurial opportunities exist and provide support for Wright et al. (2000) who argue that buyouts do not simply involve improving efficiency in companies in mature sectors. With the framework of EO we are able to identify entrepreneurial decisions and practices that add value to the business through new product/new market development in their companies that were frustrated by the parent prior to MBO. The firms in our study act more entrepreneurially than pre-MBO.

VC's enhancement of EO in MBOs appears more likely in the following post-investment activities. First where the VCs intervene in integrating the contributions of specialists in top management decision-making; influencing leadership style of the CEO; keeping value added strategy on track; approving bonuses for top management; assisting in new ventures (consortia) / new acquisitions; and broadening market focus. They all frequently face situations where they have to advise on difficult problems or have to select consultants in order to implement appropriate strategies. This is an important field where the VC’s knowledge can contribute to the EO of the firm by developing the CEO's vision and keeping the strategy focused. Last but not least, the VC uses its network to reduce the negative impact of competition and to select key figures as CFOs and new CEOs.

Secondly, where they put effort into reviewing and monitoring the quality of research and development investment plans, budgets and marketing plans. Sometimes the VC needs to invest in management information systems necessary to modernise management in order to control entrepreneurial decisions better.

An important characteristic of the CEO-VC relation is the knowledge transfer and learning that takes place, indicating interdependency of the participating parties that enabled the companies to act entrepreneurially. It is crucial, however, for the VC to understand the technology sufficiently in order to be able to assess investment in product development and acquisitions and subsequently to monitor it effectively. Also the VCs must understand the complexity and the uncertainty entrepreneurs face and the way they take strategic decisions. The VC must be skilled in developing informal co-operative relationships that stimulate exchange of high quality information, which in turn enables reliable and convincing interventions that enhance EO. In these situations the articles of association and other contracts appear to have little impact on enhancing EO.

As our case studies show, the success of post-investment relationships depends not only on effective informal relationships but also on the position of the VC as a majority shareholder. There is a need for further investigation of the post-investment involvement of the VCs to distinguish those buy-outs that can be better supervised with contractual relationships compared with those where greater emphasis on relationship building between the VC and CEO is likely to be more effective in enhancing EO.

The EO-model has been validated in this study in the context of MBOs. We compared the EO of the firm pre- and post-MBO and observed similar patterns of increased pro-activeness, innovativeness, risk taking and autonomy in two buy-outs which varied in terms of the VC's governance system, voting power of management and exit strategy. The EO-model is therefore appropriate for analysing MBOs with upside potential and the role of VCs in realising that potential. The multi-dimensionality of the model offers a variety of possibilities to relate the EO dimensions to external and organisational factors that affect the EO-performance relationship. Organisational factors such as strategy, resources, leadership styles and delegation moderate this relationship because the strength of the relationship between EO and performance varies as a function of these factors. The paper has extended the EO-model of Lumpkin and Dess to include variables that represent the financial and personal motivating mechanisms in MBOs, notably increased management holdings and interactions with the VC. In terms of the framework, these factors stimulate interaction between EO-dimensions and external/organisational factors in the specific situation of the MBO and have likely played an important role in improving economic performance.

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Table 1: Number and Total Value (**€** mn) of Buy-outs in the Netherlands (1989-99)

ear	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
NR	52	36	44	50	55	41	57	56	61	69	42
€	368	195	594	446	579	1258	856	1030	1082	3457	4463

Source: CMBOR

Table 2: Economic performance Company 1 (x Dfl 1000)

Years	Net Profit / Sales x 100%	Net profit	Sales
1992	1.1	1.051	96.587
1993	0.2	178	74.385
1994	0.1	58	60.356
1995	5.5	3.351	61.156
1996	5.7	3.350	59.046
1997	4.3	2.602	61.099
1998	6.3	4.090	65.284
1999	9.6	6.652	69.016
2000	6.0	4.438	73.933

Table 3: Economic performance Company 2 (€ 1,000) [3]

Year	EBIT as % of Sales	PBIT	Sales
1993	11	1.011	8.711
1994	17	1.799	10.638
1995	4.8	590	12.264
1996	10.1	1.271	12.533
1997	11.6	1.569	13.537
1998	13.3	1.875	14.048
1999	13.2	2.847	21.562
2000	5.9	1.536	26.012

Table 4: Summary of VC governance differences

COMPANY 1	COMPANY 2
Repay debt first; moderate dividend payment (6%)	Start-up finance; dividend paid if ROE > 25 percent
Exit: sale to large industrial buyer in 2001	Exit: flotation NMAX in 1998
CEO retired at the time of the sale	CEO sold equity stake at flotation and obtained position on the Supervisory Board; resigned after 2 years
VCs have majority of shares (co-lead)	VC has minority of shares
VC: operational + strategic + financial experience	VC: financial and IT-start up experience
No external specialist advice on strategy and organisation, but own advice	External specialist on strategy and organisation
Supervisory board member has his own position (independent from VC)	Supervisory board member is investment manager (no independent position from VC)
Dual governance system of VC: board member and investment manager separate persons with close contact	No dual governance system of VC: board member and investment manager in one person
Investment manager: controls contractual data; Board member: face-to-face interaction for equivocal issues	One person from the VC controls contractual data and face-to-face interaction for equivocal issues
VC with successful strategy intervention	VC not successful with intervention on market scope
VC significant influence on CEO's leadership style	VC less influence on CEO's leadership style

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1. (with S Thompson, K Starkey and K Robbie), 'Longevity and the Life-Cycle of Management Buy-outs', Strategic Management Journal, Vol 15 (3), 1994.

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[1]MBIs share the change in ownership with MBOs but in contrast to the latter external managers buy the firm. This may be an indication for the management's lesser deep knowledge of the business.

[2]This governance situation is quite similar with the dual form of governance in the UK. One of the differences is that a non-executive on behalf of the Dutch VC is appointed in the Supervisory Board as member or as chairman, but has no seat in the Board of Directors. Some VCs appoint their investment managers as Supervisory Board Member, others appoint professionals with entrepreneurial and industry experience. The Supervisory Board has the legal authority to defend the interest of the company as a whole. It is obligatory for public limited companies and facultative for private limited companies. The Supervisory Board has to approve the firm's policy, the remuneration of the directors, whereas in the UK the shareholders control the company. New legislation will transfer some of the authorities of the Supervisory Board to General Meeting of Shareholders (e.g. settlement of annual report, appointment of Supervisory Board members). In Holland some VCs use a dual model for monitoring their investees: an investment managers who does the deal and takes care for the routine financial monitoring afterwards and an supervisory board member who takes care for the informal communication and coaching part. In our case studies Company 1 makes use of the dual model whereas Company 2 does not.

[3]Source: flotation prospectus 31-3-98 and annual reports 1999 and 2000.

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