Missionaries of Growth and Innovation?

An Evolutionary View of Institutional Development: The Case of Private Equity Associations

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Institutional Theory (e.g. Scott, 1991, 1995; Tolbert & Zucker, 1996) serves as the basis for our understanding of how the institutional context influences business activity, however the role business activity plays in shaping the institutional context is less obvious.
Key Arguments regarding the Drivers of Institutional Change

Institutional Context:
- Regulatory
- Normative
- Cognitive

- Institutional change arises in response to institutional contradictions and misaligned interests (Seo & Creed, 2002)
- Institutions respond to functional, political or social pressures according to their resource dependencies (Oliver, 1991, 1992)
- Human practice mediates between institutional contradictions and institutional change (Heydebrand, 1977)
- Institutional change required collective and conscious choice by a critical number of agents (Barley and Tolbert, 1997)
- Such collective and conscious choice is often the result of *exogenous shocks* (Barley and Tolbert, 1997) or *focusing events* (Kingdom, 1994)
- Managers are potential change agents that influence institutions through the activities of their firms (Whittgenton, 1992)
This study looks at the mechanisms through which the institutional context shapes business activity and vice-versa in four steps:

(1) It documents how a novel institutional template evolves in response to (a) functional pressures and (b) political action

(2) It proposes a model of the influence of business activity on the institutional context and highlights regulatory responses to the success of new institutional templates in this model.

(3) It proposes an evolutionary view on institutional development and argues that the characteristics of alternative instructional templates evolve over time in response to selection mechanisms through an interrelated process.

(4) It develops a model of how (host) country characteristics influence the cross-border diffusion of institutional templates.
PE Associations (Terminology is adjusted from Michael Jensen’s (1989) notion of the LBO Association) consist of several (standalone) businesses under (full or partial) equity control of Private Equity Funds managed by specialized financial investment companies.

Two archetypes:

Venture Capital PE Association:
- Investments in entrepreneurial ventures
- Equity only
- Often minority stakes
- Often in growth sectors (IT, biotech)

Buyout PE Association
- Investments in large, established companies
- Substantial use of financial leverage
- Typically controlling stakes
- Typically in mature industries
Empirical Context: Private Equity (PE) Associations

Key differences to established institutional templates (Baker & Montgomery, 1994; Berg & Gottschalg, 2004):

- Absence of integration/interaction between various units
- Incentive alignment between equity investors and managers of individual businesses
- Professionalization of ownership
- Combination of active controlling ownership, ‘private’ status and diffused shareholder base

The institutional template of the Private Equity Association evolved in the US during the 1960s (VC) and the 1970 (Buyout) and gained great popularity during the 1980 (Buyout) and the 1990 (VC), but then spread to other parts of the world.
The new institutional template of the Private Equity Association emerged in the US in the 1980 in response to *functional pressures*:

Davis & Thompson (1994) document how the then-dominant institutional template of managerial corporate control was challenged by what became the institutional template of the Private Equity Association due to accumulated institutional contradictions (see also Jensen 1989) of the former stemming from:

- Changes in the regulatory environment by the Reagan administration
- Increasing power of institutional investors
- The emergence of a functioning market for corporate control (Manne, 1962)

However, the institutional template of the Private Equity Association has not always been a response to functional pressures. Bruton et al (2002) describe how the government of Singapore was able to create a national Venture Capital industry and this to establish an adjusted form of the US institutional template of the Venture Capital PE Association through *political* action and a combination of

- Regulatory Reforms (Scheela 1994, Lim, 2000)
- Fiscal Incentives to attract Venture Capital (Arun & Yap, 2000)
- The direct creation of government-owned Venture Capital Funds (Gibbons et al 1998)
Business activity shapes all three pillars (Scott 1995) of the institutional context. While part of the cognitive and normative pillars are related to national culture (Busenitz et al 2000, Scott 1995, 2002) and hence not prone to change (Hofstede, 1980), another part is variable as it can be influenced over time though the institutionalization of judgements (Tversky & Kahneman, 1974) or direct experience (March, 1994). Changes in the normative and cognitive pillars can ultimately trigger regulatory changes to remove institutional inconsistencies. (Seo & Creed, 2002)
The success of Buyout PE Associations in the 1980s in the US, which was closely linked to high-yield (‘junk’) bond market, triggered several changes in the institutional context:

- Initially, greatly increased public attention to the phenomenon
- Substantial ‘Negative Press’, enhanced by popularized lawsuits (e.g. RJR Nabisco) that served as focusing events
- The public attention started a change in the variable parts of the normative and cognitive pillars of the institutional context and ultimately triggered a
- Regulatory response:
  - Tax rules limit tax shield effect of leverage
  - Restrictions for the use of high-yield bonds
- Result: Buyout activity decreased significantly in the early 1990s
Institutional Theory emphasizes the pressures organizations face to adapt similar practices and structures (DiMaggio & Powell, 1983), while we observe the continuous coexistence of alternative institutional templates for the organization of (the same) business activity:

<table>
<thead>
<tr>
<th>Institutional Template</th>
<th>Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-Owned Enterprise</td>
<td>very old</td>
</tr>
<tr>
<td>Privately-Owned Enterprise</td>
<td>very old</td>
</tr>
<tr>
<td>Publicly Traded Enterprise</td>
<td>more recent, but generally established</td>
</tr>
<tr>
<td>Private Equity Association</td>
<td>most recent, arguably still emergent (Henitz &amp; Zelner, 2003)</td>
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</tbody>
</table>
As institutional templates are not created entirely new, but evolve within socially accepted frames and models (Clemes & Cook, 1999), it can be argued that institutional templates mutually influence one another through functional, political or social pressures (Oliver, 1992) in their evolutionary process:

An Evolutionary View on Institutional Development

Exerts functional, political or social pressures on

Institutional Template A

Exerts functional, political or social pressures on

Institutional Template B
Today, many Publicly Traded Enterprises imitate several of the (perceived) ingredients of the success of Private Equity Association.

From Buyout Associations, they have adopted aspects, such as
- Increased financial leverage
- The use of stock options for top management compensation (Marshall and Heffes 2004)
- Pay-for-performance schemes (Marshall and Heffes 2004)
- A reduced scope of activities organized within one organizational unit (Baker & Montgomery, 1994)
- The use of internal capital markets

From VC Associations, they have adopted aspects, such as
- The Greenfield development of new business activities
- The use of corporate venture capital
- The ‘outsourcing’ of early-stage R&D activities to start-ups

Similarly, Private Equity Association seem to adopt some successful practices of Publicly Traded Enterprises, such as the focus on a parenting effect (Goold&Campbell 1996) for their ‘portfolio companies’ (Berg & Gottschalg, 2004) or a sector focus for their deals (Gottschalg & Zollo 2004).
The influence of (host) country characteristics on the cross-border diffusion of institutional templates

The institutional template of the Private Equity Association that emerged in the US in the 1980s subsequently diffused to several other countries. However, the degree of adjustment to local idiosyncrasies, as well as the volume, performance, and nature of investment by Private Equity Associations differs drastically across these countries.

As an elaboration of the notion that national culture affects entrepreneurship (Busenitz & Lan, 1996; Mueller & Thomas, 2001), one can propose a model that considers the impact of country characteristics, such as culture (Hofstede, 1980) or more generally the country institutional profile (Kastova, 1997) as a determinant of the local emergence of ‘imported’ institutional templates.

Specific hypotheses derived from this model will be tested using data from the diffusion of Private Equity Associations to several European countries.
Status Quo: Empirical Analysis

Data Collection:
• Data on the PE Industry – Completed
• Data on Public Attention to PE Industry (Frequency of News Coverage) – Ongoing
• Data on „Events“ that reflect changes in the institutional environment – Started

Challenges:
• Development of suitable “Country Institutional Profile”
• Identify relevant Key Events for all countries
• Develop Measures of Public Attitudes towards PE Industry