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CHAPTER 19

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CORPORATE GOVERNANCE IN IPOS

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IGOR FILATOTCHEV AND DEBORAH ALLCOCK

INTRODUCTION

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It is increasingly recognized in the management literature that the initial public offering (IPO) is an important stage in the life cycle of privately held and entrepreneurial firms. At this critical juncture, a firm has overcome the first challenges of its entrepreneurial phase and entered a growth stage. As Fama and French (2004: 229) emphasize, an IPO “is the point of entry that gives firms expanded access to equity capital, allowing them to emerge and grow.” An IPO can provide an entrepreneurial firm with critical resources for its future expansion. It can also provide the entrepreneur with the first substantive access to cash from their investment of time and resources in the entrepreneurial effort.

Despite the growing awareness of the importance of IPOs among both academics and the investor community, the process by which a privately held firm transforms itself into a publicly traded company is still not well understood. While numerous studies have investigated the determinants of the going public decision (e.g. Booth and Smith, 1986; Jain and Kini, 1999) and post-issue performance (e.g. Beatty and Ritter, 1986; Brav, Geczy, and Gompers, 2000; Espenlaub and Tonks, 1998; Michaely and Shaw, 1994), there is relatively little research on the related but equally important issue of what factors influence the corporate governance mechanism of a firm at IPO stage, and how the specific characteristics of this mechanism such as board composition, executive incentives, and ownership interests of private equity investors may affect the IPO’s performance.

Organizational theorists have increasingly drawn on agency theory (e.g. Beatty and Zajac, 1994; Brennan and Franks, 1997; Mikkelsen et al., 1997) and upper echelon research (e.g. Certo et al., 2001b; Hambrick and Mason, 1984; Higgins and Gulati, 1999) to generate a body of conceptual and empirical research that is focused on corporate governance problems of IPOs. A major underlying assumption of this research is that of an information asymmetry between the IPO’s team, underwriters, and public market

investors that may create agency costs and lead to a substantial reduction in IPO performance (see Certo et al., 2001a; and Michaely and Shaw, 1994, for an extensive discussion). For example, underpricing of the stock at the IPO, the difference between the initial price at which a firm's stock is offered and the closing price of the stock on the first day of trading, is a major concern to the entrepreneurial firm and to the entrepreneur since it represents value the market ultimately sees in the stock but which the firm/entrepreneur did not obtain when the stock was first offered for sale (Daily et al., 2003; Ibbotson et al., 1988).¹

This chapter is focused on complex interrelationships between corporate governance and performance of the IPO firm. Its first contribution is the exploration of agency conflicts, not as a unitary concept as has been done in prior research, but instead as two distinctive types of agency problems (adverse selection and moral hazard). It analyzes the effectiveness of firm-level signals associated with private equity ownership patterns with regard to each of these types of agency problems within entrepreneurial IPO firms. It brings in the debate about the development of executive pay schemes at this transitional time (particularly linked with the dilution of ownership and increase of agency problems). A third contribution is related to the discussion of the governance roles of venture capital syndicates since, as a rule, IPO firms have a number of private equity backers when they come to the stock market. Finally, it proposes further areas for research to improve knowledge of this particular change in strategy, organizational structure, and the dynamic development of the firm.

INFORMATION ASYMMETRIES AND THE ROLES OF CORPORATE GOVERNANCE IN IPO FIRMS

Information asymmetries, or differences in information between the various parties to the listing process, including the IPO firm, banks-underwriters, entrepreneur, and external investors, has been the foundation of prior investigations of underpricing (Ritter and Welch, 2002). Bruton et al. (2009) show that information asymmetry leads to two distinctive types of agency problems—adverse selection and moral hazard. To illustrate adverse selection agency conflict a manager may not accurately reveal all he/she knows about a firm. As Ritter and Welch (2002: 1807) argue: “after all, small investors cannot take a tour of the firm and its secret inventions.” Specifically, at IPO this may take the form of overly optimistic estimates of the firm's revenues by one of these parties. These overly optimistic estimates can increase the expected value of the firm and in turn increases the rewards from the IPO and are a type of adverse selection agency conflict. Moral hazard problems emerge when information asymmetries make it possible for managers to pursue self-serving objectives and not act at maximum efficiency and effectiveness for the firm. For example, founder-managers may hold significant equity stakes in the IPO firm, and there is the potential for these individuals to abuse public market

investors (Bruton et al., 2010). An entrenched founder-CEO may also try to retain a leadership position even when his/her skills become inadequate to new challenges faced by the firm (Nelson, 2003). As a result of these information asymmetries, there are potential agency costs when a firm experiences an IPO since managers may not reveal actions within the firm or do not take certain actions that maximize the firm benefit (Sanders and Boivie, 2004).

At IPO investors recognize the potential impact of the agency costs associated with information asymmetries, and they will therefore anticipate potential agency costs and price-protect themselves, thus leading to an IPO discount. Prior research approximates this discount by a lower industry-adjusted offer price/book or price/sales ratios (e.g. Chahine and Filatotchev, 2008), while others associate it with greater underpricing, measured by the difference between the first-day-trading closing price and the offer price (e.g. Daily et al., 2003), suggesting that the aftermarket price provides a good proxy for an intrinsic value of the IPO firm. Some researchers, however, argue that the uncertainties and information asymmetries cannot be resolved on the first day of trading, and suggest using longer-term proxies for the stock market discount (Aggarwal and Rivoli, 1990; Loughran et al., 1994).

However, the IPO team may use corporate governance-related signals that allow potential investors to better understand the true value of the firm and reduce risks of agency problems, which in turn can improve the IPO firm's performance (Sanders and Boivie, 2004). Corporate governance studies in the IPO context have recognized a wide range of potential "good governance signals" that include board characteristics, executive incentives, and the governance roles of early stage investors. These governance factors play a dual role in addressing two types of agency conflicts in an IPO firm. First, they may convey important signals about the "quality" of IPO firm, and this may reduce the extent of adverse selection problems. For example, by attracting prestigious and experienced independent board members, an IPO firm can differentiate itself from other "poor quality" IPOs. At the same time, these independent directors may improve the extent and quality of monitoring, which imposes constraints on managerial discretion and reduces moral hazard-type agency conflicts. Likewise, venture capitalist may play important certification and monitoring roles that affect both types of agency conflicts. By carefully selecting their investment targets, they certify the quality of firms they bring to the stock market. In addition, venture capitalists (VCs) often retain their ownership after the flotation, and their objectives and post-issue monitoring incentives may be aligned with public market investors (Bruton et al., 2010).

A central premise of this research is that corporate governance factors may be important signals to investors with regard to the quality of a particular IPO firm, as well as the extent to which their interests are protected from insiders' opportunism during and after the flotation. As a result, corporate governance characteristics should have a significant impact on a wide range of IPO performance metrics, such as underpricing, longer-term performance, and survival. In the following sections, we look at different governance factors, such as board characteristics, early stage investors, and executive compensation in IPO firms, and how they may affect performance. Table 19.1 provides the main find-

Table 19.1. Content and findings of key papers focused on corporate governance in IPO firms

Research focus	Source	Sample	Key issues	Theoretical underpinning
Going public and post-issue performance	Brav, Geczy, and Gompers (2000)	USA. Sample of 4,622 IPOs, 1975–92	Underperformance of small issues with low market-to-book ratios	Agency/signalling theory
Going public and post-issue performance	Espenlaub and Tonks (1998)	UK. Sample of 428 IPOs, 1986–91	Partial support for IPO signaling hypothesis using underpricing of IPO issues	Agency/signalling theory
Going public and post-issue performance	Jain and Kini (1999)	USA. Sample of 877 IPOs, 1977–90	IPOs are tracked over a five-year period, with IPOs subdivided into survivors, non-survivors, and acquired firms. Survivors have significantly better operating performance, higher retained ownership, VC involvement, and prestigious underwriters	Agency/signalling theory
Going public and post-issue performance	Michaely and Shaw (1994)	USA. Two data sets 947 IPOs: IPO of Limited Partnerships (58) and standard IPOs, 1984–8	No support for signaling models. Research finds that lower levels of underpricing associated with higher dividends	Agency/signalling theory
Board composition and performance	Cohen and Dean (2005)	USA. Sample of 221 IPOs, January 1, 1998–December 31, 1999	Strength and attributes of top management team send positive signal to investors of future economic potential of the firm	Agency/signalling theory
Board composition, share ownership, and performance	Filatovchev and Bishop (2002)	UK. Sample of 251 IPOs, December 1, 1999–December 31, 2000	Endogeneity of board composition and share ownership. Both factors affect IPO underpricing	Agency/resource based view

Founders and boards	Certo et al. (2001b)	USA. Sample of 368 IPOs, 1990–8	Founder status on the board and founder management has a positive effect on levels of underpricing but is moderated by the proportion of insiders on the board	Agency/signalling theory
Founders and boards	Jain and Tabak (2008)	USA. Sample of 231 IPOs, 1997	Founder vs non-founder CEO firms. Find significant differences in the governance structures of founder and non-founder firms. Particular reference to ownership, board size, and venture capitalist involvement	Agency/signalling theory
Founders and boards	Nelson (2003)	USA. Sample of 157 IPOs, January 1–December 31, 1991	Founders are likely to exercise strong strategic leadership in firm governance in comparison with firms without founder CEOs and that this type of leadership may be valuable at the time of transition to public ownership	Agency/signalling theory
Executive remuneration	Beatty and Zajac (1994)	USA. Sample of 435 IPOs, 1984	Incentives used to lower agency costs are investigated within context of risk-averse executives	Agency theory
Executive remuneration	Allcock and Filatotchev (2010)	UK. Sample of 311 IPO companies, 1998–2002	Governance factors affect introduction of performance-related incentives at IPO. This is also affected by the risk-framing of the executives	Agency theory and prospect theory
Executive remuneration	Lowry and Murphy (2007)	USA. Sample of 874 IPOs, 1996–2000	No evidence that IPO options are related to IPO underpricing	Agency theory

(continued)

Table 19.1. Continued

Research focus	Source	Sample	Key issues	Theoretical underpinning
Governance and private equity firms	Barry et al. (1990)	USA. Sample of 433 VC-backed and 1233 non-VC-backed IPOs, 1978–87	The number of VCs invested in the issuing firm is negatively related to initial underpricing	Signalling theory
Venture capitalists and certification	Brav and Gompers (2003)	USA. Sample of 2,794 IPOs, 1988–96	Insiders of firms that are associated with greater potential for moral hazard lock up their shares for a longer period of time. Venture capitalist involvement seen in firms that have experienced larger excess returns	Agency/signalling theory
Venture capitalists and certification	Coakley and Hadass (2007)	UK. Sample of 590 IPOs, 1985–2003. Split as 316 VC-backed and 274 non-VC-backed	Support for venture capital certification in the early years, but a significantly negative relationship between operating performance and venture capitalist board representation during the bubble years (1998–2000)	Agency/signalling theory
Venture capitalists and certification	Jelic, Saadouni, and Wright (2005)	UK. Sample of 167 buyout IPOs, 1964–97	IPOs of MB0s backed by highly reputable venture capital firms provide better long-term investments as compared with those backed by less prestigious venture capitalist firms	Agency/signalling theory

Venture capitalists and certification	Loughran and Ritter (2004)	USA. Sample of 3,025 IPOs, 1990–8	Pre- IPO investors, in particular VCs, look to extract rents through deliberate underpricing, in exchange for preferential share allocation in further underpriced IPOs	Prospect theory
Venture capitalists and certification	Meggison and Weiss (1991)	USA. Matched sample of 320 non-VC-backed and 320 VC-backed, 1983–7	Matched by industry and offering size, they find that the initial underpricing of VC-backed IPOs is significantly lower than for non-VC-backed IPOs	Agency/signalling theory
Syndicated private equity	Bruton et al. (2010)	UK and France. Matched sample of 444 UK and French IPOs, 1996–2002	VC syndicates create principal–principal agency conflicts that negatively affect IPO performance. The extent of these conflicts and their remedies depend on national institutions	Agency and institutional theories
Syndicated private equity	Filatotchev, Wright, and Aberk (2006)	UK. Sample of 293 entrepreneurial IPOs, 1999–2002	Provide evidence that IPOs backed by syndicates of VCs are more likely to develop independent boards than are IPOs backed by single VCs	Agency theory

formance indicators of IPO firms. As this table clearly shows, previous research on the governance in IPO firms has identified a wide range of governance mechanisms that may have both value-enhancing and value-destroying effects. This may explain the ambiguity of empirical findings that so far have failed to provide a consistent picture of the governance impacts in IPO firms.

BOARD CHARACTERISTICS AND PERFORMANCE OF IPO FIRMS

Boards of directors are a common feature of companies throughout the world, so it is easy to see that, for companies, the board of directors represents a prime strategic driver. Indeed, its duties range from the appointment of directors, self evaluation measures, collective responsibility, and reporting to external audiences. However, the board of directors has a particular role at the time of an initial public offering, starting with the decision to take the company public. In this process the board will have the challenge of selecting underwriters, approving offer terms, providing vital information for the prospectus document, and essentially overseeing the IPO process (and at the point of the IPO considerable information asymmetry will exist). More recently, the fiduciary duties of directors mean that the directors are subject to personal liability for statements made at this time.

BOARD COMPOSITION AND PERFORMANCE

Investors' perception of the board of directors is often gained via the prospectus document, and strong boards provide the investor with future governance signals (Certo, 2003). Investors may view the board from the perspective of managerial talent, board independence, and entrepreneurial founders.

Human capital theory shows us that directors' expertise, experience, and specific knowledge can all add value to a company's successful performance (Hillman and Dalziel, 2003) and contribute to overall corporate governance (Arthurs et al., 2008; Carpenter and Westphal, 2001). Indeed D'Aveni (1990) argues that prestigious directors in terms of their human capital can be indicative of the overall quality of the firm (useful under the signaling hypothesis). Similarly, it is not just directors' experience that is examined here; studies have examined the age of directors (Cohen and Dean, 2005) and their educational levels (Lester et al., 2006). Arguably, age has a direct link to expertise, knowledge, and experience, which in turn translates into the ability to perform a job well (Tesluk and Jacobs, 1998).

There is also the notion of board characteristics as examined by the view of board independence. Board independence is often seen as the proportion of executives/non-

executives, but can also be seen in terms of insiders and outsiders on the board (however, not all non-executives can be deemed independent). At the time of the IPO, the board may be in a development phase, and so strategic selection of non-executive directors to balance the existing executive directors' experience gaps is vital (Shivdasani and Yermack, 1999; Westphal, 1998). As such, the requirements of balancing skills will often cause the IPO company to prefer directors who are involved with other boards (Beatty and Zajac, 1994). From a resource-based view of the firm (Pfeffer, 1972), broadening the board's experience at this particular point in the development life cycle is vital to future success. Similarly, the appointment of well-connected non-executives will provide bargaining power in discussions with underwriters and investors (Provan, 1980). They are also able to bring in further business contacts as the firm grows. A positive aspect of this practice is that, by gaining established non-executive directors on the board, certification of good governance practice is established, and thus at IPO this can (under signaling hypotheses) add additional value and differentiate a particular issue for future investors. However, the downside is that outside directors have the potential for high levels of "interlocks" (Dalton et al., 1999; Zahra and Pearce, 1989), something the UK Corporate Governance Code (Financial Reporting Council, 2010) attempts to limit. Thus, in terms of good practice, listing authorities arguably prefer more independent boards and, in general, so do investors (Gompers, 1995).

FOUNDERS AND BOARDS

Just as broader aspects of board characteristics can be considered, there is also the case of the entrepreneurial IPO that has the founders of the company on the board. Most founders who make decisions to float their companies are often considered by outside investors as "untested" from a board point of view when they take their firms public (Wat, 1983). However, in today's dynamic economy, we see the presence of founders within many company contexts (e.g. Steve Jobs at Apple, Bill Gates at Microsoft), and they are particularly relevant for younger, high-growth firms and technology firms (Eisenhardt and Schoonhoven, 1990). In the context of the initial public offering company, around one-third to one-half of flotations go public with founders at the helm, and receive handsome offer prices compared with non-founder valuations (Certo et al., 2001b; Nelson, 2003). Thus, considering the role of the founder at the point of the flotation has value, particularly as founders have considerable power due to large ownership stakes (Jain and Tabak, 2008) and extensive skills.

As a founder member of the firm, their influence is seen in defining the firm's purpose, i.e. the mission statement which then translates through the company to organizational attributes such as structure (Kunze, 1990; Vesper, 1996). Some authors (Baron et al., 1999) argue that this is the founder "imprinting" his/her will on the firm, and this will then continue unless the founder exits the company (Mintzberg and Waters, 1982). Indeed Monks and Minow (2004) argue that this is a result of the extensive ownership

that some founders have, enabling them to be revered in their company context, and greater ownership levels do indeed lead to founders commanding the CEO position (Nelson, 2003). Combined with the founder's position, this affords them extensive power, and it is not unusual to see founders in the dual role of CEO and chair (Beatty and Zajac, 1994; Daily and Dalton, 1997; Finkelstein and D'Aveni, 1994). There is also a further strengthening of founder power when a family is involved (particularly where parents and children are concerned) (Schulze et al., 2003).

The influence that the founder has through the structural aspects of the board does not, however, necessarily translate into performance. Several studies have begun to question whether firms managed by their founder perform differently from those managed by non-founders (Begley, 1995; Jayraman et al., 2000). However, the attribution of performance to founders has mixed support and is often entangled with other variables, namely ownership levels and board independence (Adams et al., 2009; Nelson, 2003; Villalonga and Amit, 2006).

The role of the founder is not infinite, though, and perhaps at the IPO, more than at any other time, it comes into question. Some question whether the founder is the best person managerially to lead a firm into the public-listing phase of its life cycle. Founders may not have the inclination to develop new skills to suit the challenges that come with a flotation (Jain and Tabak, 2008). Often changes in leadership are required (Greiner, 1972). The issue of a more independent board arises and, with it, the replacement of the founder with a professional successor just prior to the flotation process (Jain and Tabak, 2008; Wasserman, 2003).

EXECUTIVE REMUNERATION IN IPOs

For any private company undergoing an initial public offering, the process provides an opportunity to look at the key issues of executive pay and make some strategic decisions with regard to how executives are remunerated. Whilst other chapters look at executive remuneration in more detail, for the IPO, company executive pay is particularly tied to the life cycle of the firm and the professionalization aspects of the board of directors. First, the company must acknowledge the role that remuneration can play as a governance tool. Typically this comes from an agency perspective, relying on the objective of bridging the gap between owners and self-serving managers (Berle and Means, 1932; Fama, 1980; Jensen and Meckling, 1976). Second, managers must prepare themselves for the future reporting of their pay structures. From the flotation onwards, pay strategies and remuneration amounts will have to be transparent. Regardless of the wishes of the board of directors, following the IPO there will be the potential for public (and investor) scrutiny of executive pay via the annual report and accounts. The challenge for the IPO company thus is that the development of their scheme at the IPO needs to set the compensation philosophy for the immediate future of the company. It needs to address key issues about what the compensation mix should be (and how much should be provided),

what incentives need to be addressed, what might be the role of share options schemes, and in particular how these might be structured with regard to performance measures, comparators, and targets.

The transfer of ownership into the public domain gives a unique opportunity for the company to consider its philosophy with regard to remuneration. It can be considered that this will serve the company throughout this life-cycle change and could provide grounding to strategically position pay for the board of directors. Furthermore, as the company seeks to grow, it will look to hire new people to the board, and thus compensation packages become an important asset in attracting and retaining talent.

COMPENSATION MIX

The compensation mix is related to discussions about and answers to questions such as: where do you want to position pay for your executives relative to your peers or industry? The professionalization of the board (Daily and Dalton, 1992; Flamholtz, 1986) and the need for the recruitment and retention of executive talent (Conyon, 2000; Daily and Dalton, 1992) makes these initial decisions particularly relevant. First, the mix generally comprises base salary, annual bonus, and long-term performance pay. To consider these aspects fully it is not unusual for the IPO company to begin the process at least six months before the IPO, and many of the details about rewards will be placed in the firm's IPO prospectus.

Base Salary and Annual Bonus

Little seems to be said about base salaries. However, the typical CEO in the US makes between \$500,000 and \$1 million per year in base salary (*Wall Street Journal*, 2010), with the figure for the UK being £131,000 (for companies with a turnover of up to £50m) (Institute of Directors, 2011). However, for an IPO company, base salary varies and perhaps can be better described in terms of market capital valuations at the point of the IPO. As with mature companies, there is a link to size of company, with average top directors gaining base salaries of £140,000 (for market capital of £30–50m) to £208,000 (for market capital of £101–250m) (Deloitte & Touche, 2005a). However, of greater impact (and perhaps a more cost-effective method) are the longer-term incentives provided at this point.

Long-Term Incentives

Since long-term incentives make up a large proportion of executive pay for both US and UK executives (Deloitte & Touche, 2005a, 2005b), it is vital that the IPO company

remains in line with mature companies in terms of its pay structure. As with mature companies, the purpose of the long-term incentive is threefold: to align the interests of the executive managers with those of shareholders (Nohel and Todd, 2005; Rosen, 1990; Tosi et al., 1997), to strengthen the links between compensation and the long-term performance of the company (Buck et al., 2003; Conyon and Sadler, 2001; Hall, 1998; Jensen and Murphy, 1990; Kroll et al., 2007), and to reward/motivate the executive for/toward performance achievements (Liu and Stark, 2009; Mackey, 2008; Tosi et al., 2000).

After the report by Greenbury (1995), the variety of long-term incentives has increased. However, in general we can categorize them as taking one of two main forms. The executive share option (ESO) gives the recipient the right to purchase a number of shares at a specified price (usually the price when the option is granted: a point we will discuss later) for a specified period of time subject to performance criteria being met, whilst the long-term incentive plan (LTIP) awards a grant of shares (at zero cost) that vest (i.e. transfer ownership to the executive) upon the attainment of predetermined performance criteria. Both types of scheme have particular tax implications, but these are beyond the scope of this chapter, and both schemes provide a way of linking executive pay to performance (Fama and Jensen, 1983a, 1983b). The decisions with regard to performance benchmarks (which must be met in order for the shares to be bought or vested in the executive) can also be used to complement the company's strategy. For performance criteria, there are two general schools of thought, using either a market-based measure of performance such as shareholder return or shareholder wealth, or a more traditional accounting measure, i.e. earnings per share. When developing the particulars of the new scheme, the IPO company would be wise to look toward the particular practices of similar companies to provide adequate comparators to ensure ongoing competitive salaries.

SHARE OPTIONS GRANTED AT THE POINT OF THE IPO FLOTATION

When it comes to paying executives, many IPO companies prefer equity rewards over cash compensation. They provide a good signal for agent alignment (Jensen and Meckling, 1976), with a potential upside of giving ownership in a company the executives are likely to lead. IPO options are also seen to encourage a higher propensity of risk taking (Beatty and Zajac, 1994; Wiseman and Gomez-Mejia, 1998), which in turn can lead to better performance (Hall and Leibman, 1998). However, more recently, there have also been discussions about the way particular reference is made to share options at the point of the IPO, given that the executives (in particular the CEO) are able to influence the timing of the IPO and thus the option grant (Lie, 2005; Yermack, 1997). This is more significant when the CEO is also the founder of the company (Certo et al., 2003). This is particularly relevant as the IPO share option will have an exercise price equal to

the offer price for the IPO and high levels of underpricing for IPO issues have been seen for company floatations (Daily et al., 2003; Filatotchev and Bishop, 2002). With the option exercise price equal to the offer price, Lowry and Murphy (2007) argue that offer prices may be deliberately deflated so that executives maximize option gains due to underpricing (but their study shows no tangible link between options and underpricing). However, the picture is perhaps not just one of simple timing combined with CEO power and influence.

Other factors are deemed to come into play with regard to offer prices and underpricing of the IPO, for example, highly independent boards can counterbalance CEO power (Core et al., 1999) which would reduce underpricing (Filatotchev and Bishop, 2002). Furthermore, future investors might prefer companies with more independent boards (Gompers, 1995). There is also the impact that venture capitalist involvement might have on the choice of share options (Allcock and Filatotchev, 2010) and offer pricing levels (Fried et al., 1998). If venture capitalists are driving the timing of the IPO, then they may offer options at a low offer price in order to compensate the CEO for his support for the IPO timing.

For the executive, any underpricing at the point of the IPO represents money left on the table. Founder-CEOs who are granted stock options at the IPO may be seen as opportunistic managers (Zhang, 2006), using the options to generate gains that offset the wealth loss from underpricing due to their pre-IPO ownership. However, with large option awards, this might be counteracted because a low option price would provide the executive with high levels of future gains due to the increase of the share price immediately after the flotation. If shares continue to increase in value, the IPO option will ultimately increase the value and then significantly add to the level of the executives' compensation. The final caveat here would be that boards at IPO are undergoing a major transition and much of the rationale for grants relies on executives remaining within the company (usually for three years, i.e. a normal vesting period). Thus there may arguably be an alternative perspective for the IPO option, and rather than alignment, their potential for high gain can be a way of tying the executive to the board for a period of time. This may be viewed from a resource-based view of the firm perspective and might significantly attract investors as board stability could increase overall company performance.

The above demonstrates that planning remuneration for the IPO company, particularly as this takes part during the pre-IPO stage, can be difficult. There must be reference to developing schemes that balance cost efficiency, competition for talent in the sector, whilst ensuring that the scheme signals good governance for shareholder alignment. Perhaps with this in light, the following key points for the IPO company should be remembered. When initiating executive share option schemes, the board should plan and view schemes as complementary to core company strategy. This way they will link in with the life-cycle development of the firm. However, it is important to remember that the IPO process is a time of dynamic change. The board should thus keep challenging and refining compensation in line with the changes that are happening, remembering that plans will need to change as the market, company strategy, and maturity stages

change. This also might be a time of change for the board of directors. With this in mind, existing board members will need to pay particular attention to compensation and reward when in negotiation to recruit and/or retain staff. In order to do this effectively and transparently, it is best if share option plans are kept simple.

THE GOVERNANCE ROLES OF PRIVATE EQUITY FIRMS

As entrepreneurial firms gradually “professionalize,” they increasingly look outside for financial resources provided by various early stage investors. Venture capitalists serve an important role in the development of promising young ventures (Barry et al., 1990). VCs raise funds from passive investors and then invest those funds through staged financing in various portfolio firms (Gompers and Lerner, 1999). Although VCs often do not have detailed scientific knowledge about the specific technology in their portfolio firms, they are able to economize on their selection and monitoring costs by focusing their investments in certain industries. By specializing in these industries, they are able to develop a comparative advantage over other investors. Additionally, their involvement in corporate governance helps them to rapidly bring these ventures to a successful exit through an IPO and aids them in generating added value beyond the capital provided.

VENTURE CAPITALISTS AND “CERTIFICATION HYPOTHESIS”

Agency research and the related “certification” framework (e.g. Barry et al., 1990; Black and Gilson, 1998; Lerner, 1995) suggest that an entrepreneurial venture can signal its expected value by who has invested in the firm. Principal among early-stage investors are private equity investors who are the second most important group of shareholders, after founders, in an entrepreneurial venture (Lerner, 1998). This is because successful investors’ time and ability to invest in numerous new ventures is limited so they will invest in those ventures they feel will be the most successful. Thus, private equity investors would be expected from an agency perspective to be involved with those ventures they feel are going to be successful. As a result, their presence can certify to public investors the value of the IPO firm.

Private equity investors, however, are not homogeneous and represent a diverse range of different types of investors, including VC firms, buyout firms, leveraged buyout (LBO) specialists, and “business angels.” There are substantial differences in investment strategies and time horizons among these investors. For example, VCs, as

a rule, specialize in investing in early-stage ventures such as entrepreneurial start-ups, whereas buyout firms and LBO experts focus on management buyouts and LBOs. VC firms are formed as partnerships, whereas “business angels” represent wealthy individuals investing on their own behalf. The vast majority of IPO-related papers focus on the “certification” role of VCs only, and we will return to this issue later. This research places an emphasis on the roles of VC investors in the price discovery process at the time of an IPO, arguing that they may reduce information asymmetry at the time of the issue, and their presence can have a value-enhancing effect (Lerner, 1995). Thus, the presence of VC investors can mitigate the adverse selection problem in an entrepreneurial venture.

Depending on their retained ownership, early-stage investors may also have an incentive to be involved in the decision-making process and to exert a significant influence on management before and after flotation. Since seed and development funding normally causes dilution of initial founders’ holdings, it can create a misalignment of incentives in issuing firms. VC firms design their contracts to reduce this information asymmetry and maximize the disclosure of private knowledge by the entrepreneur-founder (Shane and Cable, 2002). The IPO is characterized by lock-up arrangements which make retained ownership by VCs relatively illiquid after the IPO. As a result, their retained concentrated ownership imposes a cost on them. Thus, their retained ownership signals their belief in the value of the firm to minority investors (Brav and Gompers, 2003). Second, concentrated private ownership leads to a reduction of coordination costs related to multiple types of private and public equity investors in the IPO firm and creates a Jensen-Meckling-type incentive alignment effect that jointly may mitigate the post-IPO risk of moral hazard (Jensen and Meckling, 1976). Therefore, VC investors’ ownership concentration may be a particularly important governance parameter that enhances IPO firm performance and reduces the negative effects of the “IPO discount” arising from agency conflicts. Early prior US research suggests that VCs play a certification role at the time of IPOs. VCs act as third-party certifying agents, reducing initial underpricing (Jelic et al., 2005). Megginson and Weiss (1991) find lower initial returns for venture-backed IPOs.² Using a unique sample of private firms for which there is financial data available in the years before and after their IPO, Katz (2009) differentiates between those that have private equity sponsorship (PE-backed firms) and those that do not (non-PE-backed firms). The findings indicate that PE-backed firms generally have higher earnings quality than those that do not have PE sponsorship, engage less in earnings management, and report more conservatively both before and after the IPO. While more reputable VCs initially select better quality firms, more reputable VCs continue to be associated with superior long-run performance, even after controlling for VC selectivity. The authors find more reputable VCs exhibit more active post-IPO involvement in the corporate governance of their portfolio firms and this continued VC involvement positively influences post-IPO firm performance. In the UK, Levis (2008) examines the aftermarket performance of private equity-backed initial public offerings (IPOs), based on a hand-collected sample of private equity-backed and equivalent samples of venture capital-backed and other non-sponsored issues on the London Stock Exchange. The evi-

dence suggests that private equity-backed IPOs exhibit superior performance compared with their counterparts throughout the 36-month period in the aftermarket; such performance is robust across different benchmarks and estimation procedures. However, Coakley and Hadass (2007) analyze the post-issue operating performance of 316 venture-backed and 274 non-venture UK IPOs for the period 1985–2003. Cross-section regression results indicate support for venture capital certification in the non-bubble years, but a significantly negative relationship between operating performance and venture capitalist board representation during the bubble years. Finally, Hochberg et al. (2007) find that better-networked VC firms experience significantly better fund performance, as measured by the proportion of investments that are successfully exited through an IPO or a sale to another company.

However, recent IPO literature suggests that potential conflicts of interest among pre-IPO investors may lead to higher underpricing. On the one hand, Gompers (1996) argues that less experienced VCs may grandstand, i.e. take firms public earlier than more established firms, in order to raise their profile in the market and attract capital in future rounds. On the other hand, Loughran and Ritter (2004) propose a “corruption hypothesis,” where they argue that some pre-IPO investors (e.g. VCs) may look to extract rents through deliberate underpricing, in exchange for preferential share allocation in further underpriced IPOs. Within this framework, Francis and Hasan (2001) and Lee and Wahal (2004) show that, in recent years, US venture capital-backed IPOs experience larger first-day returns than comparable non-venture-backed IPOs. This suggests the existence of a potential conflict of interests between VC firms and the IPO firm. In addition, following Arthurs et al.’s (2008) conflicting voices argument, VCs have a dual identity as both principals and agents. These investors are often part of limited partnerships that place pressure on them to obtain fast results and to seek a timely realization of their investment. Hence VCs are relatively short-term investors who are likely to be seeking at IPO to realize their gains from their value-adding activities for the venture (Arthurs et al., 2008), as well as to establish their reputation in order to raise further funds. These results are in line with findings in Chahine and Filatotchev (2008), who show that bank-affiliated VCs lead to a poorer IPO performance in France.

Therefore, previous research on the governance role of private equity investors in IPO firms has identified both value-enhancing and value-destroying effects associated with this type of owner. On one hand, private equity investors carefully select their portfolio companies and provide them with the financial and managerial support necessary to develop and grow a new venture. This leads to a strong “certification” effect that may reduce information asymmetries and associated adverse selection agency costs. On the other hand, a limited time horizon associated with lock-up arrangements and exit orientation may substantially undermine the monitoring capacity and incentives of private equity investors, leading to an increase in moral hazard costs.

SYNDICATED PRIVATE EQUITY INVESTMENTS IN IPO FIRMS

In a syndication, two or more venture capital firms come together to take an equity stake in an investment. The percentage of investments syndicated in the UK venture capital market rose in 1999 to 27 percent after having fallen for several years. This was followed by a sharp fall in 2000 and 2001 to about half this level as venture capital firms moved away from the high-tech sector following the collapse of the dot.com boom. By 2002, the more uncertain investment environment appears to have been associated with a further sharp increase, with 26.5 percent of investments being syndicated (Filatotchev et al., 2006). Private equity firms typically undertake repeat syndication over time with a network of partners (Bygrave, 1987, 1988).

Each syndicate usually contains lead and non-lead firms, with an individual venture capital firm playing both roles over time depending on the particular deal. Each syndicate is temporary in nature, with the financing structure constructed specifically for that transaction. This limited longevity of the syndicated investments may create moral hazard problems associated with the “principal–principal” relationship between syndicate members (Filatotchev et al., 2006).

Syndicated investments may be riskier than stand-alone ventures. A fully diversified portfolio is more difficult for private equity firms than for institutional investors who invest in listed stock because of the presence of large ex ante asymmetric information in investment decisions (Lockett and Wright, 2001; Reid, 1998; Sahlman, 1990). Syndication thus may be undertaken as a means of risk sharing through portfolio diversification as it permits private equity firms to invest in more portfolio companies than would otherwise be possible (Cumming, 2006).

Venture capital syndicates involve the sharing of decision-making among the syndicate members. The lower the level of cooperation among syndicate members, the greater the levels of relational risk and hence the associated agency costs. The origins of the agency costs in the syndicate may arise from the diverse objectives of members and the time-consuming nature of coordination. In VC deals with multiple rounds of financing, the lead investor may also have an informational advantage vis-à-vis other syndicate members who enter in later rounds (Admati and Pfleiderer, 1994).

This complex relationship between multiple principals is defined as a “principal–principal” agency problem (Filatotchev et al., 2006), as opposed to the principal–agent problem between investor and investee. These agency problems can in principle be addressed in a number of ways. Shared equity ownership in private equity firms syndicates may bring benefits in terms of higher levels of trust and knowledge acquisition (Beamish and Banks, 1987), as well as mutual forbearance and stability (Mjoen and Tallman, 1997; Yan and Gray, 2001), which provides an effective remedy to situations where the lead syndicate member has access to more information about the investee than the non-lead members.

However, lead venture capital firms may seek a larger equity stake in return for their greater effort in monitoring the investee and coordinating the syndicate (Wright and Lockett, 2003). The investment agreement between the syndicate members may be important in specifying rights of access to information, board membership rights, etc., for non-lead syndicate members, but may be limited by the problems associated with the complexity of contracting.

It is in the interests of the lead venture capital firm not to mislead syndicate partners in sharing information because of the potentially damaging impact on reputation and lack of willingness to reciprocate future deals (Wright and Lockett, 2003). Repeated interaction can lead to high levels of trust as syndicate members come to know how partners will behave (Lockett and Wright, 1999). As venture capital industries are typically small close-knit communities, this scope for building trust and reputations is enhanced (Black and Gilson, 1998).

Another possibility to reduce these “principal-principal” moral hazard problems is to use the IPO firm’s governance system as a mechanism for “arbitrage” between the potentially diverse objectives of syndicate partners (Filatotchev and Bishop, 2002; Gompers, 1995). Where skilled lead venture capital firms are less reliant on other syndicate members for specialist information (Admati and Pfleiderer, 1994) and are more likely than non-leads to exert hands-on influence over investees (Wright and Lockett, 2003), the development of an independent board may be important in ensuring that the syndicate functions effectively. Non-lead syndicate members may seek the appointment of an independent non-executive chair to perform the functions of an “arbiter.” Non-executive board membership may be increased through the presence of non-lead syndicate members to enhance transparency in decision-making and thus c-operation (Wright and Lockett, 2003). Filatotchev et al. (2006) provide evidence that IPOs backed by syndicates of VCs are more likely to develop independent boards than are IPOs backed by single VCs.

In addition to the above arguments, a resource-based perspective suggests that syndication can bring specialized resources for the ex post management of investments. By syndicating deals, VC firms are able to increase the portfolio they can optimally manage through resource sharing (Jääskeläinen et al., 2006; Kannianen and Keuschnigg, 2003). VC firms can access more information by syndicating with other reputable VC firms. However, in specialist areas, VC firms may seek to syndicate with industrial partners. These industrial partners may have more specialist knowledge than either the VC firm itself or other VCs. This knowledge can be important in evaluating the initial investment, in post-investment management, and in providing an eventual exit route.

As the investee develops, there may be a need to access further significant funds. The initial VC backer may have the specialist market-based skills, but need to access further funds to diversify the risk associated with scaling up the operation. As VC funds are typically small (Reid, 1998), they may seek to syndicate deals that are large relative to their fund size, which typically involve later-stage private equity funds (Lockett and Wright, 2001). VC syndicates may therefore also syndicate with private equity firms that specialize in later-stage ventures.

Again, these arguments emphasize the dual governance roles of private equity syndicates in IPO firms. By syndicating IPO deals, private equity investors may diversify their assets and undertake a substantial resource commitment to a portfolio firm. This may enhance the IPO firm's "value" and reduce agency costs associated with adverse selection problems, leading to a substantial improvement of performance. However, private equity syndicate may create their own set of agency problems associated with the the diverse interests of partners and partner opportunism. This would make post-issue monitoring less efficient and more problematic, leading to an increase in moral hazard agency costs.

DISCUSSION AND FUTURE RESEARCH

Governance research is growing in importance and the governance role of boards, executive incentives, and ownership effects is a central feature of such research. Most studies on the effects of governance on performance have examined mature companies, and have used samples drawn from the common law environments of the US and, to a more limited degree, the UK. However, a growing appreciation is forming of the heterogeneity of governance mechanisms (Aguilera and Jackson, 2003) and of how the appropriate governance mechanisms may differ as the setting of the firm changes (Filatotchev and Wright, 2005; Lynall et al., 2003). To date, empirical work has not fully explored these conceptual developments, especially in the context of IPO firms.

For entrepreneurial firms, the IPO is both the sign of a high degree of success to date and an indication that the firm will have greater resources to pursue its strategic goals in the future. For entrepreneurs, who are often referred to as "paper millionaires" until the IPO stock market flotation, the IPO is the first opportunity to actually obtain cash from their entrepreneurial venture. The IPO is thus a highly significant event for the entrepreneurial firm, where "investors' discount" can steal part of the benefit that the entrepreneurial firm and the entrepreneur may seek from the IPO. This research extends our understanding of the role played by corporate governance in the IPO and informs future research on this important event in the life of an entrepreneurial firm.

However, whether governance mechanisms developed in mature companies are fully suitable for the "entrepreneurial nature" of the IPO process is still open to discussion among academics and practitioners. For example, the debate about just how the IPO company selects members of the board still remains open to interpretation. Should independent directors be advisors to an entrepreneur, monitors working on behalf of investors, or both? Whilst some researchers emphasize the importance of the resource-based view of the board in an IPO firm, there is limited qualitative data that enables this particular aspect of the firm's development to be investigated fully. Indicators point to selection being against both resources and peer-based knowledge of the executives rather than through nominations committees (as would be found in mature companies), and the covert world of executive search companies has certainly not been explored.

As for compensation, there are two particular issues that interact with the IPO company. First, the levels of survival have a major impact on the vesting and gains that can be made from any long-term incentives that may be awarded at the point of the IPO. The undertone is that executives gain vast rewards in this way, yet many firms disappear as a result of acquisition and mergers following their offering (and some even de-list). Some studies argue that failure rates within the first three years of flotation range from 6–42 percent (Bradley et al., 2006; Kooli and Meknassi, 2007; Schultz, 1993). This is particularly relevant as many option schemes follow a three-year vesting period, failure would mean that an option lapses, and any merger/acquisition would involve the restructuring of pay/incentives. Thus the incentive mantra of linking pay to equity to enhance IPO performance still has the potential for further investigation.

The research has strong implications for studies of the short-term IPO performance and venture capital, in line with Busenitz et al.'s (2005) arguments that there is a need for more refined and specific examinations of signaling theory. The key to such future research is employing finer-grained methods which allow richer insights to be drawn. As discussed earlier in the chapter, the inconclusive results seen in much of the prior research on the performance of VC-backed IPOs is likely in part due to the coarse methods that have been used. Greater specification of the sample and of the variables is required for the investigation of IPOs and signaling. The impacts of the variables are very distinct, and if these factors are blended in a coarse manner their organizational outcomes may be ambiguous. In addition, a growing body of research within corporate finance and organizational theory maintains that corporate governance factors should not be considered in isolation from each other, but instead they should be examined as “bundles” when determining their efficiency outcomes. For example, Sanders and Boivie (2004) argue that IPOs represent a number of interrelated governance signals which may complement or substitute for each other. Therefore, further theoretical refining of signaling theory is in order.

Our survey of IPO literature suggests that institutional factors, such as the depth and breadth of the private equity industry and corporate governance-related regulatory initiatives, may affect the IPO investment process in terms of both the extent of IPO performance and the role of different types of financier. There is growing recognition that governance and the operation of VC firms may depend on the institutional environment (Chahine et al., 2012; Black and Gilson, 1998; Jeng and Wells, 2000). Further research might usefully extend analysis of the role of risk financiers in other institutional contexts, such as countries associated with network-based corporate governance systems (La Porta et al., 1997). For example, it is clear that the extent of syndication is significantly greater in the US venture capital industry compared with that in Europe (Wright and Lockett, 2003). Future analysis may also shed light on the main drivers of syndicated investments as well as their organizational outcomes.

More generally, an increasing number of studies suggest that agency problems may be different in different national settings and imply that researchers should integrate the agency framework with institutional analysis to generate robust predictions (Chahine et al., 2012). Future research should expand on this concept further and seek to more

explicitly examine the nature of agency conflicts and their implications in different institutional settings (Aguilera and Jackson, 2003). For example, in addition to French civil law contexts (e.g. Spain and Italy, Hoskisson et al., 2004), there are also German civil law and the distinctive Scandinavian legal environment (Fiss and Zajac, 2004; La Porta et al., 1998, 2000). Do these institutional environments have an impact similar to French civil law? Alternatively, investor protection in German civil law is less prevalent than in common law, but more so than in French civil law. Is the impact of German civil law somewhere between the other two legal environments?

It is important to look at specific corporate governance channels, such as board presence, contractual framework etc., which facilitate monitoring of IPO firms. Although a comprehensive analysis of this complex interplay of various governance factors goes beyond the scope of this chapter, Bruton et al. (2009) suggest that institutional differences significantly affect the roles played by different internal governance mechanisms. Researchers need to conduct a more fine-grained analysis to understand the aspects of the interplay of these variables on corporate governance.

Finally, an IPO is not the final stage in the corporate governance life cycle. In a dynamic perspective, corporate governance factors may be affected by strategic choices and outcomes, and the choice of the various governance options could be associated with changes in organizational strategy and firm performance. For example, board diversity may be driven by the organization's growing need to manage the important external elements of the environment that are related to changes in the organization's size and diversity (Provan, 1980). Therefore, the post-IPO evolution of the firm's governance system is a key research issue.

NOTES

1. Researchers commonly focus on a one-day window (trading at the end of day one) when evaluating underpricing (Loughran and Ritter, 2004). A few studies have examined trading at the end of one month.
2. Megginson and Weiss (1991) compare VC-backed IPOs with non-VC-backed IPOs from 1983 to 1987. Matched by industry and offering size, they find that the initial underpricing of VC-backed IPOs is significantly lower than for non-VC-backed IPOs. Barry et al. (1990) analyze the monitoring role of VCs in IPOs from 1978 to 1987. They find that the number of VCs invested in the issuing firm is negatively related to initial underpricing.

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