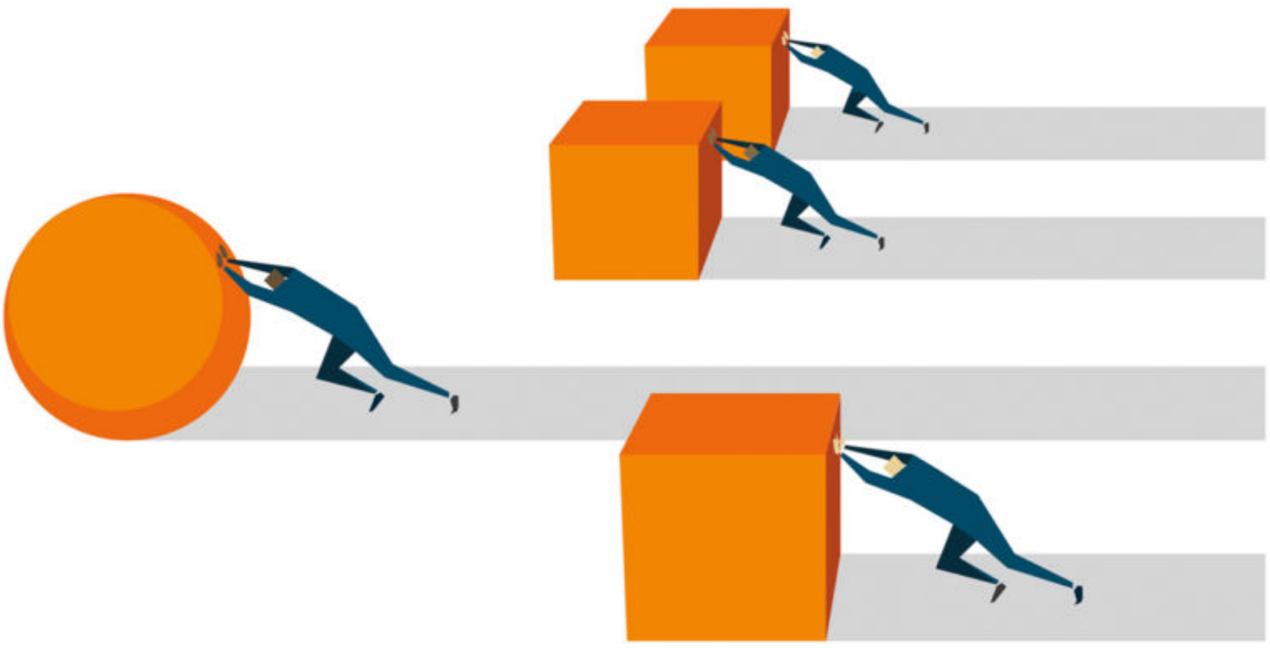
Something Money Can't Buy

The Role of Knowledge, Motivation and Agency Theory in Private Equity Investments in Owner-Managed Companies



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Executive Summary:

Since the introduction of principal-agent theory, it has both in academic circles and in professional business environments become the dominant framework with which to understand and deal with corporate governance issues between company owners and its managers. As a result, it has been widely researched how the construction of corporate governance statutes that regulate relationship between risk and reward, monetary compensation and resulting externalities; overall the alignment of interests between the principals and its agents been widely researched. Especially within top management is the continued motivation and alignment of interests important between capital owner and managers important.

The transfers of ownerships from fully owner-managed companies to externally owned companies bring principal-agent questions to the fore. How does it alter the dynamics of principal-agency relationship? How does it change the motivations of the former owner-turned manager? Specifically, in the case of large-scale private equity investments, such challenges seem all the more pertinent. As professional external ownership comes in, so is likely professional corporate governance structures which is seeking to introduce formal structures for the continued growth of the company. At the same time, the external investors are seeking to capitalize on the uniqueness of the target company and thus must try to preserve both knowledge within the organization and the motivation of part-owners staying on and company top managers. Thus, a successful transfer is key to the success of the PE fund investment and the life of the company. This leaves the period following a private equity investment in an owner-managed company especially vulnerable to missteps and bad management decisions.

This thesis seeks to apply theories of agency theory, knowledge and motivation to add understanding as to why some private equity investments in owner-managed businesses fail. By referring to relevant theories it will suggest what happens to organizational knowledge and management, when an owner-managed company gets external ownership by a private equity fund. It will describe how the agency logic within private equity funds can be detrimental to the investment in the owner-managed company and how an alternative lens of stewardship theory can be helpful in understanding some of these issues. Then, by looking at 3 cases of private equity investments, it will showcase these challenges in practice.

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Scene Setting

Private equity investments have since the turn of the century gathered pace in Denmark as a popular method of rapidly growing medium-sized businesses (DVCA). By injecting large sums of capital for expansion while at the same time changing board composition and professionalizing management, private equity ownerships have often proven a solid method of causing explosive growth in the target company exploiting un-utilized potential. This has also been the case of owner-managed companies, which because of financial limitations or managerial capability within current ownership have not been able to exploit opportunities in the market.

While initially all private equity investments in owner-managed businesses that had gone through the necessary thorough due diligence appeared to be exercises in company value alchemy waiting to happen, a scurry of recent examples paint a more bleak picture. High profile acquisitions such as retail chain Tiger of Copenhagen and children's toy producer Top-Toy have over the past years been cited in Danish business as examples of previously owner-managed businesses, that have struggled following change of ownership. Similar cases can be found in the noughties with bohemia fashion producer Noa Noa and furniture-retailer Ilva, which in the years following the transaction took heavy losses and eventually were exited with a loss. The striking feature for all the given cases is that the financial performances of the company soured in the years immediately following the shift from owner-managed company to private equity ownership while as time passed the original CEO alongside other leading managers quit jobs.

The reasons given by the problematic take-overs by PE partners were wide-ranging: They included the likes of cost control, IT-problems, problems in foreign markets, productions issues and macro-economic downturns. While there can be singular market and competition issues arguably outside of management control affecting company performance, this is also part of business management. The reasons why the company had grown to the size and position whereby it was attractive to acquire by the PE-fund was exactly, that it was robust enough to navigate safely through troubled times. In all cases, new managers on various levels of the organization were brought in to improve the situation, a scenario often repeated several times. With little luck.

It leaves the question why the original owner-manager-turned-CEO did not just continue running the successful business as per usual? The former owner-manager had the requisite knowledge of the company and market conditions and in most cases continued to sit on the board afterwards with a minority stake.

Motivation and Research Question

While working a part-time job in a small private equity fund, the author of this thesis sat in on a meeting, where the current state of fund investments was discussed. First on the agenda was a 3-year old investment of a high precision engineering company producing components for multinational wind energy companies. From the outset the investment seemed a perfect example of how private equity investment can expand a small, promising owner-managed business with a great product line by injecting cash for expansion and capabilities in the form of a solid private equity advisory board. Among the responsible PE partners in charge of the investment were a former CEO of market-leading wind energy company and a former partner of a successful management consultancy. Combined they had the required industry knowledge and knew how to successfully build an effective business organization.

After a two year-transition period, the original founder of the high-tech engineering company exited as CEO as planned and the board of the company hired a new competent CEO as well as making 1, 3 and 5-year strategy plans for the expansion. However, soon problems started to pile up as some customers decided to either end or downsize their maintenance contracts with the company and in addition the expensive machinery ordered to support customer expansion, did not seem to fulfill customer requests. Two senior managers quit for jobs elsewhere. And to make matters worse, the relationship with the local bank over renegotiations of leasing terms of the machines went sour. Inevitably, the company went out of business and the funds investment was lost.

How did it come to this? No-one doubted the business case of the original investment, the due diligence process had gone smoothly and industry knowledge and strategy of the overseeing PE-partners had been convincing. None of the board partners could pinpoint exactly what had gone wrong, until one ventured: *"If the old CEO had still been in charge, this would never have happened. He would've kept relations with the current customers, wouldn't have bought wrong machinery and would have sorted out things with the bank".*

Based on personal observations like the above and press coverage describing challenges in owner-managed businesses overtaken by private equity funds, I have ruminated about what could be the causes. This has led to the research question of this thesis:

- **How can theories on organizational knowledge, motivation and agency theory add to the understanding of challenges faced by private equity investments in owner-managed companies?**

In answering my research question, I will take as point of departure an overview and discussion of the relevant theories of knowledge, motivation and agency in businesses. Following this I will present three select cases, which illustrate some of the particular challenges posed by private equity investments and relate these challenges to the theoretical insights. In conclusion, I will analyze and discuss the insights and evaluate how these might lead to a more refined approach to more successful private equity investments in owner-managed companies.

Epistemology, Methodology and Limitations

It is a popular saying that management is not an exact science – it is hard to make a clear definition of what good or bad management practice is. This is due to its inherent qualitative and contextual nature. Management is not something in itself, it is about the relationship between organizational structures, people, performance and production processes, etc. And all of this will be evaluated in light of the given circumstances and challenges of the given business challenges and environment in general.

In recognition of this ontological nature of my research field as existing as a social construct my epistemology is rooted in a qualitative research tradition. Both the practitioners and researchers within the field of private equity fund investments stress the importance of the qualitative evaluation of the challenges as well as opportunities when joining or taking over the management of owner managed companies. This can be seen, as I show in this thesis, both in the process of assessing opportunities or "fit" between different business collaborations and potential change of ownership or in later stages when trying to explain challenges or unmet financial expectations.

In this thesis I have chosen a qualitative and inductive approach in using case studies to exemplify and illustrate the explanatory value of selected theories of the defining and critical elements in business collaboration and change of ownership that I have decided to focus on.

I have chosen a mono research method of qualitative research and interpretation through case studies in this thesis. For empirical analysis, I have made use of excerpts from Danish business press as well as interviews given to business podcasts and online television-channels. This choice was made in part because of a time constraint, but also because getting access to the actors involved in the cases proved to be more difficult than initially assessed.

There are obvious limitations in making use of this type of data. One is that I did not myself ask the questions in the interviews and thus could not decide on content, phrasing and I was not a first-hand witness to receive the answer and thus could not contextualize the answers given. Interpreting data from 'secondary' primary sources also has the problem that I will have to observe and seek to some extent infer what the actors are thinking. The flipside of this issue, is that I myself could have intentionally or unintentionally framed the questions, if I had been conducting the interviews.

Another potential issue is that while the quotes written in the articles must presumed to be accurately quoted, there is a risk that articles in news sources, intently or intently, create a certain reality by its choice of headers, descriptions and context (Goffman 1956).

However, the potential deficiencies in the comprehensiveness of the data also underline the inconclusive aim of the thesis. The aim is not to reach an absolute, final truth about agency logic in private equity funds or knowledge and motivations in owner-managed businesses, but to gain insights into these phenomena where there is a potential for conflicts.

The epistemological outset and research strategy thus follows a pragmatic approach and a philosophy of applied theory that is widely considered the norm in business management research (Saunders et al 2015).

Thesis Structure

The structure will be divided into two main halves, firstly covering a theoretical foundation, then seeking to extract these phenomena by chronicling three cases in practice:

Theory

The thesis will gain an overview of relevant theory of knowledge within the organization, construct of motivations and principal-agency and stewardship theory:

Firstly, I will look at *what* the private equity investment is investing in; that is knowledge vested in the company in form of organizational structures, corporate culture and employees. What kind of knowledge is built up by the founding director and why can it not be easily replaced?

Secondly, I will discuss the construct of motivation to understand *why* the owner-manager and key employees holding that knowledge leaves the organization or does not work hard enough to utilize it. Why do some people lose motivation to work passionately within a business when it is sold off part off to external investors? Why can motivation changing to the owner-manager even if he still holds ownership?

Thirdly, I will go on discuss *how* agency theory seeks to ensure that managers holding knowledge is still motivated to work hard. The section will cover how agency theory ties together employment incentives and alignment of goals between principal and manager, how it as a paradigm can come to dominate the corporate governance 'order of business' in private equity funds and how this mode of thinking frames the private equity investment. Lastly, I present *how* stewardship theory can be used as an alternative framework to look at agency theoretical issues and I suggest that it can be a useful alternative to view agency issues when private equity funds invest in owner-managed companies.

Practice

I will then apply the theory to 3 cases of private equity investments in owner-managed businesses from the past 30 years. Using a variety of sources from the Danish business press, I will give an account of the historic developments of the three major private equity investments in Denmark and highlight statements that are relevant to the analysis of organizational knowledge, motivation and agency theory. In the seguing analysis section I will extrapolate how these factors influenced the development of the private equity investment.

This will be rounded off by a conclusion and topics for future areas for research.

Knowledge in the Organization:

In this section I will expand on how knowledge as a concept makes the company attractive as an investment for private equity funds. I will first cover the concepts of general and specific knowledge and discuss how it filters through various areas of the company to create organizational order and hierarchy, designating decision rights to employees. Lastly, I will emphasize its' role in shaping creating effective working relationships horizontally and vertically across the organization, promote a certain corporate culture and encourage organizational trust. All are components, that will rarely be explicitly stated in an investment memorandum promoting an investment case to a private equity fund, but are essential to the future value creation.

Knowledge as a concept is central to the private equity investment. It defines the company wherein the investment is made as knowledge is abound in a modern corporation. It lies to ground of the geographical position, the organization size, products produced and the design. (Hayek, 1945) Knowledge is weaved into the company and is what makes it unique. And the uniqueness makes the company attractive and difficult to copy. It is an important point, that if the company produces a generic product in production facilities that could easily be replicated and sold through marketing channels that could easily be constructed elsewhere, the private equity fund (or anyone else for that matter) would have zero interest in paying a premium to acquire the ownership right. It would not make economic sense. This is also why financial institutions and properties rarely go through transactions as the values they represent are (quite literally) set in stone (DVCA 2018).

General and Specific Knowledge

The notion that some individuals in an organization hold unique portions of valuable knowledge is drawn from Jensen & Meckling's conceptualization. They distinguish between specific and general knowledge, the former being costly and the latter being inexpensive to transfer in organizations. General knowledge is easily quantified and communicated, that is the knowledge is transferred, i.e. simply understood by the recipient. (Jensen & Meckling 1992) The medium of the transferred knowledge can be wide-ranging, but obvious examples include books, charts or other documents that specify to the receiver what is meant.

Idiosyncratic Knowledge

Specific knowledge is at the other end of the spectrum in that it can be complex with many dimensions or interdependencies that may not be understood by everyone, it can have a technical character that requires specialized skills to understand it or it might be perishable in that it requires use immediately or it simply loses its value. The specific knowledge can also be of a subjective/experimental character – popular from performance and sports psychology, where you need to have experienced something in order to be able to comprehend it, named 'idiosyncratic knowledge'. (Jensen & Meckling 1992)

Where some types of specific knowledge may simply require a certain level of scientific education or management training to understand, the idiosyncratic knowledge is central to the owner-managed business, as it covers specific knowledge that has been built up over the running of the business since its inception.

Jensen and Meckling describes idiosyncratic knowledge as something that includes '*specific skills or preferences of individuals, or the peculiarities of specific machines, knowledge of particular unemployed resources or inventories, and knowledge of arbitrage opportunities. Such knowledge, almost by definition, is difficult or impossible to aggregate and summarize*.' (Jensen & Meckling 1992, p 4). Even though the authors argue that such idiosyncratic knowledge can always be transferred, it is a question of at what cost. Transfer will make the receiver better at making decisions in running the business, but because of the amount and the complexity of knowledge, it will take very long time and thus be very costly. Even if it is only a specific bit of knowledge and this in itself is cheap to transfer, it is hard to predict which knowledge would be required at a later stage. And if this is tacit knowledge residing with experienced specialists, it further complicates the process.

Decision Rights and the CEO as Owner-Manager

Decision rights – namely the 'power' to make decision and take actions with resources – in organizations often follow people with specialized knowledge. This makes sense as one wants the highest level of work done possible and the people who have the best knowledge about tasks under a certain domain to be in charge of it. In essence, that is why specialized doctors decide when a patient needs a heart surgery operation including spending resources on all the medical equipment and personnel required, as the doctor has the specific knowledge of when an operation is vital. The doctor in turn hired by a hospital manager who (probably) knows little about signs that a patient needs heart surgery, but has specialized knowledge about planning, finances and human resource of the hospital.

Similarly, business tend to be organized by hiring the most capable candidates for positions where they already have some skills and assigning decision rights accordingly. The best qualified get positions highest in the hierarchy and is hired (and fired) by the person with the most decision rights, namely the CEO. However, the ultimate decision right holders, those who decide whether to hire or fire the CEO is the residual claimants of the company, namely the owners/shareholders. Jensen and Meckling term this 'alienability', that decision rights can be sold or transferred and that the ultimate owners of the decision rights can capture the proceeds. (Jensen & Meckling 1992)

Returning to our private hospital example from previously, the knowledge wielded by the doctor is generating an income for the hospital paid by the patients. When the hospital has paid its' fixed costs, the owners can extract the remaining profit. In an owner-managed company, the owner (and manager) sits on both the decision rights to handle the day-to-day management of the company, but is at the same time the principal, the ultimate recipient of proceeds from the business. When a private equity fund is to invest in the owner-managed company, they are thus as shareholders buying the rights to extract the profits of the company. With that alienability also comes the privilege to decide, who as CEO of the company can best maximize those profits.

Amassing Knowledge in Organizational Structures

Bringing several knowledgeable employees together creates the opportunity of scale. The amassed composition of knowledge of various employees gathered in the company together alongside the physical products, buildings, brand and trademark that make up the value of the company. Thus, companies become '*repositories of specialized knowledge and of the specialized inputs required to put this knowledge to work*' (Demsetz 1988, p. 157).

The method whereby one ensures that knowledge is developed and kept within the company is often through employment contracts. It might make sense to make short term arrangements in the form of consulting or legal advisory when the knowledge services required are of a specific nature and of a short-term support function for the primary good the company produces. Otherwise, due to economies of scale, it makes sense to use long-term employment contracts to avoid transaction costs which are too high. In addition, it makes valuable knowledge less likely to be shared with competitors and encourages the individual employee to refine their skillset to fit the exact needs of the company (Jensen & Meckling 1976).

All decision rights in an owner-managed company is vested in the CEO's office who in turn delegates these throughout the company's organization as to maximize its aggregate value. This maximization means aligning decision responsibility with the knowledge that is valuable in certain situations. This decentralization of power is essential to make the organizational structure effective and to make the organization less dependent on the idiosyncratic knowledge of the owner-manager. The costs fall because he passes on decision rights to someone with more specific knowledge, who will make fewer poor choices due to his knowledge relevant to the decision. In addition, it simply strengthens the structure and makes it less vulnerable in case when employees higher up in the hierarchical structure one day is not there.

Decentralization does not come without costs. As the decision rights are further away from the top of the hierarchy and thus further from the ultimate recipients of the rents the company accumulates, making sure that the agents act exactly as owners wish, is difficult. Lowering the 'agency costs', the costs associated with incentive and control systems and the residual loss generated by this power decentralization, thus become key.

Because specific knowledge will be developed and needed across various levels in the organizational design, the key is to design an organization with decision rights accordingly, that optimize the loss of costs owing to inconsistent objectives between the various levels of management (Jensen and Meckling 1992). The size of the organization thus depends on the need for specialized knowledge or the degree of decentralization of decision rights and the amount of tasks, that the company needs to do. As Demsetz (1988) points out, this combination is often unique for every company and that is what makes the company as a whole very valuable: "*Each firm is a bundle of commitments to technology, personnel, and methods, all contained and constrained by an insulating layer of information that is specific to the firm, and this bundle cannot be altered or imitated easily or quickly.*" (Demsetz, 1988)

Private equity funds investing in owner-managed companies are looking for companies where knowledge is spread out throughout the organization. This makes it less vulnerable to departures of key personnel and will give proof of concept, that it can turn can generate a profit, even without the omnipresence of the owner-manager or other employees with specific knowledge. If alienated rights follow the knowledge, a new dilemma can appear. Thus, one needs a system that will ensure alignment of goals and coordination throughout organizational hierarchy. This will be explored later in the section on agency theory. In owner managed companies, the aligned goals are often part of the DNA or the culture of the company – a concept explored in the following.

Corporate Culture

Alongside the web of specific knowledge that various employees hold, is another component that is not tied in with alienable decision rights. This is knowledge shared culturally by all employees in the company.

Culture has been defined in a great many ways. Hofstede calls culture '*the collective programming of the mind that distinguishes the members of one group or category of people from others*' (Hofstede 2011, p. 3). In a corporate organizational context it has been described as 'the means by which a principle is communicated to hierarchical inferiors.' It describes 'how things are done, and how they are meant to be done in the organization' (Kreps 1984). A strong corporate culture can be a very powerful tool in creating an efficient and fluent organization and can support the coordination across an organization (Lazear & Gibbs, 2014).

Similarly, Dent (1992) recount how organizations are known to have distinct cultural properties which *"have particular codes of communication: behavior, language, dress, presentation, design, architecture, ceremony... It is embedded in a cultural system of ideas (beliefs, knowledges) and sentiments (value)" and "the appreciation of organizational dynamics requires a sensitivity to local frames of significance and interpretation"* (Dent, 1992, p. 706). He describes organizations as 'bodies of thought', something that is continually changing form. In extension of this understanding of organizations, Geertz' describes cultures as '*ordered clusters of significance*' (Geertz 1973, p. 363). It is a lens to make sense of the world and a method to guide people on what to do and appreciate it. In the context of a job function, it thus takes on an existentialist role, defining who people are and giving employees lives meaning and defining their identities. Dent terms is an '*ideational system*', something which is constructed and reconstructed and given life through actions and interactions (Dent 1992).

Such cultural '*webs of significance*' are likely unique from organization to organization and the complexities in understanding and copying them, makes the corporate culture a valuable component to an organization. The quality, that the culture is unique and cannot be easily copied, is one of the reasons why a private equity fund wants to acquire part of another company rather than building a replicate company in the same industry. Even if the organizational structure, product line, sales channels and a competitive brand was easily constructed by the brand, the organizational culture built (and rebuilt) over time would likely still make the established company much more productive and competitive. If it was that easy, similar businesses would be brought to life by entrepreneurial types. And in case of major flaws or risks in the business targeted by the private equity fund, thorough due diligence made during the buying process would (hopefully) expose such weaknesses.

Cooperation and Trust

One component of corporate culture that can be measured somewhat is the work ethic in the form of company productivity. As Miller (2002) points out a corporate culture can be both cooperative or non-cooperative and an informal work culture alongside a flat hierarchical structure can encourage high levels of productivity in one setting whereas a strict hierarchical structure can harbor similar results in another setting. The folk theorem suggests that in a game-theoretic structure where all players expect the same outcome, it is rational for every employee to work hard if he expects others to work hard. Thus, this becomes an ingrained part of the corporate culture and a valuable reason to buy into the culture. But as is similarly clear and unfortunate from the point of view of the owner, such a Nash equilibrium is also very fragile. Changes in management personnel or organizational structures can cause an 'unwinding' of mutually consistent expectations that support the high levels of productivity.

In the case of a private equity ownership that causes a change in management, this encourages a different approach to monitoring, reprimanding or rewarding employees – be it more or less - this is likely to change the work ethic from previously. And if productivity used to be high, such changes can prove detrimental to company growth. Miller describes the importance of figuring out the '*trick*' to maintaining a '*game*' of expectations and conventions in order to obtain steady levels of productivity from cooperation. With the perspective of knowledge in the organization, maintaining the corporate culture that has fostered the successful development of a private equity-targeted growth company is just as important.

This indicates the importance of trust in the organization. This can be described as a cohesive mechanism that binds the organization together and makes it more efficient: "*Trust is an important lubricant of a social system. It is extremely efficient, saves a lot of trouble to have a fair degree of reliance on other people's word. Unfortunately, it is not a commodity which can be bought very easily. If you have to buy it, you already have some doubts about what you've bought*" (Arrow, 1973, page 23).

Trust and cooperation ingrained into a corporate culture can thus have a very beneficial effect to the attractiveness of a case as a whole. In incentive system design it can to a large extent eliminate agency costs, because they can ensure that lower level employees do not shirk or that the owner-manager does not renege on his payment promises. Trust is thus an important component both in vertical and horizontal context (Axelrod & Hamilton 1981, North & Weingast 1989).

Implications for Private Equity Investment into the Owner-Managed Company

As the above section seeks to describe, organizational knowledge vested with senior managers and in the organizational culture is important for the company to function well. It is a key asset that a new owner cannot easily replace, indeed it is a major reason for the private equity fund to make the purchase in the first place, even if it is not explicitly stated in the investment memorandum. Rather, corporate culture and knowledge in the organization permeates the investment and is part of the investment opportunity 'uniqueness', if it is granted consideration in an investment prospect at all.

It will have an influence on attracting new employees or retaining those who already work in the owner-managed business. The inconclusive nature of the folk theorem further underscores the fluent and elusive nature of the corporate culture. With such ambiguity, the importance of delicate leadership becomes even more pressing. Steadiness in the organizational set-up during and following a takeover is vital to signal, that changes only occurs in terms of 'alienate' rights ownership, so that corporate culture and knowledge within the organization can be maintained. Cooperation and trust can further harness the business case.

Culture thus is an important frame for the defining norms and (often tacit) expectations of the employees. Another perspective on this is the understanding of motivation of managers and employees in businesses. This will be explored and discussed in the following section.

Motivation

Having recapped the relevance of explicit and tacit knowledge in the organization, I now turn to why the owner-manager and other leading employees are driven to work so hard (or not so hard) at deploying knowledge and skillset to the benefit of the company and the investing private equity fund.

I begin by covering seminal theory about human needs, the concepts of extrinsic motivation and intrinsic motivation, and then I discuss and relate this to research about the motivation of the entrepreneur.

Lower and Higher Needs

To explain which human forces drive motivation, Maslow (1943) in his seminal paper, ‘A Theory of Human Motivation’, lists a number of needs, each need resting on the foundation of the satiated need below. Often this is drawn as a hierarchy of needs in a pyramid. In this structure, basic physiological needs, that is the human requirement such the need for air, water, food and rest, serve as the base. Upon this rests the need for safety, that is the psychological need for security and stability. Safety and stability is not (only) physiological need of feeling safe by living in a society where home burglaries, violence or military conflict is unlikely. Stability can also be that of an employment situation or a sense of financial safety brought about by a feeling of job security, insurance policies or social security net.

After psychological needs are fulfilled, the third layer in Maslow’s pyramid concerns that of belonging and love. Such needs circle around friendships, intimacy and family. This comes from human inherent mental requisite to belong and be accepted by a group, be it small such as family or companionship as well as potentially larger groups, including those formed by co-workers in company organizations. Proof of this need in employment contexts has been widely documented, including in the Hawthorne experiments where workers, who worked harder than the average suffered a degree of social ostracism. In addition, the strong concern for equity in this work group also increased the level of cooperation, supported co-worker activities outside the workplace and made the need for a strict hierarchy largely irrelevant (Miller 2002).

The fourth need of esteem such as ego and status concerns a psychological requirement of getting recognition, respect and status from fellow human beings, which in turn gives self-esteem and a sense of worth. These are separated into lower and higher types, where the lower manifests itself into a need for outward visible signs such as recognition, fame as opposed to the higher esteem that relies on inner competences such as feeling of competence, independence and strength. The top of the pyramid is that of self-actualization which includes the complete mastery of the levels below as well as achieving the level of full potential. Thus, in Maslow's pyramid of needs, motivation is an individual force that drives the person towards a higher level. In this view, a monetary reward will only motivate to a certain extent, as at some point other needs will become primary as needs below have been covered. In the case of owner-managers who have grown their business to a size and complexity where a private equity fund is interested in acquiring it, they will have most of their needs covered as they are on the payroll already. (Stevenson & Jarillo, 1990)

Extrinsic Motivation

A different approach to explaining human motivation is segregating it into extrinsic and intrinsic motivation. Extrinsic motivation pertains to an activity which is done to attain some separable outcome, that is, it elicits some sort of reward. Different types of extrinsic rewards exist. Some students will study only to avoid sanctioning from parents, whereas others will do it because they believe it is valuable in furthering their career. (Ryan & Deci, 2002)

Within employment, extrinsic motivations are often driven by the prospects of monetary compensation. Money by itself does not provide utility, but can be used to purchase goods and services and thus satisfy some of the basic needs in Maslow's hierarchy of needs (Heckhausen & Schultz, 1995). Thus, extrinsic motivation is comparable in many respects to the concepts described by the theory of economic man, where the ideal incentive system is a strict pay-for-performance.

Measuring Efforts and Determining Incentives

Designing incentives scheme that motivates a manager to provide effort in the desired amount is challenging as it requires knowing what motivates him. In classic behavioral economics, the assumption is that of the economic man whose behavior is driven by rational, maximizing self-interests (Shapiro 2005). Micro-economics then draw up that the managers should be rewarded for the marginal effort they put into their work multiplied by a performance measure. The curve of this incentive system has a steepness, which is defined by a number of factors: Among these factors are value of the employee effort. The more profitable to the firm the effort is, the stronger the incentive has to be. For this reason, incentives are almost always stronger at higher levels in the organization. Other factors include how risk averse the employee is (Lazear & Gibbs 2014).

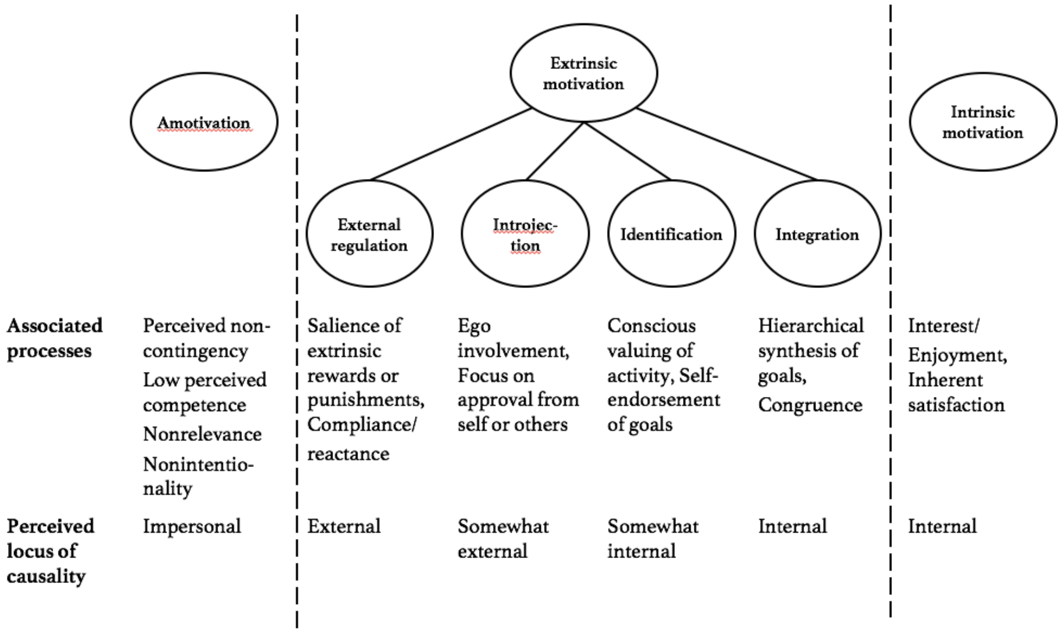
At odds, or at least supplementing this calculative view of homo economicus, is a number of theories on intrinsic motivation founded in the realms of psychology. They argue that monetary rewards alone cannot explain what drives motivation, but rather one needs to factor in the intrinsic motivation that shapes an employee's drive.

Intrinsic Motivation

Intrinsic motivation is psychologically motivated, an activity one does simply for the enjoyment of it, rather than for some separable outcome. Ryan and Deci argue that from birth, humans are active, inquisitive, curious, playful creatures with an unstoppable interest in learning and exploring. They do not require an outside incentive to do so. This inclination is naturally built upon throughout a person's life (Ryan & Deci 2000).

Ryan and Deci draw out a taxonomy of motivations which helps to understand the connection between level of motivation, the processes associated with it and the internal perceived locus of causality. The continuum easily describes the process of internalization and integration of values and from where the motivation emanates, if at all.

Taxonomy of Human Motivations (Ryan & Deci, 2002):



The enjoyment that one gets from intrinsic motivation is thus not unlike that described by Maslow on satisfaction of innate psychological needs of competence. In addition, studies have also shown that positive feedback enhances intrinsic motivation whereas negative feedback diminishes it. (Ryan & Deci, 2000) In this sense, it is related to outward higher needs of Maslow's relatedness and competence, as described by Maslow previously. One is spurred on by other's positive pad on the back and enthusiasm, not simply because it indicates that what is being done is correct, but also because it adds to a feeling of encouragement and belonging.

In this paradigm, the significance of the person's own feeling of autonomy for enhancing the intrinsic motivation is important. The reason is found in Cognitive Evaluation Theory (Ryan & Deci, 1985), which specify that the activities surrounding the intrinsically motivated activity, termed 'interpersonal events and structures', e.g. compensation and feedback, will contribute (or subtract) to the person's feeling of competence. However, this feeling of intrinsic motivations will only be sustained and improved, if it is accompanied by the feeling that the behavior is self-determined. This sense of autonomy, termed *internal perceived locus of causality*, thus is vital for the motivational intrinsic qualities of solving a task. In other words, feeling competent by getting positive feedback (or paid) by others is insufficient for maintaining intrinsic motivation. This must also be experienced internally as being self-determined and true.

Following the above logic owner-managers (alongside everyone else) is by birth intrinsically motivated to explore and develop their own ideas. But the attraction of extrinsic needs – and the basic human requirement money gives to subsist – conditions this motivation during the upbringing. However, that feeling of autonomy – being one's own boss – can as described upwards as a character trait of entrepreneurs add to the feeling of intrinsic motivation. In addition, the social feedback and feelings of belonging would also to some degree explain why intrinsic motivations of family businesses.

Value of Intrinsic Motivation

In extension of this, Osterloh and Frey (2002) argue that focusing only monetary incentives to reward work on new and multifaceted tasks is insufficient and that measurements for these are often inaccurate. Many companies rely solely on using a variable pay to reward managers for their performances, but this is not suitable for knowledge-intensive jobs, which are typical across many companies in the Western world. Rather, ensuring that the employee has intrinsic motivation is important, by for example ensuring a good work environment and strengthening working-relationships among co-workers in order to ensure the employee of appreciation and recognition. They highlight the need for intrinsic motivation for tasks that require creativity, multitasking and transfer of tacit knowledge.

Creative jobs only awarded to extrinsically motivated managers will tend to produce stereotyped repetition, as the manager will want to be produce as simple, fast and easy outputs of what already works to limit the disutility of effort. For tasks with a lot of multitasking, contracts cannot completely specify all relevant aspects of employee behavior and so intrinsic motivation is key for the employee to solve all parts of the job. With regards to knowledge sharing, intrinsic motivation is key as the transfer of tacit knowledge is complex and requires both explicit and implicit, verbal and non-verbal communication to be effective. Employees will have a tendency to freeride, because measuring the transfer of tacit knowledge and the quality of it, is very difficult. (Osterloh & Frey 2002)

This would add to the suggestion that owner-managers tend to be intrinsically motivated. Most of the entrepreneurial activity that is involved with founding a business is indeed requiring creativity, multitasking and knowledge. Due to the innovative nature of the work that the owner-managers do in companies targeted by private equity-funds, it seems intrinsic motivation is a prerequisite drive to uphold activity levels.

Crowding Out

However normal and natural intrinsic motivation might seem to the individual possessing it, it is by no means perpetual. Frey (1997) and Deci (1975) argue that by attaining extrinsic rewards there is a risk that rewards can 'crowd out' intrinsic motivation. The classic example is that of children who are initially excited about studying for school and doing their homework. However, when parents start offering rewards for doing the homework, the children will lose intrinsic motivation and end up only doing their homework, if they receive the reward. Thus, the extrinsic reward has crowded out the intrinsic motivation. (Osterloh & Frey 2002).

In the framework of cognitive evaluation theory, this is because the intrinsic motivation has been substituted by an external intervention, the feeling of autonomy can decrease and the locus of control can possibly shift. This in turn depends on aspects of the outside intervention and whether it is perceived as controlling or informing. If the informational aspect prevails, feelings of competence and self-determination will be enriched, whereas if the controlling aspect is more significant, the change in locus of causality will shift towards outside control.

Following the line of argument, crowding out theory has important implications for this thesis. It would suggest that there is a risk that the owner-manager's motivation is crowded out, when he receives a large sum of money for the company from a private equity fund. That, alongside the loss of autonomy that comes when one no longer holds sole control over the business, would suggest a decrease in intrinsic motivation, if he was still to perform his daily job as CEO.

However, empirical studies on crowding out theory have proven to be inconclusive: Kunz und Pfaff (2002) argue that post reward performance lessening indeed does exist and thus will have an adverse impact on incentive system within agency theory in prompting performance. However, according to their studies, the threat is not looming large, as the effects are stylized exceptions rather than the rule. The studies that empirically document the existence of intrinsic motivation had several conditions that makes it incomparable to the real work conditions that would prevail in a company. In addition, they argue that adults accustomed to the norms of modern society and life expect to be paid in exchange for selling their labor and thus awards are the norm. Also, most jobs involve supervision and social surveillance of some kind, either by superiors, subordinates, shareholders or the public. Most positions involve possibilities for performance improvement which may lead to increased task interest. Lastly, there are many jobs which are not inherently interesting enough to foster high intrinsic motivation. Some jobs are even performed solely because of their extrinsic inducements. Thus, concerning oneself with intrinsic motivation in such performance contracts is a moot point. (Kunz und Pfaff, 2002) In addition, other academic papers even argue that performance pay increases work interest and perceived autonomy: Eisenberger, Rhoades and Cameron (1999) demonstrate through 3 different studies that performance rewards had positive impact on subject's perceived self-determination and competence, their interest in the daily work and the relationship amongst themselves. Thus, performance rewards all contribute to the qualities that enhance intrinsic motivation.

Other theories have attempted to draw up a system for the characteristics of a certain job in combination with the psychological stimulus the job gives. Hackman and Oldham Job Characteristics Theory (1976) predicts this by drawing up five job dimensions; skill variety, task identity, task significance, autonomy and job feedback which all lead to variations of three critical psychological states. The combination of these states will result in outcomes of work motivation, job and growth satisfaction and work effectiveness. However, not all people will have the experience a task in the same manner which will result in different psychological states and dissimilarities in motivation, satisfaction and effectiveness. The determining 'moderators' are the pre-existing knowledge and skill, need for growth and the personal context such as job security, work colleagues and pay.

The tensions between extrinsic and intrinsic motivation remains an ongoing theme for business literature. For the value of this thesis, it would be valuable to discuss the specific elements driving motivation of founders and entrepreneurs as these are often owner-managers.

Motivations of the Owner-Manager

Studies on motivation on people who have founded their own business show there to be a big difference in what values drive entrepreneurs and non-entrepreneurs. As entrepreneurs can be funded by business angels or have received other forms of seed capital, they are not necessarily by definition owner-managers. On the other hand, all the owner-managers in the cases studied in this thesis can be said to be entrepreneurs as they held 100% of the stock until the private equity transaction prior to the transaction. In addition, all the owner-managers mentioned in this thesis fulfil Schumpeter's definition of entrepreneurship, namely that they are innovators, disrupting the market equilibrium and providing new combinations of a good, innovating new methods of production or opening new markets (Schumpeter, 1934). Using this definition of entrepreneurial activity for the owner-managed businesses also reiterates why these businesses described are attractive investment propositions to the private equity fund and often commands high prices: These owner-managed businesses sell a product that has not saturated the market and the potential exist for attaining market shares while professionalizing the organization.

Joel Wassermann (2002) lists the top motivations cited among entrepreneurs as autonomy, power & influence, managing people, altruism and financial gain, variety and intellectual challenge. On the other hand non-entrepreneurs cite security, prestige, financial gains, affiliation and recognition as their prime motivating factors for their jobs (Wasserman, 2002). Interestingly with regards to financial gain studies have shown that the direct correlation between owner-management and wealth is not as clear cut as many would be led to believe. Most behavioral economists would assume the entrepreneur founds his business to make a lot of money (Scitovski, 1943). And indeed, many founders believe they stand a much greater chance of becoming wealthy by launching a start-up, than by ordinary employment (Amit et al, 2000). However, according to studies, on average entrepreneurs earn no more by founding a business than they would in regular employment. Entrepreneurs on average earned 35% less over a 10-year period than if they had been in a normal job (Hamilton, 2000). Thus, even if the owner-manager through the sale of the company to the private equity fund will eventually be handsomely paid for his share, wealth is not a continuous goal that drives the owner-manager, when running the day-to-day business.

As the cases will later show, many owner-managers cite their desire for further expansion and watching the owner-managed business grow, rather than attaining wealth when they sell part of the business to a private equity fund. However, the loss of autonomy and power and influence that comes with selling the business is only partially weighed up by the payment. Noam Wasserman pits wealth and control against each other as two entrepreneurial motivations that often combat each other (Wasserman, 2002). He argues that the entrepreneur has to decide whether to grow the business organically and earn sub-normal returns on his investment idea or include outside capital investment to fund the growth in return for equity (Wasserman, 2002). This decision, to be 'king' or 'rich', is a fundamental founder's dilemma. Oftentimes, it is difficult to be both. Many early founders have so much confidence in their startup's prospects and in their own abilities and harbor such strong enthusiasm for their idea that they systematically misjudge their need for further resources or overestimate their ability to remain in control of the startup even as they take on a wide range of outside resources.

Summary of Motivations of the Owner-Manager in a Private Equity Investment

Understanding what drives the owner-manager is complex. From studies of entrepreneurs there is not one common aspiration, that all strive for. Rather, there is a list of traits including autonomy, power & influence, managing people, altruism and financial gain, variety and intellectual challenge. These can partly be associated to concepts found in psychology such as higher needs or intrinsic motivations. Some would even suggest that intrinsic motivation is a precondition when solving knowledge-intensive, creative and innovative work. What is worse, by awarding extrinsic rewards to intrinsically motivated employees, one risks crowding out the intrinsic motivation, but the evidence is inconclusive. While crowding out theory would be an appealing explanation for the diminishment of motivation among owner-managers, it seems to be only part of the picture. This is why an understanding of agency theory becomes central.

Agency Theory

This section will describe how corporate governance systems try to systematize using knowledge by incentivizing motivation. Firstly, the section describes how agency theory seeks to align goals between principal and manager by designing contracts that maximize efforts and minimize risks. In extension of this, I look at some of the criticism garnered by agency theory and suggest how it as a paradigm invariably will come to frame a private equity investment into an owner-managed company. Lastly, I will cover stewardship theory as an alternative mode of thinking about the principal-agent issues.

Principal-Agency Theory

The size, complexity and need for external capital of the modern corporation has driven the procurement of the dominant paradigm governing the relationship between employees, termed agents, and owners, termed principals. The question remains how routines, processes, architecture and people of the company should be organized to make sure that interests of all parties are aligned. For managers and lower level employees to work requires a contract specifying the tasks that is required to be solved and the accompanying remuneration. The contract also specifies how it is measured and how extra incremental effort is reimbursed. As such is specified for all employees, this should ensure that all work hard towards the same common goals of the organization, whatever these are.

The classical source and nature of motivation problems comes from the so-called externalities, when there is a disparity between the costs that the job requires and the benefits, that the manager earns (Roberts, 2004). 'Costs' in this sense is not (necessarily) a monetary outlay, but the effort associated with producing the output that generates the benefits to the manager. Also, here the term 'effort' is imperative to define: It is not merely about completing a given simple task, but all the actions surrounding the job that will affect the firm value. It could be working longer, faster, harder or giving more careful thought as to how the task is completed. In essence the "right" amount of effort really is what predominantly matches the aims of the company. Thus, the contribution to firm value equals the present value of the profit created by the manager minus his compensation (Lazear & Gibbs 2012). If the difference was easily measureable, it would be straightforward to remunerate the manager appropriately and thus motivate the manager to exercise as much effort as possible. However, save for simple sales jobs, the profits of efforts generated can rarely be observed instantly. The lack of instant measurements whereby the principal can easily measure the 'effort intensity' and remedies to this is a popular subject among performance measurement literature (Lazear & Gibbs 2012).

In addition to simple work hours, intensity and skill level, comes the considerable levels of financial and organizational resources that managers need to deploy to add value to the company. Because such resources are owned by the company and not borne by the employee, this creates additional disparity. As an example, a manager might avoid taking certain risks even if in the view of the organization, such risk-taking would make sense, because the benefits to the manager is not adequately reflected. The risk-reward by taking on a – to the shareholders – possibly very beneficial project is not attractive.

Agency Problems

All such situations can be grouped "agency problems" and the field of theory, agency theory, that emerged as an important field in economics seeks to answer how goals of the organization is aligned with managers working for it. The need for such theory becomes especially pertinent when the company grows in size and complexity and the need for external capital means that the ownership of shareholders in more diffused. The shareholders have an interest in growing their investment and are willing to bear the risk of it, but do not necessarily have the time or professional qualifications in doing so. Thus, they hire an agent, who they contractually oblige to work towards a set of goals defined by the themselves, the principal. Thus, the agent is now managing the risk and control on behalf of the principal, the residual claimant. Such contracts that denote the work load and the expected payment indeed exist not only between shareholders and top managers, but on all employee levels in the organization denoting the amount of risk and responsibility that is assumed and the compensation that follows. In this view, the corporation is a "*nexus of contracts*" which is what holding together the corporation (Meckling and Jensen, 1976).

Within the various agency models that exist, there are at least two main characteristics that are included in all of them, namely presumptions about conflict of interest and informational asymmetries between the parties (Kunz & Pfaff, 2002).

The conflict of interest covers the agency problem given above, that the goals of principal and manager are not compatible. Jensen et. al (1985) propose that the conflict of interest issues stem from that principals and agents have different views on their optimal choice of effort, risk exposure and time horizon. Or in simpler terms, the agent wants immediately all the money and '*glory with none of the work*' (Shapiro, 2005) whereas the principals will want the opposite.

Informational asymmetries cover a range of possible disparities between the agent and the principal. One is popularly known from insurance business as adverse selection, but better termed as '*hidden information*' (Arrow, 1985). This means that it is impossible to know the exact skillset of a manager and if this matches the job at hand. Also, the principal will not know if there are better qualified applicants who did not apply for the job or once the agent is hired, how exactly the manager will go about solving the tasks at hand. Or indeed if the manager selected will be working as hard as promised, if at all. Related to the questionable behavior of shirking, is the risk that the agent is doing other dubious tasks of '*hidden action*' (Arrow, 1985) whereby the agent is acting differently from how he would have acted, if he was fully exposed to the risk. This type of moral hazard might be committed because it is what is more in the interest of the agent due to his employment or the agent can simply be opportunistic and take on too much risk because of a human inclination (Jensen, 1994).

Monitoring and Incentivizing

The remedy to minimize such informational asymmetry and conflict of interest in the organization comes in the form of monitoring and incentives (Jensen 1993). Monitoring will be done by the principal, at least ultimately, and the incentives will be stipulated in contracts and comes in a variety of forms such as regular pay, cash bonuses, stock options, promotions etc. The goal is to design an incentive scheme whereby the agent provides the desired amount of effort. By making the incentive curve steeper should result in higher level of motivation.

These thoughts on AT have permeated business management since the paradigm was first formulated in academic economics literature in the early 1970's. As these thoughts diffused into business schools and management literature, it has become the prevailing institutional way of thinking about corporate governance (Zajac & Westphal 2004). The agency theory literature is awash with detailed manuals on how to write contracts that explores endless permutations of the agency dilemma while trying to balance the preferences of the parties, the nature of uncertainty and the informational structure on contracting practices (Shapiro, 2005).

Criticisms of Agency Theory

Going through literature on agency theory, there are skeptical perceptions on the inherent construction of the AT paradigm. Critics of AT-theory will argue that the proponents of agency theory are too obsessed with control mechanisms or paranoid and do not put enough emphasis on the fact that humans have capacities to be other-regarding and altruistic. They argue that agency costs can be mitigated by organizational structures that promotes cooperation and reliance on others (Donaldson 1990).

Other scholars have made the suggestion that it is the agency problems do not inherently lie with the agents, who invariably will try to cheat, deceive and avoid to work hard. This could be the case for principals as well, who exploit their agents by for example promising them prospects of promotion or glorifies the work and thus creates an unhealthy power asymmetry at the heavy expense of the agent (Perrow, 1986). In a similar vein of thought, Perrow also disagrees that one necessarily has to look at principal-agency relationships through the classical economic lens of 'homo economicus'. Employees are not necessarily work-averse, self-interested utility maximizers, and at least not all the time. In some social settings, human beings can find meaning in being generous and self-sacrificing and find goals of co-operation and team-spirit to be of higher value than egocentric, self-motivated goals (Perrow, 1986).

Another criticism addresses the simplified description of the agency relationship as dyadic. Firstly, it is uncertain if the principal is in the driver's seat. Some argue that principals are dependent on agents and do not necessarily have the time or the necessary specialist knowledge to design optimal contracts. This implies a shift of power in the asymmetry from principal to the agent (Shapiro 2005). Moreover, a solitary principal and agent is more of a theoretical abstraction, than what is seen in everyday business life. Adams (1996) suggest that in many organizations there is likely to be several agents and principals, who invariably disagree on goals or compete over interests. It might also be that the specifications in the contract are vague by design, because the principals who wrote it could not agree on the ultimate goals and thus leaves interpretation open (Shapiro, 2005).

Ghoshal (2005) makes the point that the AT paradigm, which has gone through an evolution and been perfected by scholars since the 1970's. As a result the management theories that have been taught in business schools and management courses around the world, one should not be surprised that corporate governance scandals such as the ones in Enron has emerged. It is taught that managers cannot be trusted to do their jobs and therefore must be tightly supervised and heavily incentivized to avoid "agency problems". Ghoshal accentuates the nominative determinism that innately lies in using this term, drawing on the idea of a '*gloomy vision*' (Hirshman, 1970), i.e. the pessimistic assumption that individuals and institutions are by definition seen dysfunctional. According to this paradigm, the primary objective of economic theory is to limit the costs arising from human sociological deficiencies.

Ghoshal (2005) goes on to argue that the corporate governance cultivated in business schools and in board rooms are propagated as scientific truth. Moreover, it also frees the implied parties of any sense of moral responsibility. Because mainstream economics is based on the rationale of homo economicus making rational decisions, amoral behavior in the paradigm of 'gloomy vision' is socially accepted and even to some degree lauded.

This issue is exacerbated because theories in social sciences tend to be self-fulfilling as theory is tested in social domains where they are also being applied (Gergen, 1973). As opposed to a theory in physics where atoms do not change behaviors, because a theory has been proposed, a theory about for example opportunistic behavior in organizations will become true as the managers are both subjects and consumers and will thus adapt their behavior to conform with the doctrine (Ghohal, 2005).

In this paradigm of gloomy vision and a self-fulfilling prophecy, there is a spiraling tendency for less trust in the humanistic, moral behavior and more emphasis on the surveillance of agents. This creates more distrust and paranoia in the relationship between principals and agents and poor working climate throughout the organization, absurdities in theory leading to dehumanization in practice: *"Combine agency theory with transaction costs economics, add in standard versions of game theory and negotional analysis, and the picture of the manager that emerges is one that is now very familiar in practice: the ruthlessly hard-driving,* *strictly top-down, command-and-control focused, shareholder-value-obsessed, win-at any-cost business leader."* (Ghoshal, 2005, p 77)

Agency Logic in Private Equity Funds and Owner-Managed Companies

The separation of management and finance is central to ensure that it is possible as an investor to give his investment to the manager without the manager expropriating the funds. (Shleifer & Vishny 1997) Private equity funds very much follow this logic. The fund managers do not invest in their own money in owner-managed companies, but do it on behalf of others, who in turn manage their funds on behalf of others. They accept external funds invested by institutional investors. The institutional investors vary in size and complexity, but an example is a pension fund. The pension fund is run by managers who are held in check by a board of directors which have their powers vested in them by small scale individual pension fund savers. This chain of governance mechanisms affords all principals the security and legal protection that the investment will not be absconded with and that they have the right to the proceeds. Covenants in contract stipulate how agents are responsible to the principals for managing the funds, often with the aim of creating the highest possible return. In return, the fund managers get a salary or a bonus according to how well the investments in the private equity fund perform (Andersen, 2015).

In an owner-managed company, the dynamic is obviously different. The principal and the agent are both ultimate recipients of the returns. Following this logic, there should be no agency costs as monitoring and incentivizing the CEO is not necessary. The owner-manager should automatically be motivated to work as hard as possible.

Because agency theory is the logic that dominates corporate governance of private equity, it is follows that once the investment into the owner-managed company has been made, professionalizing corporate governance structures is part of the development of the company. This means optimizing structures which minimize potential agency issues and ensuring alignment of goals between manager and principal.

However, this professionalization effort will also challenge the organization as the principals will wish to run the business solely according to an agency logic of the economic man. This can give rise to cultural clashes due to the differences in leadership styles and approaches to accounting. Dent in his cultural analysis of a UK rail company that experienced the wave of new public management in its change in strategy and accounting focus from state to market oriented business. In this study, the focus on the 'bottom line' and streamlining of the company had big repercussions to the culture of the company. (Dent, 2002)

Similarly, literature on institutional isomorphism describes why organizations that have otherwise been formed under very different circumstances and evolved differently eventually end up becoming so similar. This is in part due to normative and mimetic pressures that drive organizations toward best practice and professionalization. (Dimaggio & Powell, 1983). This can also be viewed as a criticism toward the 'bottom line' management style which views accounting as an 'answer machine' (Thomson & Tuden, 1959) where there is little room for inspiration. The similar effect is that given by the 'purification of accounting' whereby the budgets and accounting consultants' advice is viewed as eternal truths, translating uncertainties into facts. (Christensen & Skjærbæk 2010)

The differences between budget leadership styles can lay ground to considerable organizational unrest. As Hopwood (1973) exemplifies in his study on management styles how different approaches can lead to rifts within the organization. Whereas a budget constrained leadership style focuses on achieving budgets in the short term which can lead to poor working relations within the organization and short term decision making as opposed to a non-accounting, 'country club'-style leadership which is more long-term oriented, has less structure and focuses more on good relations. (Hopwood 1973)

Stewardship Theory as an Alternative to Agency Theory

The above criticisms levered of the AT paradigm leaves a very dim view of the social relationships of a traditional corporate governance system. However, these extremes based on the assumptions of economic man, have a very traditional view of motivations and hierarchical management and presumptions about motivations.

Stewardship theory has been proposed as an alternative to the agency theoretic homo-economicus-view of managers that depict subordinates as individualistic, opportunistic and self-serving. Instead, stewardship theory view subordinates as collectivists, pro-organizational, and trustworthy. (Donaldson & Davis, 1991) The behavior by the executive is in stewardship ordered so that a steward places higher interest in the organization as a whole rather than self-serving, individualistic goals. By being organization-centered, the steward seeks to further objectives that benefit the organization as a whole and thus the relationship between objectives of the stewards and the principal are always aligned. Of course, in stewardship theory, the manager does require an income for 'survival'. But as opposed to classic principal agent theory, the need is a trade-off between personal needs and organizational needs. By working hard towards organizational goals, the personal needs are met.

Following this logic of thinking, the CEO of a company should be given large discretion as heavy corporate governance oversight is counter-productive, because it undermines the behavior of the steward, thereby lowering his motivation (Argyris, 1964). Indeed, some have argued that for optimizing organizational structures, the CEO should also be chair of the board, as this would enable authority and structure over the organization. This scenario would never happen in a traditional agency-relationship (Davis et al, 1997).

Thus, it seems that agency and stewardship theory are counterparts. Agency theory believes in self-serving behavior that best fulfills the aims of the economic model of man. The psychological mechanisms that guide within agency theory are lower-order deficiency needs driven by extrinsic motivation. Characteristics of management philosophy within this approach would stress the importance of controlling risks, having a short-term timeframe and with a primary objective of controlling costs. Relationships within organizations of this type would have a high power distance and the focus would be on individualism and competition with other managers (Davis et al. 1997).

Stewardship theory on the other hand believes in collectively serving behavior as fulfilling the aims of the self-actualizing model of man. Psychological mechanisms are driven by higher order needs of growth, achievement and self-actualization and intrinsic motivation. Traits of management philosophy in this paradigm is directed at broad interest involvement, trust, thinking long term and with performance enhancement rather than cost control in mind. Relationships within the organization are characterized by a low power distance, collectivism and aligning interests with the principal (Davis et al. 1997).

Reconciling Stewardship Theory with Agency Theory

Thus, the paradigms seem irreconcilable. There are similarities in this problem to the one posed by the prisoner's dilemma that also characterizes horizontal cooperation problems within organizations (Axelrod & Hamilton 1981, Miller 2002). Setting gains and losses in a table clarifies the risks and potential gains by both principal and agent. In this version, both principal and manager define whether they choose an agent or stewardship approach. The Principal-Manager Choice Model (Davis et al. 1997) is given below:

		Principal's Choice	
		Agent	*Steward*
Manager's Choice	*Agent*	Minimize Potential Costs Mutual Agency Relationship 1	Agent Acts Opportunistically Principal is Angry Principal is Betrayed 2
	Steward	Principal Acts Opportunitically Manager Is Frustrated Manager Is Betrayed 3	Maximize Potential Performance Mutual Stewardship Relationship 4

As is apparent from the model above, the level of risk that is acceptable to the individual is key. The highest joint utility is in the principal-steward relationship (cell 4), it is when both parties choose the agency relationship (cell 1), that there is the least risk of betrayal (losses). This also means, that when one of the parties has an individualistic approach, the better choice for both parties is the agency relationship.

As with other game-theoretic analysis on cooperation, the implications too seem clear for the above dilemma. A mutual stewardship approach is most likely to occur in long run relationships and the shared confidence and trust in one another's approach is important (Miller, 2002).

Summary of Agency and Stewardship Theory

In the above I have summarized some of the key aspects of agency and stewardship theory. I have sought to gain insight into the complexities in structuring corporate governance contracts motivating employees and further I have given examples of some of the criticisms of agency theory. The dominant logic of agency theory within professional management cultures in general and in private equity companies in particular can however be a stumbling block in seeking to find common ground with owner-managers. Stewardship theory has been presented as an alternative approach to viewing the agency relationship and reconciling the two methodologies have potential for resolving some of the potential agency issues that arise following a private equity investment in owner-managed companies.

In the following, I will explore and apply these theoretical insights to select cases illustrating and evaluating their explanatory value in answering my research question.

Case Studies and Analysis:

The following section covers 3 different cases of private equity investments into owner-managed companies, namely Axcel's investment into Noa Noa, EQT's investment into Tiger and Maj Invest investment into Sticks'n'Sushi. The cases all have differing business focus, but all share the trait that they are characterized by a strong brand and corporate identity, presumed to be driven by the founding owner-manager (and his family). Also common for all three businesses is that they were kept within family ownership until the transaction. As the aim is to observe general trends for the private equity industry investments, all private equity investments were made by different private equity funds, but are all based in Denmark or Sweden.

Case 1: Noa Noa

Origin

Noa Noa is was founded by brothers Harald and Lars Holstein and in 1971. The brothers started out selling a variety of imported clothes from a small shop in Helsinore, north of Copenhagen, Denmark. Eventually they focused their business scope to producing and selling mid to high-end bohemia-style women's wear. By the 2006, the company had a several own retail shops in Denmark and a further retail presence in 1700 shops across 18 European countries, turnover of approximately 602 million DKK and an EBIT of 153 million DKK. (Børsen 18/12/06)

Axcel Investment

In December 2006 the Holstein brothers entered an agreement with Danish private equity fund Axcel to sell a 70% majority in Noa Noa. The price was not made official but was estimated by Danish media sources to be 1,2 billion DKK. The founding brothers retained a 30% minority stake. In summarizing their considerations for buying the company, Axcel quoted an un-exploited potential for international expansion as a reason for the purchase and intended to double sales within a five-year period. (Børsen 18/12/06)

Owner-Manager Harald Holstein was quoted in the Danish business press for his reason for selling and the choice of Axcel as a partner. He indicated his sentiments for the business and how the extrinsic reimbursement did not have primacy, rather, the importance of finding a domestic partner with whom they had good relations, was key:

"The sale is due to start a sliding generation shift. My brother and I have had a company for 25 years and it is natural that we now want to pass on our "child" to a pair of safe hands", says CEO Lars Chr. Holstein. "Axcel was chosen because they understand the spirit of the company and they are Danish: It was most definitely not the highest bid, but they understood the concept and we found a very attentive and good partner. The personal chemistry was also good... They speak Danish, and we have spoken to quite a few foreign companies also" (Børsen 18/12/06)

Harald Holstein also believed that Axcel could contribute to the development of the fashion house, while reiterating the importance of understanding the corporate culture of Noa Noa.

"Axcel is a Danish company with understanding of the house and the way we have driven the house. Therefore, I expect them to be a close partner in the development of our long-term growth strategy," the CEO says. But in addition, there are also ambitions to add new markets to the foreign sales channels.

"But we only went ahead with the equity funds to make sure it would not be swallowed by an industrial buyer," (Berlingske Business, 19/12/06)

Organizational Changes

Harald Holstein was set to become chairman of the board and Lars Chr. Holstein emphasized that there would be no changes in management and organization following the sale of the majority stake to Axcel:

"Nothing changes. A strong organizational structure is precisely our strength with strong commitment and faith in the brand. There is great respect for each other and the product, and it is a culture and spirit that has been created in the house," (Berlingske Business, 19/12/06)

The intentions not to make any organizational changes did not last for long. An organizational reshuffle was completed during the summer of 2007 and a new CEO was put in place by Axcel. The new management team set about implementing their expansion plans. (Børsen 29/06/08)

Axcel Investment Gets Underway

Noa Noa had been on an impressive sales and earnings trajectory leading up to the transaction. The growth however somewhat surprisingly stagnated already in the first year after Axcel's investment. Noa Noa had a turnover of 554 million DKK, down 8,9%, however EBIT was down by 31,1% from the previous year to 111 million DKK (Børsen 29/06/08). The blame was largely pointed towards the raging financial crisis. However, this was viewed as an opportune moment from the viewpoint of managing partner in Axcel, Christian Frigast:

"For Axcel, when we invest in a company, we make a plan for its development, and we follow that plan. We are long-term investors, and cyclical fluctuations are not necessarily what determines the value creation in our companies. In fact, a little stagnation may also prove to be an advantage for us

and our companies, who have the opportunity to win market shares, among other things. because it will be easier to make acquisitions, " says Christian Frigast. (Børsen, 29/06/08)

Despite the impressive growth plans, the investment was struggling. As Noa Noa could not reach projected budgets, Axcel was forced to invest further cash to service the debt. In addition they did a write-down of the value on their books of the investment. As the original founders did not co-invest, their ownership share was reduced from 30% to 9% of share ownership. By 2009 turnover was steady at 534 million DKK, but EBIT was down to 59 million DKK. Axcel still expected still to reach 800-900 million DKK turnover within 5-6 years and open 125 shops. (Børsen 08/06/09)

The company kept investing in new stores which raised turnover to 555 million DKK by 2010. However, the expansion also raised costs considerably. As the company was heavily indebted, this created problems in the long term in honoring loan requirements to the bank.

By October 2010 it surfaced that Noa Noa had missed currency hedging in their major markets UK, Sweden and Norway. The currency exposure that came along with the financial crisis had come as a surprise to management and this had severely hit earnings because foreign currencies had fallen in relation to DKK and the Euro. Out of stupendous luck, there was no currency exposure in its biggest foreign market, Germany, due to the Danish currency pegging to the Euro. (Børsen 15/04/2011)

The poor financial results led to changes in management and on boardroom level. By October 2012 a new CEO and a new chairman of the board was put in place. Together they reset the corporate strategy and intended to trim the organization by putting a focus on cutting costs and shutting down the least profitable shops. (Børsen 12/10/12)

However, this strategy had obvious negative side-effects. While Noa Noa did cut costs, turnovers also suffered. And as debt requirements were still very much an issue, by 2011, EBITs hovered around 0 and Noa Noa was suffering heavy losses.

Owner-Manager Reflections

Four years after the take-over, the brothers were interviewed for Danish newspaper Berlingske about founding their business, and how it altered work relationship with money and work patterns:

"This with a lot of money is something strange," says 65-year-old Harald Holstein and continues after a small pause: "I think about it when I get a parking fine. Earlier, it was all that I could think of for 14 days, but I no longer do that. "

"From working 60 hours a week three years ago, Harald is here once a week, and I'm here almost every day, but far from 60 hours," says Lars Holstein, who together with his brother see their new role as ambassadors who advise the new leadership... It was a dream of mass expansion and a principle of never lending money to the bank that made the brothers sell." (Berlingske Business 10/07/10)

The first quote could be seen as an indicator of a change in mindset, from intrinsic motivation qualities as the attitude towards "not wasting money" on parking fines as a way of seeing cost efficiency as a driving motivation and sign of business acumen. In itself the monetary strain of a parking fine is after all not that different whether you are a millionaire or a multi-millionaire. Rather it indicates that the intrinsic motivation of working hard, paying attention to (all) costs and expenses had transformed, maybe even as a result of the psychological crowding out mechanism described previously, when intrinsic motivations diminishes as a consequence of extrinsic rewards (Osterloh & Frey 2002).

Axcel Exits its Investment

Reports rumored by early December 2014 that Axcel was seeking to renegotiate debt requirements with the bank and sell the company on to other investors. According to sources, the bank was willing to accept a write-off of 400 DKK million of debt in order to find new investors who would take over the company (Berlingske Business 08/01/15).

The lead partner from the private equity fund discussed the investment in the Danish business press shortly after:

"Our investment in Noa Noa has not met our expectations. It was bought at a time when the prices of companies were very high and performance has not been able to live up to it. We have not seen the boost in operating earnings that we had hoping for," Axcel partner and board member Lars Cords says. (Børsen 12/12/14)

The article also chronicled the demise of Noa Noa. A branding expert, Poul Erik Jacobsen, discussed the potential resurrection of Noa Noa as a brand and deemed it impossible:

"When a brand previously defined a style but the consumer since turned their backs to it, it is very difficult to come back. In the time up to Axcel's purchase of the majority, Noa Noa were market leaders in how the style of this type of product should be. The world and consumers' desire for colors changed without Noa Noa following along, " (Børsen 12/12/14)

The same article also asked the original owners how they felt about the news.

"It hurts minority shareholder and founder, Harald Holstein a little bit that the company he founded in 1981 and where shortly after little brother Lars came in, does not perform better. But to do something about it he cannot, so he is concerned with his own housing and interior design projects and charity in Sierra Leone. The younger brother Lars, 45 years old, still owns approx. 10 pct. and is on the board of Noa Noa. He simply finds that much has happened since the brothers sold their business." (Børsen 12/12/14)

By 19/12/14 it was announced that the company was passed on to a new group of investors. The price was not made official, but due to the sizeable amount of debt in the company, it is rumored that Axcel were looking to give it away for free to owners who would take over the renegotiated debt. Since 2011 the company had been suffering losses. (Børsen 18/03/15)

Noa Noa Case Analysis Summary

The investment in Noa Noa was framed by Axcel managers at the time of investment with great potential and even as the financial crisis hit projected earnings, Axcel insisted that the potential for growth was possible even in periods of economic slump. A prudent owner-manager with idiosyncratic knowledge of the business through 35 years had probably cautioned making risky investments in expanding further into foreign markets. He certainly would have been aware of the importance of currency hedging as foreign currency fluctuations is no new phenomenon. However, the possible greed, tenacious optimism and trust in reaching budgeted numbers in a reverse ‘ratchet-effect’, where budgets were blindly trusted eventually killed the investment as debt obligations could not be met.

The Holstein brothers clear interest in selling to Danish capital fund with whom they could ‘they could talk to’, who did not offer the highest price and would keep the brand independent indicate drive higher level needs such as a sense of belonging. The statements shortly after the sale indicate a motivation that is extrinsic, but with an internal or somewhat internal perceived locus of causality, in which there is a synthesis of goals and congruence in values.

Similarly, the initial decision to change the role of the CEO role and the lower number of work hours, when Noa Noa was most in need of expertise was either determined by the agency logic of professional management at Axcel or waning work motivation with the brothers or a combination of both. In either case, the final comments about the lack of capability to do anything with regards to resurrecting Noa Noa as a business indicate a level of amotivation, bordering apathy.

Case 2: Tiger (Tiger of Copenhagen)

Origin

Tiger was founded by entrepreneur Lennart Lajboschitz in 1995 in Copenhagen as a shop selling a wide range of in-expensive items such as stationary, kitchenware, small toys and candy, often in simple Scandinavian designs. It was named 'Tiger' as originally everything had a unit cost price, namely 'a tenner', i.e. 10 DKK. (In Danish the spelling is spelt slightly different, but sounds like the Danish word 'tiger'). The founder spoke about the concept's USP as disguising the fact that it was a discount-store: *"Normally when you walk into a discount store, you feel poor. When you walk into a Tiger-store, you feel like a millionaire, because you can afford everything"* (Børsen 11/10/12)

This concept proved to become an enormous success. The number of stores grew year-on-yea, as did the turnover. By 2003, the chain was one of the fastest growing retail chains in Denmark with 46 stores. (Børsen 09/01/03) A couple of years later, they started expanding into other countries and that fueled growth. By 2012, that number had reached 170 stores in 16 European countries and the chain was growing exponentially, with a turnover of about 1 billion DKK and EBITDA of 165 million DKK. (Børsen 11/10/12)

EQT Investment

The impressive combinations of turnover and earnings led to interest from a variety of private equity funds, who all saw the potential to grow the business even further. By October 2012 owner-manager Lajboschitz sold off 70% of the parent company, Zebra, to Swedish private equity fund EQT. The total value of the deal was rumored to be worth around 1.8-2 billion DKK. (Børsen 11/10/12)

The private equity investment fueled even more rapid expansion and the following by 2014, Tiger was opening 2-3 shops every week. (Børsen 03/06/14) By 2017 the company had 745 stores in 30 different countries, turnovers of 4,3 billion DKK, but profit that year had shrunk to 82 million DKK. (Berlingske Business 17/07/17) This was largely attributed to the unrest in ownership and management.

Founding Family Leaves Management

Initially, the owner-manager announced his intention to stay on in the daily running of the company, but retired his position as CEO to an outside professional by June 2013 and instead took the position as 'Concept Director'. (Børsen 03/06/2014) The founder was after he stopped as CEO in charge of Tiger's artist collaborator and the same was true for the rest of his family who also worked in the family business: The wife, Sus Lajboschitz had the title as creative director, and Simon Lajboschitz was in charge of Japan's store concept and purchasing goods for new markets. (Berlingske Business 16/07/15)

By 2015 however, they had all withdrawn from operations. The owner-manager explained his decision by it being hard not being in control, but also hinted that his own approach to management style was different from that of the private equity fund:

"We have left the company because we have some other projects now," says Lennart Lajboschitz,

"You cannot sell 70 percent of the company and still be the one who decides. That is clear. Someone will do things differently than we have done, and they have to be free, "says Lennart Lajboschitz, who already left the role of CEO in 2013.

(Berlingske Business 16/07/15)

The encounter and cooperation between the streamlined and traditional business people and the Lajboschitz family's more unconventional approach to business also proved problematic. He jarringly spoke of the private equity fund's math-boys (translated from Danish 'regnedrenge'):

The founder repeatedly publicly made his opinion about the traditional thinking of the business world known, which he called "more reactive than proactive". Lennart Lajboschitz said: "the math-boys have too much of a say in the companies."

(Berlingske Business 16/07/15)

His approach to business focused on taking a chance more than basing future actions on past what-used-to-work. "You analyze and analyze, but you do not create anything new," says Lennart Lajboschitz.

(Berlingske Business 16/07/15)

In a newspaper interview, the chairman and representing the investing private equity fund, EQT, responded to the founders' thoughts in kind:

"When it comes to family businesses, where you choose to sell at one point, it's like you're selling your own baby and sometimes there are some emotions involved, says Ole Andersen, chairman of Tiger."

According to the chairman, Tiger's transformation from a family business largely goes according to plan. Tiger has not proved different from other companies he has worked with.

"We all know that when it comes to family businesses, where one sells something at some point, it's like you're selling your own baby, and so sometimes there are some emotions involved. But I have nothing to complain about. This transition has been completely as expected, "says Ole Andersen, adding that at the same time, attention should be paid to not throwing the things that have historically worked overboard.

"There is always a balance between maintaining the spirit and DNA of Tiger while building something that really works forward," explains Ole Andersen. "A large part of Tigers DNA lies in the products, and with Sus Lajboschitz's exit it is a goodbye to the woman who develops and selects products. There is probably someone else to take over, but the big question is how much DNA is dragging out of the concept with the founders' exit." (Berlingske Business 16/07/15)

Another business commentator remarked about the development with 'math-boys' in a blog post with the heading:

"There is no doubt that it is a far cry from the type of ownership in which an ingenious owner such as Lennart Lajboschitz decided everything in a 'messy' organizational business structure - and then into a tightly run business group, where everything could be measured and where the owners want transparent and clear lines. That's something they still work on within Flying Tiger, although they say they have come a long way... This is the reality when the big gun math-boys and girls walk in the door. Then the structures will be under control. Everything has to be measurable. And then you need to deliver results - fast!" (Berlingske Business 3/01/17)

Top-Management and CEO-Merry-Go-Round

The owner-manager family were not the only one who left Tiger following the years after the private equity fund gained ownership. For the five years following the transaction in 2012, Tiger experienced very high growth rates, but had difficulty holding the organization together. They had 5 different CEO's in place, including the original owner-manager, 2 interim CEO's, a high profile CEO headhunted from France, Xavier Vidal and his Danish replacement, Mette Maix. The departure of owner-managers and the changes on the CEO led reportedly led to resignations of around 10% of the 200 employees working in the head office in the first quarter of 2017 alone, most of whom were involved in top management. (24/04/17 Børsen)

The chairman of the board of directors reflected on the tumultuous years with rapid expansion and big changes to management in an interview to Danish business press:

"*We slipped a bit away from our concept and we had to go back on track. We have come to be very impressed shortly after Mette Maix arrived. It has been Mette's task to get the concept back to the core and let the company's DNA dissolve into the company.*

Not only did Vidal misinterpret the Tiger DNA, he did not get along with the company's founder, Lennart Lajboschitz, who of anyone knows the company and the culture. The chemistry between Vidal and Lajboschitz meant that Lajboschitz, who otherwise still sits on the board of directors and still owns almost 30 per cent pulled as far away from the company as possible. The same did his close family, including his wife Sus, who had played a key role in the development of the concept and product range so far.

Lennart is a wonderful person. There is no one who can specify a concept like he can. So any top manager who is in charge of Tiger, we would encourage you to spend a lot of time with Lennart to suck his knowledge and get his advice. Mette Maix succeeds at doing this. There is good chemistry between the two, and it is good for the company. It is also one of the factors behind the fact, that the future looks brighter now," (Berlingske Business 31/01/18)

Calls for Owner-Manager Comeback

By 2017, there was speculation in the business press that the founder would be interested in returning on a more permanent basis to running Tiger. One market observer gave his input in an opinion editorial:

"In Tiger stores it's not just about fun colors everywhere. It's also about Danish design. It's cultural... There is thought behind the fact that many of the goods sold contribute to forming communities, be it whether you buy an air hockey game for 100 DKK, that will entertain children for hours or you buy table fireworks for a dinner party. All this was created by the founder Lennart Lajboschitz, who has the crooked brain that has separated the Tiger stores from the crowd... In January, Berlingske was promoting that Lennart Lajboschitz made a comeback in the Tiger chain. It has probably comforted the many business partners, store managers and people in Tigers headquarters, who have missed their founder. But Lajboschitz did not make a comeback. He just hold his board position in Tiger, where he defends a shareholding of approx. 30 per cent, and says he "gives good advice".

The question is, if good advice is enough when the chain experiences a decline in its stores and has said goodbye to the most distinctive characters in the headquarters. The question is whether the private equity fund's people in the pursuit of growth and an IPO have come to kill the essence of the chain's success... Perhaps it's time to convince Lennart Lajboschitz to make a real comeback as a cultural carrier and global Tiger guru" (Børsen 01/05/17)

However, the sense of longing was not mutual on the side of the owner-manager. Lajboschitz reflected in an interview on if he was interested in returning to work within the company he founded. Rather he would focus on con amore-business projects such as an informal social dining-space in a converted church and refurbishing an old hotel north of Copenhagen.

"He sits on the Board of Directors, but that's it: 'I'm not part of the daily operation. My role today is that I participate in the board meetings. It's not that I'm unwilling to talk about Tiger, but my mind is really not there anymore,' says Lennart Lajboschitz." (Berlingske Business 31/01/18)

These comments came after a period where he didn't attend board meetings, because the streamlined capital fund partners had worn on him:

"When Mette calls me and wants to talk, I like to talk to her, but it's more about historical matters and not much else. It is also my impression that the people try to look at how we used to do things in Tiger. But I don't really know much about it. When Mette catches me on the phone, it's nice and I'm really happy, but it's like that, "says Lajboschitz. (Berlingske Business 31/01/18)

Tiger Investment Today

At the time of writing, the future status of the Tiger investment was still uncertain. There were several reports that EQT was heavily considering an IPO on the stock exchange, but such rumors surfacing was almost a bi-annual event. (Business 31/01/18; Børsen, 26/05/15)

Tiger Case Analysis Summary

Like in the case of Noa Noa, Tiger's owner-manager spoke of his intentions to stay on as CEO, but rather than retire to an ambassadorial advisory function, Lajboschitz and his family completely left the company, including board room meetings, in protest of the way the company was run. It appears from the passionate outbursts against the 'math-boys' and the agency-logic, that intrinsic motivation was strong to keep working with the company, but rather that Lajboschitz felt out-maneuvered and incapable of making his logic and idiosyncratic knowledge put to use. Initially he accepted he could no longer be in charge with some level of interest, but eventually seemed disinterested in Tiger with a comment such as 'my mind is not really there anymore'. From statements given in the press it was apparent that Lajboschitz was missed by commentators and Tiger employees, but not possible to gauge if Lennart Lajboschitz had been asked to return as CEO by EQT. In any case, one could argue that original motivation to some extent had been crowded out; Lajboschitz did not indicate he would be able to muster the motivation needed to take the reins again at the helm of Tiger.

The loss of specific knowledge from several key employees seemed to have an impact on the continued development of Tiger as an investment case. The loss of corporate culture and collective knowledge through mass job resignations and a lack of idiosyncratic knowledge of the Lajboschitz family became an unavoidable topic of discussion in the board room, but not acted upon until earnings were diminishing. The admission of guilt given by the chairman was framed as 'loosing DNA' and 'slipping away from the concept' and the major wrongdoing committed by the French CEO, Xavier Vidal, was to scare away the owner-managed family from working in Tiger. The replacement CEO, Mette Maix's main task is to make up and 'suck' as much specialized knowledge from Lajboschitz.

In this sense the replacement CEO, Maix, was not just headhunted as a new CEO with fresh ideas for a new corporate strategy for Tiger, she was also hired in the acknowledgement that the confrontational, agency leadership approach practiced by Vidal was insufficient and rather a leadership characterized by stewardship theory was needed. In the mechanics of the Principal-manager choice model given in the theory section, there was a slow shift from towards cell 4 where both manager and principal had a stewardship approach.

Case 3: Sticks'n'Sushi

Origin:

Sticks'n'Sushi is a Danish take-away and restaurant chain that sells Japanese food, namely sushi and yakitori meat spears. The first restaurant was founded by brothers Kim Rahbek and Jens Rahbek and Kim's brother-in-law, in central Copenhagen in 1994.

The idea of the sushi restaurant business dawned on the founders back in the 1980s when the aspiring cook Jens Rahbek Hansen returned home after six years of cooking lessons in his mother's homeland, Japan. With a Japanese mother and a Danish father who worked as a Danish fish importer, it made sense to open a restaurant serving both sushi and yakitori meat spears. The two brothers put their heads together with their brother-in-law, Thor Andersen, and developed the idea of a Japanese restaurant in Denmark. With a loan from the bank of 125,000 DKK and a lot of help from, they threw themselves at it. In addition to Jens Rahbek's yakitori education, none of the three co-workers had knowledge of the catering industry. The brother, Jens Rahbek was since bought out, but the business ownership was kept between Kim Rahbek as CEO, Kim's wife as Creative Director and Thor Andersen as CFO. (Success Criteria Podcast, Season 3 – episode 8)

Maj Invest Investment

By 2012, the founders sold off 49% share to Maj Invest, but retained 51% share ownership within the family. All family members stayed in their original leading management positions.

Kim Rahbek cites reason for the sale to get a professional partner. He calls it a professional partnership-agreement:

'For the private equity fund, Maj Invest, it was not decisive whether the fund purchased the majority of the shares or not:

"We are not so concerned about whether or not we have the majority. For us, the partnership and the chemistry with the other owners are more important than if we have 49 or 51 per cent. of the shares" says Erik Holm, Managing Director of Maj Invest Equity.' (Børsen 31/05/13)

The continued character of owner-managed business was on the other hand important to the selling party. The founders emphasize that they are still sitting at the end of the table in the day-to-day management of the company:

"We are a family-run business. So that means something for the DNA in Sticks'n'Sushi, that we have the majority shareholding. But we attach great importance to the fact that it is a partnership with the private equity fund, says Kim Rahbek Hansen, CEO of Sticks Sushi." (Børsen 31/05/13)

The transaction process was very thorough and took more than a year, from the beginning of talks until the deal agreement signing implying that building of trust was crucial as the investment would be long-term for both parties. In addition, the sellers emphasized that retaining employees was key:

"It has been important to us that both parties have focused on keeping our employees so that they also have a job tomorrow. At the same time, the focus has been on opening restaurants at a pace without compromising our quality standards, "says Thor Andersen, one of the founders of, and current board member of Sticks'n'Sushi. It's been important that it's a long-term relationship and neither Maj Invest or Sticks'n'Sushi could say how long their partnership would last. (Børsen 31/05/13)

Motivation of Top Management

CEO Kim Rahbek has since the private equity investment of Maj Invest was finalized spoken candidly about his own role and motivation as CEO and the importance of employees, implying the corporate culture and tacit knowledge they possess:

"We started out as 7 people, but now we are 11-1200 full and part-time employees and will hire an additional 300-400 next year. So my function has changed, I'm sort of a "minister of culture" and representing the DNA alongside the family. And then we have a lot of terrific people everywhere who run the shops. So my role is to be a bit everywhere. With regards to small-scale logistics, I'd say I've let go, but people in the company will probably say, that I haven't. It's probably 50/50. But I still want to know what's going on and still follow the business and day-to-day operations closely."

(Success Criteria Podcast, Season 3 – episode 8)

"I really think I have the best job in the world. It's a privilege getting up in the morning and knowing that tonight we will invite so many people for dinner across all our restaurants. And knowing we have a lot of good people working in our restaurants ready to serve them. And this is a people's business. I know it's a cliché, but in the hospitality sector in general, also hotels and so on, is run on those places you walk in to sleep or eat, that you're met by some lovely people in the reception or in the restaurant. And if you don't have good people, who know how to do their job, you don't have any business. "

(Success Criteria Podcast, Season 3 – episode 8)

When discussing the investment that Maj Invest made half a year earlier, Kim Rahbek underlined the partnership nature of the transaction, as well as the importance of value-driven business, rather than focusing on numbers:

"The transaction with Maj Invest has not really changed much on a daily basis, we just follow the plan we have made with Maj Invest for the next five years. It's a plan that we made ourselves, that Maj Invest bought into. So it's actually just a matter of following that plan and doing what we've told ourselves to do. So all it's done is given us a financial muscle to go from an organic growth to a dynamic growth, because we can enter markets quicker without having to rely on the bank."

"Philosophy means more than finances. It's important that if we want to do something specific, then the finances take over and we start discussing numbers, numbers, numbers, numbers, numbers. And something else we say is, if there is no thought behind the numbers, then the thoughts won't become numbers.... It's very important that you know what you do, and why you do it. And that starts with some philosophical considerations. Then the money will come automatically, if you then run your business accordingly.

"We have a very strong, young management team in our head office. We spend a lot of time on each other and talking to each other, to the leaders in our group and to give each other confidence in what we're doing. If the managers don't have confidence, then they can't give lower level managers the confidence needed to execute their daily tasks in their local shops."

(Børsen Career Fair, 26 november 2013)

Sticks’n’Sushi Today

By 2017, Sticks’n’Sushi had grown to 19 restaurants in Denmark, UK and Germany with 1100 employees and a turnover of 449 million DKK rising, up from 210 million DKK in 2011. 5 restaurant openings are in the pipeline for 2018. All of the family still hold top management positions. (Carlson 2017)

Sticks’n’Sushi Case Analysis Summary

Maj Invests investment into Sticks’n’Sushi appears exemplary in describing stewardship theory both in terms of leadership style of its CEO and its ‘partnership’ (as it is termed) with its private equity fund investor. Even if they are a minority principal, Maj Invest, appear to trust their majority shareholder that they run the business according to plan and that such a mutual stewardship relationship would give the highest returns. The long lead time to signing of the transaction papers, underscore the significance put into building trust on both sides. The statement made by Maj Invest that to them majority or minority stake is not all that important indicate a mentality different from the one typified by the private equity funds in the previous cases. The stewardship approach of trust and long-term performance enhancement over the agency theoretic logic of cost control is rather unusual than the behavioral displays of EQT and Axcel.

In management style CEO Kim Rahbek is also displaying many of the characteristics of stewardship theory, namely the involvement and lauding of employees at all organizational levels, the focus on collectivism and an emphasis on value-driven leadership. This importance of value-driven leadership can be seen as a sign of a particularly strong corporate culture that permeates the whole organization. One clear example of this is the famed Sticks’n’Sushi outstanding service culture that is cultivated among employees at all levels and in all functions.

In addition, he speaks with high levels of enthusiasms about his job and intrinsic motivation seems intact even if the family has been handsomely compensated for the minority stake.

Discussion

The three cases make it clear that there is a range of critical issues to consider when private equity investors go into owner-managed businesses.

Loyalty, motivation and culture is largely borne by special people and culturally carried by owner managers and it is thus particularly critical to ensure the retention of the values that the private equity managers invest in. This is accomplished in the partnership-model of Maj Invest and Sticks'n'Sushi where a relationship based on trust and stewardship theory has helped to foster an investment case where owners, managers and employees all experience the change of ownership as a continuation of the long-held values and culture of the company.

While fund managers would argue that Noa Noa crumbled under the toxic combination of debt and the financial crisis as an unfortunate miscalculation of risk management, a 'worst case' budget prognosis of stagnant sales should have insulated the business case from such developments. And while the financial crisis obviously adversely impacted the investment case, it is interesting that the miscalculations of the business case along with market conditions can be used to excuse the failed investment. The agency logic of private equity funds that drives this type of investment without prudent risk management is susceptible to heavy losses when financial gearing is high, investment horizon short and market conditions unfavorable. If then the original owner-manager's knowledge and dedication is vanishing from the daily running of the board, the odds are stacked against a successful investment.

In a business where the owner-manager stands as a beacon in the organization, who can generate countless marketable ideas and have a je-ne-sais-quoi persona, the potential risks of investment become even more pertinent. In the business case of Tiger, the bad seeds sown in the early years between the French CEO and Lajboschitz alongside the logic of 'math-boys' have diminished trust and motivations on both the board level and lower in the organization. This takes time to rebuild and meanwhile, lower earnings reduce the overall business case considerably. It seems both remarkable and surprising that in a business organization the size of Tiger, the skillset and knowledge held by the founders can be so sorely missed.

Of all the critical issues to consider there seems to be an overarching theme of dealing with the fuzzy, elusive qualities often referred to as the "DNA of the company". Taking into account all the rational logic, calculations and processes integrated in a due diligence process and the construction of business cases for private equity funds to invest in a company, it is thought-provoking how private equity-managers talk about the DNA as a black-box concept, where normal logic stops.

Christian Frigast, leading partner in Axcel, in a quote about family businesses expressed his appreciation for the need for humility when approaching an owner-managed business. But much more vaguely he also draws attention to the elusive concept of DNA:

"When you take over the majority from a family, that has run the company all their life, you have to listen. You cannot just come barging in and say you can do whatever you like, because you're from Copenhagen. There are a lot of feelings in a family-owned business, and if you don't understand the DNA, then the transaction is going to fail." Christian Frigast, Leading Partner in Axcel (Børsen 26/05/14)

When it comes to corporate culture, knowledge and people, the management philosophy and governance structures that dominate the ontological paradigm in private equity firms clearly demonstrate their limitations in the field of owner-managed businesses. It becomes apparent that the agency logic has its limitations and shortcomings when something goes wrong in an investment in owner-managed business.

The disclaimer when such an investment does encounter complications is a cultural 'black box' termed 'DNA' that was not understood. Interestingly, in the case of Stick'n'Sushi which is an owner-managed business that obviously also has a tacit corporate culture and distinctive 'DNA', cultural differences between owner-manager and private equity fund never became an issue. Rather, through continuous trust building, a common ground is shared and through a partnership rather than an uneven principal-agency, risks were diminished.

Conclusion

Despite the basic assumptions of agency theory that alienation of decision rights makes it possible to put a nominal and trade decision rights, when it comes to owner-managed businesses, the tacit and specialized knowledge and corporate cultures that lie in the organization is not necessarily part of the package. The obvious limits exist because this specialized knowledge is not visible, quantifiable or material and because they reside with the owner-manager who has built the company and the knowledge culture that lies in it from its inception. As this knowledge, corporate DNA and culture sift from the company, there is a very real prospect of the economic value sifting out of the investment case that the private equity investment invested in in the first place leaving an empty shell with diminishing nominal value. Using the regular methods prescribed by agency theory to incentivize the owner-manager to continue working hard in the company he no longer fully owns, will not necessarily work. This can largely be explained by a change in focus away from higher level needs and intrinsic motivation of working hard. This shift can arguably in some cases be explained by a degree of post reward performance lessening, but as extrinsic motivations of monetary compensation only partly lie to ground of the entrepreneurial motivation, the possible causes must be different. Rather, differences in cultures and values can drive a wedge between the private equity fund and the owner-manager. The rift is expanded by a distrust on the part of the owner-manager on one side towards the supposed accounting truths and optimizing management logic of agency-theory and low confidence on the side of the private equity fund towards the passion-driven, un-boxable owner-manager. The only way to ensure that cracks in this relationship do not develop is through mutual trust building. An understanding of the principles of stewardship theory as an alternative to the agency theoretical paradigm can aid this process and ensure an alignment of goal between agent and principal to common good for both.

I hope in this thesis to have shown some of the shortcomings of a purely rational business logic when it comes to private equity funds in owner-managed companies. As my theory and cases suggest, there is a need for a more elaborate and refined understanding of elements of knowledge, motivation and dilemmas of balancing trust and control in corporate governance design.

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