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Corporate Governance

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Active Ownership in Practice

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Abstract

Concepts like corporate governance have been developed, due to the needs of the owners to supervise the management and influence the directions of the acquired companies.

We will for the purpose of this thesis, look upon corporate governance as a means for the investors/owners to exercise influence over, and supervise the acquired company, and thereby affecting the return on investment. If corporate governance is practised, an active ownership is a prerequisite.

The objective of this study has been to explore and analyse how investing companies look upon the concept of active ownership, how this is exercised in practice, and how this could benefit both one's own and the acquired company.

In order to answer these questions we conducted an explorative and descriptive study, namely a study of a number of selected companies' annual reports, in combination with two personal interviews.

The study indicates that it is hard to find a distinct definition of what active ownership consists of, though it seems to demand actions concerning the management of the acquired company. This is mainly accomplished through board participation.

The investing companies, active on the risk capital market, consider the most important aim for active ownership to be profit maximisation. The same companies consider the access to their network of knowledge to be the main contribution to the acquired company.

Key words: Corporate governance, Active ownership and Investment company.

Acknowledgement

Accomplishing this thesis has occupied most of our time and minds this autumn. Though, it has been an interesting and challenging task, which we feel has opened our minds to new knowledge. It is our wish that You will enjoy reading this thesis as much as we have enjoyed writing it, and it will hopefully provide You with ideas for further research within the subject.

After finishing this thesis, we would like to send some words of gratitude to a number of people who have made the accomplishment possible.

Firstly, we would like to thank our tutor Christian Ax for not giving up on us, and helping us to make the thesis better, through advise and guidance.

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1. Introduction

Knowledge has proven to be the driving force behind the world economy. Companies have recently learned to increase efficiency through better participation and motivation among their employees. Now, investors have adapted this view, and learned that participation among shareholders also adds value. Capitalists, who are willing to invest ideas, as well as money, are the most successful on the market. By creating more democratic forms of corporate governance, the accountability to investors might increase. (www.corpgov.net)

1.1 Background and Problem discussion

According to Carlsson (1997), the need for corporate governance, and professionalism of ownership, has been driven by the increased focus on the management during a period of time. There are three critical factors that mainly explain the more or less dominant role of the executive management in different countries, namely; demand for competence, the inflow of risk capital, and the stakeholder model.

The development since the industrial revolution has been a result of a number of "knowledge revolutions". The demands for competence and knowledge within the management became the basic driving force in the so-called management revolution, where the ownership of the company was separated from the day-to-day management. A rational industrial operation could not be based solely on the owner's authority and the management's loyalty towards the owner. It also demands specific knowledge about the technology, processes, accounting, etc. The organisational theorists, Henri Fayol, and later Frederick W. Taylor focused on the importance of specialisation. One of Taylor's philosophies was "it is up to the management to manage". The works of these two theorists became important manifests in the management revolution, for knowledge and competence against the arbitrary exercised power of the owners. A management profession was eventually developed. (Ibid.)

The development of the inflow of risk capital to companies is another explanation to the imbalance between the management of a company and its owners. The direct, private ownership in companies has decreased and been replaced by institutional owners like investment companies, unit trusts, collective pension funds, and insurance companies. As will be discussed later, in Section 4.1, these two different groups have different views and criteria. (Ibid.)

As recently as the late 1930's, the so-called stakeholder model was introduced. In this model the owners are equalised with other stakeholders, like creditors and employees, with legitimate demands on the company. The management is raised above the other groups, and thereby seen as the actor that is able to create a balance between the others. The relation between management and owners can be seen as a distribution of work, rather than a dynamic co-operation. (Ibid.)

However, it has been argued that the strengthening of the management is a positive and necessary development, and that a strong and independent management does not exclude a strong and competent owner. The optimal situation, argued by some, for example Carlsson (1997), would be to have both a strong and competent management and owner. Yet, the disposition of responsibility and the mandate of the management must be clearly defined.

Due to the needs of owners to supervise the management and influence the direction of the company, concepts like corporate governance have been developed. Tricker (1999) provides one of several definitions of corporate governance as a means to exercise power over corporate entities. It has become one of the central issues in management and the regulation of modern enterprise today. However, the underlying ideas and concepts of corporate governance have been surprisingly slow to evolve. The supporting frameworks still owe more to mid-nineteenth century thinking, than they do to the realties of complex modern business. Governance issues arise whenever ownership of an enterprise is separated from its management. Corporate governance involves questions like: How is the power over the company exercised and legitimised? To whom is a company accountable and, ultimately, responsible? These questions are also stated by the agency theory.

Is active ownership worth anything? This question is stated in an article in Dagens Industri 2001-11-15, where Jan Hedlund argues for a board in Ericsson with technological knowledge, but without connection to the management, non-executive directors. This is an expression for the need of corporate governance.

The Swedish ownership tradition marks a line between the management and the supervision of the company. It is the role of the Board to supervise the work of the management, and if necessary change it. The management is, independently managing the company for as long as it has the confidence of the board.

The issues of power and corporate governance have never been of the same interest as now. Rolf H Carlsson states this in Affärsvärlden on the 21st of February 2001, and argues that both a company's accountability and prosperity is dependant on sufficient corporate governance. It is not enough for the board to monitor the management, it also has to participate in decisions. In the same way, a demand for return is not enough to create successful governance, it also demands clear values on how a company or an owner wants to be, and why and how this is the case.

Controlling the Board has become the most important issue on the general meeting during the spring of 2001. It is at the Board nominations the institutional investors have the greatest opportunities to influence the companies. According to Caroline af Ugglas (Finanstidningen 2001-03-16), a good owner does not need to be represented on the Board, but realises the importance of an appropriate board.

1.2 Definition

For the purpose of this thesis we look upon corporate governance as a means for the owners/investors to exercise influence over, and supervise the company, and thereby affecting the return on their investment. If corporate governance is practised, active ownership is a prerequisite. This interpretation is consistent with the ones OECD and Cadbury have, as stated below in section 3.1.

The following figure provides a simplification of our view of corporate governance. This will hopefully work as a guidance through out the entire thesis.

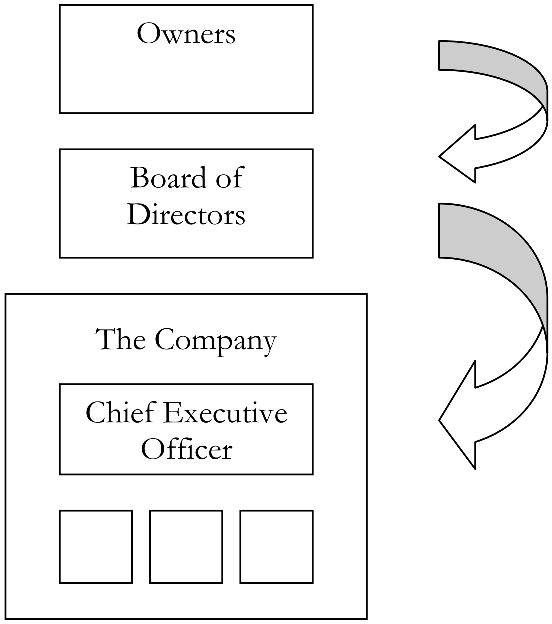

FIGURE 1:1: OUR VIEW OF CORPORATE GOVERNANCE

1.3 Research issue

As argued by Brodin et al (2000), the role as CEO in Sweden, spread further than suggested by the legislation, before the concept of corporate governance became a conventional idea. At the same time, the CEO's position compared to owners and Board of Directors was generally strong. In the light of the corporate governance debate, the significance of the bodies altered. The roles of boards and owners have been upgraded.

The companies active on the risk capital market are large owners of several Swedish companies, and they sometimes have a very large proportion of the votes. This puts them in a position of being able to practise control over the actions of the company, and according to theory they often do. (Enquist, Javefors 1996)

In the light of the discussion above this thesis will deal with the following questions:

- What opinions exist about the meaning of active ownership in companies, active on the risk capital market?
- How do the companies, active on the risk capital market, practise active ownership?
- What is the active ownership activity aiming at?

- What are the contributions to the acquired companies, according to the investing company?

1.4 Objectives

The objective of this thesis is to explore and analyse how companies, active on the Swedish risk capital market, look upon the concept of active ownership, and how this active ownership is exercised in practice. Further, we will explore and analyse how, according to the investing company, the actions taken could benefit both the company itself and the acquired company.

1.5 Potential contribution

The topic of corporate governance has occupied the academic circles for a long time, but even so the debate concerning "boardroom effectiveness" is far from being settled. The need for boards to achieve efficiency of management is even more critical than ever, due to the increased shareholder activism.

Corporate governance consists of many things, active ownership is one of them. This is especially interesting for us since it holds a central role in the approach of the investing companies. A lot of research regarding the risk capital market has been conducted, yet none of them discuss the control mechanisms that could be used by Investment companies, and its similarities, e.g., Venture capital and Private equity companies, to practise company control, and how this affect the parties involved.

We believe that this thesis could be beneficial since it provides new, empirical knowledge on how investing companies look upon the concept of active ownership, how this is practised, and the reason for doing it.

1.6 Scope and limitations

We have limited this case study to only comprehend three kinds of actors on the risk capital market; namely; investment companies, venture capital companies, and private equity companies. We have disregarded other actors such as private investors and other institutional investors, such as securities brokerage companies, insurance companies, collective pension funds and unit trusts in our empirical study.

1.7 Outline

Chapter 2 *Methodology*

It is important to clarify the overall research approach since this approach might influence the results of the study. Dependent on different kinds of research issues, various types of research methods can be used. To clearly state the methodological choices made also gives credibility and trustworthiness to the thesis.

Chapter 3 *Corporate Governance*

A basic understanding for the underlying theoretical framework is essential in being able to understand the empirical study presented later on. In this chapter we intend to present the concept of corporate governance, in order to provide the reader with a basic understanding for the problems involved in this question.

Chapter 4 *Actors on the risk capital market*

In this chapter we intend to provide to the reader a short presentation of some of the actors on the risk capital market, which has a reputation of being active owners. The reason for doing this is to clarify some of the rather confusing terms regarding different kinds of investors.

Chapter 5 *Results of the empirical study*

In our empirical study, we have conducted annual report analyses of six companies together with two interviews. The results of these will be submitted in this chapter. When presenting the result of the interviews, we have chosen not to present them according to the disposition of the questionnaire, because of the cohesion of the thesis.

Chapter 6 *Analysis*

In this chapter, the results of the empirical studies will be analysed and discussed in connection with the theoretical framework. We will also add our own reflections and thoughts.

Chapter 7 *Conclusions*

The purpose of this chapter is to try to answer the research issue: What opinions exist about the meaning of active ownership in companies active on the risk capital market? How do the investing companies practise active ownership? What is the purpose of practising active ownership for the investing company? What are the contributions to the acquired companies?

2. Methodology

It is important to clarify the overall research approach, since this approach might influence the results of the study. Dependent on different kinds of research issues, various types of research methods can be used. We have chosen to use interviews and document study, which we believe will lead us to a result that is in accordance with reality. To clearly state the methodological choices made also gives credibility and trustworthiness to the thesis.

2.1 Research approach

This thesis will take both an explorative and a descriptive approach. It will take an explorative approach because it provides some basic knowledge concerning the concepts of corporate governance as well as different kinds of companies active on the risk capital market. To present some basic knowledge regarding the research issue is of importance since this provides foundation for the study. The descriptive approach is based on a description of how the companies practise active ownership, and how this is of benefit to one's own and the acquired company. (Lekvall, Wahlbin 1993)

The study is a qualitative one. It consists of data, which are gathered, analysed and interpreted, and these data cannot in a meaningful way be quantified, i.e. expressed in numbers. Qualitative studies are usually case studies or surveys with small selections. Quantitative studies are expressed in numbers and can be analysed in a quantitative way. (Ibid.)

We believe that a quantification of the findings of our study is almost impossible to do in a meaningful way. Since this study has an explorative approach, and aims to increase the knowledge regarding the concept of corporate governance and active ownership, the qualitative method appears to be the most appropriate one.

2.2 Accomplishing the empirical study

In order to accomplish the empirical study, we conducted studies of a selection of annual reports, together with two interviews, in order to deepen the understanding of the issue. The choice for interviews were rather simple, since there was no other suitable way to collect the kind of data proper for the study. The questions we needed to ask were too complex to be posed in a mail questionnaire. Also, interviews gave us the opportunity to ask questions as they came and to further develop some answers. Conducting interviews with open-ended questions gave us an advantage and also the respondents the opportunity to influence the stated questions and reflect upon them, based on their experience of the topic and knowledge of important issues.

The main problem, that could be substantial, when conducting interviews, regards the problem of access, i.e. to get in contact with the right respondent and make an appointment to carry out the interview. (Lekvall, Wahlbin 1993) This problem became evident to us, when contacting the companies, only two of them had the time to meet us. The companies that were not able to respond were studied through analysis of their annual report for year 2000.

In the annual report analyses, the focus was on active ownership, and the relationship to their holdings. The issues we concentrated on were; how the active ownership, that the investing companies claim to practise, is exercised, what the aims of this activity are, and how this can contribute to the acquired company.

2.3 Data collection

The information used in this thesis could be dividend into two main groups; primary data and secondary data. Primary data is the information that we gathered ourselves, and we chose to do this by conducting interviews. The secondary data is published or unpublished material already written and compiled by someone else for another purpose.

2.3.1 Collection of secondary data

A wide collection of secondary data is important when doing this kind of research. We wanted to obtain a basic understanding of the problem before conducting the interviews, therefore we studied literature, published articles and information from the Internet. When searching for literature and in data bases the key words that we used, individually or in combination, were:

- Corporate governance
- Agency theory
- Investment companies
- Risk capital market
- Venture capital companies
- Private equity companies

When we performed the annual report analyses, we looked upon six companies active on the risk capital market, and their views of active ownership, as expressed in the annual reports. Given that this data is complied by someone else, for another purpose, this could pose a problem since it might not be entirely suitable for our purpose.

2.3.2 Collection of primary data

Regarding the primary data, we chose to conduct qualitative interviews, since they offer us a closer contact with the respondents and also the possibility to have a more open discussion. An open discussion will, according to us, lead to more honest and thought-out answers. We conducted the interviews with support from a questionnaire with open-ended questions (provided in Appendix 1), which gave the respondent the possibility to discuss freely around the issues.

When conducting interviews it is important to consider four different kinds of errors that might occur.

- Measurement errors, these are dependent on the non-verbal communication between researchers and respondent, such as expectations, body language, and chemistry.
- Errors depending on insufficient knowledge and misinterpretation from the researcher.
- Errors caused by poorly defined questions, not adequately prepared and worked through.
- Errors due to missing respondents or answers.

As soon after the interviews as possible we wrote them down and compiled them in order to have them in mind, and not risking forgetting any important details. Using a tape-recorder while doing the interviews helped us in this process. In addition to this, both of us were present when conducting and interpreting the interviews.

To limit the risk of insufficient knowledge, we did not conduct the interviews until we had thoroughly studied the literature and other written material regarding corporate governance.

Due to the use of interviews, we were able to limit the extent of missing answers. However, in the study of annual reports, a problem could occur if the companies did not express the issues studied. To minimise this problem, we only selected companies discussing the interesting issues.

2.4 Quality of research design

Lekvall and Wahlbin (1993) discuss two kinds of errors that might occur when conducting a study. One is that the respondents are not representative for the entire population, this will not be further developed. The other is that the measurement used is not appropriate to show a truthful picture. The later error is called measurement error. These errors might appear in two forms: low validity or low reliability.

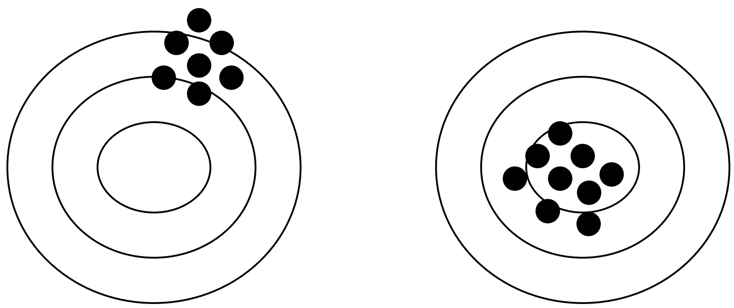

FIGURE 2:1: VALIDITY AND RELIABILITY
Source: Arbnor, Bjerke 1994

This figure illustrates the concepts of validity and reliability. Validity measures the systematic biases in the study, and reliability measures the ability of the method to resist chance.

2.4.1 Validity

Validity deals with ensuring that the chosen method measures the desired concept. Three kinds of validity are described by Arbnor and Bjerke (1994). Face validity, which can be evaluated by the researcher through evaluating the reasonableness in the results. Internal validity, also called relevance, refers to the logical relation between the findings and the theory. External validity deals with the problem of establishing whether the findings can be generalised to the entire population. To establish external validity the research must be replicated and multiple case studies be performed.

To establish validity we have tried to use as many sources of evidence as possibly, and to link them together. We have studied books as well as articles and other types of published and unpublished materials. We have also given the key informants the opportunity to review the compiled interviews to further establish validity. We have also encouraged the respondents to freely discuss the questions and add questions that they find important to our research. When conducting the annual report analyses we concentrated on the issues stressed by the earlier respondents in the interviews. In this way we tried to obtain similar information. Due to the problems of establishing external validity in this kind of study, we will not draw any general conclusions. We will only draw conclusions about and discuss the specific cases studied.

2.4.2 Reliability

According to Lekvall and Wahlbin (1993), reliability deals with ensuring that the findings of the study would be same if another researcher conducts the same procedures all over again. The goal of the reliability is to minimise the influence by chance. Factors that can influence the reliability of the study are; differences in the respondent's state of mind, health or mood, a distractive environment when performing the interview, and variations in the way questions are asked.

In order to increase the reliability in the study, we have given the respondents the possibility to study the questions in advance. We believe that this enhances the quality in the answers since they are better thought through, and not something that the respondent answers without consideration.

To further improve the reliability in our study we used a tape recorder during the interviews. This, in combination with the fact that both of us compiled the answers, reduces the risk of misinterpretation. We also asked the respondents to review the draft, which could further reduce this risk.

Concerning the annual report analyses, we believe that the reliability is rather high. The issues stated in the annual reports are hopefully well thought through, and thereby the risk of misinterpretation is reduced. Also, when repeating the study, the annual reports for the year 2000 will contain the same information, and thus lead to the same results of the study, but possibly different conclusions.

2.5 Selection of respondents

In order to find proper respondents we looked at different listings of investment companies, mainly Affärsvärlden's and Lycos'. After studying these listings we looked at several investing companies' annual reports for the year 2000, available in the library of the School of Economics and Commercial Law, Göteborg. Out of these, we chose the ones that discussed active ownership in a way that could help us answer our stated questions. We also contacted several of the companies on these lists in order to conduct interviews. The reason for doing this was to deepen the understanding of the topic, and obtain information not included in the annual reports. However, in these harsh times and with many interim reports issued, only two companies could spare the time to meet us.

2.6 Limitations of the study

Our inexperience in conducting interviews might have influenced the answers received. This is something that has to be kept in mind when reading this thesis.

Another thing is that the annual reports might have some shortcomings as a source for secondary data. They are produced for commercial purposes, and the content might therefore be coloured by the aim to attract attention from stakeholders. Though, the information gathered is not of a sensitive nature, and thus, the risk of the company trying to create a distorted view is limited. Nevertheless, we have been aware of the problem when analysing the information.

Another limitation could be that several of the sources used are originally written in Swedish. This is a potential problem since when translating a text, errors might occur due to translation and/or misinterpretation. We have tried to limit this risk by using relevant technical dictionary, e.g., business dictionary, and comparing facts with English literature.

3. Corporate Governance

A basic understanding for the underlying theoretical framework is essential in being able to understand the empirical study presented later on. In this chapter we intend to present the concept of corporate governance, in order to provide the reader with a basic understanding for the problems involved in this question.

The concept of corporate governance is build around the relationship between owners and management of the company. In order for the company to obtain new capital from the market, this relationship has to be based on trust and continuity. The overall objective for the owners is to have a return on their investments. Therefore, the owners must feel comfortable with the management since they are the ones operating the company, and have the obligation to function as an extension of the owners. It is the management that are managing the owners' capital and are in some ways responsible for the return. (Ds 1998:64)

There is a delegation of responsibility and authority within the company. The owners delegate the responsibility to the Board, which in turn delegates it to the top management. This could result in a conflict of interest between the management and the owners. In order to ensure that the company is managed in a way that meets the interest of the owners, supervision is necessary. Though, some owners have gone even further to protect their interest and are to some extent involved in the management, or at least the process of decision-making within the company. The relationship between management and owners are discussed in the agency theory. (Ibid.)

The agency theory, developed by Jensen and Meckling, highlights the existing conflict of interests between the owners of a company and its management. The theory is an extension of information economics. An agency – principal relationship exists when someone (an agent) is contracted to perform on behalf of someone else (the principal), and therefore is given decision-making authority. One example is the relationship between the owners of the company and its board, but the relationship exists on different levels within the company for example between the board and the CEO. A certain amount of responsibility to manage an entity is delegated to the agent, but thereby is also some enterprise risk transferred to the agent. (Mathews, Perera 1996) If no agency problems were to exist, there would be no need for corporate governance. In this ideal world the management and the owners would have the same objectives and thereby no conflict of interests. However, this stage has not yet been reached, and corporate governance is thus a useful means for the owners to practise supervision.

3.1 What is corporate governance?

When studying the literature, we found that corporate governance was a concept that could be looked upon in various ways. It covers a large number of distinct economic phenomena, and the concept of corporate governance is poorly defined in literature. As a result of this, many different definitions about the concept have been raised, though many of them have similar features. Due to this, we decided to list some of them and try to explain the framework, supporting these definitions.

Corporate governance is more than control and demands for return, but to make decisive decisions. It is about having clear values and to know why and how. Rolf H Carlsson argues this in an article in Finanstidningen 2001-03-16.

The OECD's definition of corporate governance is: The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. (Millstein et al 1998)

Another definition of corporate governance is provided to the Swedish government in 1998: Corporate governance has a practical meaning of controlling an organisation or a transaction. In a more limited extent, corporate governance is above all, a question of controlling a company. The control mechanisms available for the owner are described further below in section 3.4. (Ds 1998:64)

A third definition is stated by Keasey et al (1999, vol 1): Corporate governance deals with the ways investors can assure themselves of getting return on their investment. Corporate governance mechanisms are economic and legal institutions. It can be argued that the market forces in advanced economies should be sufficient to ensure that the companies are managed in the best way in the eyes of the investors. However, some are sceptical that it could solve the entire problem of corporate governance. These opponents argue that corporate governance is a straightforward agency perspective, sometimes referred to as separation between ownership and control.

According to Molin (1996), corporate governance structure can be seen as a device that allocates the residual control rights over the firm's non-human assets. Ownership will work differently, or rather; constitute different governance structure, depending on the number of owners and organisational form. Although governance is an issue in small, closely held firms, it tends to be more significant in large, publicly traded firms. If there is more than one owner, effective exercise of control rights requires interaction and co-ordination among the owners. That will be more difficult the larger the number of shareholders, and particularly so in large firms with diffuse ownership.

The Cadbury Code of 1992 intended to improve the way UK companies are managed, this definition is consistent with the OECD's. Its concern is with the whole area of corporate governance "the system by which organisations are directed and controlled" – and puts an emphasis on systems, processes and controls over accountability and decision-making, which lie at the heart of every organisation. The objective of the Cadbury Code is to focus on three fundamental pillars of good corporate governance: Openness, Integrity and Accountability. (Hopt, Wymeersch 1997)

The differences in definition of corporate governance could, among other things, depend on cultural differences. As can be seen from the following section, there are two main subsystems that corporate governance can be divided into.

3.2 Cultural differences in corporate governance

The Corporate Governance system can be divided into subsystems. The system might differ due to different aspects like historical aspects, legal systems, and ownership structure. These differences influence the economic behaviour and the company structure. (Ds 1998:64)

One of the systems that predominates the developed economies today is the Anglo- American "market-based" model, with widely dispersed shareholders and a fairly vigorous corporate control (or take-over market). The other system can be represented by the Japanese and German "relationship-based" system, with their large bank and inter-corporate holdings, and conspicuous absence of take-overs. (Chew 1997)

In the "market-based" model, supervision is mainly conducted through hostile take-overs. The management of the companies have, due to the risk of take-overs, incentives to manage the company in a successfully manner. If the company is poorly managed, it risks being bought by another company. The new management of the company might, through restructuring, benefit from investments made by the former management. Hostile take-overs are therefore an efficient way to ensure that the management control the company properly. The "market-based" model is foremost represented by the United Kingdom and the United States. (Ds 1998:64)

In the "relationship-based" model, banks and similar institutions are intermediates, which supervise and evaluate different choices of investments on behalf of the investors. This supervision is regarded as having a sufficient disciplinary influence on the management of the company. The "relationship-based" model is, as mentioned before, foremost represented by Japan and Europe. (Ds 1998:64)

3.3 Control mechanisms

Molin (1996) and Keasey et al (1999) have exemplified specific control mechanisms available when an individual shareholder cannot perform monitoring personally. Such mechanisms are Board of Directors, proxy fights, the take-over market, financial structure and also legal protection.

3.3.1 Board of Directors

The Board of Directors is one important part of the management of a company. Shareholders appoint the Board to act on their behalf, and the Board in turn, monitors top management and ratifies major decisions. In extreme cases, the board might replace the CEO of the company and other members of the management team. (Keasey et al 1999 vol 1)

In principle, the Board has a very important role, but there are some reasons to doubt its effectiveness in practise. The Board consists of executive directors (members of the management team) and non-executive directors (outsiders). On the one hand, it would not be reasonable to expect the executive directors to monitor themselves. Though, on the other hand, the non-executive directors might not do a very good job in monitoring the executive directors. Firstly, they might not have financial interests in the company, and therefore no personal gain from improvements in company performance. Secondly, many non-executive directors are busy people, they are often representatives on several boards, or are CEOs of other companies, and therefore might have little time to think about the company's affairs or gather information. Thirdly, the non-executive directors might owe their position in the board to the management, which in the first place proposed them for directors. (Ibid.)

3.3.2 Proxy fights

A basic control mechanism, stated by Molin (1996), is to exercise the right to vote on the general meeting. However, small shareholders might lack the incentive to incur the cost of attending meetings and investigating managerial performance. Therefore, in large, publicly held firms, replacing inefficient management on shareholders' meeting typically involves proxy fights. In a proxy solicitation, a dissident shareholder challenges the current management be seeking the authority from voting representatives and proposes alternative candidates for the Board of Directors.

Unfortunately, proxy fights might not be a very powerful tool for disciplining directors in a company with dispersed shareholders. There are several reasons for this. First, and most important, there is a significant free-rider problem. The dissident shareholder has to bear the entire cost of realising that the company is under-performing and also, typically, the expenses of launching the proxy fight. This might include everything from locating and mailing the shareholders to persuade them. In contrast, the benefits from these actions accrue to all shareholders in the form of higher share price. Given this, a small shareholder is not likely to launch a proxy fight. Second, even if a proxy fight is launched, shareholders have little incentive to think about whom to vote for since their vote would not appear to make much difference. One easy way of thinking is: "the devil you know is better than the devil you don't". Finally, company law often allows management to use company funds to promote management's candidates for director. (Keasey et al 1999 vol 1)

3.3.3 The take-over market

A hostile take-over is a third control mechanism presented by Molin (1996). It poses a threat on the management to control the company in a successful manner. Firms with agency problems risk being taken over by better regimes.

In a typical hostile take-over, a bidder makes a tender offer to the dispersed shareholders of the target company, and if they accept this offer, acquires control over the company and so can replace, or at least control, the management. Take-overs can thus be seen as rapid-fire mechanisms for ownership concentration. A great deal of research supports the idea that hostile take-overs address governance problems. The most important is that take-overs usually increase the combined value of the target and the acquiring company, indicating that the profits are expected to rise afterwards. Take-overs are widely interpreted as the critical corporate governance mechanism in the United States. (Keasey et al 1999 vol 1)

There are some questions regarding the effectiveness of take-overs as a control mechanism. Firstly, take-overs are so expensive that only major performance failures are likely to be addressed. The bidder has to pay the expected increase in profit during his management to the former owners, otherwise they will simply hold on to their possessions. Secondly, acquisitions could actually increase agency costs when bidding management overpay for acquisitions that bring them private benefits. Thirdly, take-overs require a liquid capital market, which give bidders access to large amounts of money on a short notice if the tender is accepted. Finally, hostile take-overs are a politically vulnerable mechanism, since the managerial lobbies oppose them. (Ibid.)

One of the problems with governance mechanisms like monitoring by Board of Directors or large shareholders, or proxy fights, is that those who incur the costs of improving management only receive a relatively small part of the gains from it. A hostile take-over is in principle a much more powerful mechanism for disciplining management since it allows someone who identifies an under-performing company to obtain a large reward. (Ibid.)

3.3.4 Financial structure

Another important source of discipline on managers, according to Keasey et al (1999, vol 1), are provided by corporate financial structure, especially the company's choice of debts. If a company takes on debts, it limits the efficiency of the management, at least if the management wish to repay the debts. For debts to be an effective source of discipline however there must be an appropriate penalty in case of default, there must be an effective insolvency procedure.

3.3.5 Legal protection

In Molin's publication from 1996, the legal protection as a control mechanism appears to play an important role in providing limitations to managerial discretion. A fundamental role of the judicial system is obviously to enforce shareholders' formal control rights.

The most important legal right for an owner is the right to vote at the general meeting on important company matters like, mergers and liquidations, and election of board. However, voting is expensive to the individual owner since the shareholder actually has to be present at the general meeting to be able to exercise the right to vote. The owners appoint the Board of Directors, but even so, this is no guarantee that the directors represent the shareholders interests. The structure of boards varies greatly, and the effectiveness of these has been a controversial question. (Keasey et al 1999 vol 1)

3.3.6 Large shareholders

A large shareholder has a greater opportunity to collect information about, and monitor the management of the company. Owners of large possessions also have enough voting control to put pressure on the management. The benefits of large owners are that they have both the interest of getting their money back and the power to demand it. Also, permanent large owners have the advantage of having the ability to influence the management of the company patiently. (Keasey et al 1999 vol 1)

Given that the small shareholders have little incentives to monitor managers, some commentators have suggested that the only way to improve corporate governance is to ensure that a company has at least one larger shareholder. This could be accomplished either through an institutional owner or large private holdings. At one level this argumentation must be right, if one shareholder owns 100 per cent, there is no separation of ownership and control. If one large shareholder owns less than 100 per cent, agency problems will be reduced, however not eliminated. First, the shareholders will still under-perform monitoring and intervention activities since he will not gain 100 per cent of the profit from it. Second, a large shareholder might use his voting power to improve his own position at the expense of other shareholders, for example persuade management to divert profit to him or agree to not interfere with management in exchange for a repurchase of his shares at a premium. Finally, the large shareholder might become management. (Ibid.)

4. Actors on the risk capital market

In this chapter we intend to provide the reader with a short presentation of some of the actors on the risk capital market, that have a reputation of being active owners. The reason for doing this is to clarify some of the rather confusing terms regarding different kinds of investors.

4.1 Different kinds of owners

The ownership structure of the company is of relevance to how the management is supervised. Because of this, this section will discuss different kinds of owners and their willingness to influence the actions taken by the management.

Brodin et al (2000) argues that unit trusts have a tendency towards short-term investments, since competing on a market with a shorter perspective. Collective pension funds, on the other hand tend to have less pressure from their principals, present and future beneficiary, and are therefore able to make more long-term investments. The insurance companies represent a cross between the two previous, and they often have experience from managing their own business. Different kinds of investment companies and foundations might even have specific, expressed or implicit, grounds for actions, and often claims to represent a more long-term perspective than others with a more changeable portfolio. These companies also tend to be practising a more active ownership the previously mentioned.

Different kinds of investors tend to take different actions when they are dissatisfied with the management of the company. The following model shows these actions in a clear way that is easy to grasp.

High	Foreign investors		Large, dispersed private possessions
		Insurance companies Pension funds	
EXIT	Small private possessions		Investment companies Large, concentrated possessions
Low	State and organisations with ideological possessions		State and organisations with connected businesses
	Low	**VOICE**	*High*

FIGURE 4:1: TRADITIONAL OWNERSHIP BEHAVIOUR.
Source: Enquist, Javefors 1996.

Exit, and its opposite entry, as argued by Enquist and Javefors (1996), includes the actions taken by a passive owner. These owners are more likely to see the possession as a capital investment. The owners act through exit, selling their shares, if they are dissatisfied with the company, and through entry, buying shares if they believe in the company.

Voice includes owners, which practise an active ownership. This can be done in a number of ways like participating in the general meeting, board representation, and through contacts with the management of the company and other shareholders. (Ibid.) Voice is an attempt to change rather than escape, and has some advantages over exit. If exit is practised, there is no way to use the opportunity to practice voice. But, on the other hand, if voice is practised, one can always later exit. Voice can therefore be looked upon as a way to postpone exit, and exit can be seen as a last resort after the failure of voice. (Keasey et al 1999 vol 1)

Many start-up firms require substantial capital, and a firm's founder might not have enough funds to finance this project alone, and therefore must seek outside financing. Considering the high uncertainty in a new business it might be difficult to obtain loans from banks or other creditors. The same situation occurs for the troubled company seeking fund to restructure. One way to seek funds, in this situation, is to turn to the actors active on the risk capital market. In the following sections three of these actors will be shortly described.

4.2 Investment companies

Von Essen (1997) defines investment companies as companies that acquire shares in other companies in order to increase the value of the own company. To increase the value of the acquired company, and by that the holdings, the investment company practice indirect control. The investment company often has the possibility to appoint or dismiss the Board of Directors, though they are seldom involved in the daily management of the acquired company.

There are different kinds of investment companies; the control has a direct connection with the ownership. The lesser the control and ownership, the more pure investment company. The more control and ownership, the more operating investment company. (Ibid.)

In order to be called an investment company, there are some aspects that must be looked upon, though these aspects are not any definite criteria. (Ibid.)

- The parent company should have a core business of owning and managing shares in other companies.
- The vital part should be as a minority owner.
- The acquired shares should mainly be in listed companies, which also imply that they should not own 100 per cent.
- The owning should be referred to several companies.

In Sweden the investment companies have a central role as an instrument for corporate governance, which has increased during the past decades. Compared to other large institutional investors, such as insurance companies and securities brokerage companies, the investment companies have a more active approach when it comes to corporate governance. They take part in reconstructing and rebuilding companies that are in the need for support, and through initiating and participating in mergers, acquisitions and buyouts they play an active and offensive role in the business world. (Nationalencyklopedin)

4.3 Venture capital companies

A venture capital company is investing in companies, not publicly listed. It is not however, simply an input of capital, but presumes an active participation from the investor, for example through board representation. The investment is usually limited in time in a way that the venture capital company will exit the acquired company in a foreseeable future, often within five to seven years. This exit takes place when the acquired company no longer adds value to the investment. (http://www.vencap.se)

According to the National Venture Capital Association, venture capital companies generally: (http://www.nvca.org)

- invest in new and rapidly growing companies,
- assist in the development of new products and services,
- adds value to the company through active participation,
- exposes itself to high risk, with expectation for high return.

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business (different stages of development are provided in Appendix 2). Among different countries, there are variations in what is meant by venture capital and private equity. In Europe, these terms are generally used interchangeably and venture capital thus includes management buyouts and buyins (MBO/MBI). (http://www.evca.com)

Venture capital is a relatively new concept within Sweden. As many other things within the financial area this concept are also coloured by the United States, where venture capital is a defined form of investment, and has existed since the 1950's. (http://www.vencap.se)

One difference between venture capital and private equity companies is that a private equity company invest in companies at a later stage of its development, and does not necessarily presume the same degree of active ownership. (Ibid.)

4.4 Private equity companies

Private equity companies provide capital to enterprises not listed on a stock market, and can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues – a succession in family owned companies, or the MBO or MBI of a business by experienced managers may be achieved using private equity. (http://www.evca.com)

Lerner (2000) describes private equity organisations as providing finance to high-risk, potentially high-rewarding projects. These firms protect the value of their share of equity by doing a thorough due diligence before the investment, and afterwards retain insights through representation within the company. The private equity industry increased dramatically in the late 1970's and early 1980's. An important change that took place during this period was the rise of the limited partnership as the dominant organisational form.

Subsequent years saw both a very good and trying times for private equity investors. Thus, the 1990's saw a dramatic growth and excellent returns in almost every part of the private equity industry. This recovery was triggered by several factors. The exit of many inexperienced investors at the beginning of the decade insured that the remaining groups faced less competition for transactions. Another reason was that the increasing technological innovations created extraordinary opportunities for investments. Yet another reason was that many new companies were founded, and offered to the market due to the good market conditions. (Ibid.)

5. Findings from the empirical study

In our empirical study, we have conducted annual report analyses of six companies together with two interviews. The results of these will be submitted in the following chapter. When presenting the result of the interviews, we have chosen not to present them according to the disposition of the questionnaire, because of the cohesion of the thesis.

5.1 Annual report analysis

To answer the stated questions we conducted analyses of the content of annual reports for the year 2000, from a selection of companies, regarding the active ownership. The companies selected were; Affärsstrategerna, Aktiebolaget Custos, Industrivärden, Investor AB, Ledstiernan, and Ratos. All of these are companies with the business concept to invest in other companies' shares.

5.1.1 Affärsstrategerna

Affärsstrategerna is a Swedish venture capital company. The business concept is to invest knowledge and capital in newly founded companies or projects within the main areas of IT/Internet, Life science/Medical technology, and Wireless. The investments of Affärsstrategerna should have both potential growth and opportunities to become a world leading company within its line of business.

Affärsstrategerna considers itself to be an active owner, with significant input of both time and knowledge into the acquired company. Board representation is a central issue, Affärsstrategerna is always represented in the Board of Directors, and participates in both strategic decisions as well as operational ones. All acquired companies have continuous contact with an Investment Manager at Affärsstrategerna. The Investment Manager has both experience and knowledge about the specific line of business, and could therefore support the acquired company.

Affärsstrategerna is aware of the risk of investing in newly founded companies, and claims that its knowledge of the line of business, and the commitment to the company, gives a better insight in the company and therefore a risk reduction. The financial risk is also reduced through investing in different sectors.

When developing the investment portfolio, knowledge and competence are obtained, and a value-creating network is established. This network is useful to the acquired companies since it contains specialist competence, which is normally reserved for the larger companies. Examples of competence provided are in the process of recruiting, legal, and international aspects.

Affärsstrategerna usually stays as an active owner until the company is well established or publicly listed. When the acquired company can meet the demands raised by the market, Affärsstrategerna will exit the company.

5.1.2 Aktiebolaget Custos

Custos is a Swedish investment company, with the business concept to invest in companies with high potential for increased value, within no specific sector or line of business. Through active ownership the value of the acquired company should be increased further, and also reducing the risk.

Important elements in the investment strategy are to focus the ownership to a limited amount of companies, foremost listed ones in Sweden or the Nordic countries. It is vital for Custos to have a large percentage of the shares, to ensure the possibilities for active ownership. The time-horizon for Custos investments is dependant on the value creation in each specific situation, and is normally two to seven years.

Active ownership is very important for Custos. Besides investing capital in companies with high potential for value increase, Custos should contribute further by participating in, and developing the acquired company. The areas that Custos focus on are; growth, company structure, asset structure, capital structure, and operational improvements. The goal of the ownership strategy is to create prerequisites to ensure that these focal points are highlighted continuously. Apart from this, Custos should, as an owner, make sure that the acquired company is able to attract and keep skilled management, that the Board is efficient and aims at the same goals as the management and the owners, and that the acquired company acts on a long-term perspective.

5.1.3 Industrivärden

Industrivärden is one of Sweden's leading Investment companies with some of the largest Swedish companies in its portfolio. Through an active ownership Industrivärden seeks to influence the portfolio companies and thereby generate the best possible return for its own shareholders.

The mission of Industrivärden is to invest in shares, with a focus on large companies, and through active ownership create a value increase. The strategy is to invest in a limited number of companies that are judged to have a high return potential. The portfolio of listed companies primarily consists of core holdings and medium-term holdings. The core holdings are in companies in which Industrivärden has a substantial part of the shares, and therefore the opportunity to influence. The active ownership is exercised primarily through representation on the boards of the core holdings. The representatives are persons with a high level of financial and industrial experience, and based on this, active ownership is exercised with a long-term approach with a focus on strategic issues.

Industrivärden contributes to the acquired companies through assistance in resource allocation and injections of capital when needed. The ownership entails clearly formulating and communicating the demands that Industrivärden makes as an investor. Active ownership also warrants an involvement in the formulation and realisation of the acquired company's strategy. Active ownership thus requires financial and industrial knowledge, as well as, thorough and well-grounded analyses, and also the rules of the game, the ways of working, and the opportunities on the financial market. Through active ownership Industrivärden contributes to the acquired companies' development, which can entail extensive changes if necessary where the results are not shown for a long time, and investment are therefore made on a long-term basis.

5.1.4 Investor AB

Investor AB is Sweden's largest listed industrial investment company with a long-term active ownership in a number of public global companies. Investor is characterised by having an extensive international network of industrial and financial experience and competence. Investor is actively seeking investments in companies with high growth and return potential, and has some criteria when investing in a new company. These are basically the following: a strong management, a potential for profitable growth, a well defined and solid business model, a well-developed financial plan and structure, as well as a reasonable valuation and high return potential

Investor's model for creating value is based on active investment activities in combination with active ownership. Through a focused investment organisation and well-developed valuation models, a platform has been created for investing in companies with the potential to generate high return. In each investment situation, Investor contributes to the development of a company by providing more than capital. Through combining experience and competence with future oriented and proactive ownership, Investor has historically been able to deliver high return.

Corporate governance is a central part of Investor's operations, designed to create value among the different holdings and ultimately for the own shareholders. Different corporate governance models are based on the division of roles between shareholders, Board of Directors and management. The platform for Investor's active ownership is the board of directors, through which it is possible to ensure that each company has the right management for its development. Through long-term, active board work, knowledge can be accumulated about a company and its industry, which can be converted into specific value-creating opportunities.

In the acquired companies, the board representatives are usually directly associated with Investor by being, for example, members of Investor's Board or Management Group. Investor's representatives often hold the position of Chairman or Vice Chairman in core holding companies. Board representatives take an active role in the work of the Board, but can also function as advisors and discussion partners for management between board meetings. These people have solid and extensive industrial experience from top management positions in international corporations. In addition, Investor has a group of analysts, which continuously monitor and analyse the core holdings, their competitors and markets. They are in regular contact with different players in and around the companies thoroughly examining, among other aspects, their strategies, structure and valuation.

However, in many cases, Investor can contribute with other experienced representatives from its extensive network, for example, personnel from the internal organisation or representatives from other acquired companies. The work of the Board often involves issues like fundamental discussions about the organisation of board work, the design of business models and defining the right organisational structure for a company. Investor can contribute with internal specialists for certain specific issues within corporate finance, human resources, and communications, among other areas.

5.1.5 Ledstiernan

Ledstiernan is a venture capital company, newly listed on the Stockholm Stock Exchange, which has applied to become an investment company. Ledstiernan is a significant shareholder in approximately 30 companies, and a good half of the invested capital is in the mobile communication sector.

Ledstiernan seeks investment alternatives, especially in Swedish and Finnish unlisted companies, within the mobile communication industry, and the companies are evaluated through thorough analyses and due diligence. These investments are made solely or in co-operation with other actors on the market.

Ledstiernan claims to be an active owner. This is practised through board representation and close communication between Ledstiernan and the acquired company. The representatives on the board have long experience of managing and develop companies within different lines of businesses, as well as industrial and financial competence. The active ownership consists of acting as a discussion partner and someone who enables opportunities, not otherwise existing, for the acquired companies. This could be expressed through strategic advise, recruitment, and financing.

Ledstiernan has the ambition to exit the company within two to five years, and the exit strategy has been developed already in the early stages of the investment. Exit could either be done through an industrial exit, where payment is in form of shares or cash, or a stock introduction. In the exit process Ledstiernan's strategy is to co-operate with investment banks.

5.1.6 Ratos

Ratos is active on the private equity market where it invests only in unlisted companies, and takes active participation in the ownership. Another feature for this type of ownership is that it is limited in time, there is always an exit-point. To eventually exit the company is a natural part of the value creation, normally this occurs when the goals of the investment are reached or when the ownership is no longer creating value.

Ratos core competence is not specific for any line of business, instead the focus is on contributing to the strategy and goals of the specific object, together with analyses of the competence, financial resources and the network of contact. A geographical limitation is however made, Ratos focus only on companies within the Nordic countries. The determining factor of the investment is whether value can be created through Ratos competence and resources, or not. Ratos has made a conscious choice of not investing in a company at an early stage, instead they focus on companies in growth.

Through acquisitions, development and divestments of companies, Ratos creates value added to its shareholders. Only through active ownership, the value of the investments can increase. Ratos practise its ownership control through participation in the Board of Directors, though also tries to influence other officials in the company. It is thereby important that the whole management is in agreement with the owner's intentions and ambition. Ratos role in the acquired company is to function as an adviser and assist with analyses, formulation of strategy and objectives, together with financial competence and resources. To be able to identify needs and take appropriate means of measure, it is vital to have efficient control systems in the acquired company. This further implies that Ratos is updated on issues concerning both the specific company and the entire line of business.

5.2 Interviews

To deepen the understanding of the active ownership practised by the venture capital and private equity companies, and to be able to answer more profound questions, we conducted two interviews. The two companies selected were the international 3i, were we interviewed the operating director Gunnar Huss, and Bure Equity AB from Göteborg, were we talked to Irené Axelsson, Vice President of Investor Relations.

5.2.1 Interview with Gunnar Huss at 3i

3i is one of the leading international venture capital companies, present in Europe, the United States and Asia. In Sweden, 3i bought the listed private equity company Atle AB during the spring of 2001. (http://www.3i.com)

The mission of Atle was to acquire, develop, and dispose unlisted companies. The business was not specified to certain lines of business, but investments were sought in all industries and lines of business with potential growth. One of the notions of Atle was that the company was an active owner. Through competence and networks of outsiders, Atle was able to on a long-term basis actively change the development in the acquired companies. The length of the investment was usually between three to seven years, but the determining factor was for how long Atle considered it to contribute to the acquired company. This is in accordance with the mission of 3i, and is therefore still valid. (Ibid.)

The focus of investments in 3i is on IT and technology companies, established emerging companies, MBO and LBO (leverage buyouts). In Sweden a Leverage Transaction Team has been established to advise 3i in questions concerning MBO's and LBO's in mid-size, well established companies in most lines of business. Important criteria for investment are strategic position on the market, a skilled management, reliable cash flow, possibilities for exit within two to seven years, and opportunities for growth. A Technology Team has also been formed, consisting of extensive experience of the prerequisites of this market. (Ibid.)

Active ownership

Gunnar Huss is of the opinion that there is no unambiguous definition of active ownership. Instead, it varies from case to case, depending on the company, its business situation, and other factors. There can be no absolute checklist. The active ownership demands a continuous dialog with the company, some kind of influence on the direction of, and the course of events within the company.

The basic idea in 3i, is to be active owners in unlisted companies (only in exceptional cases listed companies). The rational behind this delimitation is foremost that the possibilities to achieve something in unlisted companies are far greater than in the listed ones. The unlisted company does not have the same resources, and the investing company therefore has more to offer. The odds to see an increase of value are higher in these companies, and increasing the value is the business concept of 3i. The company can be either an established or newly started company.

3i always has a rational behind entering a company, to only enter interesting companies in which it believes that something could be accomplished. The acquired company also has to have a potential to develop. However, it is also the nature of 3i to eventually exit the company. 3i stays in the company for a limited time, and during that time there is a plan for what to accomplish and how. If the discipline to exit is missing, the value of the investment will erode.

When a company with potential, in any branch or industry, is found, active ownership is a necessity. It does not matter how good the ideas are, if the power to take them to action is missing. However, co-operation with other stakeholders, foremost management and other owners, is also important. There has to be a respect for the traditional roles, it is not the investing companies concern to run the operational business, this must be left for the management to handle. For this reason it is important to have a competent management with sufficient knowledge about the company’s line of business.

A company can either turn to 3i for support, or 3i can contact a company that they consider interesting. There is no guide on how to select investments, the judgement is mostly based on experience. The most common reason for a company to turn to 3i, is that they have an idea, but does not have sufficient funds to carry this through. The company wants 3i to take part in an issue of new shares, and in this way obtain additional funds. 3i evaluates the company's business plan and conducts several due diligence, among others legal, taxation, of accounts, competition and environment, dependent on the individual case. The important issue is if the business plan is realistic and relevant. When a decision is made to enter the company, there must be an agreement on how the company should develop, and how to reach these goals. This agreement often takes the form of a contract, especially if there are other owners, and includes clauses on issues, which need consensus.

The vision and the business concept are evaluated when deciding on whether to invest in the company or not. Although, events happening along the way might affect them, therefore it is important to remain flexible and be prepared to re-evaluate the standpoint.

How to practise active ownership

To be an active owner is a full time job, though the intensity of the contacts between 3i and the acquired company varies from case to case. Someone from 3i is usually represented on the Board of Directors. The background of this person is dependant on the competence and experience needed in the individual company.

It is important for both the acquired company and 3i that the former has a qualified management. The management and its competence should be evaluated when the contact is established. To have an appropriate management is considered a great strength, not having an appropriate one could be a risk factor. The task of 3i is to see the possibilities of the company, but also to identify the risks. If the management does not have the competence or the ability to develop the company, it has to be replaced. If there is no competent management present, 3i needs to take care of this. The business plan has been agreed on before the entry, and this has to be executed by the management. 3i might assist with different alternative steps to reach the goals, these question does, however, belong in the Board.

In the Board of Directors, 3i can contribute with the knowledge that is currently missing. 3i has a network of competent people. Many companies turn to 3i for funds, but in the end they are often most thankful for increased knowledge. Large companies often have specialists to help them, whereas small companies do not. This is yet another reason for 3i to focus on the unlisted companies. The contribution to the acquired company is assistance with doing the right thing at the right time and also with complementary competence.

If 3i is the only investment company present in the company, which is usually the case, the activity of 3i is higher than the activity of other owners. Usually, there is an open dialog between the owner, the board and the management. The level of intensity of this dialog depends on the situation of the company, in case of large changes, for examples mergers and acquisitions, the need for communication increases substantially. In this situation 3i works both as an advisor and a consultant. To be able to interfere as little as possible in the operational work, there is a need for quality control to ensure that proper procedures are taken within the company.

There is always a continuity in the active ownership within 3i, but it also has to be adjusted to the specific situation. Extra time has to be spent on the company when preparing it for an introduction to the stock market; 3i prepares and helps in doing this. An investment company could offer credibility to the company during this introduction.

Through investing in a company, 3i wants an appreciation in value, yet, every new case also adds to their pool of knowledge. 3i regards itself as good at documenting and process experience and create systems. The intranet gives everybody in the organisation the opportunity to share others experiences. 3i evaluates and documents all the acquisitions, which contributes to a large pool of knowledge to be used in similar investments. It is also a way to assess the annual rate of return on the investment (ROI).

The usual exit-point is within three to five years, but could be prolonged if further contributions can be made or new opportunities arises. Otherwise, it is important for 3i to have the discipline to exit.

It is important to obtain information from the acquired company in order to act properly. 3i has a model that is probably more active than the traditional one. The model is based on legal demands on consolidation. The model of 3i is to every month demand different kinds of information from the company, for example results and inflow of orders. This is one way for 3i to keep track of the company and to spot potential downturns. Continuous monthly reports and continuous contacts, participation in the work of the board and company visits are also instruments to monitor the company and its business.

Considering co-operation with other owners, this could exist when an owner has the same opinion as 3i, and they together could obtain majority in a specific issue. Another type of co-operation is to share a large investment with another investment company. In this way the competitor becomes a partner, and they act as one owner.

5.2.2 Interview with Iréne Axelsson at Bure Equity AB

Bure Equity AB is a private equity company with a focus on unlisted companies within the TIME sector; Telecom, IT, Media, and e-Knowledge. (Annual report Bure 2000)

The strategy of Bure is to combine the portfolio focus on profitable companies within the TIME sector with a strong involvement in the company's development, from early phases to stock market listing, sale or distribution. Bure combines private equity with industrial and financial competence. (Ibid.)

Bure has an established model for managing its investments, this is to ensure that the greatest possible value is created. The starting point is to identify sectors in which Bure has prerequisites for creating value. The selection criteria include growth, profitability, and sector fragmentation. Within each sector Bure then identifies companies with potential to develop and becoming leading companies, and joins them as a proactive owner. Bure contributes to the development not only through capital, but also through financial and industrial knowledge, as well as access to a network of contacts and collaboration partners. The objective is to realise the holding through a listing or through structural transactions. Growth of value for shareholders is the main objective for Bure, not positions of power. (Ibid.)

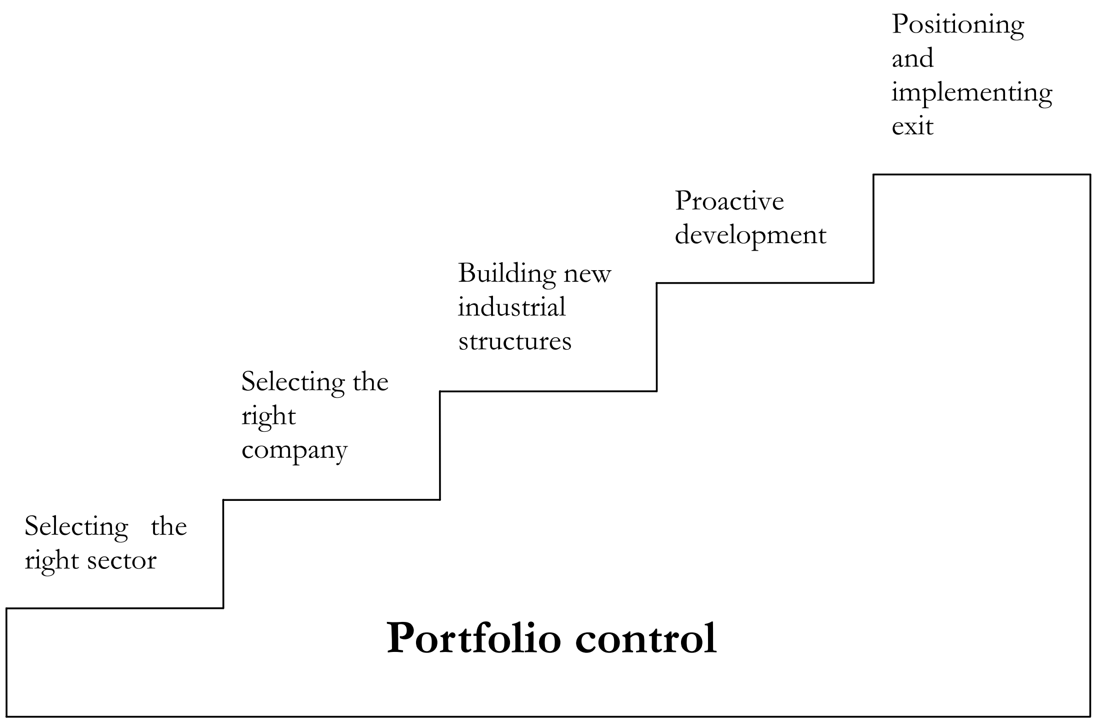

FIGURE 5:1: MODEL FOR CONTROLLING INVESTMENTS
Source: Annual report Bure 2000

Bure's model for creating value by developing companies and restructuring sectors is a process, which takes approximately three to five years. The first company within every area is called a hub company. Around this company, additional and larger companies and, sometimes, a new sector structure are built. Through supplementary acquisitions and mergers of operations, and in some cases, restructuring and demergers, Bure tries to create a new strong company. When the desired company structure has been established, the company generally achieves high growth, and plans are made for exit. This could be done by stock market introduction or industrial structural transaction. (Ibid.)

Active ownership

According to Bure, an active ownership is far more than just the capital, it is also to participate in the strategic development of the company, to help the company taking further steps. This is symbolised in their logotype, a stairway. Bure is an active and focused owner, providing access to a network of knowledge, a mixture of financial and industrial thinking. Bure claims that it is important to have a suitable team to coach the company in a prosperous way. Bure does not want to be the sole owner, it is preferred to have the founder of the company and other owners present. However, Bure wants to be the majority owner in order to execute decisions. This majority can be obtained, either directly or through options at a later stage. It is important that the ownership agenda states that Bure eventually will obtain majority.

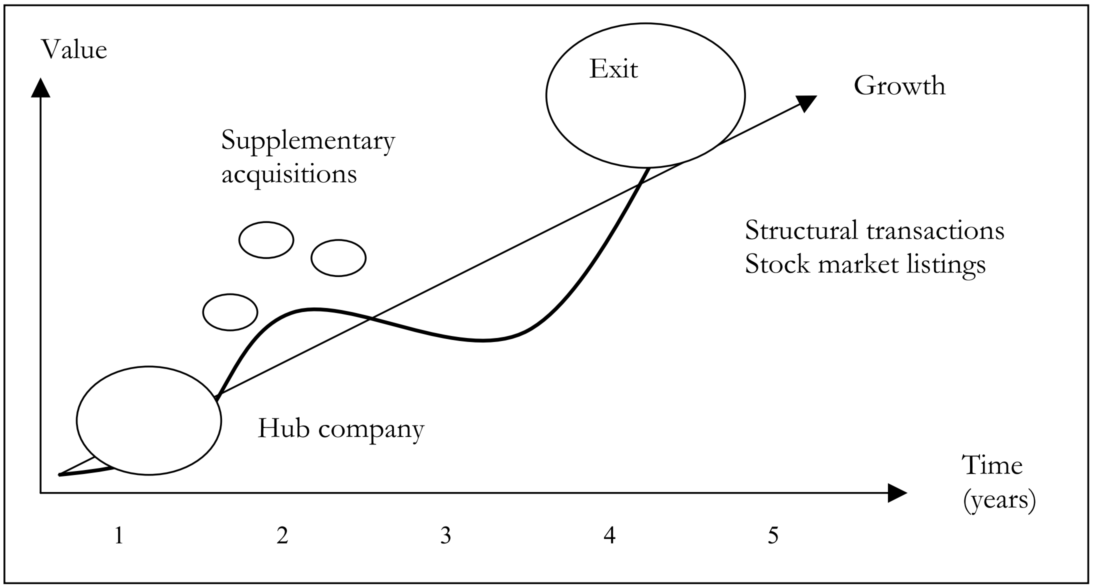

FIGURE 5:2: VALUE DEVELOPMENT OF THE INVESTMENTS
Source: Annual report Bure 2000

It is important to assure that proper management is present in the acquired company, otherwise it has to be changed, either in part or completely. Bure aims at having a common ownership agenda, where the important issues are settled between the owners.

Bure considers itself to be a very active owner. The work's point of departure is always within the Board together with other managerial functions, for example controlling. Board participation is always an instrument used by Bure. The Chairman of the Board is usually the Chairman of the business area in question.

Whether Bure or the company in question initiates the contact is dependant on the market conditions. In periods of recession many companies seek to obtain finance from Bure or similar companies. In other cases, investment banks or corporate finance departments might participate. However, Bure only invests in unlisted companies with a known record.

Before entering a company, several aspects are evaluated such as legal aspects, financial aspect, management, and business concept. This provides

Bure with good knowledge about the acquired company and therefore a base for support. This is also useful when preparing the company for introduction to the stock market. In this preparation some of the issues are to create order, establish certain routines, assess security, and evaluate legal contracts. It can also involve establishing relations with analysts and consultants.

Bure is no operating group, there is always an intention to exit the company within approximately three to five years. When entering a company the exit alternatives have already been evaluated, and it is of importance that this is included in the ownership agenda. The ownership agenda should be firmly established in the Board of Directors. This agenda is individual for every case however some lines are recurring.

The rational behind this business concept is to create value for the shareholders of Bure. Within Bure, methods have been developed to create the largest possible value, and they are convinced that this is the right way.

How to practice active ownership

The active ownership within Bure is expressed through a strategic plan and higher demands on the Board than other owners. Bure assists in finding the current position of the company and where it is heading. The acquired company does however need to have a business concept when it turns to Bure, it needs to know what it is that it wants to do, and that this is profitable. Bure focus only on established companies with a known record, and not on newly founded or turn-around companies, with a possibility to become market leader. Bure makes decisions and advise regarding the operational work, but it is the CEO's mission to execute it.

The contribution to the acquired company is that it has a stabile owner to support it, and usually obtains greater knowledge. It is also provided with a different way of thinking, assistance in recruiting competent personnel, and evaluating and strengthening the management. Another contribution is that the acquired company, in case of negotiations, can rely on Bure and its reputation. This is of substantial magnitude if the representative from Bure holds a special knowledge about the line of business.

Bure tries to contribute to the company through participation, especially when changes are necessary, for example concerning strategy; is the company aiming to wide or to narrow? Is an internationalisation required? When it comes to supplementary acquisitions, Bure has extensive knowledge and can be of assistance. Much of the activities take place within the Board of Directors, but also through a number of issues where staff from Bure supports the company, for example recruitment, education of the employees and the management, and development. The education of the management deals with the issue of understanding routines and implementing them. Make sure that it takes one step at the time.

The demand for information from the acquired company consists of a monthly, written report of the accounts and from the CEO. Through the Board, other kinds of information are acquired. Due to the close relation between Bure and the acquired company, there are one or two contacts, from whom, important informal information can be obtained. Bure thinks of itself as skilled in this area. The amount of contact between the two parties varies depending on the phase of the acquired company. A lot of work has to be done in the beginning and in case of an introduction to the stock market.

In order to create a driving force in the organisation, Bure's wish for the acquired company to have incentive programs for the employees.

6. Analysis

In this chapter, the results of the empirical studies will be analysed and discussed in connection with the theoretical framework. We will also add our own reflections and thoughts.

6.1 Opinions on active ownership

The expression "an active owner" gives no clue on how this can be achieved, nor does the theory provide any guidelines. This leaves room for the investing companies to interpret the concept on their own, though many similar features exist between the interpretations.

When looking at the results from the empirical study, none of the companies were able to give an absolute definition of what active ownership consists of. However, they have quite the same notion of the concept. According to 3i there is no definite definition of what active ownership is, and how it is to be practised. 3i does not have an absolute check list/policy on how to practise active ownership. Though, some issues are recurring in most investments, such as a continuous dialog and some kind of influence over the acquired company and its business. In the investments of 3i, there is always a continuity, but the actions taken have to fit to the particular company and its situation and needs.

Bure is of the same opinion as 3i that active ownership has to be more than simply investing capital. It also implies participation in the strategic development of the acquired company. The representative from Bure does not mention anything about a policy for active ownership within Bure. However, based upon the other facts in the interview, we draw the conclusion that no such policy exists.

None of the companies that we have studied has, in their annual reports, even tried to define or describe the features of active ownership. This could imply that neither these companies could find an easy definition.

6.2 Practise of active ownership

The theory does not provide any absolute ways on how to practise active ownership, though it offers some control mechanisms, both formal and informal, such as participation on the Board of Directors, proxy fights, or affecting the operations in other, unspecified ways. For a large owner, with capital invested, it is important to control and monitor the investment in order to increase its value and reduce the risk taken. An active owner does not exit the company if the direction is dissatisfactory, but tries to influence it in the desired way. As seen above, none of the companies have a clear definition of what the active ownership consists of, but agree on that it calls for influencing the company, its management and direction.

The most commonly used control mechanisms, as we have experienced in our study, is representation on Board of Directors. This is used by all of the investigated companies, and is the departure for all the actions taken. The Board is the arena for practising active ownership. Through this body strategic issues are settled, control is exercised, and the management influenced. The acquired company could also gain access to the extensive network of knowledge existing in the investing company, through the Board. The investing company appoints the representative to the Board, based on the specific requirements of the acquired company, a representative that have the knowledge and experience currently missing on the Board. The representatives on the board are persons with extensive financial and industrial experience. This knowledge provides an understanding for the events of the acquired company, and a foundation for advises and guidance, but also a risk reduction for the investing company. The representative from the investing company is someone with knowledge specific for the line of business in which the acquired company operates.

Apart from the similarities between the investing companies, regarding board representation, there are also some differences in how to practise active ownership. The venture capital and private equity companies appear to have a closer contact with the acquired companies operations than the investment companies. Though the degree of participation could also differ between venture capital and private equity companies. One example of this is that Bure always has a representative on the Board, while 3i expresses it in terms of “usually”. This can also be seen when studying the annual reports, on how the companies chose to emphasis active ownership, and also the participation in and contact with the acquired company.

Besides this formal form of corporate governance, the investing company practise control through a continuous and close dialogue between the acquired company and the investing company. Through this dialogue the investing company could assist and affect the management of the acquired company. The theory provides knowledge about formal methods to exercise corporate control, but none regarding alternative, informal ones. Though, through the interview we have seen that this is an important part. As an active owner, the investing company has a close dialogue with several functions within the acquired company. The active ownership does not only consists of board representation or attendance at the general meeting, but a continuous informal contact through for example meetings, company visits, and phone calls. A close and continuous dialogue between the acquired company and the investing company is a significant part of the informal governance in both Bure and 3i. Within both companies, a network of wide competence is present, and this can be used for advise and assistance in several different questions for example; recruitment, education, mergers and acquisitions, internationalisation, and stock market introductions. The intensity of this communication varies depending on the acquired company's specific situation. In the event of large changes, for example acquisitions or stock introduction, the communication is more frequent than normally.

Both Bure and 3i demand monthly, written reports from the acquired company. Information regarding the accounts, the results, inflow of orders, and other important events should be reported. Bure uses this information together with other informal contact with the acquired company to monitor the situation. 3i also uses other informal contacts and expresses a notion that information about the company is necessary to be able to practise active ownership.

It is in the nature of the different investing companies to enter different kinds of objects in different stages of development (See Appendix 2). The venture capital companies; Affärsstrategerna, Ledstiernan, and 3i, enter companies at an early stage of their development, and therefore have an opportunity to influence the vision and the business concept as well as the strategy of the company. When entering this kind of company, the venture capital companies have the possibility to influence the acquired company through its greater knowledge and experience. Through guidance and assistance, the venture capital companies have the power to affect the company's actions in the desired direction. The actions taken by the venture capital companies vary between different investments depending on the needs and situation of the specific company.

The private equity companies; Ratos and Bure, focus on companies at a later state of development than the venture capitalists, companies with a known record. However, they still enter companies, in which they can influence the strategy. The acquired company has a vision and a business concept proven successful, but the ways of getting there might be improved. The active ownership is practised through board representation together with informal actions, like education, support, and guidance. In this way the private equity company is able to influence the direction of the acquired company and thus ensure that the company is profitable and successful.

The investment companies; Aktiebolaget Custos, Industrivärden, and Investor AB usually enter listed companies, and practise active ownership through board representation, and some guidance and advise given through this body. In their annual reports they ambitiously express their activity as owners, and how much they can provide to the acquired company. We, however, when comparing with the other companies, ask ourselves how active they really are. Compared to the other companies' annual reports, the Investment companies provide little information on how active ownership is practised, besides board representation.

Though, this does not need to be a consequence of actions taken by the Investment companies, but a result of the acquired company's size and age. It might be difficult to affect a company with a vision that goes back, for example 100 years, and has the size of, for example ABB. Another difference from the venture capital and private equity companies is the length of the investments. The investment companies focus on long-term holdings without any specified exit.

It is in the nature of both venture capital and private equity companies to exit the acquired company after some time. This was evident in the interviews where both Bure and 3i stated that the exit point is crucial. Without exit, the gains of short-time boost will be diminished. Ledstiernan expresses the ambition to exit the acquired company after two to five years, and the plan for this has been developed at the early stages of the investment. Ratos however, does not specify a time when exit should be done. Though, the ownership is always limited in time and the exit normally occurs when the goals of the investment are reached, or the ownership no longer creates value. As in the case of Ratos, Affärsstrategerna do not set a time limit for when to exit an acquired company but specifies the time to when the acquired company is ready to meet the demands on the market. At this time Affärsstrategerna will leave the company and invest in a new business.

6.3 Aims of the active ownership

After completing the study and asking us the question why companies, operating on the risk capital market, are practising active ownership, we came to the conclusion that the main reason for entering a company is to increase the value for its own shareholders. In order to do this some actions have to be taken to ensure that the acquired company develop in the desired direction. By doing this, the investing companies also reduce the risk taken when investing in the company. Through active ownership, the investing companies gain better control of their investments and thus obtain the possibility to influence the increase of value. If the investing companies are not active, the value of the investment might increase, though the only thing that the investing company can do is to wait and see, and hope for the best. Nevertheless, each investment also adds to their network of knowledge and this can be useful in the next, similar case.

Bluntly, the investing companies talk a lot about how their own company favours from investments, for example through adding new knowledge to their network. However, in the end, this is their way to maximise their profit and by this add value to their shareholders.

6.4 Contributions to the acquired company

Apart from this, the investing company has the purpose to gain financially from the investment, the acquired company is provided with financing and thus the opportunity to carry through operations not otherwise feasible. It is also provided with a stabile owner in possession of extensive knowledge and experience. This can be advantageous in cases of recruiting, educating management, mergers and acquisitions, and all other situations of which the acquired company has no experience.

Other examples on how to contribute to the acquired company are participating in and developing the acquired company, and to ensure that it is able to attract and keep skilled management, as in the case of Custos. Industrivärden offers assistance in resource allocation and injections of capital if needed. Ledstiernan's active ownership consists of acting as a discussion partner and someone who enables opportunities not otherwise existing for the acquired company. The overall contribution is that the acquired company is provided with some kind of mentor, someone to turn to when times are harsh or when proper actions are unclear. This is something that could be far more valuable to the acquired company than the input of capital, according to the investing companies.

The acquired company is foremost seeking finance from the investment company. Though, 3i as well as Bure experience that the contribution mostly appreciated by the acquired company in the end, is that of knowledge and know-how. Since this is an opinion expressed by the investing companies, we must ask ourselves if this is true. Could it be that, like the investing company is looking for profits, the acquired company is only looking for finance? If this is true, the idea with active ownership would only benefit the investing company and not the acquired one. Nevertheless, we believe it must be some benefits to the acquired company, when they are provided professional knowledge they might lack. The contribution is probably more substantial the smaller the company. This implies that the venture capital and private equity companies do contribute to the acquired company. The holdings of the investment company do, on the other hand, sometimes even have more experience and knowledge than the investor, and the contribution can thus be questioned in these cases.

7. Conclusions

The purpose of this chapter is to try to answer the research issues: What opinions exist about the meaning of active ownership in companies active on the risk capital market? How do the investing companies practise active ownership? What is the purpose of practising active ownership for the investing company? What are the contributions to the acquired companies?

There are many different actors on the risk capital market, and as we have discussed above we have focused on investment, venture capital and private equity companies. By looking at these companies, with different choices of operation, we have been able to draw some conclusions about the active ownership, its purposes and contributions.

The investing companies found it hard to define the concept of active ownership, though they had a notion of its features. They agreed that it is a prerequisite to take actions concerning the management of the company. We cannot however, blame the companies for not being able to define the concept, since no clear definition can be found in the theory.

While studying the companies and their activity within the acquired companies, we found that, although all of them are active owners to some extent, there are differences in the magnitude. It became evident to us that the companies, classified as investment companies, exercise active ownership to a lesser extent than the venture capital and private equity companies in this study. This was something that we did not expect.

At the beginning of this study we had a notion that these, some of Sweden's largest shareholders in some of Sweden's largest companies were to be more of a driving force within their holdings. Though, after studying the theory about these actors, their approach tends to be more justifiable since practising active ownership on such large companies, besides through board representation, could be rather difficult. Another explanation might be that many of the investment companies holdings are in old and well established companies, and it might therefore be hard to change and influence things.

We also came to the conclusion that the most powerful and used control mechanism was the Board of Directors. It was through this body that the investing companies practised most of their active ownership. Board participation was also a requirement for investing capital in the company, and in this way protect the investment.

The purpose for taking an active part in the management of a company or project is to maximise the profit, i.e. increase the value of the investment. Several companies expressed that the experience provided by an investment adds knowledge to the network. Still, this ultimately leads to larger profits in a future investment.

Obviously, a company that turns to an investing company is seeking finance. However, as expressed by the investing companies, we believe that the contribution of knowledge and experience is at least as valuable as that of capital. Without capital, the other contributions would be worthless.

8. Suggestions of further research

During the time that we have worked on the thesis, issues and questions have arisen, too comprehensive to deal with in this thesis. They would however be of interest to study, and would therefore be suitable in another thesis or essay. One issue is how the internal control is affected by the occurrence of an active owner, do these owners influence the internal control systems?

Another interesting study would be to see this study from the opposite direction. How does the acquired company look upon active ownership? What does active ownership consist of according to the acquired company? Which contributions do the acquired company experience, and which is the most valuable one?

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Appendix 1: Supporting document for the interviews

Opinions on active ownership

How do You define active ownership?

Do You consider Yourselves as active owners?
- In which kinds of companies?
- Why these?
- In which kinds of companies do You not enter?
- Why not?
  - Too large?
  - Foreign companies?

Practise of active ownership

How is the active ownership expressed in practice?
- Financial objectives
- Plans of action
- Vision
- Business concept
- Strategy
- Markets
- Partners
- Financial structure
- Board composition
- Appointment of CEO
- Other

Is there a policy for how to practise active ownership?
- Why/why not?
- In case of an existing one, how does it work?

Do You have any demands for information on the acquired company?
- Reports?
  - What is reported and why?
- Meetings?
- Company visits?

Is there any co-operation with the other owners on certain issues?
- Why/why not?

Benefits from an active ownership

Why do You enter as active owners?

- What is the contribution to Your own company?
- What is the contribution to the acquired company?

Appendix 2: Different stages of development

Seed financing – Capital, which is distributed to an inventor or an entrepreneur, to evaluate or examine a concept or idea, in order to develop a product, before a company has been established. This can also be used to finance a research project with commercial potential.

Start-up financing – Capital to a company for product development or initial marketing. The company is newly founded or has been operating for only a short period of time. The product has usually not been commercially tested. To this category can, what in American literature is called first-stage financing, also be brought. This is, financing a company, which has used its original capital and needs and additional input in order to initiate commercial manufacturing and sale.

Expansion stage financing – Can be divided into early and late expansion. Early expansion is sometimes called second-stage financing. This includes financing a company where manufacturing and sales are steadily increasing and there is a need for additional working capital. The company has probably not yet accounted for any profits. At the later stage of expansion, third-stage expansion financing is a company, which is experiencing a boost, where sales are strongly increasing, and where high profitability is shown. The capital is usually used for marketing, working capital, and improvements of products.

Mature stages – This stage include companies, which have gone through their first period of growth and are starting to stabilise or consolidate. It could also include financing of companies in the need for reconstructing.

Bridge financing – Financing companies in growth, expected to be listed in the nearby future.

Buyout financing – Capital for acquisitions or buyouts of a company, for example MBO's or LBO's.

Turn-around finance – Capital provided to mature companies in operational or financial crises, in order to change the negative development.

Source: http://www.vencap.se