Corporate governance and corporate social responsibility interface: a case study of private equity

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Abstract
Purpose – This paper aims to explore why private equity (PE) cares about corporate social responsibility (CSR) of its investees given their relatively short investment time-horizon and how it designs corporate governance (CG) bundle to achieve both financial and CSR goals of the private firms it invests in.

Design/methodology/approach – Case study design is applied to get deeper insights on the why and how questions posed. Analysis is based on triangulation of secondary data and in-depth interviews with both PE and their investee firms.

Findings – The authors find that long-term sustainability supported by CSR increases firm value. They also outline specific CG bundle that the PE uses to achieve both its financial and CSR goals. CG mechanisms appeared to reflect agency theory, but even more resource dependence theory.

Practical implications – The outlined CG bundle could be used as a template for all types of private firm owners to improve both financial and CSR performance of the firm.

Originality/value – The paper adds to fragmented area of CG and CSR interface. The authors specifically focus on several under-researched contexts of this interface: private small and medium size firms (SMEs), emerging markets and PE investors.

Keywords SMEs, Corporate governance, Private firms, Corporate social responsibility, Private equity, Emerging markets

Paper type Research paper

1. Introduction

Corporate governance (CG) debate in 21st century has started to move away from the shareholder supremacy and financial performance maximization objective toward including non-financial stakeholders and socially responsible agenda into CG equation. Such move is driven and supported by international organizations such as OECD, United Nations and European Commission via various guidelines, standards and recommendations, and is well illustrated by the Business Roundtable’s recent redefinition of corporate purpose away from solely serving the interests of shareholders to committing to serve all stakeholders (Business Roundtable, 2019).

Yet, the research field exploring the interface between CG mechanisms and corporate social responsibility (CSR) is still fragmented and new studies are called for (Jain and Jamali, 2016). We answer to this call by exploring how a private equity (PE) fund – Baltic – enacts its CSR goals by designing CG mechanisms on its investee firms in transforming Baltic countries: Estonia, Latvia and Lithuania. The study enriches the literature from several aspects. First, PEs are institutional investors with relatively short investment horizon that invest in private firms, i.e. it could be expected that their focus would be purely on quickly improving financial performance of their investments and neglecting CSR.
because the effect of the latter is directed more toward longer time horizons (Peters and Mullen, 2009). Also, studies have shown that institutional investors with shorter time horizons may find CSR costs unjustified (Jain and Jamali, 2016). Although there are plenty of studies on CSR on public financial markets, PE type investors have been studied much less (Crifo and Forget, 2013). Thus, it is not obvious why PE is interested in CSR, let alone actively enforce it.

Second, as PE is a class of professional investors that increase the value of their investee firms by improving their CG practices (Acharya et al., 2013), it is valuable to understand how they design CG bundles that improve both the financial and CSR performance of their investee firms. PE is considered an important actor in fostering sustainable practices of unlisted companies (Crifo and Forget, 2013), and thus its expertise and experience could be valuable also for other types of private firm owners.

Third, it is known that CG and CSR practices are diverse across countries and regions due to differences in institutional contexts (Aguilera and Jackson, 2003; Ding et al., 2019; Matten and Moon, 2008). While there are plenty of studies available about CSR and CG practices in larger developed countries, smaller emerging countries have remained relatively understudied (Jamali et al., 2017; Amos, 2018).

Fourth, majority of studies conducted about both CSR and CG discuss large public firms, while private small- and medium-sized firms (SMEs) are relatively underexplored (Estapé-Dubreuil et al., 2016; Jamali et al., 2017; López-Pérez et al., 2018). In contrast, our focus is specifically on private SMEs. Finally, by adopting a case study approach we are able to gain deeper understanding of the interaction between CG and CSR practices, both in terms of why and how. Hence, the aim of the paper is to uncover the reasoning for CSR and respective CG mechanisms that PE applies on its investees.

The paper follows the classical structure where Section 2 lays theoretical foundation for the study by discussing key concepts applied and develops research questions for the empirical part of the paper. That is followed by overview of the case company, research methodology and data in Section 3. Results of empirical analysis are presented in Section 4, and the paper closes with discussion, conclusion, limitations, implications and recommendations for future research in Section 5.

2. Theoretical setting

CSR is defined as “the responsibility of enterprises for their impacts on society” (European Commission, 2011). More specifically, “CSR is the commitment of a business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life.” (World Business Council for Sustainable Development, 2004), and it is always beyond what is required by the law. CSR being something beyond the firm’s interest is proposed in some definitions (McWilliams and Siegel, 2001), but in this paper, we do not assume this should be the case. If anything, we could add that CSR is not in an immediate interest of the firm.

Meta-analyses have concluded by now that there is a business case for CSR (Busch and Friede, 2018; Wang et al., 2016). When we look at the studies related to firm value, specifically, then results are more mixed indicating several boundary conditions (see overview in Hu et al., 2018). Oftentimes, CSR does not have direct effect on firm value, but via more intensive R&D and innovation (Bocquet et al., 2017), taking appropriate risks (Harjoto and Laksmana, 2018), generating social capital that is used as insurance during times of uncertainty (Borghesi et al., 2019) or better reputation (Jeong et al., 2018, López-Pérez et al., 2018). These mechanisms assume relatively long time-span to influence firm value. But even if we add traditional financial performance measures such as earnings, return on assets/equity and sales growth, studies (Jeong et al., 2018; Peters and Mullen, 2009; Porter and Miles, 2013) emphasize that longevity of CSR is crucial for positive
outcomes. Therefore, not only does CSR bear fruit in the long term but it also takes time to integrate CSR with the firm’s business operations.

PE investors, however, cannot afford to wait for decades until their investees achieve the desired return on investment. They are investors who raise capital from large financial institutions such as pension funds, sovereign wealth funds and insurance companies and invest into private firms with the aim of increasing the value of investee and divesting it typically within a timeframe of five to seven years with a significantly higher value. Their aim is to increase the value of the investment, but fast growth that PE requires may come at the expense of social and environmental considerations (Estapé-Dubreuil et al., 2016). The literature has also identified several impediments in incorporating CSR in business strategies, such as difficulties in balancing short-term and long-term performance goals (Szekely and Knirsch, 2005) or complexity in comprehensively measuring social and environmental performance indicators (Hegevold et al., 2015).

Furthermore, some studies even argue that engagement in CSR activities could be interpreted as a manifestation of an agency problem where managers further their own social, career or political agendas at the expense of shareholders (McWilliams and Siegel, 2001). Also, one cannot overlook the location effect: Ding et al. (2019) found on the basis of 26,000 firms in the USA that deviating either positively or negatively from the average level of CSR within a given locale is associated with decreased firm value. Thus, on one hand it would be reasonable for PE to conform to the levels of CSR characteristic to an emerging country environment rather than promote its continuous increase. However, on the other hand, it has been argued that firms from developing countries promote CSR to compensate for legitimacy and reputational deficit in the eyes of foreign investors (Zyglidopoulos et al., 2016; Marano et al., 2017), i.e. it might be easier for a PE firm active in developing markets to sell CSR-conscious firms to foreign investors.

Given the controversial views discussed above, it is not at all evident, why or how CSR, which has a long-term effect on performance, would serve PE’s objectives. We certainly acknowledge that engaging in CSR initiatives may have purely moral or deontological roots, but in this study, we approach the issue from a teleological lens encompassing two motivations: instrumental and relational (Aguilera et al., 2007). Crifo and Forget (2013) label it strategic rather than ethical grounds. Hence, we pose the first research question:

**RQ1.** How important is investee companies’ CSR for a PE firm in developing markets?

PE investors do not assume management position in their investments. Thus, due to the separation of ownership and management, PE cannot directly implement CSR principles within its investee firms. Instead, they are using the means available to owners, namely, CG, to motivate the managements of its investee firms to follow CSR principles.

CG deals with how owners of the firm direct and control the firm (Huse, 2007) via various CG mechanisms such as selection of appropriate executive team for the firm, systems for motivating, controlling and supporting the executive team. These mechanisms allocate authority among owners, board and top managers, and impact, regulate and control decisions made at the top of the firm (Roe, 2004). A set of such CG mechanisms in place in any firm is referred to as a CG bundle (Aguilera et al., 2008). Since the classic work of Rediker and Seth (1995), the scholarly research has increasingly recognized that CG mechanisms should not be viewed in isolation from each other but rather as bundles when analyzing their effectiveness (Filatotchev and Wright, 2017). In other words, any single CG mechanism is not sufficient for effective governance of the firm. Different mechanisms complement each other, and collectively achieve better results than individually. Furthermore, there are several mechanisms that could be used to deal with the same CG issue and thus could be substituted for each other. Thus, an owner can choose which mechanism to use in any single firm and which one not to. Also, as different mechanisms have different costs, the cost-benefit aspect needs to be taken into account in the design of
effective and optimal CG bundle (Aguilera et al., 2008). Given that private SMEs are much more resource constrained than large public firms, the cost aspect is one of the reasons why CG designs that are effective and optimal for large firms might not be directly suitable for private SMEs.

The focus of governance scholarship has historically been on large public firms and how to handle the agency conflict (Jensen and Meckling, 1976). However, literature dealing with private firms has shown that principal-agent conflict, although important, is not necessarily the main issue for them (Uhlaler et al., 2007; Brunning et al., 2007), but other topics might have equal or even higher prominence. For example, in contrast to large public firms that typically have dispersed ownership with liquid and diversified portfolios, private SMEs tend to have concentrated owners whose livelihood depends highly on the well-being of their firm, which is not a liquid asset. In terms of CG, it has several implications. First, private SME owner has more relative power vis-à-vis the management team compared to stockholders of large public firms, and thus can potentially influence the decisions of the management more, have less information asymmetry, etc. This reduces the need for typical principal-agent conflict related CG mechanisms like extensive control systems and board monitoring roles. Instead, CG mechanisms in SMEs are more inclined to resource provision. This is to say that the analysis of boards and management in private SMEs benefits more from resource dependence theory (Pfeffer and Salancik, 1978) than agency theory. Accordingly, Hillman et al. (2009) conclude that adopting resource dependence lens is instrumental in understanding boards.

Second, rather than principal-agent conflict issues principal–principal conflict, i.e. relations between concentrated owners, might arise instead and require certain CG mechanisms that help alleviate these potential tensions. Third, as private firms are relatively illiquid assets, it is more difficult for the owners to sell their shares if they do not like the choices made by the management and/or the results of the firm. Therefore, compared to the stockholders of public firms, they do not have the possibility of exiting easily and investing somewhere else, which means they tend to be more interested in the performance of this particular firm. More intense interest has in turn implications for the CG bundle.

In addition to the distinctions in ownership structure, another significant differentiating factor between large firms and SMEs is the available resource base. This has again various consequences on CG. First, SMEs need to be more cost-conscious with their CG mechanisms, they cannot afford (and probably do not even need) extensive reporting systems, hire expensive consultants, etc. Second, SMEs have less managerial resources, which means that the management needs more support and counseling from owners and/or the board. Thus, the board’s advisory, networking and strategizing roles (Uhlaler et al., 2007) gain more relevance in alleviating the problem of resource dependence (Pfeffer and Salancik, 1978) and improving firm performance (Pérez-Calero et al., 2016).

As the issues large public firms and private SMEs face are different, it is expected that CG mechanisms used in the bundle also differ. To understand how professional private firm owner such as PE tackles these governance problems in their governance bundle design, we pose our second research question:

*RQ2. Which CG mechanisms does PE use in investee companies to achieve both its financial and CSR goals?*

**3. Method and data**

Phenomena that are in early stages of development, such as interface between CG mechanisms and CSR, are better suited for qualitative research (Yin, 1994; Di Toma and Montanari, 2017). Case study method is appropriate when the phenomenon is complex, and it is difficult to draw a line between the contextual factors influencing the phenomenon and the phenomenon itself. Also, how and why research questions and the focus on
contemporary events speak in favor of case study. While case study is often considered as an exploratory tool that identifies empirical regularities or offers in-depth sense-making, this paper is aimed at theory building via strategic case selection (Flyvbjerg, 2006) and “unveiling the phenomena’s actual or possible mechanisms” (Tsang, 2013). Little is known about the CG mechanisms that address both financial and social performance of the firm. Underlying every mechanism are certain processes and qualitative approach helps to uncover those (social) processes. In particular, qualitative inquiry is about how these processes are created and given meaning rather than analyzing causal relationships between variables (Denzin and Lincoln, 2008).

Theory building assumes certain case selection strategy. Flyvbjerg (2006) divides case selection strategies into four categories: extreme cases, maximum variation cases, critical cases and paradigmatic cases. This paper adopts critical cases approach: by closely examining one PE firm’s practices with their portfolio companies, we claim that our findings in terms of choosing particular CG bundles to boost value growth via CSR are applicable in other cases as well. In other words, critical case strategy enables to generalize that: “If it is (not) valid for this case, it is (not) valid for (m)any (other) cases” (Flyvbjerg, 2006).

Having said that, there is no universal method to identifying a critical case, but Flyvbjerg (2006) recommends to search for cases that most likely confirm or least likely falsify the proposition. As explained above, professional investors are the best candidates to adopt CG bundles that increase the value of the acquired firm. Doing so is the basic ingredient of their business model and core competence. Therefore, the approach PE chooses for enhancing CSR practices and value growth is not particularly idiosyncratic; such firms are expected to apply the so-called dominant logic that should add value to any type of investor or owner. To establish theoretical generalizability, we applied the following methodological principles (Andrade, 2009): decided on our unit of analysis (portfolio company), conducted theoretical sampling (the informant having enough knowledge and experience), established chain of evidence (both between primary and secondary sources and between interviewees) and conducted thematic text analysis and categorization until reaching theoretical sufficiency.

Our case company is PE fund called BaltCap, which was founded in 1995 and since then has invested in about 100 private firms in the three Baltic countries: Estonia, Latvia and Lithuania. The current (as of March 2020) portfolio includes 35 firms. The investee firms cover wide range of industries and development stages. We chose BaltCap as the case PE firm due to several reasons. First, being established in 1995, it is the oldest (and also the largest) PE firm that is still active in the Baltics. The 25 years of experience in the PE industry acquiring, developing and divesting private firms is an indispensable source for learning about how to increase the value of private firms via CG. Second, BaltCap has stated clearly and publicly that they follow responsible investing principles which allows us to specifically study the CSR aspect in the private firm value creation as well as the interconnection between CSR and CG. The Baltic countries as a setting are interesting for several reasons. On one hand, the Baltic countries are members of European Union (EU) since 2004. Their legislative systems and key institutions have gone through a harmonizing process with EU standards. This means that at least in terms of regulatory practices the countries are comparable with other EU countries. On the other hand, breaking out from a socialist system only about 30 years ago, the transformation both in legislation and in terms of softer aspects such as norms and business culture, including views on social responsibility of business has been tremendous and still ongoing. Therefore, analyzing the topic in this context can provide insights also for other emerging economies going through transformations from a closed political system to more open systems.

The study is based on various secondary data available regarding BaltCap and its portfolio companies, as specified below. In addition, we conducted five semi-structured in-depth interviews plus a follow-up interview to get more details on the research topic (Table 1).
Our research process was as follows (Appendix). First, we familiarized ourselves with company background information such as BaltCap’s annual reports, CSR code, BaltCap’s Environmental, Social and Governance (ESG) Reports for years 2011-2018, overview of its investee companies. That allowed us to formulate research questions and respective interview questions. We then conducted three separate interviews with representatives of BaltCap (Interviews 1-3) to get more detailed understanding of their thinking toward CSR and CG. After the first BaltCap interview, we slightly modified questionnaire to cover new emerging themes. Based on BaltCap partners’ interviews transcribed to verbatim, we conducted thematic analysis and suggested initial CG bundle model.

To validate the model, we asked BaltCap for the contacts of its investee companies. Interviewing investee firms enabled us to analyze the topic also from their point of view and make sure that governance mechanisms described by BaltCap were actually in place. We chose the investee firms to interview such that we could cover the whole investment process from acquisition to exit. BaltCap helped us to establish contacts for the interviews (BaltCap itself was not present during the interviews).

Our first investee interview (Interview 4) was with the CEO and minority shareholder of a company that BaltCap acquired in 2016. As the interviewee was a shareholder and CEO of the firm also prior to BaltCap’s investment, he was in a good position to discuss the whole acquisition process and the holding period activities. The CEO was also in a good position to compare BaltCap’s governance practices with these of prior investors. Our second investee interview (Interview 5) was with a board member and CFO of a company that BaltCap exited recently (in 2018) allowing us to discuss the holding period and the exit process. We also conducted one additional follow-up interview with BaltCap to clarify any outstanding or unclear issues. All interviews lasted for about 1 to 1.5 hours. Such triangulation of secondary data with various types of interviews allowed us to get a more accurate and complete understanding of the actual situation. Data analysis took place in several stages that involved travelling back and forth between the data, emerging categories and related literature to follow the principle of constant comparison. We thus applied a hybrid approach of thematic analysis that incorporated both the data-driven inductive approach and the deductive a priori template of codes approach, mostly captured by our interview questions.

### 4. Results

This section discusses our findings about the research questions posed. With regard to RQ1, BaltCap announces that their “primary purpose as a business is to create long-term value for our shareholders and investors” (Company website). This clearly underlines the relevance of capital owners over other stakeholders. However, the firm maintains that excellent financial performance is not enough to reach this goal – it has to be achieved with responsible and sustainable business practices that take into account the interests of various stakeholders. Thus, the long-term value and accelerated value growth for shareholders stem from other domains than only bottom line.

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**Table 1** Summary of interviews

<table>
<thead>
<tr>
<th>#</th>
<th>Interview type</th>
<th>Date</th>
<th>Length</th>
<th>Location</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>BaltCap</td>
<td>05.02.19</td>
<td>1 hour</td>
<td>Baltcap office</td>
</tr>
<tr>
<td>2</td>
<td>BaltCap</td>
<td>14.02.19</td>
<td>1 hour</td>
<td>Baltcap office</td>
</tr>
<tr>
<td>3</td>
<td>BaltCap</td>
<td>17.07.19</td>
<td>1 hour</td>
<td>Over Skype</td>
</tr>
<tr>
<td>4</td>
<td>Investee firm</td>
<td>06.08.19</td>
<td>1 hour</td>
<td>Firm office</td>
</tr>
<tr>
<td>5</td>
<td>Investee firm</td>
<td>08.10.19</td>
<td>1.5 hours</td>
<td>Firm office</td>
</tr>
<tr>
<td>6</td>
<td>BaltCap (follow-up)</td>
<td>16.10.19</td>
<td>0.5 hours</td>
<td>Over phone</td>
</tr>
</tbody>
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Source: Created by authors
I think CSR is fundamental. What is the essence of entrepreneurship? To be a valuable firm you need to generate some value and if you do generate the value then mostly it is CSR. (Interview 1)

BaltCap sees a clear connection between CSR performance and financial success in PE business model. Fundamental improvements in firm operations, including how it relates to its environment, how it deals with business partners, employees and surrounding community all improve the long-term outlook for the company. BaltCap sees itself mainly as the “buy and build” type investor, i.e. it aims to increase the firm’s value mainly via growing the scale and scope of its business activities, rather than less socially responsible activities such as aggressive cost cutting (e.g. lay-offs) or financial engineering. The premium for BaltCap stems from the next investor’s assessment that certain investments have already been made and the quality of earnings in the investee is higher. That, in turn, influences the value of the company at exit.

In order to successfully sell a company you need to show new potential owners the long term sustainability of the firm. It is not that we care only about the 5-year investment horizon, but we need to give to the next owners a company that is in great shape. In that way the potential exit value is also higher. (Interview 1)

Thus, for BaltCap CSR and financial performance go inextricably hand-in-hand. Following these principles is then not only a “nice thing to do”, but it also has a clear business case. PE admits that CSR has been a growing theme in the region and BaltCap may outperform other PEs due to their longer experience as younger competitors tend to be concerned merely about the financial side of business. Hence, there seems to be a learning curve in CSR – it takes time to realize its role, how to apply it effectively, how to measure the returns to other stakeholders and how to communicate with the society:

To say that we have a blueprint for how it is done […] I would be lying. It’s a journey for us. […] I believe we are improving […] because we are asking less stupid questions and focusing on the things that matter. We understand the value for society, we understand the value of communication with the society. (Interview 3)

That said, what are the mechanisms applied by the PE?

BaltCap’s approach to designing CG bundle is similar regardless of the characteristics of their investee company. Some differences may be in smaller details of the bundle, but overall principles remain the same. The key elements of BaltCap’s CG bundle are depicted in Figure 1 and discussed in detail below.

![Figure 1 CG bundle applied by BaltCap](image-url)
There are two strategic pillars ultimately determining the constellation of BaltCap’s CG bundle. As the signatory of United Nations Principles for Responsible Investments (UNPRI), the first principle for BaltCap is to follow *responsible investment strategy* (Figure 1). UNPRI promotes incorporating environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable long-term returns (Principles […]). Based on these principles, BaltCap has created its own responsible investment strategy, which covers the whole investment process from investment selection and due diligence to investment governance and later exit. For example, BaltCap has excluded certain sectors that are potentially controversial in terms or CSR, such as arms, tobacco or hard spirits manufacturing, gambling, human cloning and genetically modified organisms from its fields of activity. In the same vein, BaltCap does not get involved in hostile bids. As part of its investment evaluation and due diligence procedures BaltCap always conducts an analysis of ESG aspects and takes these findings into account in its investment decisions (BaltCap’s ESG Policy). BaltCap compiles a separate report on environment, but other aspects are embedded in general due diligence and this process is extremely thorough:

When BaltCap came, the depth of due diligence was absolutely different standard [compared to earlier investors]. Very tiresome. (Interview 4).

Hence, responsible investment strategy embeds both negative and positive screening elements, to avoid and seek out particular circumstances in potential investee company. As said, the aim of PE is to conduct successful exit after approximately five to seven years. In BaltCap’s case, there was at least one occasion whereby potential strategic investor was declined because of its questionable business practices and the plan to close down the plant and move operations elsewhere. Members of the executive board, who were also minority owners, were reluctant to sell to the particular investor and BaltCap ceased negotiations. Hence, just as responsible investment precludes hostile bids, responsible exit takes into account the views of acting management and minority owners.

The second pillar of the CG bundle deals with the co-operation with investee companies, namely, principle of *active ownership* (Figure 1). BaltCap always takes a role of an active owner, which is typical for PE. As one partner explained during the interview, being an active owner means contributing to the success of the business by helping the management, but at the end of the day, the active owner is responsible for the business.

You are like a partner to the management […] You discuss business issues with the management, not only control the management. (Interview 2)

Compared to passive owners who may only look at quarterly supervisory reports and “fall asleep during the board meeting” (Interview 3), active owners frequently discuss every aspect of the business with the CEO. BaltCap partner(s) sitting in the board support the investee company in important negotiations and business fora, promoting education in the field, issuing guarantee letters for loans, etc. At the same time, being an active owner does not mean taking the role of the management.

“You have to be active in the ownership level and not meddle with operational management. It is very important to keep separate roles”. (Interview 2); “From my point of view it works well and both ways: if they want to consult, they call me and same thing if I want to discuss something.” (Interview 4); “BaltCap did not enforce its own vision; ideas for new projects still came from us [the company], but BaltCap always thought along.” (Interview 5)

The role of active ownership is enacted via other means, or CG mechanisms. One of the key problems CG should solve is potential divergence of interests, both between owners and managers (vertical agency problem) and between different owners (horizontal agency problem). There are several mechanisms that BaltCap uses to tackle these issues.
The first CG mechanism, \textit{CEO selection and motivation} (Figure 1), starts already from the investment selection phase. Namely, the ESG analysis conducted during investment evaluation phase covers also the mindset of remaining owners and the management team. If the mindsets are too far from that of BaltCap, it poses a risk of cultural misfit and irreconcilable misalignment of interests and might result in BaltCap not investing in this company, or if it does invest then the new management with suitable mindset is typically brought in. For example, in one investee company we interviewed, BaltCap invited and appointed two industry experts from abroad, the CEO and the deputy CEO. These experts shared the growth mindset of BaltCap and as industry experts were well suited to taking the firm to the next level. The choice of management team is the basis for success.

“We invest largely into the management of the firm. We do not invest unless we are convinced that we have a team that will realize the plans”. (Interview 1); “If we need to control and tell then it is the wrong CEO and then we need to replace that CEO.” (Interview 3)

The second step of the “CEO selection and motivation” mechanism deals with the motivation side. To align interests, the CEO and key executive team members usually will become minority owners of the firm. Either by co-investing with BaltCap or by getting stock options. Making the management team co-owners so that their biggest pay-off will come at the exit, form “aggressive incentive structures” (Interview 3) and is the mechanism for aligning their interests with those of BaltCap. Investee company CEO (Interview 4) also deems manager’s co-ownership or options an effective mechanism especially given the objective of PE to increase the value of companies. It binds the manager more tightly to the company and prioritize successful exit over other goals. BaltCap does not use explicit CSR contracting, however, such explicit CSR motivation is influenced by other CG mechanisms in the bundle: “Code of Conduct” and “Controlling role: KPIs and ESG reports” (both of which are discussed later).

If the investment is made, the selected CG mechanism for solving principal-principal conflict is \textit{shareholders’ agreement} (Figure 1), which stipulates strategic framework for the company, roles and responsibilities, etc. The process of drafting the agreement is a great way for discussing expectations of various owners and finding a solution that is acceptable for all. It helps to eliminate negative surprises in later phases.

“You would rather discuss all these aspects before they occur. What happens if someone wants to retire? How do you solve conflicts between owners? The more such things you can agree upon beforehand, the better.” (Interview 2); “The process of drafting and signing new shareholder agreement took a very long time. As a minority shareholder I am legally well protected should something go wrong.” (Interview 4)

The CG mechanisms discussed so far are dealing predominantly with agency issues (both vertical and horizontal) and alignment of interests with other shareholders and with the executive team. The remaining CG mechanisms, however, are more related to owners’ attempts to help the executive team achieve the aligned goals, i.e. provision of resources. The main vehicle for that is setting up appropriate boards who work actively with the executive management team, the CG mechanism “Board composition and communication” (Figure 1). BaltCap prefers relatively small boards, where two seats belong to the fund, and in total no more than five members are appointed. Board communicates every week:

“I’d say that in the form of meetings we meet six times a year, but discussion or communication is weekly for sure. (Interview 1).

The board has both \textit{controlling} and \textit{advisory roles}, as presented by respective CG mechanisms on Figure 1. As part of the \textit{management control function}, monthly reports on agreed KPIs are discussed in board meetings. In addition, budgets looking 12 months ahead are required. CEO of investee company (Interview 4) reflected that establishing such formal monthly board meetings was the biggest change in CG when BaltCap acquired the
firm. Among other things, CSR issues are discussed explicitly or implicitly in these meetings.

All firms are regularly audited and the auditors are invited to share their insights to the board. In addition to economic performance all firms are scrutinized in terms of responsibility issues and ESG reports are compiled. However, in addition to typical control function, the board takes a more active role by advising the executive team on various topics (CG mechanism Advisory role: board strategic input, industry experts on Figure 1):

Control function is the basis, which is there anyway. But I think we go far beyond it. (Interview 1)

The advisory role mechanism offers partnership to the management: if needed, industry experts are sought to join the board or temporary advisory boards are formed to solve specific problems. Finally, BaltCap makes sure that portfolio companies follow the Code of Conduct (Figure 1), the standardized guidelines for entire portfolio and also BaltCap itself. Investee company CEO (Interview 4) expresses the view that Code of Conduct refers to the type of management philosophy that BaltCap invests in to begin with rather than changes the behavior of the bought companies:

If I were a different type of manager and used to achieve success via bribing, Code of Conduct would probably not stop me. (Interview 4).

Still, all CEOs have to formally confirm that they follow Code of Conduct and diverging from it is the basis for interference by BaltCap. BaltCap also organizes trainings to portfolio companies related to corruption, fair competition practices, adhering to changing laws, etc., to keep the document “alive”. Hence, Code of Conduct is both a facet of responsible investment strategy and active ownership. In sum, BaltCap achieves its objectives to create long-term financial and CSR value by applying CG bundle that comprises six distinct, yet related, CG mechanisms all of which rely on and implement responsible investment and active ownership strategy.

5. Discussion and conclusion

Our study illustrates how PE weaves CSR into its business logic. While previous studies have shown that institutional investors with shorter investment horizons (like PE) do not necessarily see value in CSR, our case study shows the opposite. Following CSR principles such as fair treatment of business partners, employees and community, respecting the environment and avoiding corruption improves also the financial outlook of the firm and thus increases the potential value for owners. This confirms the value-enhancement hypothesis of CSR (Jensen and Meckling, 1976) and strategic CSR thesis whereby both the society and the firm experience increased benefits (Porter and Kramer, 2011).

Our case study supports the conclusions by Mishra (2017) and Kim et al. (2018), who showed that innovative and growth-oriented firms were better able to extract benefits from CSR in terms of firm valuation. As the main goal of BaltCap is to increase the value of their firms, and according to their experience the source of value is increased company size and capacity rather than financial engineering or cost cutting (Interviewee 1), then it might be claimed that CSR is particularly favorable in the presence of growth aspirations. Furthermore, our study is in alignment with the conclusion by Crifo and Forget (2013) and Estapé-Dubreuil et al. (2016), who demonstrated remarkable shareholder activism and engagement on the part of PE including its policies related to CSR. The PE presented in our case study uses appropriate CG bundle to enhance both financial and CSR value of its investee firms. Accordingly, our case study supports Galpin et al. (2015) who discussed the importance of creating the culture of sustainability throughout all levels of a firm using various mechanisms, and showed that such sustainability focus may be rewarded by improved brand equity, market share and customer loyalty.
Our results confirm that CG bundle implemented by PE uses mechanisms derived from both agency theory and resource dependency theory, whereas the latter is relatively more emphasized. The boards of the BaltCap’s investee firms did provide advice and counsel, established clear and frequent channels of information flow, and enabled preferential access to resources as conjectured by Pfeffer and Salancik (1978). At the same time, alignment of interests via shareholder agreement and established reporting practices in accordance with agency theory were not neglected either.

In general, our case firm uses strong CG, which according to Borghesi et al. (2019) can be described by including CG mechanisms such as inseparable ownership and control (CEOs are invited to become shareholders), small boards with little ethnic and gender diversity (typically five members two of which are from PE), frequent board meetings and vigilant control, protection for minority shareholders (shareholder agreements) and open reporting (quarterly KPIs, ESG reports) in the CG bundle. What is interesting though is that strong CG and active ownership, which is typically deemed shareholder-oriented practice to boost short-term performance, is in no opposition with CSR. Owners’ genuine belief in the supremacy of socially responsible behavior and stewardship thereof (Melis and Nijhof, 2018), appointing like-minded top-management, code of conduct (including trainings for managers) and annual review of ESG performance supplemented traditional CG.

Our study suggests that for PE socially responsible practices gain practical relevance in time; hence, longevity of CSR (Jeong et al., 2018) as a precondition for positive outcomes is valid regardless of the relatively short investment horizon in investee companies. As our case demonstrated PE firm itself had a history of learning and developing the appropriate extent and aspects of CSR to be integrated to their core business, and it was still an ongoing process. This is in alignment with suggestions of Høgevold and Svensson (2016) who showed that businesses’ sustainability efforts are dynamic, not static. BaltCap was at the forefront of CSR in its own industry, a role model among PEs and an active player in promoting social responsibility in the Baltics. As such, we somewhat disagree with the findings of Ding et al. (2019), which stressed the importance of sticking to average levels of CSR in the region. Here, it is important to note the differences between Europe and the USA: socially responsible investing is more mainstream in Europe (Louche and Lydenberg, 2006) and positive outlier may not be “punished” as in the USA.

The study makes several contributions to the literature. First, our case study adds to the theoretical discussion on the linkages between CG and CSR. The study shows how private firm owners, who are not themselves in the managerial roles of the firm, can increase both the financial as well as CSR value of their companies by designing appropriate CG bundles. Second, our research adds to the relatively fragmented literature of CSR and CG interface focusing on it based on case study method, which reveals deeper insights. Third, the study focuses on private SME segment, which is underexplored area both in CSR and CG literature. Finally, while majority of CSR and CG literature discusses predominantly larger regions, especially Anglo-Saxon countries, and more recently also Continental Europe and a few larger emerging markets, smaller transforming regions have been left underexplored. Our study fills this gap by focusing on small transforming Baltic countries.

We would also like to highlight several practical implications from our study that could prove useful for private firm owners, investors and private firm management teams. First, the study shows that CSR is relevant also to investors with short time horizons. Even though the measurable effects of CSR might reveal themselves mostly in the long run, the CSR impact on firm’s financial value is more imminent because the valuation is dependent on the future outlook of the firm. Second, our case study discusses specific CG bundle that professional investors design for private SMEs together with explanations as to why such choices have been made. These insights on how an owner can enhance the value of her firm by appropriate CG design can be used also by other private SME owners as none of the CG mechanisms discussed in the article are PE-specific.
The study is not without limitations. While on the positive side the case study approach allows us to gain deeper insights, it might lack generalizability both in terms of geography and firm context. Other similar studies focusing on different markets and different firm contexts, such as firm size and ownership structure are called for to reveal more nuances.

References


Further reading


Appendix

**Figure A1** Overview of research process

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