The Impact of Private Equity Investment on Corporate Governance of Private SMEs

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Abstract: For a long time, the development of small and medium-sized enterprises (SMEs) in China has been encountering bottlenecks, mainly due to narrow financing channels, mainly through loans from friends and relatives and bank loans, while equity financing and debt financing are obviously insufficient. Private equity investment can not only bring SMEs the necessary funds for development and broaden financing channels, but also provide positive governance factors in the management of enterprises and help owners to supervise the management of enterprises. At the same time, private equity investment can drive the rapid progress of China's high-tech industry and promote the good development of China's economy. The article concludes by pointing out that SMEs should take corresponding measures from themselves to proactively attract private equity investment and broaden the path of enterprise development, and also makes suggestions on how China should further promote the development of private equity investment.
Keywords: Private Equity; Small and Medium-Sized Enterprises; Corporate Governance

1. Introduction

Since 2018, the state has put the development of SMEs on a more important position, providing innovation incentives, tax incentives, and financing support for private SMEs. By the end of 2021, the number of private enterprises in China had reached more than 40 million, contributing more than 50% of tax revenue, more than 60% of GNP, more than 70% of technological innovation achievements, more than 80% of urban labor employment, and more than 90% of the number of enterprises. However, the difficulty in financing has been the main problem faced by SMEs, which seriously restricts the sustainable development of SMEs. With the continuous development of society and optimization of financial environment, domestic private equity funds are developing rapidly and their number and scale are increasing.

2. The mechanism of the effect of private equity investment on the corporate governance of SMEs

2.1 Organizational structure and business difficulties of SMEs' governance

2.1.1 Organizational structure.

China's SMEs are highly unified in terms of ownership, operation and supervision, and have not established a truly reasonable and effective corporate governance structure, organizational structure and effective authorization and supervision system, with a high risk of decision-making failures. According to a survey of 88 private SMEs conducted by the Shenzhen Stock Exchange, the proportion of shares controlled by the largest shareholders is generally above 50%, and the control of the top five shareholders usually exceeds 90%. (As shown in Table 1)

Table 1 Distribution of decision-making power of private enterprises (family enterprises)

	operating decisions	General management decision
The owner himself	58.8	54.7

Owner and the principal managers	29.7	34.5
Owner and others	0.3	0.4
board of directors	11.0	10.0
someone else	0.2	0.4
summation	100	100

Source: China Private Enterprise Development Report (2007), Social Science Literature Press

2.1.2 Operating difficulties.

As of 10 months in 2021, private enterprise loans accounted for 53.5% of new corporate loans, up 11 percentage points from the end of 2019, and the credit spread between private and state-owned enterprises has been about 150-200bp since 2019, making financing difficult and expensive. From the perspective of independent innovation, SMEs contribute 70% of patent innovation, but the proportion of R&D investment in revenue is below 7%, and the strength is still less than the high investment of 10% in large companies. From the talent level, SMEs contribute 80% of employment. Although the rebound of SME job postings is higher than that of large companies as the epidemic turns slow, SME companies have high talent turnover due to their small scale, poor stability and insufficient welfare benefits, and are not attractive enough to high-caliber talents, and labor shortage and recruitment difficulties are still common.

2.2 Reasons for private equity investment to intervene in corporate governance

The process of private equity investment is divided into three aspects: supply, operation and use of funds, and there are two levels of principal-agent relationship, involving investors, private equity investment institutions and entrepreneurs.

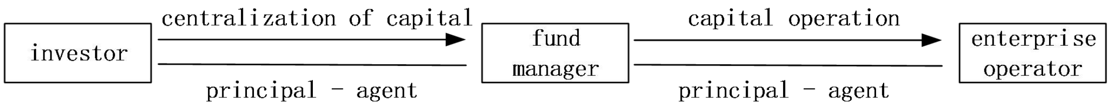

Figure 1 Private equity investment process

As shown in Figure 1, one is the private equity investor and the fund manager. The investor wants as much return and as little risk as possible, while the manager wants both a high return on capital and the maturity of the investee company to enhance its reputation. Second, private equity fund managers and business operators. Specifically, first, private equity investment aims to achieve superior investment returns, and it does not rely solely on the performance of the company itself, often using its own advantages to find the optimal solution and using its voting rights to influence decisions on major corporate matters. Second, the private equity team has tremendous pressure and motivation. Poor performance not only makes it difficult for the fund to survive in the market, but also causes reputational damage, and the lucrative compensation provides the motivation to gain a deeper understanding of the underlying company's industry, equip it with the appropriate talent and resources to expand the market, and help the company grow and develop together. Finally, private equity can accumulate and grasp effective information through long-term and stable relationships with investee companies, and gain information advantages to alleviate the problem of information asymmetry.

2.3 Analysis of the impact of private equity investment on the governance style and structure of SMEs

2.3.1 Impact on shareholders' meeting and board of directors

Although they are considered outsiders in the board of directors of the company, on the one hand the directors stationed there are often experts with professional expertise in their respective fields, such as investment director, finance director, personnel director, etc., can use their On the other hand, the board of directors and supervisors can be urged to improve the direction of efficient operation by establishing a perfect system of independent directors, stipulating the proportion of independent directors in the investee company, their remuneration and independence, so as to effectively supervise the operation and management of the investee company and check and balance the internal control power of the company, and improve the company's The imbalance in the allocation of power at each level forms a reasonable management supervision and control mechanism.

2.3.2 Influence the governance mechanism of the company

To solve the principal-agent problem between private equity and investee company management, compensation, equity and option incentives, valuation adjustment agreements and binding mechanisms are generally used. Private equity is entered into by using incentives that give management equity and option interests because the goal of private equity is to earn high profits, but only by selling shares of the company, and if the target company is operating well with growth potential, the sale can be highly rewarding. Private equity investors use their position on the board of directors to monitor management, and in order to limit management's propensity for risk, management employment terms often include dismissal, removal and buy-back of management shares.

2.3.3 Influence the equity structure of the company

The entry of private equity brings about a relatively concentrated shareholding structure or debt structure. The purpose of private equity is not to control the company, but to sell the company for a long-term positive trend in order to obtain excess returns. In order to facilitate the supervision and management of the company, they have a seat in the board of directors or enjoy the right of veto, which will help the enterprise to establish a standardized system.

2.3.4 Provide information and experience, and leverage reputation and brand influence

On the one hand, private equity managers usually have financial and legal expertise and rich experience in investment management, as well as strong cognitive and handling abilities in a complex business environment, and are able to provide professional consulting services to SMEs, optimize their management concepts, reduce their business risks and improve their business models, in order to achieve capital appreciation and thus obtain high returns. On the other hand, the team, investment level and historical performance of private equity funds are a kind of brand influence, and this influence is an invisible appeal to the invested enterprises, which can not only help the invested enterprises to attract more investors and customer resources, but also help the enterprises to improve their market visibility and form a healthy and healthy development. In addition, some globally renowned private equity can help investee companies develop overseas markets with their brand influence, so that their products can enter the international market smoothly.

3. Relevant experience and suggestions

First of all, the relevant legal construction in China is not yet perfect. Secondly, in order to solve the problems of insufficient number of private equity institutions, insufficient capital sources and unbalanced regional development in China, we should give full play to the guiding role of the government, give financial support and tax preferences, expand the channels of private equity capital sources and introduce more social capital. Again, IPO as the main exit mode of China's private equity funds, but by many factors such as national policies and enterprise operations, all may lead to IPO failure. Finally, there is a lack of relevant high-level professional talents, and it is necessary to strengthen the comprehensive training of talents in corporate management, finance and taxation, banking and finance, etc., to provide multi-faceted support for private equity development in collaboration with accounting firms and law firms, and to integrate relevant resources in the industry to build a financial service platform.

Enterprises should comprehensively examine the situation of investment institutions, such as capital management volume, invested or in investment cases, investment strategy, post-investment management and other information to reduce information deviation between the two sides, which is conducive to further communication and integration of investment institutions and invested enterprises' objectives. At the same time, enterprises should be well prepared for the introduction of quality institutions, such as accurate positioning, core competitiveness, high technology level and talents, road show preparation, detailed and focused business plan, etc. At the same time, it should also pay attention to the equity and corporate governance issues after introducing institutional investors, and actively cooperate with the post-investment management of private equity funds, either by asking for professional knowledge from private equity institutions, inviting talents from investment institutions to conduct training, or providing management positions to realize the role of investment institutions in promoting the growth of enterprises.

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