Briefing

FINANCING, BUSINESS STRATEGY, CORPORATE GOVERNANCE AND GROWTH OF MEDIUM-SIZED BUSINESS: AN EXPLORATORY COMPARISON OF THE UK AND GERMANY

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Summary

This Briefing compares the role of corporate governance for the strategic dynamics of M-firms in the UK and Germany. Drawing on matched pair case studies in the biotech, software and precision engineering sectors, our study documents the significant differences in the orientation of UK founders toward project-based ventures and German founders toward the life-long organic growth of the firm. These differences are explored in relation to corporate governance institutions, such as the availability of external finance and the role of boards, which support (or potentially undermine) these different types of growth strategies. Based on these differences, we tentatively identify several trade-offs for M-firms related to the different institutional environments of British and German corporate governance. While UK firms have advantages in getting rapid access to larger amounts of risk capital in the early stages of growth, German firms operate in more stable environments that support organic expansion and innovation based on gradual maturation of internal capabilities. However, German firms face managerial development and succession problems.
1. Introduction

This research aims to better understand how small businesses grow and evolve into medium-size (M) firms by focusing on the role of corporate governance in the UK and Germany. The strengths and weaknesses of UK corporate governance institutions for the growth of M-firms will be examined through a comparison with the German Mittelstand, with its famously strong export competitiveness and high innovation capacity (Simon 1996). Past comparisons have found that German high-technology start-ups have achieved higher growth rates in both sales and employment, attained higher labour productivity during their ‘adolescent’ stages, and had higher rates of survival than their UK counterparts (Cowling et al., 2007). Still, the UK has particular strengths in some sectors, such as biotechnology (Haagen et al., 2006).

In order to explore whether and how corporate governance institutions influence the strategic growth of M-firms, this Briefing presents the results of a pilot study based on case studies of matched pairs of UK and German M-firms in three high-technology sectors: biotechnology, precision engineering, and software. Our main findings suggest that the different corporate governance institutions of UK and German M-firms lead to strategic trade-offs for M-firms in each country. British institutions appear more conducive for bringing high-risk, technology companies to the stock market at earlier stages of their life cycle. But the strong time pressures and exit orientation of major investors and even founders may often undermine the organic growth and development of UK M-firms. The institutional environment of M-firms in Germany seems, on the whole, to be more conservative toward financing of early-stage and high-risk ventures, but may have advantages in stabilising the medium-term growth and strategic orientation of M-firms. These strengths also carry risks in the longer-term for German companies, which face more serious issues of founder succession and higher costs of exit via mergers and acquisitions for well established firms. Better understanding of these institutional trade-offs may have implications for commonly held views of ‘best practice’ in the UK.

This Briefing is organised as follows: Section 2 provides a brief summary of corporate governance institutions in the UK and Germany. Section 3 summarises the main findings of our case studies of M-firms in the two countries. Section 4 discusses the themes identified in the case studies with regard to implications for public policy, business practice, and future research on M-firms.

2. The institutional setting of M-firms in the UK and Germany

Corporate governance and finance are widely considered to have a strong influence on organisational capabilities associated with growth. For M-firms, this influence is most significant during the transition from the original founder-manager template to the more ‘professionalised’ stage in their evolution accompanied by the search for external finance and development of larger management teams. Corporate governance parameters, such as outside directors, ownership patterns, and involvement of venture capital firms, play an important role. Yet corporate governance institutions differ widely across countries, and may therefore be an important factor in shaping the comparative success or competitive advantages of M-firms in different sectors of the economy.

2.1 Founder orientation and the imprint of national business systems

The ability of a firm’s founders to formulate and implement strategic initiatives that capitalise on environmental opportunities is vital to the long-term survival and growth of the firm. Founders frequently serve as CEOs and often have unique, often technical, capabilities critical for the success of their ventures. At the same time, the influence of the founders depends strongly on the ‘imprint’ left by the type and distribution of institutionally available resources at the time of foundation (Stinchcombe, 1965). Founders’ strategies are not only shaped by the particular historical and institutional setting at their outset, but these strategies often persist in
later periods, despite changed market environments, because ‘business strategies...build commitments that are costly to change’ (Hannan et al., 1996). But how and why do entrepreneurs choose some organisational building blocks over others as cognitive templates and strategic resources for a new enterprise (Johnson, 2007)? Conversely, do different institutional environments provide different opportunities and constraints for such choices in ways that bestow comparative institutional advantages for different types of firms or strategies (Hall and Soskice, 2001)?

Before examining how founders utilise different corporate governance institutions in developing strategies for growth, this section provides a selective review of past studies in order to highlight the broad institutional differences in corporate governance in the UK and Germany by looking at finance, ownership, and the role of boards.

2.2 Financial systems and ownership patterns

The role of financial institutions in supporting Germany’s SMEs is well explored (Vitols, 2005; Deeg, 1999; 2005). Public savings banks and private cooperative banks are widespread and dedicated to lending and services for small firms, as well as being strongly embedded within local communities. Bank loans provide access to long-term, fixed-rate sources of funds that are particularly relevant to small and medium-sized (SME) businesses. The risks of these loans are shared in complex ways through formal associations and cooperative arrangements that link banks, public programmes and the German state (Lane and Quack, 1999). German SMEs utilise internal financing and bank debt as main funding sources (Bluhm et al., 2007; BMW T, 2007; Hommel and Schneider, 2003; KfW, 2007). While this approach was considered highly efficient in the past, an ongoing debate remains as to whether German SMEs have become increasingly undercapitalised over time (Creditreform Wirtschaftsforsch – Frühjahr 2007, 2007; Bartelt and Jacob, 1998; Martens and Michailow, 2003; Kayser, 2003).

German governmental institutions also provide finance for SMEs (BMWT, 2007; Irsc, 2005). For example, the Kreditanstalt für Wiederaufbau (KfW – Bank of Reconstruction) provides capital to the public saving banks, as well as running programmes which are linked directly to SMEs. The state has recently been important in promoting equity financing for high-tech start-ups and incumbent Mittelstand (early and later stage), typically allowing private venture capital investment access to matching public funds. Credit guarantee associations have been created in each Federal state as private limited companies that assist firms with a lack of sufficient collateral to gain access to finance and minimise transaction costs in the assessment of the borrowing firms. Hence, Germany’s bank-based financial system has become more sophisticated and equity-oriented in recent years.

Given the historical reliance on external bank finance, German SMEs have a strong propensity to remain owner-operated by the company founders for relatively long periods of time. The very notion of ‘Mittelstand’ is often associated with the idea of a family business, run by the founder, founder’s relatives or offspring. ‘Mittelständische’ entrepreneurs are considered to be more emotionally attached to their business than hired managers and their business is an integral part of their personal self-fulfilment (Berghoff, 2006). Generational continuity is still perceived to be an aim that distinguishes the Mittelstand and sometimes considered an inherently beneficial trait (Institut für Mittelstandsfororschung Bonn, 2007).

The continuity of founder control and use of bank-based finance mean that German SMEs often do not strive for capital market or private equity investors, but intend to remain financially independent (Albach, 1998). Reliance on bank loans allows firms to grow without diluting the founder’s equity. Founders also appreciate the reluctance of regional banks to interfere in day-to-day business. Even if SMEs go for venture capital, managers and/or owners often attempt to buy back the shares later, instead of choosing the exit option of ‘going public’ (Bartelt and Jacob, 1998).
These patterns hold true even in very ‘new’ sectors characterised by radical innovation patterns, such as biotechnology (Lange, 2009). Yet this focus on multigenerational continuity may lead entrepreneurs to delay developing a succession plan or to discount possible external solutions (e.g., involving a partner, or a long-term employee, or selling to a third party). German SMEs are often poorly prepared to face this difficult and conflict-laden process (Gruhler, 1998; BMWT, 2007).

In the UK, M-firm finance is mainly geared towards private equity where specialist investors acquire an equity stake in potentially high growth unquoted companies. There are over 170 active UK private equity firms, which provide several billion pounds each year to unquoted companies. The private equity firm faces the risk of failure, but is also rewarded by the company’s success through realising a capital gain by an ‘exit’: selling their shares back to the management or another investor (such as another private equity firm), a trade sale (the sale of company shares to another company), or a stock market listing. The last option has become particularly popular after the establishment of the Alternative Investment Market (AIM). Since its launch in 1995, over 2,500 companies have joined AIM raising more than £34bn in the process, both through initial public offerings (IPOs) and further capital raising.

While later-stage finance from venture capitalists and business angels is more prominent in the UK than in Germany, these funding sources constitute a relatively small proportion of the total SME finance (Cowling et al., 2007). UK firms also utilise bank finance, but at a rate slightly below Germany (Cowling et al., 2007). Bank-firm relationships are generally weaker, and bank funding is limited to overdraft facilities and is less oriented toward long-term fixed interest rate finance. Public support programmes for small firm finance also exist, but these are quite small relative to Germany.

2.3 The corporate governance role of boards

The growth from small to medium size is a critical threshold in the firm life cycle that places new demands on the board and often goes with a wide ranging shift in the structure and roles of board members. Founders are often replaced or become members of a larger team of executives. The monitoring function of the board becomes more distinct from day-to-day management, and often non-executive directors play a growing role. In the case of an IPO, the board must promote accountability to a much wider body of minority shareholders. Boards also have strategy and resource functions, such as providing access to external resources via their social networks, using experience as a basis for strategic advice, etc. (Aguilera et al., 2008). As critical resources of the firm change over their life cycle, M-firms often face new challenges such as commercialisation and marketing, as well as internationalisation of their business.

Little research has examined the corporate governance of German Mittelstand firms (Goutas, 2007). Many M-firms are sole proprietorships or private limited liability companies, which have limited public disclosure and no mandatory supervisory board. Following a reform in 1994, larger M-firms may adopt the legal form of a ‘small corporation’ (kleine Aktiengesellschaft) which requires a two-tiered board with a small supervisory board made up of three persons, including a chair. The supervisory board monitors the activities of the management board, and advises on matters of corporate strategy (Helm et al., 2004). This form may be favored by outside investors and externally recruited managers, since it guarantees the independence of the management from the founder but without the full set of costs of the traditional corporate form. Listed firms also face requirements of the German Corporate Governance Code, which promotes various best practices on a ‘comply or explain’ basis such as the use of variable elements of executive remuneration and the formation of committees in the board. Larger corporations with over 500 employees are also subject
to a larger and more formalised structure for the supervisory board, including employee codetermination.¹ Board-level codetermination thus does not apply to most M-firms, but employees may be also represented by works councils that play a formal role in decisions regarding human resource management and thus reflect Germany’s stakeholder-centered model of corporate governance (Jackson, 2005).

In the UK, corporations of any size have a great deal of discretion over the structure of the board. However, the ‘professionalisation’ of M-firms is often associated with their stock exchange listing and potential compliance with the Combined Code. For example, one study of British pre-IPO firms in 1999-2003 shows that nearly 52% of firms had a founder-CEO, but 60% of firms also had a non-executive chairman (Filatotchev 2006). While founders usually retain their leadership position, the board tends to shift towards outside representation, particularly in firms with private equity backing.

In sum, founder orientations are shaped by the wider institutional context of finance, ownership, and corporate governance. These institutions ‘imprint’ the organisation with a particular set of resources and capabilities and may be potentially very important for the trajectory of future growth. In the UK and Germany, such institutional differences seem particularly marked. In order to further explore the strengths and weaknesses of these national institutions for M-firms, the next section will report the findings of our comparative case studies of matched pairs of firms in the UK and Germany.

3. Themes from the case studies

Previous research does not provide a detailed picture of how corporate governance influences growth strategies in M-firms. No publicly available data exists on small, privately held companies that would include variables of interest (eg, information on corporate governance, ownership structure, growth strategies, etc.). Hence, our study has adopted a comparative case study design to provide in-depth analysis of similar firms in the UK and Germany. Case studies are well suited to study the process of how corporate governance influences strategic decisions, and are intended here as a pilot study to guide future larger-scale research and policy analysis of these issues.

3.1 Methodology

The case studies are based on face-to-face interviews conducted at M-firms in each country between February and April 2008. The ICAEW defines companies to be medium size when employing between 50 and 249 employees. Given our interest in growth transitions, our cases included some firms just under the threshold to ‘medium size’. A matched pair of firms were selected in each of three industries characterised by high level of growth opportunities – biotechnology, software and precision engineering. Two German firms were selected in the biotech sector in order to look at a wider range of governance characteristics based on both privately held and post-IPO mid-sized companies. The final sample included three firms in the UK and four firms in Germany. While these cases should not be considered representative of aggregate national patterns, our matched pairs design allows us to gain some insights regarding variation both within and between countries. Our findings should be nonetheless treated as only tentative and as a pilot study for future research on nationally-representative samples of M-firms.

The interviews were conducted with the founder, CEO, CFO or other managers responsible for corporate governance and investor relations issues. We conducted one or two interviews per company, each lasting two-three hours. Interviews were conducted in either English or German.

¹ In large corporations, the number of supervisory board members must be a multiple of three and contain either one-third or half employee representatives. Typically, boards consist of 12 or more members, thus creating very different dynamics and high costs for the firm.
recorded and fully transcribed, systematically coded according to major themes of the study, and then compared both across countries (eg, each UK-German pair) and within countries (eg, similarities and differences among the UK firms). The interviews were based on a semi-structured questionnaire with both open-ended and specific questions with regard to the foundation, stages of financing, the role of the board, and strategic development of each firm. Table 1 provides a summary of our key findings discussed in the following sections.

3.2 Founder orientation and imprinting

Founders had a variety of business opportunities for creating firms in both the UK and Germany, including both market pull and technology push factors. Despite these broad similarities, striking differences were evident between the founders’ fundamental orientations. In the UK, entrepreneurs in all three cases had a strong project-orientation. Founders viewed the business as a finite project within their career and often began the project with a view or plan for their own exit after reaching a particular goal. Founders did not express long-term commitments to the business venture. For example, a founder of a very successful software company clearly indicated that:

‘...our thinking was we might develop this programme which might take a couple of years and then we’d probably ... sell it to a company, or give it to a company and get a royalty for it, we weren’t planning to set up a business ourselves.’

This UK software company was founded in 1993, and became cash-generative at a very early stage. It also expanded internationally, with a rapid growth of sales abroad. However, the original owners sold the firm to an industry buyer in 2003 and remain involved only as occasional consultants. Likewise, the UK biotechnology company in our study was founded as a university spin-out. Within just two years, the founder came to play a more limited role as a non-executive director and resumed his duties as a university professor. The only UK case study with strong founder involvement was a precision engineering firm. Even here, the company was set up by a serial entrepreneur hoping to develop technological side of the business and sell it to a larger industry player. In his view, this was a typical model for the UK:

‘In those days there were hundreds of mid-sized companies turning over 50, 100, 200 million pounds... who were competing, but the competitive environment was very strong. What’s happened then with this acquisition by people like [major Company A] or [major Company B] is that hundreds of companies have disappeared over the last 15 years... My original idea was to set up a holding company with intellectual property from which applications could derive and then set up operational companies beneath the holding company and raise financing and dilute the equity of the operational company but not the holding company. And those operational companies could be sold off but you keep the core intellectual property’.

In three out of four German cases, our interviews indicate that founders have a life-long orientation which is associated with longer-term commitment to their business. When talking about the founders’ original orientation, a CFO of a software company commented:

‘They certainly see it as a dream come true, like running such a company in such a niche market ... right now, these days, we have 100 employees ... they couldn’t, I think, really imagine doing something else ... If they see an exit or kind of a merger or transaction coming up they would really like to have an active role, also, in the future organisation as part of a bigger group.’

6 One rival software firm was founded in 1984, but sold by the founders to an American firm and later again to a large Japanese corporation. The other leading rival was founded in 1996. When asked about a possible sale by a major newspaper in 2007, the CEO and founder replied, ‘We have had inquiries. But we have capital and want to realize our visions on our own.’
In another German case, the founders had initially invested a substantial amount of personal money into the firm and undertook very large entrepreneurial risks. Eventually, the company did undertake an IPO in order to finance further growth and the two founders reduced their ownership to 30%. The CFO of the firm commented:

‘They still own about 30% and I think they are very careful not to dilute too much so that they cannot at least try to keep control of the company with minority shares...to make it difficult for competitors or other companies to try a hostile takeover....I think it's basically the Founders’ baby really, and they are very much involved and also in the life here in [local town and region]. And so I think it's a little bit also a commitment to the people living here and working for the Group that they see, because if you look at potential companies taking us over, I think it's not too difficult to imagine that what they need is the technology, what they don't need is the production facilities. So, in a way, there's a concern that not too much would remain of this and the Group would be more of less dissolved after acquisition. I think that's not an idea that the Founders would like too much, so that's why they still have 30%.’

Overall, our interviews suggest substantial differences between founder orientations in the UK and Germany. The UK M-firm founders seem to be dominated by project orientation, whereas German entrepreneurs consider their ventures as a life-long endeavor even when their involvement falls short of this ideal for any variety of reasons. While such differences are sometimes explained in the media as reflecting cultural differences (eg, the individualism and self-motivation of the UK entrepreneurs in contrast to a more collectivist approach in Germany), in the next sections we argue that there is a more proximate set of causes. Founder orientations relate to differences in the institutional environment and emerge in dialogue with the strategic orientations of key financial investors and the role of the board.

3.3 Stages of finance and ownership

Our literature review identified significant differences between bank-based financing in Germany and equity-based finance in the UK. Our case studies show that these national differences are, in part, less categorical than often assumed, particularly due to the stronger development of equity-based forms of finance in Germany relative to the situation prior to the mid-1990s. Here we compare the role of banks, private equity, and IPOs in turn.

3.3.1 Banks

UK firms in our sample indicated strong barriers to accessing bank finance. For example, the CEO of a listed precision engineering company in the UK clearly indicated that:

‘...it suffices to say that it must be great to be able to get such financing as in Germany because such financing does not exist, in my view, in England at all, actually. If you're pre-profit you can't raise a bank loan. So we have never had a bank loan, ever, in our existence. So there's what they call a funding gap in the UK, and the banks [major Bank A, Bank B, Bank C], it appears that they do offer such facilities, in practice we've found that it never happens. Such facilities would be very useful if they were available. And the Government has a scheme, it's the small firm loan guarantee scheme but it simply does not work for pre-profit companies. And I'm not aware of anyone who's ever even gained such a loan, actually’.

Other case studies indicate that the true picture is more complicated. For example, the software company in the UK was able to obtain a bank loan at a very early stage of its life cycle. However, this firm had a marketable product and stable cash flow very soon after its foundation, which may explain its successful application for a bank loan. Meanwhile, the role of bank financing in our sample of German firms was more modest than expected.
German banks are reluctant to finance very high risk ventures lacking some established collateral or proven cash flow. Banks do not tend to finance very early stage investment in high technology sectors characterised by high levels of technological and market uncertainty or where lead times for product development are high. Nonetheless, banks did provide finance to the older biotechnology firm in our sample, which was established in 1981 and grew largely through self-financing and an initial equity investment. The firm developed close and almost traditional linkages with their Hausbank that proved important for financing their further expansion. The CEO explained that banks provided finance for their most recent investment of €2m to build a new office building and reshape their production facility:

‘In practice, the banks are running through our door saying that we should borrow more money. We have been here 26 years and have worked with [local bank] since the beginning....We have always made efforts to be a good customer, and the bank has always followed our development intensively. We have our bank advisor, with whom we meet regularly and who has seen our development from the very beginning. We try very hard to inform them of our situation, even more than is necessary. For example, we made quarterly reports, things that we didn’t really need to do. We tried to develop a strong rating, and the bank has honored that by acting generously toward us. It was never a problem for us to receive loans...The [local bank] has the advantage that they haven’t changed their advisors often. The [major bank A] made a huge number of mistakes by changing their people and their image. Sometimes they wanted small and middle-size firms and sometimes not. They once told us that they couldn’t make any money lending to our firm [CEO laughs]. Then they wanted to work with us again. Really stupid. The [local bank] was very consistent and has worked with us over the long-term.’ [Translated from German]

3.3.2 Private equity investors

Three of the four German firms reported some form of private equity funding at early stages of their development, either in terms of venture capital backing or business angel investment. Similarly all three UK firms interviewed had substantial venture capitalist involvement. Despite these broad and possibly unexpected similarities, our interviews did reveal substantial differences in the orientation and exit strategy of private equity investors in the two counties. In the UK, interviewees strongly emphasised the short-term orientation of private equity investors, and a relatively high pressure on them to exit. For example, a UK biotechnology firm that has been supported by venture capitalist specialising in university spin-offs, indicated that:

‘...their model is investing in companies and then something’s got to happen to those companies because companies like [the venture capital group] can’t ever realise any value just by holding investments in companies, particularly companies that don’t pay any dividends... they will need to exit, they need to sell their shareholding to ... crystallise the gain. Hopefully it will be a gain they’ve made on the investment and they can use the proceeds of that to invest in other companies.’

This pressure to exit leads private equity investors in the UK rushing their portfolio firms to the stock market, which, in some cases, may be premature. Some companies are simply not ready to enter a fast growth phase after the listing and live up to the expectations and time horizons of their post-IPO shareholders. As the same interviewee indicated:

‘So this wasn’t a company that had been going for five or ten years and then raises some money and then floated. It had been going for a very short space of time. It just takes time for a company to get processes in place and people to learn how to work together and understand what their roles are and all that. I think people kind of take that for granted if
they’ve been working in organisations that have been around for a long time. You just think, well, there’s a process for this, there’s an accepted way of doing that and we really didn’t have that. ... we’d have probably got to where we are now quicker if we’d been around for, say, five years as a company before we floated.’

The CEO of the UK-listed precision engineering company clearly indicated that premature exit and listing exposes companies to a double pressure coming from the market and investors, which may have negative consequences on growth and strategic development:

‘The City is working within a time frame of months usually, let alone years, so the City ... if you’re saying you’re going to be profitable in two years or three years time, for them that’s never… the City itself mostly services the institutional client not the private high net worth individual. The private high net worth individual is more appropriate for companies like ourselves than the institutions.’

Our interviews with German firms provided a different picture. Although private equity investors are present in German companies, some displayed relatively long time horizons and did not seem so intent to rush companies to the market. For example, the software company in Berlin indicated that their state-sponsored venture capital investor and business angel have a longer-term approach to the company:

‘I think we were very lucky with the deal because he’s more like a long-term thinking investor and not a short-term exit driven one, so we are happy to have somebody who wants to develop the company further and not make the quick money.’

These results suggest that the nature of private equity investment and venture capitalist involvement may be very heterogeneous, both within countries and between them. What seems critical here is the strategic orientation of these investors. A major difference in our case studies was that private equity firms in the UK are often strongly exit-oriented, whereas some German investors had relatively longer time horizons. Partially, this may explain differences in founders’ orientation in the two countries.

3.3.3 Ownership following an IPO

Two UK firms and two German firms in our sample were listed on the stock exchange and have undergone an initial IPO. This shift substantially changed the composition of shareholders and shifted corporate governance towards a focus on accountability to new outside shareholders. Interviewees cited the high costs associated with listing requirements in both countries in terms of company reports, although with the introduction of electronic reporting these costs have been gradually reduced. Additional costs of listing include the demands on the board of directors to communicate with shareholders, and shareholder scrutiny more generally. Particularly for the listed biotechnology firms in both countries, these firms faced strong challenges with regard to shareholder expectations and maintaining loyalty. Still, these expectations reflected some more subtle differences in the depth of UK and German capital markets. The CFO of the UK biotech firm explained the challenges of dealing with portfolio investment from large City financial institutions as follows:

‘Perhaps if we had received just private money…those investors would be more knowledgeable biotech investors. They would have know more what’s involved, their expectations would have been different from the sort of investors we’ve got, like [major investment bank A, B, and C] who are just generalist fund managers who look at us as an investment like many others. That said, it hasn’t been too bad…but generally, I think probably there’s undue expectation of the company…we probably would have been better off as a small VC-backed company.’
Meanwhile, the German biotech firm has yet to attract investment from the sort of major funds sponsored by UK institutional investors – despite being older and having more established revenue sources than the UK firm. Their shareholders include a more eclectic group of individual small shareholders, often former customers or people drawn from personal contacts. As the investor relations officer explained:

‘The IPO of our company happened just at the end of the stock market hype...since then our stock market price has experienced decline and the real value of the firm is much higher than our current share price....So we must communicate to investors that the money they invest in the firm is not just used for research, but aims at getting a return on investment. But that requires time. There are always the shorties who buy the stock today and sell it tomorrow, but there is also a core of long-term investors who may have all sorts of motives for investing, but usually have a personal one – they believe that one day, I might really need this product.’

In sum, our cases suggest that UK founders became more rapidly diluted because of the emphasis on private equity-based financing and growth though the subsequent IPO. In Germany, however, ownership patterns remain more stable than in the UK, both in companies that remained private and utilised bank loans, but also in listed firms where founders retained a strong controlling stake. However, this type of ownership is not without problems, either related to succession or incapacity to engage in strong control of owner-managers by outside directors or other shareholders.

3.4 The role of the board in corporate governance

Significant differences exist between the formal structures of boards. In our British cases, boards had between five and seven people. All three firms had two or more non-executive directors (NEDs), and NED-led committees for audit and remuneration matters in compliance with the Combined Code recommendations. Some non-executive directors were appointed by venture capital investors, and in two cases founders had shifted into non-executive roles following their exit. In our German cases, all four firms were incorporated as joint stock companies (in the German Aktiengesellschaft) with two-tier board structures comprising a management board and separate supervisory board. The supervisory boards consisted of either three or six persons as required by law. Supervisory board members represented a broad spectrum of relevant stakeholders or strategic service functions. Two firms had a lawyer, an academic or scientist, and a local CEO or entrepreneur. Another firm had a lawyer and two entrepreneurs drawn directly from among the shareholders of the company. Finally, the software firm had five persons (the sixth seat formally being empty) – a business coach, an American VC investor, an intellectual property lawyer, a software entrepreneur and a manager of a consumer electronics firms. All four German firms deviate from the recommendations of the German Corporate Governance Code by not utilising committees of any kind.

Despite these differences in structure and membership of boards, outside board members in both countries seemed relatively passive regarding their role as monitors in relation to key strategic decisions. For example, when asked about what members of the supervisory board contribute to the company, the CFO of software firm in Germany answered:

‘Honestly speaking, not too much, because it’s like what could you expect out of four meetings, each time one hour ... and you cannot really discuss strategic options within one hour. So what we do sometimes we have lunch or dinner with ... face to face with one of these guys and ask for advice but we feel that there’s a need right now to restructure also, and then probably even have something like a strategic group of people next to the formal Supervisory Board and to get more into this workshop mode where you get more out of it.’
The UK-based M-firms indicated a rather passive involvement of non-executive directors, despite the greater presence of committees and potential for informal communication. For example, the CFO of the UK biotech firm said:

‘I see the role of the Board as a sounding board for the executives and to bring to bear their experience and expertise. But I think it probably is also to challenge the executives, making sure that we’re delivering on what we said we were and that we’ve got strong risk management in place and that we’re managing the business in a kind of prudent and competent way. I think you’ll just get different levels of each of those two things from different non-execs. Some of the guys are just happy with the status quo and don’t really challenge us.’

Despite the broadly similar passivity of board members, our interviews did allow us to identify some more subtle differences in the orientation of board members engaged in monitoring. UK boards adopted a stronger shareholder-orientation. The role of non-executives was more explicitly modeled around the perspective of outside shareholders regarding issues such as reporting and relevant business performance targets. Given the early exit of founders at the UK software and biotech firms, non-executives were also more strongly involved in the overall professionalisation of the management team and sometimes faced less of a power differential with the inside management.

Meanwhile, German boards seemed more concerned with broader issues of the firms’ strategic relations with stakeholders, including but not limited to investors. The boards at German M-firms also operate alongside strong founder involvement. One critical issue in this regard concerns issues of succession in German Mittelstand firms. Passive boards are likely to encounter substantial barriers to developing professionalised management teams and preparing fully for issues of founder succession. One German biotech company had been run by a single manager since its foundation in 1981 with a supervisory board made up of three shareholders – two with entrepreneurial backgrounds and one lawyer. These shareholders inherited their shares as family members of three private investors who put the initial money into the firm, but who were never involved in the management.

Beyond the issues of monitoring, boards may also play broader resource roles and give less tangible forms of strategic input to the management team. In both countries, interviewees cited examples of the board influencing important strategic decisions regarding external finance and broader issues of business and corporate strategy. In Germany, the supervisory board of one biotech firm was critical in deciding against early expansion into the US market before both assuring new funding and developing a stronger market basis there through clinical trials.
One supervisory board member of the precision engineering firm likewise used his experience as CEO of a local firm to encourage a radical shift in the business portfolio through divestment from a project-based business segment that lay outside of the core competence of the firm. In the software firm, the most active role was played by the lawyer, who has given advice and offered solutions related to important business risks related to core intellectual property issues. In the UK, for example, the biotech firms have non-executives involved in a number of advisory roles related to business negotiation, but also scientific R&D issues. Still, an effective resource role for non-executives was by no means universal in either country. The UK software firm had a high profile chairman from the broader industry, but this person played a more limited role around formal monitoring and financial matters with little hands-on engagement with strategy matters. This problem may be exacerbated when founders or private equity investors have strong incentives to exit the firm, rather than pursue more gradual organic growth. In this case, boards may lack focus or lack incentives to pursue the strategic development of core competences in a consistent fashion and may overemphasise control functions at the expense of their resource roles. Since the recruitment of board members often relies strongly on inter-personal networks of the founders, putting together an effective team remains an important challenge in practice.

In sum, recent corporate governance initiatives in the UK and continental Europe have emphasised the importance of outside directors as a key governance factor. Our study also suggests that boards remain a critical interface between external accountability and the internal management of the firm. But in M-firms, boards face a dual set of demands to monitor and enhance accountability to outside investors, but also to contribute to the strategic development of key resources as firms grow from small to medium size. For high technology firms, many of these resource issues concern the further commercialisation and sales development for new products based around a core technology. This dual role has inherent conflicts. Moreover, the role of the board may be further complicated in cases of strong founder involvement, where ultimate control rights continue to reside with the management team.

Given these complexities, we caution against drawing sweeping conclusions about the relative strengths and weaknesses of boards in the UK and Germany. Our case studies do suggest some interesting hypotheses for future research. Namely, UK boards may have a stronger shareholder-orientation and place greater emphasis on monitoring, but may be lesser equipped to deal with longer-term strategic development and fostering growth. In Germany, the general reliance on the stakeholder model of board organisation provides better fit in terms of longer-term strategic development and more focused strategic and advisory support to the management team. However, our case evidence suggests that German boards are less effective in dealing with problems associated with managerial development and CEO succession. In both countries, more research is needed to determine how the passivity of board members is shaped by other variables such as relevant education, poor incentives, or whether the selection of members is too strongly dominated by the founders and executive team.

4. Discussion: implications for policy and practice

This Briefing has compared the role of corporate governance for the strategic dynamics of M-firms in the UK and Germany. Most academic studies and policy initiatives have focused on particular aspects of M-firms in isolation (eg, stock market financing) or in single countries. Our approach was intended as a pilot exploration of these dynamics, but consciously adopting a more holistic perspective that combines qualitative case studies with cross-national comparison of institutions. This approach illustrates how the strategic orientation of founders of M-firms interacts with, and is shaped by, wider national-level corporate governance institutions, which thereby support (or potentially undermine) different types of growth strategies.
Our main findings suggest several possible trade-offs for M-firms stemming from the different institutional environments of British and German corporate governance. In essence, these trade-offs revolve around the advantages in getting rapid access to larger amounts of risk capital in the early stages of growth in the UK relative to the more stable environments that support organic expansion and innovation based on gradual maturation of internal capabilities in Germany.

The institutional environment of UK M-firms appears more conducive for bringing high-risk, technology companies to the stock market at earlier stages of their life cycle. UK firms are thus more able to overcome an important hurdle in their strategic development by gaining access to risk capital, which may be particularly important in sectors characterised by radical innovation, such as biotech. While initially advantageous, the early shift toward outside ownership and shareholder-oriented corporate governance arrangements also creates its own set of pressures and momentum for further strategic changes that may be less beneficial for M-firms in the medium term. Founder orientations are more limited and project-driven, placing the generation of new sellable intellectual property before the creation of stable organisational routines and concepts for product delivery. This orientation seems strongly influenced by the exit focus of private equity investors, and the powerful opportunities and (results-driven) expectations created by the stock market. As a result, we observed several cases of a premature listing of companies and creation of unrealistic investor expectations, which come ahead of a genuine strategic maturation of products, sustainable streams of revenue, establishment of organisational routines and capabilities, etc. The resulting constraints on the time-horizons and strategic focus of the founders may further bias firms to engage in early exit through trade sales or M&A, rather than attempt further organic growth. We hypothesise that these institutional constraints may be one important factor in explaining the lower survival rates of UK M-firms found in past research.

The institutional environment of M-firms in Germany seems, on the whole, to be more conservative toward financing of early-stage and high-risk ventures. While this has certainly limited the generation of new start-up firms in Germany, this approach has potentially strong advantages in stabilising the medium-term growth trajectory and strategic orientation of M-firms. The availability of long-term bank finance, the presence of longer-term private equity investors and stakeholder-orientation of boards reinforce or support founder orientations toward the life-long control and involvement, as well as more organic development and gradual maturation of the strategic capabilities of M-firms. Of course, founders and investors do have various options for exit in Germany and also may be increasingly able to generate equity-based forms of risk capital. However, M-firms in Germany are less constrained by these pressures and retain a greater pallet of institutionally viable options for growth. While we hypothesise some distinctive advantages for German M-firms in building organic growth strategies, a critical long-term problem remains the issue of founder or CEO succession and the general ‘professionalisation’ of the management team. These issues may create longer-term barriers to growth despite medium-term successes of the firm.

Our report has a number of policy implications. First, no single solution or recipe exists to address the growth problems of M-firms. As argued above, this Briefing suggests that different institutional arrangements have different comparative institutional advantages for different growth strategies, and these may be appropriate for different sectors or types of firms. M-firms are influenced by a complex interaction of organisational factors and national institutional environments. One implication is that piecemeal regulatory initiatives or benchmarking of best practices may not lead to the desired results or may even undermine existing strengths. Policy must address not just the formal legal framework of corporate governance, such as company law or corporate governance codes, but
also consider how policy interacts with the broader sets of incentives and orientations of entrepreneurs, financial institutions, and others investors. Second, our analysis indicates that besides economic and financing factors, the growth trajectory of the M-firm is significantly affected by the original orientation of its founders and corporate governance parameters, such as ownership structure and board development. The Government and support organisations may achieve substantial positive outcomes by focusing entrepreneurs’ attention on these issues.

Third, professional organisations such as the ICAEW may have a significant influence on M-firms by extending their training and advisory functions from accounting and operations management aspects to raising awareness of the importance of ‘professionalisation’ of management team and supporting strategic roles of boards.

Finally, our Briefing suggests the potential benefit of further study of the issues of founder orientation, corporate governance and barriers to M-firm growth. This Briefing has used in-depth analysis and comparative case studies to identify potential research issues and put forward a number of important hypotheses linking corporate governance and M-firm development. One avenue of research would be to test whether these results are applicable for a larger sample of M-firms across different industry sectors in the UK and abroad. However, insights from this Briefing should help in better specification of key variables for these studies. For example, our study found many similarities in the formal structures of corporate governance, such as outside board members or venture capitalist ownership. Statistical analyses should aim to better capture the orientations of entrepreneurs and the social processes involved in finance and corporate governance. For instance, the apparent passivity of boards found in this Briefing may reflect other factors, such as the process of recruitment and selection to the board and how this interacts with founder influence. In other words, more research is needed to better understanding the factors that make boards more or less effective. A parallel but equally important research strategy involves extending the qualitative and comparative approach to a larger scale. Our analysis of national institutions was focused on financing options available in the two countries, and their impact on founder orientation and corporate governance. However, institutional theory suggests a number of other important factors such as managerial education, employee involvement, business associations, social networks, national support systems, etc. and future studies may address the impact of these institutions on growth of M-firms. The definitive account of the problems and prospects of M-firms in the UK is yet to be written.
Table 1: Corporate governance, founder orientation and financing of M-firms in the UK and Germany: a comparison

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<th>UK</th>
<th>Germany</th>
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<tr>
<td><strong>Founder orientation</strong></td>
<td>Project-orientation (no long-term commitment)</td>
<td>Long-term orientation (high commitment to product/market)</td>
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<td></td>
<td>Serial entrepreneurship</td>
<td>Entrepreneurship as a calling</td>
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<td><strong>Bank financing focus</strong></td>
<td>Operational aspects; cash flow and collateral-based lending</td>
<td>Project development; long-term finance with focus on regional or SME development as public good</td>
</tr>
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<td><strong>Private equity focus</strong></td>
<td>Early involvement but strong exit orientation</td>
<td>Later involvement but longer-term orientation; partnerships with state-sponsored investors</td>
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<td><strong>Ownership changes following an IPO</strong></td>
<td>Rapid dilution of founder ownership; increasing involvement of institutional investors</td>
<td>Founders retain control; passive role of external investors; potential successions issues</td>
</tr>
<tr>
<td><strong>Board functions and processes</strong></td>
<td>One-tier board system; shareholder orientation of independent directors</td>
<td>Two-tier board system; higher skill diversity of independent directors; focus on resources and strategy; potential succession issues</td>
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References


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Gregory Jackson is a Professor of Business and Society at the University of Bath, School of Management. His research examines how corporate governance is influenced by diverse organisational and institutional contexts, particularly using the cases of Germany, Japan, the UK and USA. His publications include the book Corporate Governance in Japan: Institutional Change and Organisational Diversity (OUP 2007) and he has been published widely in top academic journals. He held previous positions at the Research Institute of Economy, Trade, and Industry (Tokyo, Japan) and the Max-Planck Institute for the Study of Societies (Cologne, Germany).

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