

Problems and Solutions Arising from Principal Agent in Private Equity Investment Funds

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Abstract. Entrusted agency plays an important role in private equity funds. Through entrusted agency, it can realize the professional and standardized services of enterprises, and effectively establish the relationship between enterprises and investors. However, at the same time, the defect of the delegate agent leads to a certain risk in this operating mechanism. Based on the perspective of entrusted agents in private equity, this article systematically introduces the problems and reasons behind entrusted agents in private equity investment funds by sorting out relevant research results, and how to avoid risks and protect interests. For the risks of information asymmetry, contracts can be signed and sent. In the way of people's supervision and improvement of the law, for the risk of supervision, regular reporting can be adopted and the third party can be reasonably used for evaluation. For market risks, the corresponding legal mechanism can be improved. This study is of great significance for strengthening and improving the efficiency of fund operation and promoting the healthy development of enterprises.

Keywords: Principal agent, Private equity, Principal agent risk.

1. Introduction

1.1. Research Background and Significance

At present, China's economic form is still severe, after the end of the epidemic, China's economic development is a stable trend, for companies seeking capital in China, private equity has become one of the most common investment and financing methods after the capital market. As of January 2022 the total number of private equity investment institutions established in China was 24,646, and the total size of funds under management of surviving private equity fund managers increased by 514.364 billion yuan in a single month, a 2.60% increase from the previous month, reaching 20.28 trillion yuan, achieving a breakthrough of the 20 trillion yuan mark, and standing at a new height. This makes private equity play an important role in primary market development [1]. Looking ahead to 2024, China's private equity market will usher in a new phase of regulation and development, and private equity, as a long-term investment, is expected to continue to be dominated by state-owned and industrial capitals [2].

Private equity plays the role of intermediary in the economic market. Private equity does not need to let the enterprise to bear the risk of entrepreneurship, which, the commission agent in the private equity fund plays an important role, for many entrepreneurs, the commission agent relationship compared to a single investor has more advantages, the commission agent as an intermediary for investment and financing, directly determines whether the private equity fund can obtain the income, the risk of the commission agent for the control of the key issues that should be paid attention to the private equity, and for the The solution of these problems is also the defence that every fund manager should master.

This paper takes the research perspective of entrusted agent in private equity investment fund, focuses on analyzing the possible risks in entrusted agent and gives corresponding solutions. The results of this study can broaden the research scope and application field of private equity, and at the same time, the risk analysis of the entrusted agent risk can reduce the business risk of enterprises, so

as to broaden the investment and financing channels of enterprises and better meet the financing needs of enterprises, which is of great practical significance for the long-term development of enterprises in the future.

1.2. Research Content

Literature analysis method. By reviewing the literature and summarizing and analyzing the views of existing scholars, a more comprehensive summary of the problems of principal-agent in the context of private equity, and analyzing a series of problem-solving measures to strengthen the operational efficiency of private equity investment and financing.

Comparative analysis method. Comparative study of the proportion of entrusted agents in private equity transactions to conclude that entrusted agents are an important part of private equity, and solving the problem of entrusted agents can largely help the healthy development of private equity.

2. Concept Definition and Analysis

2.1. Definition of the Concept of Private Equity

Private equity investment refers to investment institutions or individuals investing in unlisted companies in a non-public manner through the establishment of private equity funds [3]. Private equity invests primarily in the primary market, so it has a longer investment cycle and usually targets start-ups with great potential. For companies, private equity not only has the benefit of increasing the capital of the company, but also can bring advanced technology, marketing and other professional skills to the company, with the help of professional knowledge, so that the company can develop better. At the same time, private equity has many shortcomings at the present time. For example, in the process of private equity investment, because there is no cash flow and discount rate to assess the value of the company, it is difficult for investors themselves to estimate the future trend of the company, resulting in the investment rate of private equity will be greatly reduced. Therefore, looking for a professional organization to carry out the entrustment of asset operation has become one of the most important ways when operating private equity.

2.2. Definition of the Concept of Principal-agent

The principal agent relationship is prevalent in the economy and society and refers to an agency relationship that exists due to information asymmetry in economic transactions, where the principal delegates a portion of its rights and entitlements to an agent, who in turn acts on behalf of the principal under certain constraints [4]. In the case of private equity investments, the principal agent is twofold: between the investment fund manager and the investors on the one hand, and between the investment fund manager and the enterprise on the other.

2.2.1 Investors and investment fund managers

The first level of the relationship is characterized by the fact that the investor and the investment fund manager achieve their investment objectives through the spirit of contract, whereby the investor entrusts the management of assets to the investment fund manager based on trust in the investment fund manager. Investment fund managers should fulfil their obligations of good faith, prudence and diligence in accordance with contracts and the law.

Investment fund managers in most cases are asset financial institutions that manage the funds, and these financial institutions usually have a wide network of co-operation with other investors and enterprises, through which the investors can obtain more benefits for the management of the company and gain access to a large amount of resources. However, at the same time, China's existing laws do not provide checks and balances on investment fund managers, resulting in some investment fund managers taking advantage of their poor information to create advantages and violating the legitimate rights and interests of investors through a series of backroom operations.

2.2.2 Investment fund managers and enterprises

The second level of relationship is characterized by the high professionalism of the investment fund manager to effectively help the healthy development of the enterprise, therefore, the professionalism and risk-resistant ability of this kind of manager is required to be higher, and at the same time, it is necessary to have a series of financial knowledge and professional ethics, which can efficiently promote some of the development of the enterprise, so as to enable the enterprise to obtain more economic benefits. Therefore, investment fund managers mainly help enterprises solve the problem of investment, and at the same time obtain stable and sufficient funds [5].

However, in the process of enterprise financing, the security of funds and the stability of financing channels make the enterprise's ability to raise funds insufficient because of the unstable factors outside the market, the inconsistency between the interests of the enterprise and the investment fund manager, and the lesser supervision of the investment fund manager.

2.3. The Relationship Between Principal Agents and Private Equity

In the actual investment process, high returns are often accompanied by high risks, and custodianship also means that investment fund managers are able to provide professional guidance on strategy deployment, operation and management, which improves the competitiveness of enterprises. Data from the China Securities Investment Fund Industry Association shows that in the first quarter of 2022, the number of fund custodian products in China reached 352,600, and the amount of custodianship exceeded 198.66 trillion yuan [6]. It can be seen that proxy is an important part of private equity, and addressing the risks of proxy is an important part of promoting the sound development of private equity.

3. Risk Analysis of Principal-Agent Generation in Private Equity Transactions

3.1. Information Asymmetry Risk Analysis

The core problem of principal agent is the problem of information asymmetry. In microeconomics theory, information asymmetry theory is used to illustrate the impact of the asymmetric distribution of relevant information between the two parties in the incomplete information market on the market transaction behaviour, and the resulting efficiency of the market operation. In the process of private equity transactions, based on the signing of the contract between the principal and the agent, the information asymmetry can be divided into two parts: before the signing of the contract, the information asymmetry is adverse selection, and after the signing of the contract, the information asymmetry is moral hazard.

Prior to the signing of the contract, as investment fund managers possess specialized knowledge, they have a tendency to generate opportunism, and when the interests of both they and the investors are not aligned, the investment fund managers can sign the contract with the investors through concealment and deception, subjectively maximizing their own interests. For example, in the e-commerce market, compared with the traditional market, there are many ways for sellers to obtain information, and the quality of the product itself and the value of the merchant are difficult to be tested by buyers; therefore, many sellers use this information gap to entice buyers before they place orders.

After a contract has been signed, economic agents are likely to act to the detriment of the enterprise and investors in order to maximize their own interests. The moral hazard problem in China's financial reform is a blatant behaviour due to unequal power and responsibility [7]. For example, a person who has insurance on their car may be more careless when driving through life than they were before they bought the insurance, however, insurance companies are unable to monitor the participant comprehensively every minute of every day, so the only way to ensure that behaviour is stable before and after participation is through the moral restraints of the participant themselves.

3.2. Oversight Risk Analysis

The effective implementation of proxy requires supervision, and for investors, the most reliable protection is supervision. Investors expect the public to pay attention to the formation of effective external supervision to protect their legitimate rights and interests, but the current form of investor protection in China is still not optimistic [8]. On the one hand, a positive supervisory role can constrain inefficient investment by firms and thus promote investor protection; on the other hand, excessive supervision can put market pressure on firms and affect the efficiency of both parties. Therefore, how to supervise and the process of supervision need to be measured.

3.3. Market Risk Analysis

The number of private equity and venture capital managers from Q2 2022 to Q2 2023 is shown in Figure 1. The overall weakening of the equity market in the second half of 2023 saw the number of private equity managers fall from 14,000 in Q2 2022 to 13,000 in Q2 2023, with a continued decline each quarter. In Q2 2022, there were 219 newly registered and completed filings of private equity fund managers across the country, and by Q2 2023 there will only be 97 in a single quarter, while there will only be a paltry 11 completed filings of private equity fund managers in Q2 2023.

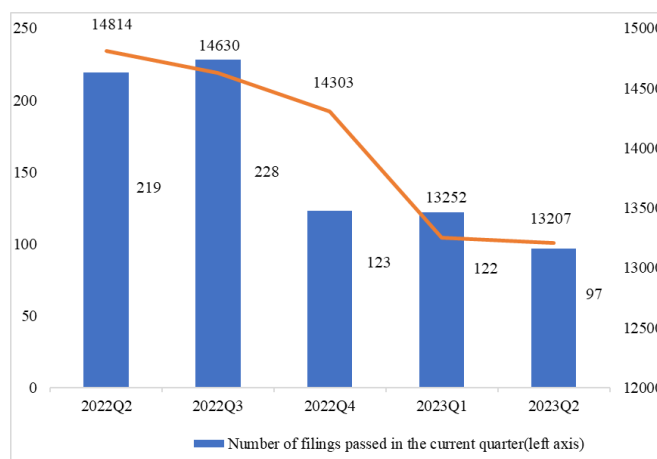


Figure 1. Private Equity Volume and Venture Capital Managers from Q2 2022 to Q2 2023 [9] (Source: China Fund Industry Association)

From the experience of market cycles, in order to resume and continue deal activity, buyers and sellers need to be in a relatively stable economic environment [10]. It can be seen that enterprises that rely on the laws of market development to solve the problem of investment and financing difficulties need to have a favourable external market trading environment.

4. Solutions to Various Risks

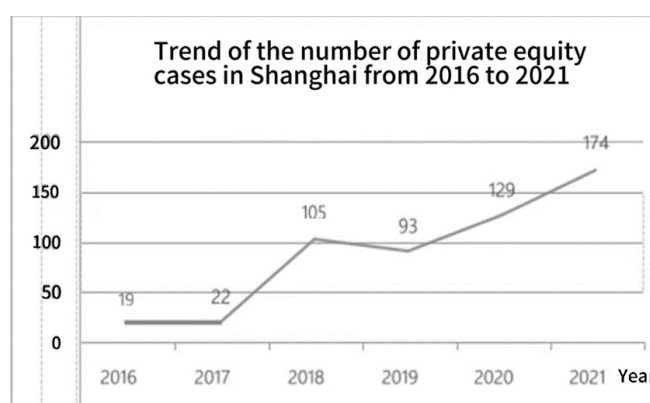


Figure 2. Trend of the number of Private Equity Cases in Shanghai from 2016 to 2021 (data source: China Shanghai Financial Court)

In recent years, the number of cases involving private equity caused by various risks is increasing year by year. Figure 2 shows the number of cases involving private equity funds in Shanghai from 2016 to 2021.

As can be seen from Figure 2, the number of cases of private equity is increasing year by year, and the corresponding risks are also increasing year by year. In order to effectively reduce the risks of private equity investment, the state needs to improve the relevant laws on private equity investment, strengthen supervision, promote the improvement of information disclosure mechanism and optimize the market environment. Experts in Liu Jianjun suggested that the innovation of rule of law has far-reaching significance to the development of the private equity industry. Pay attention to regulatory behavior, carry out differentiated supervision, promote the accurate and effective development of supervision, and strengthen regulatory requirements [11].

4.1. Information Asymmetry Risk

The problem of information asymmetry leads to the information disclosure. With the development of private equity, more and more cases are caused by asymmetric information. Information asymmetry has become a problem worth solving in the management of private equity funds, and it is also one of the issues that investors are most concerned about. This problem can be solved by signing complicated contracts, improving the formulation of laws and sending special personnel to supervise.

4.1.1 Sign a contract

According to Contract Law of the People's Republic of China and Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds, by means of contract, the interests of investors are guaranteed, and the understanding of information disclosure and the fairness of information symmetry are made. Therefore, signing a perfect and effective contract has become an urgent task. In private equity investment, complicated contracts are often signed to stipulate the interests, risks and incentives between investors, fund managers and invested enterprises, which can reduce the problems of information disclosure and information asymmetry. However, the equity of investors' interests in China is still insufficient and needs to be supplemented by relevant laws.

4.1.2 Send someone to supervise

It is also one of the effective ways to send someone to supervise it. Regulation can be divided into two types. The first category is government supervision, and the second category is that investors send people to supervise, so as to ensure that information can be transparent and synchronized and effectively guarantee the interests of investors. First, relying on the authority of government audit and making full use of the "immune system" function of government audit to protect investors' interests; Second, investors can find a fund custodian and introduce them into the governance. The custodian has the obligation to keep the fund and supervise the behavior and decision-making of the fund manager and can ask the fund manager to give a reasonable explanation after violating the contract, so as to ensure that investors can disclose the information in time and synchronously. Therefore, fund managers have become a common choice for investors to solve the problems of information asymmetry and information disclosure.

4.1.3 Legal perfection

Private equity has a lot of risks. In 2021, China issued a special "Administrative Measures for Information Disclosure of Unlisted Public Companies". It plays a vital role in balancing information symmetry and openness. The promulgation of this law reduced investors' worries and balanced the relationship between fund managers and investors. The law is the most effective and authoritative in China. In order to effectively solve the problems of information asymmetry and information disclosure, we should speed up the improvement of the upper-level law system, make the industry self-discipline, administration and judicature work together, effectively solve the risk of information asymmetry, and speed up the development of diversified mediation mechanisms to protect the legitimate rights and interests of investors to the maximum extent.

4.2. Regulatory Risk

4.2.1 Periodical reports

For investors, regular reports are an important source for investors to obtain company information, and also an important indicator for investment decision-making. Regular reports shall include the summary and analysis of the production and operation, financial status, investment development, governance and internal control of the enterprise during the whole reporting period, and adhere to the principles of truthfulness, accuracy and completeness, and shall not contain false records, misleading statements or major omissions.

At the same time, all directors, supervisors and senior management personnel of the enterprise shall be present when the periodic report is disclosed to ensure the authenticity of the periodic report, and the special audit opinions of the Board of Supervisors shall be disclosed in the announcement of the resolution of the Board of supervisors. If the company needs to quote third-party data, it shall ensure that the quoted content is sufficiently reliable, objective and authoritative, and indicate the source.

4.2.2 Third party evaluation

Liu Zuankuang et al. believe that, at the enterprise level, it is necessary to build an information sharing mechanism among enterprises by building a relationship network, so that the three-party information resource sharing can reduce the problem of information asymmetry among enterprises, so that they can invest in cooperation in a state of trust and improve the efficiency of cooperation. [12].

4.3. Market risk

Market risk are unpredictable and unknown. For this unknown difficulty, in order to develop safely and healthily, investors and fund managers need to use many years of capital experience, make a comprehensive analysis of industry insights, relevant professional knowledge facing problems, and cooperate with market research, and give enterprises the most perfect solutions to reduce damage.

For the early enterprises, the enterprise management is in a poor state, which can not guarantee the integration of organizational structure and management system, thus leading to the decline of the development speed of the enterprise, the inability to formulate solutions in time, the low management level, and the inability to effectively supervise and ensure that each employee can complete the work efficiently. Investors with capital experience can help enterprises to develop and give them effective governance programs. Enterprise founders can also collect corresponding policies and current market conditions through the investigation of markets and products, and formulate current development strategies, and promote the development of enterprises and maximize the interests of investors under the temptation of fund managers' incentive mechanism and effective supervision.

5. Conclusion

Principal-agent of private equity is an important role in enterprise financing and plays an important role in finance. Since Premier Li Keqiang put forward "mass entrepreneurship and innovation" in 2014, in response to the national call, China has vigorously developed private equity investment to improve the level of innovation and entrepreneurship, stimulate market vitality, achieve full competition, promote economic development, and become an important force to support the development of the real economy. However, with the continuous expansion of the private equity market, the characteristics of high risk and high return of private equity and the increasing risks year by year, investors need to make a comprehensive analysis by studying the professional ability, moral reputation, entrustment experience and coordination and communication ability of fund managers when choosing the principal-agent to bring a certain degree of safe and healthy operation after the equity investment.

In this paper, many papers, periodicals and related laws about the risks and countermeasures of private equity investment are summarized and sorted out, and relevant data are found and analyzed, and the related risks and current solutions of private equity investment principal-agent are summarized.

In the research process, this paper mainly sorts out the main risk measurement methods we have mastered at present. Due to the limitation of data resources, other market risks are not included in this paper, and there may be some deficiencies in the research scope. In the future, this article will include more market risks and update the data to expand and deepen the content of this article.

Authors Contribution

All the authors contributed equally and their names were listed in alphabetical order.

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