

The PE-Backed Portfolio Company Board

Driving Value through a Contemporary Approach to Governance

Amid one of the greatest and longest market expansions of modern days, the private equity industry has continued to deliver outsized returns. But, these have come with ever-increasing leverage ratios and growing exit multiples. Gone is the “golden age” of private equity, where making money seemed easier and markets were less efficient and less competitive. As the industry has matured and adjusted to this new reality, the best private equity firms are putting more time, energy and resources into generating attractive returns than ever before.

Adding value goes well beyond “buying right” or just cleaning up the balance sheet. Firms today need more operating expertise, proprietary insight and “edge” around industry dynamics and commercial strategies. They can hardly afford missteps on execution given the short timetables to accomplish the increasing number of agenda items required to generate the same kind of historic returns. All of this translates into the need for more talent, and that talent needs more specific skills to help investors win new deals, price them effectively and manage ownership objectives through an exit. Private equity firms have come to address this need in several different ways, but one seemingly universal trend is the increasing use of outside independent advisers and board directors.

A BOARD MODEL FOR A MORE COMPETITIVE LANDSCAPE

While private equity has long been a user of outside advisers and independent board directors, these individuals were more frequently “friends and family” who operated in token positions and/or were cachet names that helped raise the profile of the sponsor. On occasion, such directors were also versatile and hands-on enough to lend expertise into industries of interest.

Now, sophisticated and bespoke portfolio company boards that leverage outside talent to bolster management teams and help drive operating agendas are increasingly the norm.

As noted by Ken Hanau, a managing director at Bain Capital who leads the firm’s industrial and energy vertical in North America: “Doing every part of the business well is more important today than ever because the competition and the capital are getting more and more intense ... we're going to win by an inch, and we don't know which inch will get us over the goal line.”

The following best practices are helping many of the top-performing private equity firms get the most value out of their boards in this mature marketplace:

1 Identify independent directors early

Increasingly, sponsors are tapping potential board directors early in the diligence process. In fact, some sponsors are reaching for potential directors before they even see the first book on a new deal. These individuals serve first as outside advisers, helping assess the specific asset as well as its value-creation opportunity and the competitive landscape within the given industry. It is common for multiple advisers to be deployed as firms move into later phases of the diligence process. The extent of advisers’ activities varies, based on the individual’s availability and capacity as well as the sponsor’s evolving needs during the bidding effort. These activities may include: assessing the strength of the management team, validating the existing business model, developing transformation plans, evaluating key commercial and operational risks, and helping to rationalize the price.

In many instances, advisers will be hands-on in creating specific action plans to drive immediate value post close. Among other things, these plans may involve the consolidation of IT platforms, footprint rationalization and organizational redesigns, and supply chain optimization programs. Throughout the diligence process, both sponsors and advisers alike think ahead to the immediate business needs, and how to ensure the infrastructure will be in place to begin addressing these needs on day one.

“It’s a much more proactive endeavor today,” said Paul Peterson, managing director at Wind Point Partners. “There’s much more thought put in very early into a deal. We like to identify directors early so they have some ability to weigh in on the opportunity, and so we think about the makeup of the board throughout the deal process, from the beginning.”

Richard Carey, partner and co-head of the industrials sector for Permira, recalls a past investment whose success hinged on the ability to build a stronger, more integrated software capability. This need was identified during the diligence phase and drove both the investment thesis and the early search for a software company CEO to serve on the board. Defining the need prior to the close of the deal allowed both parties to align on the agenda early and not lose time later on. The board remained a step ahead at each turn, driving a “transformation of the entire business model over a short period of time” and creating a highly attractive asset that demanded a premium at exit.

As we see in this example, leading investors are leveraging their advisory networks during deal processes to test alignment around strategic thinking and work styles and to get a better sense for those they want to ask to serve as independent board directors post-close. Similarly, the advisers have the opportunity to get a better sense for the culture and values of the sponsor and for the merits of the transaction, enabling them to do their own diligence before accepting a more formal board appointment. While adding additional independent board directors also occurs later in the investment cycle, waiting to find initial directors may cost the deal or valuable time in refining the investment thesis and operating agenda.

Align board expertise to the business needs

In addition to getting ahead of the curve on timing, it is also imperative that independent directors bring a concrete skill set to the table. According to Carey, the private equity model is so well understood at this point that “you shouldn’t need to bring someone onto the board just to teach management what private equity is. Now, it’s about looking for people whose capabilities and experiences line up with what you need to create value in the first place.”

Designing an effective board requires a rigorous review of the skills of the individual directors as well as the capabilities of the board as a whole. These skills can be highly specific and niche or big-picture and strategic — but they are all mission critical.

The potential board needs are virtually limitless. Firms may consider specialized expertise based on a digital/technological strategy, an acquisition or roll-up plan, a massive investment in operational improvement, a large-scale sales force effectiveness project or product innovation and development plans. Most importantly, however, investors rely on independent board directors to push them beyond an internally driven viewpoint and to think about how to leverage investments to truly transform industries. Per Ken Hanau, “Not only do we drive value from the capabilities of our outside advisers, but we also benefit from the network effect of the relationships that these advisers bring.”

At Spencer Stuart, we are seeing this trend manifest in a growing number of functional experts on boards, where previously firms primarily tapped only CEOs. Today, we are seeing an increase in other director profiles, including CFOs and leaders in IT, cybersecurity, marketing, HR/labor and even technical experts.



Even firms that have a long history of building strong outside boards have adjusted. "When we were founded 50 years ago, the model was to use retiring or retired CEOs as part of the diligence and governance process, and that remained pretty consistent for most of those 50 years," said Tom Pryma, a partner with AEA focusing on investments in the value-added industrial products and services sectors. "As we've grown in size and now have more companies looking to potentially go public as part of the exit, we're increasingly looking to add someone who's a former CFO and can fulfill the audit committee chair role. In most cases, we've found that role to be valuable even if that company isn't going public. In an age of accounting, IT and cybersecurity issues, having an expert in these areas has been additive."

Despite the growing specialization, there is still value in reserving one or more board seats for a marquee CEO/business leader with the broader business perspective to help mentor the portfolio company CEO, anticipate changes in the business that others might not see, and add to the overall credibility and quality of the investment.

Another emerging consideration is board diversity, though not to the exclusion of other criteria. It would be a mistake to assume that trends in public company governance aren't occurring in certain private equity circles as well. While the call for diversity on boards is more pronounced in public company environments, a mandate for greater diversity is emerging in private equity, as an increasing number of investors are recognizing the value of diverse boardrooms and the richness of perspectives this diversity brings. Limited partners and executive teams are echoing this sentiment, especially as it relates to gender diversity.

As the number and types of director profiles have increased, firms are looking further afield for director talent than in previous years. "In the past, we would have never done a formal board search where we would have retained a firm like Spencer Stuart. But we're doing that more because we are thinking more about the mix of the board and exactly what directors are bringing to bear," said Brian Hoesterey, president of AEA Investors.

3 Build the right board culture

As private equity boards expand and include a wider variety of perspectives and capabilities, the need for the right board culture has become more critical. Historically, boards composed of a small group of insiders were likely to have a natural camaraderie and style fit, with directors bringing similar perspectives about a business to the table. In this era of bigger and more diversified boards, the best private equity firms welcome a broader set of perspectives, but also want to maintain the pace of decision making and a healthy and productive dynamic. Firms are spending considerable time assessing potential directors on their culture fit and ability to work effectively along three dimensions:

- » The private equity firm
- » The portfolio company management team
- » The board and other directors

Most investors expect their portfolio company board members to spend significant time with them in assessing the company's progress against the value creation plan, evaluating whether changes to the plan are needed and prioritizing activities to achieve targets faster. The most effective board members understand the business, are able to assess the horsepower of the talent relative to the needs of the business and are willing to get involved — without trying to run the business. They have the emotional intelligence to build trust with the CEO while simultaneously serving the interests of the owners, and to work collegially with other directors on value-creating initiatives.

The ability to drill down into the business and play devil's advocate while operating at the right strategic level and maintaining the trust of management and fellow directors is a valuable skill set, one that can be challenging for those who are used to being the boss.

Hoesterey explained: "What we look for is: One, can they operate in a board environment and be critical yet collegial, because you won't be effective as a board member if you can't do that. Two, do they have enough broad business perspective that they can see things at a higher level and draw analogies from other industries or from their past to potentially help management anticipate challenges and opportunities."

Firms employ a number of tactics to evaluate the ability of independent directors to deftly balance these competing requirements. Some look for directors with prior governance experience, or at least experience where they had to serve as an adviser. Most prefer but don't require previous exposure to private equity. Significant referencing can help build an in-depth feel for the individual's style. Some firms consciously assess potential culture fit of advisers during the due diligence period, which provides an opportunity to see the person interact with stakeholders early on and minimizes the risk of a future board appointment. To take assessment to the next level, firms most committed to making sure their boards are operating at peak effectiveness can leverage modern culture assessment and diagnostic tools to select directors who align with the culture they are seeking to build.

4 Adopt more formal board structures

Having the right people around the table is an important step in building an effective board, but a thoughtful onboarding program and good governance processes and structures are also needed. Though not trying to re-create the extensive reporting requirements of public companies, private equity firms recognize the value of establishing board structures to increase accountability and build good governance habits early, especially when a public offering is anticipated.

Good governance in private equity is about striking the right balance between more formal governance approaches and the need to move quickly and focus on value-creating activities.

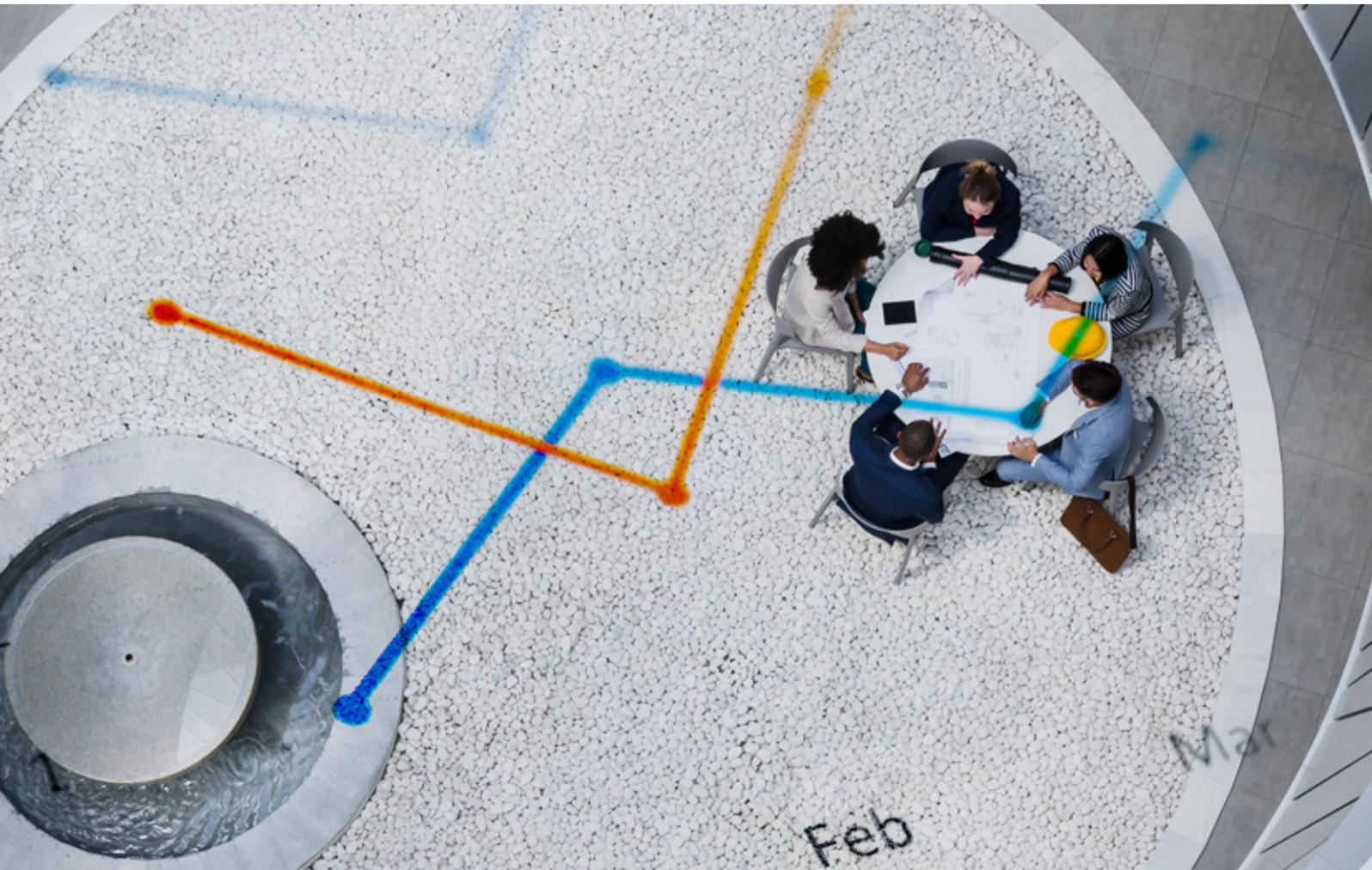
While board sizes vary depending on the private equity firm, as does the number of independent directors, we are seeing a few trends in portfolio company board governance, including:

- » **Board committees, especially audit and compensation committees, often with independent directors as the committee chair.** Some committee structures are more formal than others, especially for larger deals, those with public debt or those in club deals with more than one sponsor represented.
- » **Board leadership.** Some firms regularly appoint a non-executive director as the board chair to serve as a conduit and point person between the board and management. The independent chair can help protect the CEO while conveying the expectations and demands of the owner, preserving the relationship between management and the sponsor. Firms frequently look to the chair to serve as a mentor to the CEO, especially if the company is public and the CEO doesn't have public-company experience, or even in cases where a CEO is new to private equity, new to the sector or simply a first-time CEO.
- » **Executive sessions and board evaluations.** Creating opportunities for the board to have candid conversations about their own performance is an increasingly utilized tactic in helping private equity firms improve board effectiveness.
- » **New director onboarding.** Having a thoughtful onboarding program can help new independent directors integrate by immersing them into the board dynamic and operating culture. A strong onboarding program is frequently a symptom of healthy board processes and structures.
- » **Compensation.** Portfolio company director compensation is generally more focused on equity, giving directors skin in the game and aligning their incentives with those of the shareholders. However, cash compensation has become an increasingly common component of board remuneration, particularly as boards grow in size and become more diverse. In some cases, cash compensation has equaled what public company peer groups offer. However, in such instances, the larger equity upside is also normalized to public company standards. In almost all instances, independent directors have the additional opportunity to invest their own capital into the deal, providing the chance to maximize their return through an otherwise inaccessible vehicle.

CONCLUSION

Serving as an independent director of a portfolio company can be a tough assignment. The best directors understand their role, provide important industry, operating and market insights, and effectively balance their allegiance to the portfolio company and the private equity firm. Finding independent directors with the right expertise and the emotional intelligence not only adds value to the particular investment but can also add value to the firm's broader network.

With the bar rising for portfolio companies, the old board model is no longer sufficient. Today, the most effective firms build highly customized, "working" boards that operate throughout the entirety of the ownership cycle, often starting before a deal is even closed. By building boards that align with the business needs early, evaluating the culture fit of potential directors and establishing board structures that balance good governance with value creation, firms will be best positioned to drive value and get the edge they need in today's highly competitive private equity landscape.



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