Joining the board of a PE-backed company

By Todd Monti

fourth Quarter 2008 49 Heidrick & StruggleS governance letter For independent directors, service on the board of a company backed by a private equity (PE) firm offers exposure to unique professional, and potentially financially rewarding, opportunities. The attractions of such service cited by current and former directors include: • The excitement and intrinsic interest of new business challenges coupled with experience in a realm of intensive value creation. • The prospect that independent directors who serve successfully on one board may be tapped to serve on the boards or as the CEO of other portfolio companies in the future, eventually becoming part of the PE firm’s informal stable of talent. • The greater potential for significant personal wealth creation over time. Beyond the allure of such service, prospective board members who have served only on the boards of publicly traded companies, either as an executive or nonexecutive director, should be aware of the differences they can expect to find at companies where a controlling stake is held by a PE firm. The differences in a number of key areas — as well as the type of contribution independent directors can make there — are examined below. Board Composition Pre-acquisition PE firms look closely at the existing board of the target company and consider which board members they would like to retain. Although it may retain one or two existing directors, the PE firm attempts to populate the board of a new acquisition with the firm’s investment professionals. The specific formula for composition differs, of course, from company to company and PE firm to PE firm, but generally speaking there are often eight to 10 total board members, very few of whom may be independent. Of those, some may already be part of the PE firm’s network. Over time, as some of the investment professionals rotate off the board to other assignments, the proportion of independent directors may increase. It may also increase as the PE firm prepares to take the company public and needs more independent directors in order to increase its attractiveness to investors and to meet the independence requirements mandated for a public company. Nevertheless, the composition of the board is likely to remain overwhelmingly in favor of the PE firm’s employees, and many of the other differences in board service flow from this fundamental fact. Board Dynamics Board composition affects board dynamics. On the boards of publicly traded companies, board dynamics are rooted in the distinction between two groups — executive and nonexecutive directors. Much of the energy on those boards, through such roles as a lead director or a nonexecutive chair and such practices as nonexecutive sessions, is devoted to making those dynamics work successfully. On the boards of PE- Joining the board of a PE-backed company What to expect when a private equity firm taps you to provide oversight to one of its portfolio companies? Here are several important differences in such service and in the contributions you will be expected to make. By todd Monti and Jeffrey Sanders Todd Monti is managing partner of the Global Private Equity and Venture Capital Practice at Heidrick & Struggles. Jeffrey Sanders is a partner in the firm’s Board of Directors Practice. Many directors find it refreshing to spend less time on pedestrian issues of compliance and more time on the business itself. — Todd Monti 50 directors & boards Heidrick & StruggleS governance letter backed companies, there are often at least three distinct groups of directors: the PE firm’s investment professionals, executive directors, and independent directors. Further, the investment professionals work together both inside and outside the boardroom, which to a new independent director can appear to be more monolithic than the group of disparate nonexecutive directors typically found in public companies. However, this disproportion between PE directors and independent directors — far greater than that between execu- tive and nonexecutive directors in public companies — doesn’t necessarily dimin- ish the importance of the independent director. In fact, because the indepen- dent directors are so few, their outsid- er’s perspective can carry a great deal of weight in the boardroom. Further, these independent directors are almost invari- ably the best of the best and PE firms know that they need views beyond the purely financial. Often, too, the independent director can act as a sounding board for the CEO before the CEO takes an issue to the full board. The independent director can be valuable in providing an unbiased third-party perspective. The CEO will some- times seek the advice and counsel of a fellow CEO on the board, welcoming the responses of someone who sees things from a similar perspective. Decision Rights Car r y ing weig ht, howe ver, do es not mean having an equal say on the board. The PE firm ow ns the company, and independent directors do not represent shareholders. At the end of the day, the PE firm is going to make the critical de- cisions, presumably after seeking advice from its directors. Independent directors must be comfortable with this or they are likely to find the experience frustrat- ing. However, most PE firms value the independent directors’ input and will utilize it in important decisions. Compliance Privately held companies are not sub- ject to Sarbanes-Oxley (SOX) compli- ance requirements and other regulations that consume much of the attention of public company directors. However, that doesn’t mean such experience is irrelevant for PE-backed companies. When acquiring a private company and looking for a chair of the audit commit- tee, PE firms will often look for a public company CFO to fill the role. Because the PE firm ultimately seeks an exit, it will begin to bring the company up to SOX standards so that when the time comes the infrastructure for compliance will be in place. An independent direc- tor’s experience with SOX at a public company is extremely valuable during this crucial period of transition for the portfolio company. On the other hand, that experience will be less valuable when the PE firm has taken a public company private. The firm may choose to hold such companies longer than it would an acquired com- pany that was already private, so compli- ance experience is less important imme- diately following the acquisition. Further, the company should have already been in compliance when it was acquired. Oversight In exercising fiduciary obligations, inde- pendent directors of public companies If, as a prospective candidate for director of a PE-backed company, you are comfortable with the general differences between public and private board service, you should then ask some additional questions about the specifics of the situation. Among the most important of those questions are the following: • Why have I, in particular, been asked to join this board? When a PE firm adds outside directors to the board of a portfolio company, it usually has some specific objectives in mind. It might be planning to take the company public very soon and therefore needs outside directors. It might be seeking to fill a competency gap, such as lack of knowledge of a specific geographic market or of the strategic use of a key technology. You should determine what the firm is looking for and consider whether you can provide it. • What is the financial condition of the company? Is the company in good financial shape or are there legacy issues to contend with? Understanding how the company has met targets regionally and by business line is helpful, as is understanding the history of turnover at the executive level. Understanding the company's debt obligations and payment structure can also be helpful. • When will the PE firm seek to monetize the investment? The timing of the PE firm's exit strategy may change in response to unforeseen economic changes, but barring such cir- cumstances the firm's principals should have a good idea about when they intend to get out. An understanding of this time frame can help you determine how long you are likely to serve on the board and how it fits into your other commitments and long-term plans. This is typically discussed with the sponsor prior to joining the board. • How is the company positioned in the market and what are the PE firm's expectations? You should determine if this is a company that has an opportunity to grow organically and/or through acquisition. Also, it is helpful to know if the plans are primarily to maximize cash flow or to balance cash flow optimization and growth. • Can the company meet the PE firm's objectives for the business? It is beneficial to under- stand how the business is performing relative to plan and whether it has increased or decreased in value since the transaction. This can affect management's tenure, the PE firm's feeling about the investment, and the potential wealth creation opportunity that will be available. — Todd Monti and Jeffrey Sanders The upfront understanding fourth Quarter 2008 51 Heidrick & StruggleS governance letter must be well versed in the operations, financials, and strategy of the compa- nies they oversee. As directors, they must analyze P&Ls, sign off on accounting, and evaluate analysis produced by man- agement. Despite such experience, the newly minted independent director of a PE-backed firm may be surprised at the far more detailed analysis that goes on among the directors. During due diligence, the PE firm has scrubbed the financials and fundamentals of the company as thoroughly as possible. It has put everything under the microscope, and has a fine-grained knowledge of most aspects of the company's operations. Further, the members of the board who are employed by the PE firm and have a significant eq- uity stake in the company will usually go into business and financial analysis with much more passion and at a far deeper level than some independent directors of publicly traded companies. Independent directors, lacking that detailed knowledge, may find that they initially have difficulty keeping up with investment professionals on the board on financial matters. Instead of feeling uncomfortable, however, independent directors should regard this situation as an oppor tunity to learn about the company as well as about how PE firms practice their craft. Many directors find it refreshing to be able to spend less time on pedestrian (though, of course, necessary) issues of compliance, as on a public company board, and spend more time on the business itself. At the same time, independent directors can provide insights from a CEO and management perspective and offer practical busi- ness advice that a purely financial focus leaves out of account — which is pre- cisely what the PE firm wants from an independent director. Strategy A portfolio company will have to pur- sue industr y-specific strategies, deal with competitors, and address many of the same kind of strategic issues that public companies face. However, the ul- timate strategic goal of a private equity investment is a lucrative exit, whether it's sooner or later. All other strategic considerations are subservient to that over r iding goal. Independent direc- tors must not only understand industry strategy and the like but also understand it within the framework of the PE firm's exit strategy. Because the st r ateg y can abr uptly change due to economic cycles or chang- es in capital markets, the independent director must also be adaptable. For example, not so long ago it was often the case that PE firms acquired private companies and typically took them public within 24 to 36 months. Today, however, with an economic downturn and great turmoil in capital markets, the path can be far longer. Succession Planning It has often been argued that succession planning is second in importance only to the fiduciary duty of public company directors. Depending on the PE firm's holding period and time to exit, succes- sion planning will var y depending on sponsor and investment thesis. G ood governance cannot by it- self guarantee business success. But it can be argued that the dif- ferences between public company and PE-backed company governance confer some substantial advantages on the lat- ter. With a less diffuse set of sharehold- ers, aligned objectives, freedom from the quarterly earnings grind demanded by public markets, and the ability to reach decisions quickly through the PE firm's involvement on the board, PE-backed companies routinely achieve above-average performance. In some cases, value is identified by looking for companies that have long- term sustainable business models, yet have poor governance; the interests of the owners and management aren’t fully aligned. The PE firm will introduce a governance structure that brings those interests closer together. While the PE- backed structure cannot be imported wholesale into public companies, inde- pendent directors who experience the difference by serving on the boards of PE-backed companies may find some useful lessons for directing governance in the public world toward the creation of value. ■ The authors can be contacted at tmonti@ heidrick.com and jsanders@heidrick.com, or by phone at 312-496-1345. The board will usually go into business and financial analysis with much more passion and at a far deeper level. — Jeffrey Sanders