Getting the return you want: How some very successful PE investors build their boards

This edition examines what you as a private equity investor can consider as approaches to make the boards of your companies work more effectively. It is the result of initial conversations with 12 experienced private equity investors and board members. If you are an experienced board member, you may agree, disagree or have another perspective on the topics discussed. If you share those ideas with me, I will try to share them with others in future editions. If you are less experienced as a board member, you may also have some additional thoughts, and likely will have much to learn from the experts sharing their wisdom.

A successful board is one that contributes well to helping its company reach its goals. For larger investments (e.g., KKR or TPG buying billion-dollar enterprises led by professional management), the board functions more like a public company board; it is thinking about the long-term health of the enterprise as well as achieving short-term goals. For firms making investments in smaller companies, the goal of the board is to achieve the returns estimated in the investment thesis documents, by the means specified therein or by other means.

Boards achieve these goals by making decisions and providing direction to the management team. Specifically, boards typically manage long-term performance (e.g., redefining key strategies to achieve the desired outcome at exit) and examine, adjust and add to the talent in the organization in relation to achieving the desired outcome. Boards typically also handle tradeoffs between competing objectives (e.g., culture and talent), prioritize long- and short-term goals, and oversee short-term performance.

THE CONTEXT AND WHO THE BOARD MEMBERS ARE DETERMINE HOW THE BOARD BEHAVES

How a board carries out its activities can vary. You can think of the process of supporting the CEO and management in establishing the optimal strategy for the business, monitoring the implementation of that strategy, and challenging and supporting management in performing their duties as defined by three factors:

- The context established in the deal within which the board must operate
- The composition of the board, including whether the CEO and chairman roles are held by the same individual or different individuals, and the right mix of skills and backgrounds for different company situations
- How the board members behave with each other, including what they aspire to do, how they communicate with each other, and how their personalities interact.

This edition covers the first two factors and we will take up the third in a subsequent edition.

THE STRUCTURE OF THE BOARD DRIVES THE BEHAVIOR OF THE BOARD

The powers of the board are delineated by the company's bylaws. By carefully writing the bylaws (and the provisions by which they can be changed) key investors can ensure control of the board on the most critical issues. The bylaws limit and influence the behavior of board members.

The way the board works together is driven substantially by the interests of the investors who serve as board members. While board members have a fiduciary duty to the company, there may be conflict on the board that will be hard to resolve within the frame of "what's best for the company" to the degree that board members' interests as shareholders vary. Different funds may be at different periods of their life and may need different things – "somebody needs a home run, somebody needs to put more money into the deal, somebody needs to lower their basis." This conflict can be solved by one investor buying out the others, and smart deal structurers include buyout mechanisms in the original agreements. Lead investors also can try to manage this challenge by making sure all key groups are invested in the same securities. Many PE firms insist that outside board members make a substantial investment of personal funds in the deal, ideally on the same terms and with the same structure as the PE firm.

Some investors try to ensure that management teams have as much of their personal net worth as possible invested in the same security investors do. If they bring in co-investors, they try to ensure co-investors have the same objectives. As one investor stated about a particular case: "We had to recapitalize a company and put the three big investors on the same page. After that recap, our interests were the same, same price, same security, same everything. That made for big cooperative decision making."

The board is often supplemented by other governance mechanisms. For example, it may often be stated as part of the deal negotiations that lead and other investors will get certain information in between board meetings and will meet regularly with and discuss performance directly with the management.

Bylaws, capital structure, and the board and other governance mechanisms are the context in which the board does its work. Getting these elements right is important.

BOARD COMPOSITION OPTIONS

Private equity-owned businesses operate under a range of boardroom structures including combining the chairman and CEO roles and splitting them; with independent directors and without them; with industry specialists and without them. The company's problems and challenges are a big factor in determining who should be part of the board.

Size. The right size for a board is five to seven and no more than eight people who open their mouths at a meeting and vote. Most PE investors think that that's the number of seats to have. This sort of size constraint usually means you have to prioritize because there are more kinds of people you might want on a board than there are spots for them.

Types of potential members. Potential board members include chairman, CEO, other members of the management team, representatives of the major investors, non-executive industry, sector, or functional experts, and outside operating executives. The CEO is always on the board. Almost always there are a few investors, and sometimes one or two additional management team members. Some firms add two industry or functional specialists. Some situations require a board observer seat.

WHO SHOULD BE THE BOARD CHAIRMAN?

The board chairman is a crucial role. The chairman is responsible for leading the board, making sure that agendas have the right information and for driving the meetings. His or her role is to foster open, honest, candid and productive board communications involving all board members. The chairman is responsible for synthesizing board members' perspectives and communicating the synthesized message to management. The chairman sets the tone and regulates the conduct of the board.

Choices for chairman include: the senior deal team leader, the CEO, or a non-executive who is not the lead investor. Under what circumstances should the chairman be the CEO, under what circumstances should it be an investor; under what circumstances should it be someone else?

In one model, ***the investor leading the deal*** serves as the chairman. By separating the roles of CEO and chairman, the board can more readily confront the management of the company with issues the latter would prefer not to raise. A non-executive chairman reduces the opportunities for the company management to obfuscate important issues at the board level and increases the likelihood that the CEO will perform satisfactorily.

Some PE firms almost always make ***the CEO*** the chairman. "We find it empowering to good CEOs to also be the Chair of the board, and we console ourselves that we usually have enough shareholder control and enough bylaw protection. It's a big velvet hammer." One situation where this can work is when almost all the value is created in doing the deal rather than in managing afterward. It's desirable because it lets the CEO be empowered and it has very little downside. This can be the case when the main value of the acquisition is cheap assets that the PE firm believes they can sell for much more in the near future when they expect market conditions will have changed. The opportunities for these kinds of deals have decreased for PE over time because there are now lower-cost investment vehicles to use on asset-based plays. Another situation where making the CEO chairman makes sense is when you have a strong desire to do the deal and the incumbent CEO can control whether the deal happens and also has a strong desire to be the chairman.

A third possibility for chairman is an ***independent non-executive director***. An independent non-executive chairman can provide strong leadership not biased by a leaning to either investors or management. Independent non-executive chairmen have the particular ability to be arbiters, and to combine aggressive leadership and independence from investors and the management. One independent non-executive chairman characterized his role as follows:

> I talk to the board a lot, I don't just take what the board says and run with that to the CEO, I will challenge them ... I will say, "I don't quite understand that, give me a little reasoning here why this is more important than not" and they know I am going to say "so what" so they really have to put together their thought process better. I will ask them if we have unanimity. When I have a discussion with (the CEO), I share it back with the board. I am very close to the pulse of the board. ... I understand what their feelings and concerns are which makes it easier to go to the CEO and say, "Here's what we on the board are seeing." ... If he says, "I get it, I understand their concerns, let's talk about it," we have a call. The CEO may say, "I know that this is an issue, let's not have this as a recorded board meeting but let's discuss it." This open communication is the glue of an effective team. As a result, we are not fighting these wars in a back room.

An independent non-executive chairman may be particularly useful when there is a substantial risk that the CEO may need to be replaced. Then the chairman can also become the CEO if taking on the CEO role is temporary. If the CEO needs to be replaced, an outside director can step into an interim CEO role. "You're lucky to have one outside director who can be independent and break a tie. A non-executive chairman of the board who is really engaged is a good way to warm a guy up in the bull pen." Otherwise it may be difficult to find someone quickly to be CEO. "It's hard for a really good guy to come on and take a job unless he knows he's going to be successful."

WHO ELSE MIGHT BE ON THE BOARD, WHAT ROLE THEY MAY PLAY AND WHAT ARE THE PROS AND CONS OF HAVING THEM ON A BOARD, OR CIRCUMSTANCES WHERE THEY ARE REALLY IMPORTANT?

More people from the private equity firm or other investors. Typically, there are at least one other besides chairman (or two if CEO is chairman). You may have to add even more as part of arrangement with other investors.

Junior PE professionals. You may have two or three relatively junior professionals from your firm on the board who will run the numbers and make sure that short term targets are being met. The benefit of their being on the board is their development. Senior professionals need to leverage their time by giving some of the grunt work to junior professionals. The cost is that they take up a seat that could be used by someone who could add more value. An alternative to having them take a board seat is to have them work closely with the company's CFO and attend but not vote at the board.

Other company officers. Some firms automatically populate the board with both the CEO and the CFO. Having the CFO on the board can be a good idea if you have the seat available and the CFO can provide useful insight and perspective from inside the company. On the other hand, CFOs often have limited ability to see the forest for the trees. If you don't put the CFO on the board, you can have the CFO (or other officers) attend particular board meetings in order to inform directors and answer questions. Company officers can be used as a sounding board for determining the ease of implementing a planned course of action. Because the discussions are different when officers are present, boards need to have both types of sessions to make sure sensitive issues get aired (and they are limited in their ability to do that when the CFO is also on the board).

One sensitive issue when other officers are on the board is the CEO's compensation. If there are other officers on the board, the board can meet in executive session with management team members excused to discuss and decide, or if there is a compensation committee, to hear and consider its report.

Outside directors. Outside directors may be operating executives who are functional experts or industry insiders. Outside directors can add value in strategy discussions and can win the trust of the CEO. This person can play an important role in supporting the CEO and fostering a more cooperative dynamic on the board, especially if the CEO has a voice in putting the person on the board, A CEO may be less concerned about a hidden agenda and more readily buy into an idea suggested by an outside director. Outside directors can sometimes bring credibility other board members may lack; an outside director who has been a successful CEO in a business can be more effective in a board role than someone who hasn't had to run a balance sheet.

Outside directors are not viewed consistently as helpful because they typically are not deeply involved with the business as other board members are. Investors are often involved on a weekly, not a quarterly, basis and are performing the role of the board along the way, outside of formal board meetings. If you have a formal board meeting with an outside board member in the meeting, and with two people from your firm who are deeply involved with facets of the business, "you are either dumbing down the meeting for the new person or the meeting is over the head of the outsider."

Investors can recruit industry talent to the CEO and CFO roles. Investors can also bring their networks aggressively to bear in building a working board. For example, an investor in a frozen sweet goods business recruited his former boss, a CFO of a large baked goods business, to the frozen sweet goods company board, and this board member oversaw the installing of needed IT systems at the frozen sweet goods company. This investor also recruited to the frozen sweet goods company board another person out of food service with end user relationships (e.g., Starbucks) who oversaw rebuilding the frozen sweet good's company's food service organization.

On the other hand, many investors view bringing in functional expert to compensate for a weakness of the CEO as having dubious value. "They don't make great members because only 20% of the meeting is dealing with that." You can get the benefit of the expert's perspective and value without putting them on the board by hiring them as advisors.

In almost any deal, some outside independent perspective is very valuable. Many firms get this perspective by putting two or three fully independent directors on the board of every company, to create highly customized boards that align with the investment management plan. In these models, the early board activities are "business building" – first, focusing board members to use their expertise on systems and processes the business really needs, and second, to install systems and processes that the board really needs, such as the board packs and helping management get the financial data that they want. For example, the business may not have collected the right kind of data for balance sheet management. The board's subsequent conversations shift to strategic development and growth. Here, "conversations become quite rich where we're batting around strategic topics around how to improve the value of the business."

Other firms get this outside perspective without having independent board members by using outsiders as advisors or consultants. You would particularly want to have independent outside board members when having independent directors is a differentiator in terms of businesses that are willing to partner with you. An independent director might be important if it adds to the value creation and you think the CEO will respond more readily to a board member's suggestions than to an advisor or consultant.

Operating partners. Putting operating partners of the investment firm on the board requires care. Because they are operators, some operating partner directors may seem to the CEO to want to run the company themselves. They can undermine the confidence of CEOs. "Operating partners have a skillset and have insight into what the CEO is doing but may want to run things and make the CEO fearful." Operating partners with domineering personalities can develop a reputation for being unpleasant to work with and alienate potential deals. A good operating partner needs to have more than operating skills; they need to understand their role and how they are going to interact with the company's management.

Former owners/ founders. When private equity buys businesses from founders, founders often stay involved but the private equity investors take control and usually propose changes. "There is some dissonance through redirecting how the company functions and where it is going. You deal with the sacred cows and there's a lot of trauma." It is challenging to have founders with board seats but who are no longer running the business. "They can be bitter and disruptive or sit in the corner silent and change the whole tone of the meeting." Former owners/ founders can be hard to deal with in those circumstances, because they probably don't want to not attend or to resign. If you promise a board seat to founders who were leading the day-to-day business, they may say they have a legal right to be on the board. To minimize the disruptive effects of a founder, some firms resort to having only one official board meeting a year. Others give the founder or founders another role but not a seat on the board. "To the degree that is possible, we don't have the founders on the board unless we feel really good about them."

When there is a grumpy founder or concerned management team, a PE firm can give sellers the option of appointing an independent board member from a list the PE firm provides. "There are entrepreneurs who have a tough time going from an environment where they are in control to one that there's not in control. Having them appoint an independent board member has worked pretty well. It's certainly better than having them on the board directly."

Generally, firms prefer not to have founders on the post-acquisition board but sometimes they have to agree to a board seat for them as a condition in buying the business.

Observers. Some situations involve board observers. This arrangement may give the investors the benefit of the observer's insight into a company that operates in "a business line in which the investor is currently active or in which it is seeking to expand" without giving the observer fiduciary duties. The arrangement may promote a relationship with a potential strategic partner. To avoid the observer's gaining undue influence or access to privileged information, the arrangement needs to be documented carefully. The American Bar Association (ABA) recommends that the board observer agreement "expressly provide that the observer has no right to vote on matters brought before the board (or any committee), and that the observer's presence will not be necessary to establish a quorum at any meeting." The ABA adds that the board observer agreement "should not grant the observer any veto rights over corporate matters." Even if the observer cannot vote on corporate matters, the board may occasionally seek the observer's input.

Getting the context right and getting the composition right sets the stage for a very effective board but the board still needs to act in the right ways, which will be the subject of the next edition.