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Corporate Governance in Private Equity Companies: Can it add value?

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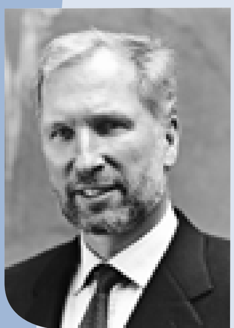

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Private equity investment companies are now being confronted with the results of their success (10% -15% of the total stock market capitalization in recent years): ever more capital is chasing increasingly fewer suitable target companies. This not only requires a change in the way private equity companies (PECs) screen, select and access potential investments, but also challenges the traditional way in which PECs, in the phase between acquisition and exit, work with their respective partner companies. A new paradigm is emerging: Working with the partner companies is becoming increasingly important. PECs need to be close to their investments for control reasons, to provide a variety of resources since capital alone is not enough, and, finally, to be a true sparring partner in order to optimize the strategizing process.

One promising area is corporate governance (CG) to which most private equity companies have paid barely any attention so far. Many believe that it is sufficient to meet the legal requirements regarding corporate governance and they do not see the potential value added that superior corporate governance can offer. Most PECs pursue active ownership, but only few have defined the principles of CG. To detect this value, however, one first has to understand the fundamental differences between the private equity and stock-market-quoted companies, which dwarfs the legal differences that exist between these entities across Europe. In the second part we specifically look at the role that the board can play in private equity investments.

Understanding the differences

The dominant CG paradigm for stock-quoted companies is the "principle agent problem". The principal (investor) cannot control the agent (management) fully due to an asymmetry in information. Basically this means that management has more comprehensive and up to date information about the business than the outside investor and has obtained this information more conveniently, i.e. at a lower transaction cost. Whereas management receives information in the course of their daily work, investors have to spend extra time and money. CG aims to align the investors and management's interests (e.g., via stock options) as well as supervising the management at minimal transaction cost in the shareholders' interest.

There are three basic flaws in this "principal agent theory":

1. It is too pessimistic about human behavior (e.g., money is the dominant motivation, all management will deceive investors if they can).

2. It assumes that currently there is no imbalance of power between investors and management, but equal contractual relations. However, empirical evidence indicates[1] that in complex organizations, power shifts to the executive side (which is conveyed by the many flawed stock option plans that favor management despite poor performance).

3. There is an implicit assumption that investors will not withdraw their investments if associated transaction costs are low. Although the very notion

1 Steger, U. (2004): Mastering Global Corporate Governance, Wiley, p. 45.

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of the stock market is to make assets liquid by establishing permanent market prices and bringing buyers and sellers together, no individual shareholder is driven to "voice" his/her concern in companies with 10,000, or even a million, shareholders and become engaged in, e.g., improved CG. She/he would have to shoulder the cost, the results are uncertain, and any improvement will benefit everyone else who did not become engaged ("free-rider problem"). Therefore the incentive is to simply "exit" the investment in case of dissatisfaction. This loss of "responsible ownership" is the core of the corporate governance crisis in widely held public companies.

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If substitutes - e.g., institutional investors - step in to assume the ownership role in stock-market-quoted companies, another set of principal agent issues arises. As the recent prosecutions and settlements in respect of the (pension) fund industry indicate, fund managers and individual shareholders' interests are not synchronized. In addition, funds would shy away from any involvement that limits their ability to trade stocks; they do not want to be regarded as an "insider". This is why they have been pushing for structural CG reforms that would provide features that could be observed from the outside (e.g., the number of independent directors, committees etc.). The bad news is that there is no empirical evidence that such structural features in CG improve company performance at all.

Due to this "outsider perspective", which is necessary for the permanent liquidity of the asset, one can conclude that PECs cannot learn much from the current CG debate on stock-market-quoted companies, because their CG issues are completely different.

Contrary to "outside" investors in stock markets, the PECs are "insiders" in the companies in which they invest. One can argue that this "insider" position is the compensation for forgoing liquidity and for investments that are "locked in" the target company for 3-7 years. In addition, the companies in which PECs invest are an unfavorable choice: if they were not experiencing problems (poor performance, succession issues etc.), why would they be sold?

And from the PECs' side: if the value added does not indicate a turnaround, a strategic renewal opportunity, or accelerate new growth opportunities, where is the value added to be found relative to other financial tools (e.g. a bank loan)? In any case, as a dedicated partner that contributes to a development strategy's implementation and to the enhancement of the competitiveness of the companies in which they invest, PECs have ownership with an insider status. This creates specific corporate governance dilemmas,[2] which differ from those of public companies, but need to be made transparent and managed.

However, the insider status also solves some CG issues. As a more or less majority owner, there is no "free rider" problem. Clearly the information asymmetry is – due to the involvement – lower (simultaneously, making the "principal agent problem" less relevant). The transaction costs of the involvement are "part of the package", and need to be overcompensated by the value added of their involvement (if not, then the PECs have a different problem).

Corporate Governance Issues in Private Equity

The list of potential CG issues to be managed in PECs are as follows:

- The PECs represent a strong shareholder and they may undermine the board.
- The PECs' involvement can blur the clear responsibility and accountability of the owners, boards and management (especially, if the legal requirements of the boards are described in more in detail and members are personally liable). Hence, there is need for clarification.
- If there are minority shareholders, the shareholder agreement might not have foreseen all potential sources of conflicts. The mechanism for aligning interests might therefore be insufficient.
- Within the specific PEC framework, the "usual" governance issues need to be solved: the need to have a board that adds value beyond compliance, continuously high performance, and management of dynamics over time.

2 Dilemmas occur frequently in management. They are defined as situations in which not all goals can be completely met with the given resources and in a given time. Therefore priorities have to be set, but completely neglecting other goals might be counterproductive. However, dilemmas cannot be solved, but need to be managed.

A board's function in a private equity framework

One thing is clear: there is more complexity in the "triangle" shown in the relation between the PEC, board and management than in the "usual" hierarchical relation between the board (as representatives of shareholders) and management (see Figure 1). Simultaneously, reducing this complexity by staffing boards with the PECs' full-time employees leads to other disadvantages:

- If a company were to have a diverse portfolio of investments across industries, which occurs frequently, it would be very expensive to employ widely experienced board bembers with industry knowledge.
- PEC representatives may quite often only have financial expertise and have no need or opportunity to develop qualifications to serve on boards.
- PECs with a larger number of investments tend to have more opportunities for learning than others.
- PECs' specific role in M&A and exit can lead to conflicts of interest if a partner company's board is dominated by the PECs' employees.

Given this special profile demanded from board members, organizing an appropriate pool of candidates for board assignment remains challenging. At the same time, ensuring the board's performance in the "triangle" can be a PEC's true value-added service. PECs are always obliged to capture learning, so that their overall investment decision and interaction patterns in top PECs' four major disciplines improve over time: Defining the investment case measuring the essential – not everything, improving the portfolio company's balance sheet considerably, and making the shareholder the crux of activities, i.e. ensuring value acceleration through joint efforts for the active shareholder.[3]

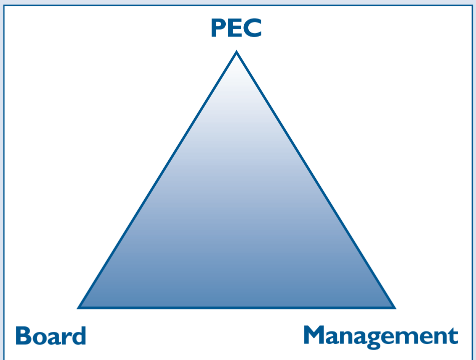

Figure 1 - CG triangle at PECs

With the ultimate withdrawal decision in mind, three tasks crystallize for boards:

- Monitor and assess the (financial) performance as well as the business's conduct, based on a business case rather than on very short-term measures,
- Recruit (e.g. from a proactively organized pool of experts), remunerate and release the top team, and
- Add value to corporate development through input and feedback to the strategy and its implementation, the organizational design to support the strategy and other key issues (e.g., acquisitions, and de-investment) as they emerge.

These are no trivial tasks and the details of the circumstances are important to find an optimal division of labor, which should be transparent to all involved.

The crucial Board-Management relationship

If the "checks and balances" principle is applied, and the board is separated from the management, the question of the division of labor (and power) arises as one of the key question with respect to CG. Please note that this question too is not concerned with the board's legal composition: in practice a one-tier board with an "independent" chairman and a large majority of outside directors functions exactly the same way as the two-tier board with its separation of the supervisory and management boards in relation to the CEO/top management. The sensitivity is obvious: every tremor at the top can trigger an earthquake within the organization.

First, the relationship is often guided by the "CEO life cycle". New top management

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3 Cf. Rogers, P., Holland, T. and D. Haas (2002). Value acceleration: lessons from private-equity masters. Harvard Business Review, Vol. 80 (6), pp. 94-101.

"If everyone involved understands the complexity of the "triangle" and cooperates to find a workable solution, it is possible for great corporate governance to work."

is intensively scrutinized, but if it has a positive track record, the board often takes a less assertive position, although it should be more assertive before the CEO dominance becomes counterproductive, which normally occurs after 10 years. This pattern might be less relevant for PECs as they should sell earlier.

Secondly, the different responsibilities should be clearly defined, e.g. in a "code of governance", the content of which would very much depend on the type of board the PECs as the responsible owner expect.

Thirdly, the board should clearly define its information needs and the delivery process. Much time is wasted and communication required because management has no idea of what the board really wants and the board does not take the trouble to define what it thinks is needed for its work.

And, fourthly, there should be some rules in respect of "emergency situations" so that, e.g., the chairman of the board and the chairman of the responsible committee could make or approve decisions if a dramatically urgent situation were to occur and only inform the full board later.

As difficult as it may seem, our experience has proved that if everyone involved understands the complexity of the "triangle" and cooperates to find a workable solution to which everyone adds the best value in respect of their specific competencies, it is possible for great corporate governance to work.

The benefits of superior CG are clear:

- A better thought through and workable strategy,
- Better coaching and professional support of management,
- Quicker adjustments to new situations, emerging risks and opportunity, and
- Greater transparency about management performance, which is not only important for replacing non-performers, but also rewarding high performers adequately.

This is the bottom line that investors expect.

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