Private equity governance

BoardRoom editor Kate Geenty takes a look at how private equity investors approach governance, and what they look for in board composition.

First and foremost, private equity investors look to build value in companies they invest in, says Institute of Directors (IoD) Chartered Member Peter Tinholt, the Chief Operating Officer of Oriens Capital Fund. "It's about creating good strong businesses, that are much stronger and sustainable than they were when we came in," he says.

He says poor governance leads to poor performance and poor returns, so getting the board right is important. "Good governance can enhance a company's reputation and credibility. Companies that have good governance and transparency are more marketable."

BOARD COMPOSITION

IoD Member Mark Vivian, a partner at venture capital firm Movac, says ideally he likes companies he invests in to already have some sort of governance structure in place. That might be just the firm's lawyer or accountant acting as its board, but it's a start. "Often it will be a smaller, more casual board, and we look to develop that into a truly professional board, where members are remunerated, there's a recruitment process that goes on to identify and attract those board members, and a full analysis is done of skills and experience that's needed around the board table."

Movac, which invests in businesses with some sort of technological aspect to what they are doing, typically takes one board seat when it invests in a business. In the space in which Movac works, Vivian says an ideal board size is between three to five members. "It would be us, and two to four others, depending on the size and complexity of the business. The entrepreneur may or may not be on the board as a director, they normally are."

He says Movac is pretty upfront in the initial conversations it has with potential partners about what it expects in return for its investment. "A board position is part of that. We will also have some say in what we think the board should look like. It's about what we think is in the best interests of the company. We need to know there's a good mix of skills and experience around the board table. Ideally we don't want a whole board full of investors."

When it comes to skills, Vivian says industry experience is important, but not critical. What he looks for in an independent director is the ability to make decisions quickly, be able to deal with a dynamic environment where things can change from week to week, and be willing to step up and help when times are difficult. "We've seen a number of experienced and well-known directors step away from the board table and essentially go missing when things get tough."

He likes a 'noses in, hands out' approach to governance. "What I mean by that is, you've still got a chief executive running the company but the directors really do need to know what's going on. They all need to be compelled to find out what's going on and understand the different complexities rather than rely on others around the table to do that."

Personality also plays a part in who will make a good fit as an independent director. "In any of these journeys there will be ups and downs along the way, so we need to know that the others around the board table are people we can build strong robust working relationships with, and that ideally those relationships will ride the good times and the bad times," Vivian says.

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>
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Oriens Capital Fund, which invests mainly in privately owned businesses that are regionally aligned, also requires at least one board position when it invests in a business, but depending on the scale of its investment that can sometimes rise to two. "The first director, typically, is one of us. If we get a second one, then who fills that position will really depend on the skills needs around the board," says Tinholt. "Accordingly, we certainly like to have a skills review done, and a gap assessment made to make sure that we get good people on there to drive the business forward."

He says the discussions about board composition can start early on in the negotiation process. "Typically in heads of agreement negotiations, when you're shaping a deal you talk about that. Some of those things can sometimes get a bit contentious, but the key is that it's part of a due diligence process."

"You've also got to be a bit careful, because if there's an existing board, that board will ultimately decide on the investment opportunity. So you've got to navigate your way through that."

In terms of how much say a private equity investor has in board composition, a lot depends on how big a stake they are looking for. "A private equity owner coming in and buying 70 per cent is very different from someone looking to invest 20 per cent," Tinholt says.

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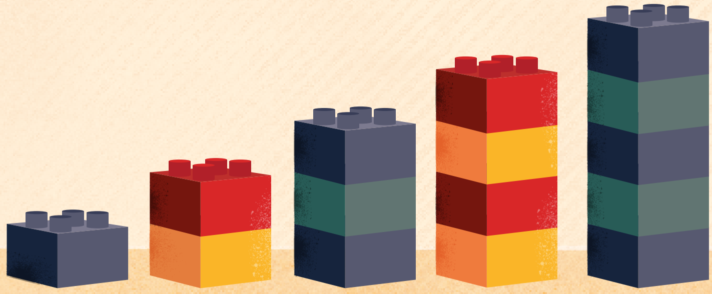

Private equity strategy

1. Focus – clear agreement with management about what is important.
2. Decisiveness – a preparedness to act.
3. Results orientation – a drive for strong returns – time bound.
4. Engagement – robust regular communication within the board and the executive team.

Source: Oriens Capital

Peter Tinholt

INDEPENDENT CHAIRS

Rather than take the helm themselves, private equity investors generally prefer to see independent chairs on the boards they are involved in. "We don't want to be an adjudicator, we'd much rather have a mediator who makes sure we navigate a path that's acceptable and gets buy-in from all other parties. That takes a lot of skill, and a good chair who can manage that has to be someone with experience," says Tinholt.

"An independent chair is really important," says Vivian. "As part of that, we want someone who has a strong professional relationship with the CEO, or the potential to grow one. We do plenty of reference checking of potential chairs of organisations, their skills and experience, their strengths and weaknesses, what they are like as mentors and guides, particularly when things get tough – and they will get tough at different points in the company's journey."

RELATIONSHIP WITH FOUNDERS

Vivian says the founder or owner of any business they look at is one of the critical components Movac considers when evaluating an investment opportunity. "People are probably the key factor in our decision making, the founder – what's his or her background, what have they done before, what have they achieved in the past?"

He says that, when going into a business, it's important to respect what the founder has done. "The founders and entrepreneurs who run these companies are often absolute experts in what they do."

"A lot of their financial worth and their personal and professional profiles are built up in these businesses. Getting private equity in will be a major transition, going from owning the business to having a share in the business, and that can be an emotional rollercoaster for them."

"When it's your own company you can do what you like. When there are external investors that's when things get more complicated. So, yes, the idea of getting external investors sounds really attractive but obviously other factors go along with that. All of a sudden the business owner is required to have a board, some sort of governance structure, and the additional workload that comes with that."

For some owners, what initially sounds like an attractive proposition loses its appeal once they consider the realities of other people having a say in their business. "We've walked away from opportunities and, vice-versa, entrepreneurs have walked away from us. They liked the principle of external capital but didn't like the practicalities of it," Vivian says.

Tinholt has experience as a chief executive and managing director of companies that have been owned by private equity companies, so he has also sat on the other side of the deal. He says it's critical to figure out a way of working together that works for all parties. "Sometimes you see businesses where the chief executive has really delegated and empowered their teams very well, but then others are very autocratic and 'it's my way or the highway'. We certainly spend a lot of time making sure that we can actually work with the owner–founder to make sure there's good alignment there."

EXECUTIVES AND INCENTIVES

When working with smaller companies it's important to have everyone on board with its direction and strategy – particularly if things are changing. For this reason, private equity investors generally like to see the executive team on the share register. "With everyone having skin in the game, there is a sense that we are all working on this together," says Tinholt.

Vivian also thinks incentivising executives helps align everyone's interests. "Often, depending on the size of the company, employees won't be getting true market rate, or what they think the market rate might be. Having equity or options on offer to executives is a way to top them up in a non-cash way. At the end of the day, it's all about having people aligned in a common goal, and that's about building value in the company."

STRATEGIES, GROWTH AND SUCCESSION

Private equity board members typically want to make sure the organisation has a good, executable plan and a timeline. "It's often quite focused, because we're about value creation. Whereas sometimes the companies we're working with haven't had the same focus and systems," says Tinholt.

He likes the use of board tools, which can capture all of the policy documents, format the board papers, and can keep everything well-organised and easily accessible by all directors.

Vivian says private equity can be one way of solving succession planning issues in the New Zealand SME market. He says a lot of business owners seem to expect their children or management team to eventually take the reins. "What we've started to see is, if the next generation or the management team don't want to take over, what happens to the business? Unless there's another option, these are businesses that will literally die with their owner, and that's a real challenge."

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