***Why Private Equity Firms Create Portfolio Company Boards. . . Voluntarily.***

***By Mike Lorelli***

Public companies have little choice. Private companies have little obligation. But they typically arrive at the same result. A carefully selected, working Board of Directors, with regular meeting cadence, agendas, committees and all the same trappings. Surprisingly to some, this is not a case where *“Your actual mileage may vary.”* The similarities are many.

First, a couple of current statistics to calibrate the relative size of the two buckets. According to a Wall Street Journal Op-ed piece on November 17th, 2017, there are only 3,671 public companies ($500m+ revenues) in the US today, after all the M&A over the decades, half the number as in 1996. In contrast, private equity has quietly exploded, with an estimated 17,103 portfolio companies today (data from Private Equity Info) . . . and the vast majority of these have Boards. But why? Private equity isn’t exactly known for a shortage of IQ or lack of scrutiny of every G&A dollar.

**Why The Private Equity Portfolio Company ‘Hold Period’ Matters**

Public companies theoretically can go on forever. . . with no ‘deadline’ date, unless you suffer the fate of Kodak. Hopefully each successful CEO era will be thoughtfully and strategically replaced by another successful CEO taking the firm through the next ‘McKinsey S curve’ of growth. In contrast, the average private equity firm owns a portfolio company for 5.6 years which creates a different set of dynamics. The agenda kicks off with a comprehensive ‘100 Day Plan’ to get a lightening start on the new Strategic Plan, and wring any excessive spending out of the equation from the very first second of the Hold Period.

Keep in mind, private equity is driven by 3 measures:

* IRR
* Cash-on-Cash Return
* Hold Period (less is more)

Two of these three measures are time driven, and hence the incredible immediacy to everything. ‘Tomorrow’ really means ‘this afternoon.’ ‘Next year’ means ‘next week.’ Riverside’s COO and Vice Chair Strategic Initiatives Pam Hendrickson states “Putting a Board in place and doing a GAAP audit are essential parts of their 100 Day Plan.” A meaningful calibration from Riverside’s 13 year veteran, and overseer of their 81 company portfolio. Hendrickson further adds “*There’s no time to mess around in this high multiple environment. You really need the growth plan pretty quickly. A good Board will help you formulate, as well as identify pitfalls.”*



***“Putting a Board in place is an essential part of the 100 Day Plan.”***

Riverside Company’s COO, Pam Hendrickson

**What’s In It For The Private Equity Firm**

According to Kendra Jalbert, Vice President Operations at Private Equity Info, *“If the p.e.’s goal is to spin it back out, they can’t run everything. They can’t be the whole Board.”* Allan Grafman, a former Operating Partner at Mercury Capital, states rather matter of fact that *“When you’re working with other peoples’ money (the Limited Partners) you can’t run it like a proprietorship. No one person has the answers. With a good Board, we get to the destination faster, and usually with a smarter answer, with more of the right people rowing. I’ve never seen a portfolio company without one.”*

*“Various entities are formed to limit liability. A properly structured and run Board can add to the shield,” says Capital Partners’ Managing Director Rob Tucker.* Tucker adds *“A Board takes an interest on behalf of investors, lenders, and employees while others aren’t watching, caring about the interests of those who aren’t always there.”* Riverside’s Pam Hendrickson adds *“I can’t think of a time when we didn’t put a Board in place. Even our Strategic Capital Fund, where we take minority interests, insists on a Board where we will have one person. Governance is so much of our focus. If proper Governance is in place, everything else will follow.”*

Rob Tucker gets right to the point on the value of a Board upon exit of the portfolio company, *“Every p.e. obviously discounts the Management projections by some number, based on the perceived quality of Management and other factors. To the extent that there are tight practices, audits, KPI’s, rigorous reporting, all decrease the discount. Lack of a Board would result in a larger discount. Existence of a Board with minutes signals a higher level of professionalism.”* Riverside’s Hendrickson believes *“Valuations are definitely more Art than Science. A seller doesn’t want lack of a Board to be one more thing the buyer believes he will have to fix. And on Riverside’s exit, one reason we get paid well is we’ve done these things right.”*

Riverside’s Pam Hendrickson believes very religiously *“The value Boards bring to little companies is enormous. Good Outside Directors will often see things the CEO misses. And will ask provocative questions ‘Have you ever thought about … and highlight potential pitfalls calling upon their own experiences.”*



***“Lack of a Board would result in a larger (Exit) discount.”***

Rob Tucker, Capital Partners

An informal survey of Managing Directors and Operating Partners suggests the number of portfolio companies with Boards is probably around 85% to 90%. One Fund Manager adds anonymously *“Operating Partners with Investment Banking backgrounds make crappy operators. You need Outside Directors who have been-there-done-that.”* Other Managing Directors weigh in. David Gold, presently CEO of Dyno Holdings LLC, and a former Operating Partner at both Riverside Company, and Bunker Hill Capital sees many strong attractions for the Board creation. His experience includes both, as he describes it, a more structured approach, as well as a smaller private equity sponsor where the approach is more ad hoc. *“In both cases, the model is the same. One Outside Director with industry expertise, the second (of 2) Outside Director with deep functional expertise in the area crucial to the portfolio company.”* David further describes the success formula:

* Serial Board members are a plus. They know how to zero in on the leverage points, and participate efficiently, and lend a hand to the CXO’s where appropriate
* Lay out the 12 month rolling Board meeting calendar in advance, complete with Committee meetings
* Supplement the engagement with a monthly financial call, so the Board is always up to speed, and engaged. Dispenses with length financial reviews at the Board meetings. Keep the Financial Review in the Board meeting to 30 minutes, given the monthly financial call backdrop
* Board agenda needs to strike the right balance of Strategy and Tactics. But have a meaty strategic agenda to fully utilize the Outside Directors
* Book must be out a full week in advance
* CEO should be reaching out informally to the Board between meetings. And using them to lend a helping hand to some of the B Players where they can help get them there faster. The Team is rarely all A Players



***“Serial Board members are a plus. They know how to zero in.”***

David Gold, former Operating Partner Bunker Hill Capital, and Riverside Company

Rob Tucker, Managing Partner at Capital Partners again weighs in: *“For larger private equity firms, virtually all companies will have Boards. Only small, and perhaps fundless sponsors, might not have a formal Board.”* Tucker also believes in smaller Board size *“Typically 5 or 7, always an odd number. The Outside Directors bring value with an outside perspective, and an ability to challenge the inside thinking.”*

**Is There Push back from a CEO who really doesn’t want other people in his sandbox?**

While it’s been said, or at least surmised that there may be push back from the portfolio company CEO and/or Management Team, Capital Partners Rob Tucker quickly acknowledges *“Boards that are too energetic can get in the way. But I haven’t seen Management resistance, though there may be some mumbling unbeknownst to us.”* Tucker *adds “while SOX is a public company thing, tentacles of it nevertheless emanate to the private markets.”*



***“If the p.e.’s goal is to spin it back out, they can’t run everything.”***

Kendra Jalbert, VP Operations, Private Equity Info

**What’s In It For The Outside Director**

If you’re in the mating dance of being mutually checked out for a portfolio company Board role, one of your first questions should be where the company is in the p.e.’s Hold Period. If they’re just buying it, great. Everything is going well so far, unless this was a distress sale. (and you’ve already climbed onto the fire truck). And you’ve got 5 years to hopefully gain some stock option appreciation. If it’s in Year 4 or later, that raises questions. And the runway for your options is obviously shorter. Alive Pilots generally don’t take off from an intersection half-way down the runway.

Riverside’s Hendrickson adds “We’re careful in the selection process. A small company Board is a lot of work, and that makes the process mutually self-selective. The better Outside Directors get asked back again. And all are invited to our annual Riverside University two day offsite. . . an educational experience and a perk.”

Committees are fewer than with Public Boards. Typically just Audit and Compensation. Not a burning need for Nom/Gov, given the tight quarters. Nor do we see a lot of time spent on CEO succession, with a 5.6 year hold period. CEO’s aren’t given the benefit of the doubt very long, perhaps in contrast to Jeffrey Immelt’s 16 years at GE. One private equity CEO remarked that he felt his tenure was like the half-life of Uranium.

You’re likely to be involved in the full-bandwidth of the agenda, considerably more than in a public Board environment. And since the Board is considerably smaller than a public company board (the CEO, two from the private equity firm, 2 or 3 Outside Directors), the atmosphere and interaction will be a lot more intimate. Riverside’s Hendrickson demands *“Outside Directors to be active, provide insight and direction, and ask hard questions.”* The hidden value she believes may be *“The operating rhythm of a company is in large part set by the Board meetings. It forces discipline.”*

Again, brace yourself for the rocket-launch 100 Day Plan. While the work will be on the part of the Management Team, the Board is close enough to the action to be watching and feeling the artillery fire.

*The 100 day plan is actually the first strategic exercise,”* states Mark A. Pfister, author of *‘Across The Board: The Modern Architecture Behind an Effective Board of Directors.’* Mark continues *“Boards with extensive strategic planning experience have historically outperformed those lacking this important discipline.*”

Your p.e. will have piled on a hefty portion of debt, so covenant-watch is part of the game. Easy to scrape close to the guard rails when you’re doing 160 MPH laps, so be sure Management provides the Board a rolling 8-Quarter Covenant projection model. And be in a position to alert the lender months in advance. Better to be on the forward side of credibility.



***“When you’re working with other peoples’ money (the Limited Partners) you can’t run it like a proprietorship.”***

Alan Grafman, former Operating Partner, Mercury Capital

Top-Grading was probably part of the acquisition model, and volunteer yourself to serve a double role … checking out candidates, as you might have as much if not more operating experience as everyone else, but also as an Outside Director you can and should take part in selling candidates on the opportunity. Enthusiasm is contagious, and appreciated.



***“The 100 Day Plan is actually the first strategic exercise.”***

Mark Pfister, Author of Across The Board: The Modern Architecture Behind an Effective Board of Directors.

A new Strategic Plan is typically in order and your p.e. will book an offsite with the Management Team and Board, usually with some experienced Strat-work facilitation. The expectation should and will be there for you to be adding the value you are bringing as an Outside Director. . . knowledge of the category, high level introductions you can facilitate, experience with companies in similar stages of growth, and the like. Talk to the P.E. in advance, and gain insight as to their expectations for the session . . . and earn your keep. If not more so. Give them a return on their investment (you!).

Blink twice, and a couple of smooth Board meetings later and we’re approaching the target setting for the next Year’s operating plan. It feels like the Final Approach, as the Flight Attendant always says. But these budget setting conversations can be sparky, given that potential bonus dollars will be on the table.

And so, the cycle continues. With one additional nuance. It’s never too early to be thinking about the Exit. It actually began before the acquisition close.

On the softer side, an important role the Outside Director can play is that of a confidant and sounding Board to the CEO. After all, it is lonely at the top, and even the CEO needs someone to confide in, and occasionally kick the dog (better than kicking subordinates). The best Outside Directors I have had in my 4 CEO roles were those that offered this ear to me, and in my years as a Director, I’ve returned the courtesy, that was thoughtfully given to me. My dog was appreciative.

**Conclusion**

There are many anecdotes, but some strong recurring themes to having a private equity Board, include:

* The positives are many; the negatives were unseen in these interviews
* Careful Outside Director selection, relevant experience, active participation, are all critical success factors
* Outside Directors need to fully understand the Hold Period and the dynamics it creates
* While the quantitative benefits of private equity Boards are hard to quantify, the numerous ‘data points’ unanimously agree on the value.

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