Feature

Private equity board audits

Dr Sabine Dembkowski provides insights into the state of play of board audits and board development in the world of private equity.

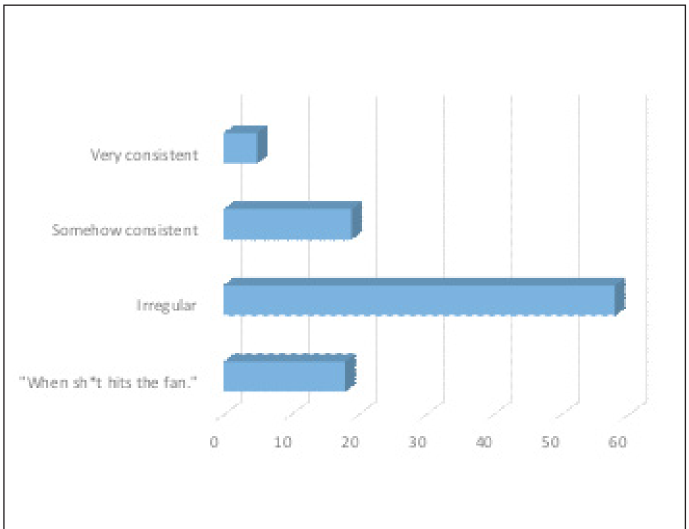
Private equity is widely seen as being an industry that is at the forefront of value creation. Some firms achieve well above average returns for their investors. In these days, this requires skills and expertise well and far beyond financial engineering. We wondered if and how the industry makes use of board audits and development programmes as part of the value creation process.

In this article, we bring together insights from conversations in the industry with a poll during the industries leading event for operating partners in London. Between January 2015 and May 2016 we conducted 100 in-depth conversations with professionals in the industry. In April 2016, we lead a panel discussion at Private Equity´s International Operating Partner Forum in London where another poll confirmed the learning of our conversations in the industry.

Operating partners in private equity are dedicated to working with the companies their firms are invested in to increase value. The role was initially created by large capitalisation private equity groups in acknowledgement of the importance of driving corporate change in building value as the realisation grew that the role of financial engineering is decreasing. Today mid-market private equity firms typically have dedicated operating partners too.

The Operating Partner Forum was attended by over 150 operating partners. At the time of the poll, there were 120 operating partners and 30 service providers in the room. Let´s first have a look at the poll question and the result:

How consistent would you describe your approach to board audits/development?



Operating partners thrive on challenges and are turning many screws to generate value for their firms. We know from many conversations behind closed doors that operating partners always wonder if there is a trick they missed.

These results reveal that while many levers may be pulled this particular lever of value creation is at the moment severely under leveraged. In fact, it is fair to say that there is a rather low adoption rate.

The big question is why? Why do we have such a low adoption rate in an industry that is all about value creation? In an industry where there are fierce measures and it is quite transparent if and to what extent the fund has managed to create value for its investors? Here the insights we gained in our in-depth conversations in the industry provide us with unique insights and help us to understand what really needs to be done.

Need for a properly instituted learning culture

The key reason that came up over and over in our in-depth conversations is first and foremost the concept of how such a measure can be 'sold' to the chairman and CEOs of the portfolio companies. Would it not indicate that there is a certain doubt that they can do the job? The private equity firms rely on the skill of the chosen chairman and CEOs and the attractive performance reward structure. The investment managers and operating partners only start to step in if anything does not go to plan and key performance indicators clearly signal that the value creation process is behind the plan.

This practice results in the fact that a disproportionate amount of time is spent on companies that are not performing. One of the operating partners wondered what the returns could be if the good firms received the same amount of attention. He had experienced for himself how much time was taken to help struggling firms instead of helping already well-performing firms to become even better. This was counter to anything he had experienced in the world of professional sports and was his definition of insanity in the industry. Would it not be easier to make good firms great and achieve even greater returns from them? He wondered what could be achieved if there was a regular audit that provided all executive and governing boards with feedback on a regular basis.

A number of operating partners freely admitted that each time a board audit had been initiated in the past, there were real problems and at times the results were used to provide further evidence for difficult decisions ie firing a member of a board. Thus, they felt that by now such measures have a 'certain reputation' that is not helpful.

Our operating partner mentioned above was quite adamant that the industry leaves large sums on the table by focusing on those that are not performing and not making use of a genuine and systematic process for learning at the top of the organisation. In his mind, there should be a systematic institutionalised process in every firm with annual board audits. Any board should take regular time out and reflect the results. We could not agree more.

They would like to have a system that provides real data and less interpretation, a genuine evidence-based approach and one that can potentially be administered by themselves without taking up too much top executive time.

Cutting-edge organisations are always seeking a system, a system that has a basic structure at its heart: a mechanism that guides learning and self-correction. It is quite a surprise that given all the talk about governance, transparency and the pressure of creating value, private equity does not make greater use of this lever of value creation. This relates to the next reason stated by our conversation partners.

Need for board audits that facilitate genuine learning

Some professionals in the industry had recent experiences with headhunting firms that they described at best as 'sobering'. Behind closed doors they felt that the outcome did not warrant the expense. What is more, they did not see how the way the 'results' were presented facilitated any learning.

They would like to have a system that provides real data and less interpretation, a genuine evidence-based approach and one that can potentially be administered by themselves without taking up too much top executive time. Training is available and with new technology and platforms systems can be put in place that can avoid expensive consultancy fees. Over time, each firm can build up data that provides insights into 'what good looks like' and systematic training programmes can be put in place.

Need for a broader expertise in the industry

The third argument was that this 'soft stuff' is somehow difficult. The investment managers in the industry more often than not have an analytical mindset and started their career in investment banking and top management consultancy. It is not part of their traditional training and it is hard to find evidence and measure the value. It is far easier to do so with a cost-cutting project. Well, board audits and development programmes may be out of the comfort zone of professionals in private equity but if they want to realise superior returns in the future for their investors they need to broaden their repertoire of value creation tools, stretch and learn.

Miles Graham, a seasoned private equity professional and CEO predicted that a consistent approach to conducting regular board audits and subsequent board development programmes will in a few years time be part of the standard practise of leading firms in private equity.

These results demonstrate that even an industry that is widely regarded as being at the forefront of value creation is slow in integrating board audits and development programmes into their value creation process. In this article we uncovered the state of play in the private equity industry, provided some 'hard' data and uncovered reasons for the slow adoption. Trusted advisers, investment managers, senior HR professionals as well as chairmen, CEOs and non-execs face quite some challenges in introducing and institutionalising board audits and development programmes. We and some far-sighted professionals in the industry predict that an institutionalised process will in a few years time be part of standard practise of leading private equity firms. What hinders the introduction of institionalised processes more than anything else is a shift in the cultural mindset. In this the private equity industry is not different to any other industry. Studies will show us that the firms with institutionalised processes will be at the top of the performance league tables.

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