PRIVATE EQUITY GOVERNANCE

Private Equity Governance: Driving Value and Returns

By Kennedy Chinyamutangira

It is well understood that private equity firms seek to take as much control of a company as necessary to execute their investment thesis, giving equal importance to value extraction and value creation.

Why is maintaining control over governance so important? Because it gives private equity the leverage to drive value and returns. Below, we examine key governance approaches that private equity firms adopt in pursuit of this quest, and what boards and management teams at companies controlled by private equity firms can expect.

AN OWNERSHIP STRATEGY TO MAXIMIZE VALUE

Boards of directors are entrusted as fiduciaries for stockholders in private and public settings; however, public company stockholders must rely on the board and executive officers to act in their best interests to maximize shareholder value.

The private equity leveraged buyout strategy typically involves the acquisition of a majority ownership stake in a portfolio company, which generally allows the sponsor to appoint the board of directors and fill key executive management positions.

Conversely, public company ownership can be widely dispersed among various stockholders who individually would not be able to influence the board's composition. Thus, ownership of large public companies can often be separated from the stewardship of the company by one of the classic principal-agent dynamics of the business world.

Ownership and governance of a private organization are typically well aligned, if not one and the same. This structure empowers sponsors to implement turnaround plans, discharge growth and expansion strategies, and optimize the capital structures of the businesses they acquire to maximize value to the private equity firm.

REORGANIZING AFTER AN ACQUISITION

Following a buyout, the private equity firm's partners or deal makers will make up most of the company's governing board. Alternatively, the firm may appoint its allies with specific industry knowledge or who have experience with similar business models.

Next come management changes, including in the chief executive officer position. As part of the investment thesis, private equity firms must consider how to build a leadership team that can grow the business. Even before acquiring the portfolio company, the private equity sponsor will identify top talent for key roles and move quickly once the deal closes to install them into position to begin the work of unlocking value.

Founders may be retained at the helm in some scenarios if their vision and that of the private equity firm are aligned. They and the management team may also continue in their positions if their leadership, skills, and talent are what the private equity group believes are necessary to take the private company to the next level. However, this will be under the watchful eye of a board controlled by the private equity sponsor.

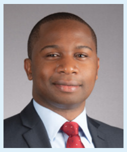
It is common for private equity firms to have operating partners on retainer. These private equity professionals specialize in executing and operationalizing the private equity group's strategy. Operating partners are more immersed in the company's day-to-day operations, working closely to introduce operational efficiencies and sound internal controls, uncover synergies, and eliminate excess costs.

WHEN GIVING OTHERS A VOICE IS THE ANSWER

The exception to private equity's total control is when the private equity sponsor follows a growth equity strategy, which is becoming more common as private equity and venture capital dry powder continues to increase. A proliferation of late-stage start-ups and other large, established private businesses are seeking financing in the form of growth equity to expand further and solidify their market penetration before determining their exit strategies.

Unlike buyout firms, growth equity funds usually will not take on a controlling ownership interest in the private business. Depending on the size of the investment, board seats or board observer positions may be granted to afford the private equity firm significant influence but not complete control. While this gives the sponsor some power to influence decisions, it is typically more of an advisory role.

There is ample evidence that sponsors improve the performance and profitability of private businesses through effective governance, regardless of their level of involvement. The stellar returns that private equity has generated over the past few decades leave a track record of creating and extracting value that speaks for itself. D



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