What is different about Private Equity Governance? V2

What is the purpose of this article?

1) Enable shareholders, board of directors, and C-suite to have a discussion regarding what is different about PE (private equity) governance.
2) This article provides general concepts. You need to understand your specific situation. You should consult your lawyers for legal advice. This article does not provide legal advice.

What are the critical learnings in this article?

1) PE shareholders and PE governance is focused on value creation.
2) In a private company with PE shareholders, the decision making authority of the board of directors and of shareholders can be very different from public company governance.

Where does PE fit into the overall governance framework?

There is a broad range of how decision making is structured in different types of companies.

1) Public company with no controlling shareholder. A founder might still have effective control, even though they have less than 50% of the voting shares.
2) A public company may have a voting trust. One person had the authority to vote all of the shares in the voting trust.
3) A public company may have dual class shares. Some shares may have no voting rights. Some shares may have multiple votes. This enables founders and families to retain voting control of a company even when they have a minority of the shares.
4) A public or private company may have PE shareholders. They may have certain rights, such as being able to appoint a certain number of board directors.
5) In a private company, PE may have a wide range of governance options.

PE and management are aligned with a common focus on long-term value creation.

Shareholders, the Board and C-Suite all focused on value creation with a common set of metrics.

1) Decisions are based on maximising this long-term value, even if short term quarterly or yearly profits are impacted.
2) PE firms often have exit time horizons, often between 7 and 10 years.
3) The bulk of potential management compensation is aligned with the value shareholders achieve when they exit.
4) There some PE funds with long-term or perpetual time horizons, which require more complex compensation structures and metrics for management.

Public company shareholders and management are often not-aligned.

1) Many public companies do not have long-term value creation metrics, targets, or regular reporting of results against these targets.
2) Many shareholders, such as pension funds have a long-term time horizon. The board of directors and management are often focused on quarterly and yearly targets, and achieving the public guidance they have issued.
3) Management compensation is often not aligned with shareholder returns. For example, when share value drops: management is often issued new stock options at a lower price; management is still given major bonuses; etc.

The PE asset class has outperformed public company markets.

PE has outperformed public market benchmarks over the last five-, ten-, and 20-year periods.[1]

Public companies often have little significant long-term value creation.

Mark Leonard, CEO of Constellation Software, in his April 20, 2018l CEO letter. “Qualified and competent Directors are very rare, and not surprisingly, the track record of most boards is awful. According to the 2017 Hendrik Bessembinder study of approximately 26,000 stocks in the CRSP database, only 4% of the stocks generated all of the stock market’s return in excess of one – month T-Bills during the last 90 years. The other 96% of the stocks generated, in aggregate, the T-bill rate over that period. This means that 4% of boards oversaw all the long-term wealth creation by markets during that period. Even more disturbing, the boards for over 50% of public companies saw their businesses generate negative returns during their entire existence as public companies.” [2]

PE company board directors and shareholders have a deep understanding on the company.

PE boards and shareholders may:

1) Have deep involvement with the company, unlike many public company boards.
2) Have two-way communications with the CEO and C-Suit weekly or more often.
3) Have support staff to analyze ongoing company reporting and do follow-up questions.

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4) Regularly assess whether or not there is the right CEO.
5) Require the CEO to have a coach.
6) May have a board director or PE shareholder deeply involved in critical value creation initiatives such as M&A.

Public company boards often:
1) Take the approach of “noses in, fingers out”, unlike private equity which has fingers in.
2) Have limited two way communications engagement with the CEO and C-Suite.
3) Only have third-party analysis of the company when there is a crisis or major event.
4) Assess whether there is the right CEO only when there is a crisis.
5) Do not have directors deeply involved in critical value creation activities.

The majority of public company directors have limited understanding of their companies.
A McKinsey survey of board directors showed that most had little understanding of their companies. Only 16 percent said directors strongly understood the dynamics of their industries, just 22 percent said they were aware of how their firms created value, and a mere 34 percent said they fully comprehended their companies’ strategies.[3]

What are some of the decision making differences between a public company with no controlling shareholder vs a private company controlled by PE shareholders.
In public company some of the decisions with the greatest impact on long term value are made by the board e.g.
1) Approving the CEO’s strategic plan.
2) Approving major business changes or major changes to financial leverage.
3) Appointing or terminating the CEO.
4) Nominating directors, who require election by the shareholders.

The above decisions in a private company controlled by PE are often made by the shareholders. Sometimes the shareholders may set the strategy and appoint a new CEO to carry out the new strategy.

Fundamental corporate transactions (e.g. sale of company, merger, sale of substantially all assets of corporation) often require shareholder approval. The decision making process can be much faster in a private company.

PE shareholders may the authority to restrict or even over-ride the decision making authority of the board of directors.
1) PE shareholders may have a unanimous shareholders agreement, which specifically limits the decision making authority of the board of directors and reserves certain decisions for shareholders. In this scenario, PE shareholders have the potential to veto any board decision or make any decision on behalf of the company.
2) PE shareholders may have certain veto powers over certain company decisions even without controlling votes.
3) PE shareholders may be in a voting trust enabling one individual to make decisions based on the voting rights of all the trust members.

What are your next steps?
If you are in a PE governance environment, either a stable situation or transitioning:
1) Step 1 is to document the expectations of the key members your governance environment, which may include: PE shareholders, the board directors, C-Suite, regulators, etc.
2) Step 2 identify the differences in expectations.
3) Step 3 outline the principles and process for moving towards a common set of expectations.
4) Step 4 assess your legal governance documents relative to expectations and make the required changes. Not all expectations can be included in legally binding documents.
5) Step 5 put in place an ongoing process to monitor and manage expectations.

What if you’re not in a PE governance situation? Your next steps are the same. You will still need to understand and manage the expectations of major shareholders.

Footnotes:
[1] A year of disruptions in the private markets McKinsey Global Private Markets Review. April 2021, Page 22
[2] https://www.csisoftware.com/docs/default-source/investor-relations/presidents-letter/presidents-letter-april-2018-final.pdf
[3] “Corporate Boards need a facelift”, Eric Kutcher, (McKinsey Partner) McKinsey website, May 4, 2018
https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-strategy-and-corporate-finance-blog/corporate-boards-need-a-facelift

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What further reading should you do?
What is corporate governance?
http://koorandassociates.org/corporate-governance/what-is-corporate-governance/
What are your company's decision making principles?
http://koorandassociates.org/corporate-governance/what-are-your-companys-decision-making-principles/
What is the purpose of your company?
http://koorandassociates.org/corporate-governance/what-is-the-purpose-of-your-company/

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