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Private Equity Partner-CEO Relationships

Good intentions, bad execution

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Diana, Princess of Wales, was a naïve young woman with no practical understanding about day-to-day life as a member of the Royal Family. Her mother-in-law encouraged Diana to consider her as Diana's mentor in adjusting to the dynamics of being a Royal.

Elizabeth had good intentions. Did Elizabeth see a problem with that idea?

> *How can the Queen of England mentor The Princess of Wales about how to manage the Queen!*

Diana's mother-in-law had a busy life as Queen. How available could Elizabeth be for Diana if her daughter-in-law called for help?

Would Diana even call?

The Queen assumed Diana would reach out to her. But Diana was young and full of confidence about her ability to handle things herself.

Good Intentions Bad Execution.

As Sally Bedell Smith notes in her book about Queen Elizabeth and Princess Diana, all parties had good intentions. What was missing was a thoughtful design of the intervention and excellence in execution. Diana stumbled her way through life as a Royal in ways that proved tragic for herself and for her children. (Bedell Smith, 2012).

In our work with private equity firms, The Queen-Princess drama of Good Intentions Bad Execution is played over and over again in the dynamics between private equity partners and portfolio company CEOs who have never managed a private equity-dominated Board of Directors.

This CEO is often a Founder of a successful company. That CEO knows how to manage a founder dominated Board of Directors. This CEO could also be the family member in a first or second generation family-dominated business. The CEO knows how to manage a family dominated Board of Directors.

Are private equity dominated Boards of Directors the same?

Diana was thrilled with the idea of being a Royal. The CEOs we work with are thrilled with the validation of their business success through a check written by a private equity firm. There is an intellectual understanding that acceptance of this check also involves accepting a loss of independence. The CEO is now only one of many CEOs who are part of private equity partners' portfolio of companies.

Intellectual acceptance and behavioral change are not the same.

How Big Is This Problem?

From 2000 through 2007, Private Equity (PE) PE funds acquired a total of nearly 3,000 companies in the United States, with a total transaction value exceeding $1 trillion. Using archival data from 126 PE transactions in the United States between 1990 and 2006, Gong & Wu documented a CEO turnover rate of 51% within two years of the public announcement of the transaction (2011). According to the authors, these removals are usually related to CEOs having lost the confidence of the private equity dominated board of directors. They are not often related to the company having outgrown the CEO.

If 51% of CEOs are removed within two years, what are the consequences?

One consequence is turmoil and uncertainty for customers.

A second consequence is turmoil and uncertainty for employees.

A third consequence is after the non-compete contract expired, the PE firm may have groomed its next competitor. After all, the CEO was one of the reasons the company wrote the investment check in the first place. These CEOs often come with outstanding reputations in their sectors.

A more disturbing consequence is private equity burn-out with the time demands to work with CEOs who do not “get” private equity dominated Boards of Directors. As PE Partners increasingly begrudge the time required to deal with CEO behavior, they start biasing investment decisions towards serial entrepreneurs. At least serial entrepreneurs understand the rules of the game and have demonstrated ability to conform to those rules.

PE Partners reduce their stress at the cost of lost opportunity for institutional investors. After all potential investment options are taken off the table when investments are biased in favor of serial entrepreneurs. And since there are only a limited supply of successful serial CEOs, the laws of supply and demand would suggest there will be a premium placed on these investments.

This article will discuss practical techniques Private Equity partners can take with their new CEOs.

Private Equity Dominated Boards of Directors have their own unique rules of the road just as large cap public companies have their own unique rules of the road.

Private Equity partners can help their CEOs by avoiding vague offers of help like the Queen did with Princess Diana.   Provide CEOs with specific roadmaps for how to work with PE dominated Boards. We provide a model for such a road map below. Assume that managing a founder dominated Board does not prepare CEOs to manage private equity dominated Boards.

Based on our consulting work and with the help of some fabulous PE partners, we have come up with some instructions:

THE CEO's GUIDE TO WORKING WITH PE DOMINATED BOARDS

1. Get Over It Quickly. You now have a formal reporting responsibility to the Board of Directors.   And the PE partners on this Board have a formal reporting relationship to the institutions or individuals that helped fund our investment in you. You may have loved the life you once had: you were a big fish in a small pond. You now have reporting relationships. Get over it quickly or quietly resign. In our world, everybody is responsible to someone.

2. Nose In/Fingers In. The phrase "Nose In/Fingers Out" is a common cliché in corporate governance: let the CEO execute business. The Board should focus on asking questions. Leave the CEO alone. At private equity dominated boards, this slogan does not apply. Institutional and private investors expect their private equity partners to be deeply involved in the investments.   PE fingers are always in

operations. It is not a reflection on you if this happens. " If we trust that the work you are doing is on track, you will find we still have fingers in your operational decision making. And if we don't trust the work you are doing, two of our hands will quickly be on the steering wheel!"

3. Rattle Our Cage. Everybody leads busy lives. It is up to you to rattle our cage before the next board meeting. We will get over the interruption. We will not get over being kept in the dark by you.

4. Bring Negative News to Us ASAP. With other types of Boards, there may be enough lag time between meetings to allow you to identify a problem and then declare "problem solved!" We don't work that way. As much as we hate to hear bad news, hearing about bad news late in the game is even worse for us. Late in the game is defined as more than 24 hours passing between you hearing about the problem and us hearing about it.

5. Organize the Board Agenda by Priority. At some large company public boards and at many nonprofits, the Chairman/CEO manipulates Board focus through the use of the agenda setting process: have the start of the Board meeting agenda be dominated by routine/procedural matters; have the middle of the Board meetings be dominated by employee Show & Tell presentations; and leave the most controversial matters to the end when Board members are concerned about catching trains/planes. This tactic will not work with us. If you don't put the most controversial issue at the top of the Board agenda, the PE partner on the Board will make sure it gets there anyway.

6. Do Not Blame Others. We come across like we expect perfection all the time but we really don't believe anyone can achieve it. If you make an error, disclose it as soon as possible and tell us what you have learned from the experience. Tell us what YOU have learned. Don't blame others. You are the one with ultimate accountability.

7. Passive Aggressive Behavior Will Get You Fired. If you say "yes" to our suggestions you had better mean it. We don't deal well with CEOs who tell us "yes" to our face and then implement "no."

8. What Hat Do You Want Us To Wear? We may act as though we expect you to have all the answers, but we know you do not. We are here to provide audit/oversight. Do not forget we are also here to provide advice/counsel. Call us up. Use us as a sounding board. We will perceive this as a sign of trust. Be specific to ask us to put away our "audit and oversight" hats. Ask us specifically to put on our "advice and counsel" caps. Our default mode is to wear our "audit and oversight" hats. Asking us for advice/counsel is not considered a sign of weakness.

The above eight steps will help CEOs better manage private equity dominated boards.

"I Don't Need Coaching."

These steps are not easy to accomplish because they involve unlearning past habits of success. As we all know, unlearning is harder than learning.

CEOs might benefit from outside coaching even when they initially say, "I don't need it:"

Why should the PE partner insist on a coach despite the CEO's objections?

In our story of Elizabeth and Diana, we pointed out that Elizabeth could not provide confidential suggestions to Diana regarding how to manage the Queen and her family. There are limits to the degree to which a PE Partner can provide confidential suggestions about how to best manage the PE Partner and fellow Board members. The best Coach is someone who is not the PE Partner. It is going to be an outsider who understands the dynamics of PE Boards. The Queen cannot counsel Diana on how to manage the Queen.

Crisis avoidance is about solving issues before they become acute. The Queen had good intentions. But she lacked the time to proactively reach out to Diana on a regular basis. PE Partners will say, "I'm available to you." The reality is that they are often too busy to reach out proactively.

Diana was too proud to ask for help. And CEOs will be too proud to admit they need help. Bring in a coach with the mandate and the time to proactively reach out to CEOs before issues become problems.

Follow up good intentions with good intervention structure.

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