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INSTITUUT VOOR BESTUURDERS
INSTITUT DES ADMINISTRATEURS

PRIVATE EQUITY & CORPORATE GOVERNANCE:

a company perspective

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Entrepreneur(s)

A term referring to one or multiple key manager(s), mostly the founder(s) of the company in which private equity funds invest (so-called portfolio companies).

Governmentally-backed fund

The term refers to a private equity fund, which draws at least partially capital from governmental institutes.

Portfolio company

The term is used to refer to a single company or group of companies in which one or more private equity providers are directly invested. In its origin, the term refers to the ‘portfolio of companies’ private equity providers invest in. An alternative term might be an ‘investee’ company. This report focuses on the governance of the ‘investee’ or ‘portfolio’ company.

Private equity fund or provider

This generic term refers to any designated pool of investment capital targeted at all stages of private equity investment from start-up to buyout, including those held by corporate entities, limited partnerships and other investment vehicles¹.

Privately-backed fund

The term refers to a private equity fund, which draws its equity solely from non-governmental investors. This may be both private individuals, families, institutional investors, the public market, etc.

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FOREWORD

This publication is a true milestone in the ambition and mission of GUBERNA. From the outset, some 20 years ago, it has always been GUBERNA's ambition to sensitise companies in developing their governance model in line with, and preferably even in anticipation of important strategic and structural steps in the corporation's development cycle. To this end, GUBERNA has been doing quite some different types of research projects, to identify major steps in the governance life cycle and to take stock of important drivers of change in the governance model. As an example we can refer to the research on listed companies, growth companies, family business evolution and the like.

One of the main lessons learned from those years of research is that the structure of a company's shareholding, the type of owners as well as their relative importance, governance attitude and maturity highly affect the governance model. A special case in this respect is the role and impact of private equity.

In 2012 GUBERNA decided to invest additional resources in further investigating the impact of private equity capital on an investee company. To this end, we started an in-depth desk research of existing academic as well as practice-oriented research on that topic. Later on we investigated the business practice and developed a database on private equity providers as well as investee companies in Belgium. We wanted to get a detailed view of both sides of the picture, investigating what the governance requirements and prerogatives of private equity providers were as well as researching how investee companies experienced the governance impact of private equity providers, stepping into their capital.

Thanks to the input of numerous team members of GUBERNA over the last 3 years, we are very glad to be able to publish the results of our desk and field research. A special word of thanks goes to dr. Olivier Van der Brempt who converted the rich set of research data into a practice-oriented booklet.

Let us hope that the lessons learned may help growth companies in preparing for the next step in their growth financing and in pro-actively professionalising their governance and business management so that become attractive parties for the private equity providers. At the same time, we hope that our booklet may also convince private equity providers of the importance of an open and professional governance relationship with their portfolio companies in order to turn their investment into a success.

Prof. dr. Lutgart Van den Berghe
Executive Director

ACKNOWLEDGEMENT

Dear Reader,

GUBERNA would first of all like to express its sincere gratitude to the 34 entrepreneurs, investors and experts who participated in this project. Without their crucial insights and expert views, this publication would never have come to be.

We would also like to thank the partners of the GUBERNA' centre for Growth Companies being: EY, SRIW, Sowalfin, UWE, ING, GIMV and Agentschap Ondernemen. Their longstanding support provides GUBERNA the possibility to develop this research as well as multiple other practice-oriented projects aimed at stimulating value-driven corporate governance in growth companies.



A special word of gratitude to EY for designing this publication. Thanks to their support, this endeavour has been brought to a successful conclusion.



Sibylle du Bus de Warnaffe
Business Development Director &
Chair of the Centre for Growth Companies

December 2015

EXECUTIVE SUMMARY

*“Good corporate governance
is key to creating lasting value”².*

The entry of a private equity provider in a company raises a wide variety of corporate governance challenges throughout all phases of the investment lifecycle: how to determine an appropriate valuation? How to choose the right partner? How to divide decision rights across shareholders, board of directors and management? How to involve private equity representatives in the board of directors? How to interact and report to the private equity provider? Etc. **This publication aims to raise awareness to these challenges and develop clear insights on how private equity funds and investee companies might solve them.**

To attain these goals, we integrate two rich data sources. First, we draw on a review of **the relevant literature and codes on corporate governance and private equity**. After all, we are convinced that corporate governance’s long-standing tradition in structuring decision powers, professionalizing companies and fostering collaboration among shareholders, directors and managers may provide crucial new insights in how to develop effective working relations between private equity providers and portfolio companies. Second, we draw on **34 in-depth interviews with private equity providers, portfolio company managers and experts** to identify the challenges at hand and introduce possible solutions to these challenges. The integration of both data sources provides a rich set of such insights. Below, we elaborate on our main findings.

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1. A crucial change in the corporate governance model

The first main finding is that the entry of a private equity provider (strongly) affects the historically-developed positions and interactions between company shareholders, board of directors and management. In other words, it impacts the (in)formally developed corporate governance model. After all, a private equity investment in a company's capital inherently affects the ownership structure in this portfolio company and alters the power balance among shareholders. In all likelihood, it also has an impact on the board composition and thus its functioning. Moreover, it will also influence the responsibilities at and questions asked of management. The extent of these changes of course differ from company to company and from deal to deal. In short, the entry of a private equity will affect shareholders, board of directors and management. Below, we elaborate on how the entry of a private equity provider affects these three corporate governance actors across the four investment life phases: initial, pre-investment, collaboration and exit phase.

2. Initial phase: Are we ready for private equity?

Before searching for and contacting (a) private equity provider(s), it is crucial to be aware of the consequences and challenges at hand. Hence, the key phrase in this phase is **“Preparation is half the work”**. This entails two elements:

1. Ensure that you are aware of the changes that may or are likely to occur to your corporate governance model (i.e., shareholders, board of directors and management) due to the entry of a private equity provider; and
2. Subsequently, develop an opinion on each of these possible changes, and rank them in function of importance.

To help you take these two steps, we draw on the main findings of our analyses to introduce below four sets of questions: (a) one overall question, (b) shareholders-, (c) board of directors- and (d) management-related questions. By reflecting on these questions, you get a clear idea of the characteristics you are looking for in a private equity. Moreover, it will prepare your company for the search of a private equity partner in the next phase.

a) One overall question

- The overall question that entrepreneurs need to pose is whether their company, their shareholders and their management are sufficiently mature and willing to work on the professionalization of their corporate governance model, including professionalizing their shareholder governance (work together with (a) new external shareholder(s)), the functioning of their board of directors (ready to share decision power), and their management (alter its current decision structures)? After all, our analyses show that private equity providers tend to have a significant impact on the composition, functioning and professionalism of these three actors.

b) Shareholder-related questions

- How much external capital do we need?
- How does this translate in a percentage of shares?
- What is the minimum percentage of capital/shares to which we want to hold on to to have (some) control?
- Is syndication between different private equity providers an option given that it may complicate collaboration among investors, but that it may also bring additional skills to the company?
- Are you aware of the differences among private equity providers when it comes to their investment strategies, their typical investment periods and the resources they may bring to the table? And what are your preferences respect to those three characteristics?
- Is our ownership structure and shareholder governance sufficiently transparent and professional?

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c) Board of directors-related questions

- How many representatives of the private equity would you ideally like to have or are you willing to accept in your board?
- Do you wish to include independent directors in the board, knowing that this is a highly sensitive topic for private equity providers?
- Private equity providers differ largely when it comes to their contributions to the board: hands-on, hands-with, or hands-off what do you prefer?
- What added-value are you looking for in your new board members?
- Who will be the chair after the entry of the private equity provider? Which skills does this person need?
- What are the skills, resources, and competences you would like to gain by adding the representative(s) of the private equity provider to your board?

d) Management-related questions

- Key managers will in all likelihood be assessed during the due diligence phase. How strong and professional is your management team today?
- How will you react when the private equity provider perceives a weakness in the management team and asks to replace or to add a manager?
- What is your perspective on the remuneration including profit sharing schemes for key managers?
- What is your perspective on key personnel clauses such as good leaver – bad leaver clauses?
- Private equity providers tend to demand extensive reporting of financial and non-financial information. Is your management ready to spend time and resources to further improve the reporting?

3. The pre-investment phase: Matching portfolio company and private equity provider

Discussing and answering the questions above provide entrepreneurs with a clear idea of what they are searching for in a private equity provider. Now it is time to search for and attract an appropriate partner and subsequently develop a shareholder agreement.

A first crucial finding is that not all companies will be able **to attract** one or more private equity providers. This may be due to external events – such as a financial crisis or stricter financial rules – as well as internal characteristics (e.g., growth potential, requirements of external capital, reasons for attracting capital, etc.). We find that portfolio companies may particularly boost their attractiveness to private equity funds by increasing the professionalization of their company and particularly of their reporting system system BEFORE they approach potential private equity providers.

When it comes to **choosing a private equity provider**, an entrepreneur's answers to the questions discussed above in the initial phase serve as input. During the pre-investment phase, his/her initial answers are further fine-tuned based on the opportunities available and challenges at hand. Our field research reveals that besides the straightforward objective criteria (such as valuation, percentage of shares, and investment period) particularly a strategic and personal fit are perceived as crucial. A **strategic fit** refers to the need for a similar perspective towards the future goals of the company as well as to the modalities and roles of the shareholder, board of directors and management. A **personal fit** refers to the need of all old and new partners to develop some kind of collegiality. After all, the actors involved are not machines, but need to interact and work together on a regular basis to maximize outcomes.

Once an appropriate partner has been identified, the criteria for collaboration need to be formalized in a **shareholder agreement**. For an in-depth discussion of all elements of a shareholder agreement, we refer to specialized law firms. Our analysis rather elaborates on the process of developing a shareholder agreement. Here, practice reveals that the process of developing a shareholder agreement is typically more time consuming, and costly than initially foreseen. Nevertheless almost all interviewees emphasized that discussing each possible scenario and developing a mutually satisfactory answer to each topic serves as the foundation of an effective working relation. It goes without saying that **“an ounce of prevention is worth a pound of a cure”**.

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4. The collaboration phase: The corporate governance framework at work

The primary formal forum for dialogue, besides numerous informal discussions, is the board of directors. As a result, it is not surprising that our interviews indicated that the entry of a private equity provider has a crucial impact on the composition and functioning of the board. In particular, it has a crucial impact on: (a) optimal performance of board roles, and (b) optimal decision-making.

a) Optimal performance of board roles

Private equity providers may differ widely when it comes to their roles in the board of directors. One role that all private equity providers share is that they clearly **monitor** whether their investment is spent wisely and in line with the agreements. To do so, private equity providers pay much attention to develop a professional reporting system. Particularly, the transparency, timing, format and content of the financial reporting receives much attention. After all, this provides the private equity providers the possibility to react in a timely manner on possible challenges and opportunities. This also reduces the latitude of management to invest in “pet projects”.

When it comes to **strategy**, we notice much more variation among private equity providers. Although all had an impact on the strategy through the development of a business plan in the pre-investment phase, private equity providers tend to differ in their involvement in strategy during the collaboration phase. Many of the interviewed entrepreneurs indicated that they were rather disappointed when it came to the added value of private equity providers in developing the strategy. Nevertheless, some differentiating factors were identified:

- If private equity provider hold a majority rather than minority stake in the portfolio company, they are more likely to invest in the company’s strategy;
- If the private equity providers invest as a syndicate, one investor is likely to take the lead, while the other investor(s) tend(s) to act more passively;
- Private equity providers that use a more interventionist investment strategy are likely to invest more time and resources in developing the portfolio company’s strategy, than those private equity funds, which draw primarily on their financial knowhow to add value;

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- Fostering a portfolio company's strategy demands clear knowledge of the portfolio company and its industry. As a result, more specialized investors (e.g.: those who invest solely in a few industries or investment managers with a background in the portfolio company's business) will tend to be better positioned to add to the portfolio company's strategy, than more generalist investors.

Private equity providers pay much attention to the portfolio company's **leadership**. The key managers are after all crucial for private equity providers to attain their aspired added-value. As a result, private equity providers may replace a manager when (s)he is perceived as unfit for a task. In this sense, a few investors replaced key managers (CEO or CFO) before their entry. Afterwards, they had almost all a say in the hiring and firing of managers, but only when private equity providers had a majority share, they also had full control over this process.

b) Optimal decision-making in the board

With respect to the way private equity providers influence the board decision-making, we learned the following insights.

With respect to the organisation of board meetings:

- It is common that there is frequent contact between private equity providers and portfolio company managers outside board meetings.
- Private equity managers do not always join board meetings equally well-prepared, which affects their added-value to the company.

With respect to board dynamics:

- Cooperation between private equity provider and a portfolio company tend to become more difficult when external and/or internal events reveal that both parties hold different interests towards the company (such as, investments, which may negatively affect the portfolio company's valuation at exit, capital increase, etc.).

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- A sound shareholder agreement, some independent directors and a competent board chair can help to stimulate and improve cooperation between private equity and portfolio company representatives in and outside board meetings.

With respect to board information:

- Although private equity representatives may (non)deliberately use the information received in your board in other participations, only a few entrepreneurs have considered the confidentiality of information as a possible risk.
- During the first board meetings, much time is spent on fine-tuning the content, timing and format of the information, particularly of the financial information. In so doing, private equity providers arouse a professional reporting system and foster objective decision-making.

With respect to conflicts of interests:

- Conflicts of interests seem not to occur that frequently. Some private equity providers deliberately invest in only one company per industry to limit conflicts of interests
- When it comes to conflicts of interests, transparency and openness is regarded as key. The conflicted member is expected to inform the board as soon as possible.
- If private equity providers are investing in a syndicate, it is crucial for them to know who the other investors are and what their aims are.

5. The exit phase: Exit as an output of the CG model

Our findings reveal four possible routes to exit:

- Selling the portfolio company to another company (so-called trade sale);
- Selling their private equity shares back to the portfolio company's shareholders or management;
- Selling their private equity shares to another financial investor; and
- An initial public offering or IPO.

With respect to the exit, our interviews suggest the following lessons:

- It is a best practice to apply the same valuation formula both at the entry and exit phase.
- Most investors indicate that they generally have a clear idea and preference at entry with respect to how they would like to exit a particular investment. However, much can change throughout the investment.
- Searching for buyers of their investment is a clear part of private equity's business.

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Lessons learned

- (1) If your company is not willing to work on its corporate governance, private equity may not be the best type of funding.
- (2) Preparation is half the work.
- (3) Choosing a private equity partner demands a strategic and personal fit.
- (4) Drafting and agreeing upon a shareholder agreement takes time and resources, but is worth every penny as it fosters effective collaboration throughout all phases of the investment cycle.
- (5) Monitoring a portfolio company's functioning is the baseline of each private equity partner. In this sense, private equity providers pay much attention to the quality, timing, and format of the reporting on non-financial and financial information.

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- (6) Private equity providers differ largely when it comes to their added-value to portfolio companies' strategy.
 - (7) Private equity providers pay much attention to the portfolio company's key management and this throughout all phases of the investment. After all, the actions of these managers largely determine their profit.
 - (8) In our cases, conflicts of interests occurred only rarely.
 - (9) The entry of a private equity provider is highly time and resource intensive.
 - (10) Using the same formula to determine the portfolio company' valuation at entry and exit is regarded as a best practice.