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"THE GOVERNANCE GAP": AN UNTAPPED VALUE DRIVER FOR PRIVATE EQUITY

This is the Executive Summary of the research paper – the full version is available at www.ysc.com

OVERVIEW

The research paper is based on interviews with more than 40 senior leaders in the global Private Equity (PE) industry in 2019 and 2020. Respondents included PE partners, and Chairs and CEOs of PE-backed portfolio companies. Based on our research, we conclude that:

1. The PE industry is reaching an inflection point as a consequence of its growth and because of changing market and societal conditions.
2. Better governance of portfolio companies helps PE firms: enhance value creation, reduce risk, and build trust with stakeholders.
3. There is a "Governance Gap" driven by poor quality execution, lack of diversity in board composition, and lack of oversight
4. There are practical steps that PE firms can take in order to improve board effectiveness as well as making the mindset shift from Corporate Governance as a practice determined by individual Partners to Corporate Governance as an essential element of ownership.

"I think you are going to see private boards across VC and PE will have more structure, more independents, and become more diverse. Not just because of pressure but because it is seen as real value driver. This stuff really matters."

Partner at Large Cap PE firm

CONTEXT: GREATER SCALE REQUIRES BETTER GOVERNANCE

Over the past decade, PE firms have grown significantly in number and size. The Economist reported in May 2020: "The 8,000 firms run by PE in America account for 5% of its GDP, and a similar share of its workforce." The growth of the industry brings two challenges: first, there is greater competition among PE firms for companies to invest in, which means that prices are higher and it is more difficult to generate returns; second, the industry is facing intensifying scrutiny around how it operates. These factors are intensified by the current Covid-19 crisis as well as broader economic, cultural, societal and environmental factors.

FINDING 1

The landscape is changing, and the industry is at an inflection point. Driven by increasing competition and prices, PE firms are having to be more transformational in how they create value. PE investors (Limited Partners, or LPs) are increasing the pressure on firms around social and ethical impact. PE board members are currently most concerned by ESG (Environmental, Social, and Governance) and Cybersecurity. They believe that Talent and Diversity will become more important in the future. Some in the industry do not believe there is a need for change in how they oversee their investments. Some are addressing it through standardization of approach, while others are focussed on how they develop the judgement and capability of individual partners.

FINDING 2

PE-backed boards have an inbuilt governance advantage. PE backed companies have an inbuilt advantage over their publicly listed counterparts. Having investors on the board limits the "agency problem" of PLCs where shareholders are reliant on a third-party board to represent their interests. PE-backed boards are typically more informal and agile, and they tend to make decisions in the service of long-term value creation rather than worrying unduly about quarterly results.

FINDING 3

There is a complex picture around variability of approach. The "Governance Advantage" means that investors can adapt board arrangements to meet the needs of an individual company. Variability is not only seen between firms but also within firms where partners have considerable autonomy. Underpinning this variability are different views on the purpose of the portfolio company board: strategic alignment (46%); corporate governance (39%); selection and management of the executive team (36%); hands-on involvement in running the business (21%). There are also different views on best practice: disciplined execution of board processes (52%); optimizing board composition (43%); ensuring that the board is aligned to value creation (38%); regular board evaluation (33%); effective use of sub-committees (29%). Finally, there are opposing views on whether the board or the majority investor should make the decisions (38% vs 62%) and whether the PE firm should go through versus around the board to interact with the executive team (31% vs 38% respectively) – although it should be noted that for some PE firms there is no distinction between the PE firm and the Board.

FINDING 4

In practice the variability translates to a lack of effectiveness. While in theory this adaptability and autonomy is a positive aspect of the "Governance Advantage", in practice it presents risks, especially in an era of change. Only 25% of respondents believe that PE-backed boards are currently effective. While 89% of respondents acknowledged that it is best to have a non-executive Chair, in reality only 44% consistently do so. Participants also identified issues around the following: a narrow focus on financial metrics and operational issues at the expense of strategic decision-making; counterproductive investor behavior; and a lack of board evaluation. Finally, only 18% reported consistency in their firm's approach to corporate governance oversight.

CONCLUSION:

The "Governance Gap" – a risk and an opportunity. We anticipate that competition in the industry will continue to increase, meaning that PE firms need to focus on maximizing all their levers for value creation, including corporate governance of portfolio companies. We expect that at the same time scrutiny of the industry will also continue to grow, from media, politicians and LPs, leading to greater demands around transparency as well as ethical, legal and moral responsibility. Our research suggests there is a "Governance Gap" around execution, diversity and oversight. We believe that PE firms who ignore this "Governance Gap" will lose out to their peers who embrace it is an opportunity to enhance value creation, reduce investment risk, and build trust with stakeholders. This will require practical changes to how PE firms operate (outlined below). More fundamentally, it will also require a mindset shift from Corporate Governance as a practice determined by individual Partners to Corporate Governance as an essential element of ownership. In our experience, PE firms bring high levels of drive, pace, agility, and curiosity, all of which can help them to bridge the gap.

RECOMMENDATIONS:

PE firms need to focus on improving execution, board diversity and oversight.

1. **Develop and implement a best practice playbook outlining their firm's approach to corporate governance aligned to investment philosophy, overseen at firm leadership level.**
2. **Invest in developing Partners and future Partners around the skills and judgement required for effective management and governance of portfolio companies.**
3. **Invest time and energy to optimize portfolio company board dynamics, behaviors and processes, drawing on internal / external specialists in board effectiveness.**
4. **Identify internal / external specialists on key corporate governance issues (e.g. CEO / Chair selection D&I, sustainability, cybersecurity) in order to identify and share best practice.**
5. **Regularly review principles, practices and outcomes around diversity and inclusion within their PE firm, their portfolio companies, and the boards and management teams.**
6. **Regularly review principles and practices around communication and reporting at a portfolio company, fund, and PE firm level, with a view to increasing transparency and trust.**
7. **Conduct annual independent evaluations of board effectiveness, and as part of that carry out 360 degree feedback on all board members including the PE Partners themselves.**

"What I would encourage the board to do is to be trained on governance and how to operate during board meetings. It would be good to see that. It would be good to get them focussed more on board effectiveness and have some benchmarks and measurement."

CEO, Large Cap portfolio company

"I'd take the view that board governance in portfolio companies is under-valued by some and under-exploited by many as a tool for value creation"

Senior Advisor at a Large Cap PE firm

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