GOVERNANCE

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Programme Boards – room for improvement

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News

Succession planning and company strategy

'Companies should be able to clearly connect the succession plan and talent development programme to the corporate strategy and investors are interested in how these will contribute to the execution of strategy and the risks associated with not having the right people in place', according to the Financial Reporting Council (FRC) feedback statement on its discussion paper, *UK Board Succession Planning.*

Nomination committee

An active nomination committee is key to promoting effective board succession. Committees should consider carefully the future membership of their boards ensuring there is alignment with company strategy, both current and future.

Greater clarity over the committee's role and responsibilities would help to promote its purpose and standing and the majority believed that nomination committee reporting could be improved. Suggestions included: the board recruitment process including information on external advisers, search and selection criteria; inclusion of board biographies and contribution to board performance to support re-elections; more information on talent pipeline management and how this supports senior level succession planning; details of initiatives in place promoting board and executive appointment diversity; board evaluation outcomes; whether contingency plans are in place, and reviewed, to deal with sudden and unexpected changes in directors; and a statement of whether succession arrangements are in place for all board members and key management.

Board evaluation

Overall the view was that board evaluations should inform and influence succession planning and that while succession planning should be part of the annual evaluation it should be seen as a continual process. Investors commented that they appreciate companies that have separate board sessions on succession planning.

Other suggestions included: directors identifying attributes they bring to the board enabling the nomination committee chairman to build up a blueprint for the operation of the board and to strengthen it by planning succession at an early stage; reviewing the nomination committee (and board appointment process), assessing board composition and agreeing plans for increasing diversity; formalising non-executive director induction and linking it more explicitly to on-going development; and including communication, culture and dynamics in board reviews.

Pipeline

Talent management was highlighted as a strong motivational force for employees wishing to develop their career within the company and achieve senior positions. A number of respondents talked about the need for aspiring board candidates to be exposed to directors and board experiences. However, the nature, variety and frequency of interaction should be considered carefully. It was also felt that the nomination committee should consider taking a more active interest in talent management and the board be involved in assessing more layers of management, though this practice is becoming more prevalent. Board apprentice schemes were advocated as a means of establishing an external pipeline of candidates and the role of executive search advisers was also highlighted, it being suggested that better two-way communication between them and nomination committees was needed.

Diversity

Greater board diversity should be encouraged though there is also caution against 'diversity for the sake of diversity': boards must be clear about the particular skills needed and assess these objectively. Furthermore, boards as a whole should be better informed about the link between diversity, strategy and business value. Practical suggestions to improve diversity included aligning succession planning internally with the organisation's diversity strategy and externally with the Davies report and recommendations. The succession plan could be used to: restate diversity objectives; emphasise the breadth of diversity; state the business case for board diversity; outline the relationship between board and executive committee diversity; and to set out targets, including how to achieve and review these.

Institutional investors

Investors would like to know more about how internal talent is nurtured and developed for succession planning and to what extent the executive team and the board think diversity is a component in planning and managing the talent pipeline. While there is a limit as to how much boards can share, particularly when they are actively recruiting, investors would like assurance that these matters are considered effectively so as to avoid a situation where the issue of succession becomes the 'elephant in the room'.

Next steps

There was some support for further guidance, in particular on the issues of the role of the nomination committee and reporting on succession planning, and this will be considered as part of the revision of the *Guidance on Board Effectiveness*, later in 2016. For the current reporting season, the FRC will review and analyse nomination committee disclosures (including board evaluation reporting for the FTSE 350) and comment on their findings in the 2016 *Developments in Corporate Governance and Stewardship* report.

For the full feedback statement go to: https://frc.org.uk/News-and-Events/FRC-Press/Press/2016/May/Succession-planning-should-be-aligned-to-company-s.aspx

News

Private company governance

'Risk management, getting a grasp on competitive intelligence and defining a company strategy are their top three challenges', according to a recent report from *Forbes Insights*, in association with KPMG. The report, *Private Company Governance: the call for sharper focus*, finds that 'corporate governance remains a key issue for private businesses and NGOs and that different oversight and direction structures can create considerably different outcomes for long-term viability of businesses. Understanding the challenges faced by board directors across a range of companies and sizes, may provide insight into how board models can be best fine-tuned to perform their respective function well'.

Key findings

- The top three governance challenges cited include improving risk management oversight, assessing innovation and emerging competition, and confirming/establishing company strategy.
- Other key governance challenges include achieving regulatory compliance, leadership succession planning and global compliance.
- The most visible challenges to board effectiveness include budget/resource constraints, conflicts of interest (including the presence of related party transactions) and a compromised board due to an over-representation of controlling shareholders.
- Fast-evolving technologies may help to spawn more relevant and efficient reporting for management and the board.
- Private company directors are looking to their governance processes and controls to improve M&A outcomes, enhance financial risk oversight and optimise the finance organisation through performance evaluation and succession planning.

Board challenges

The biggest issues facing boards were: risk management and oversight (cited by 28 per cent); assessing innovation and emerging competition (also 28 per cent); confirming/establishing company strategy (23 per cent), boards of smaller organisations in particular facing this challenge; and board effectiveness (17 per cent). Areas of least concern were: a divided ownership group (10 per cent), over-reliance on management's information (13 per cent), and director time and workload (16 per cent).

The key area of challenge for boards was seen as budget/resource constraint (36 per cent), followed by conflicts of interest/related party transactions (28 per cent) and over-representation of controlling shareholders came in equal third with boards serving only in an advisory capacity (25 per cent). Of least concern to the participating executives were lack of formal structure and under-utilisation of third-party resources/research.

Improving the board

A number of areas for improvement regarding financial information and organisation were cited by respondents as prudent, including improved information in the area of financial risk management, improved information for treasury/capital allocation, and tax and credit decisions. Areas of least concern were found to be M&A information and accounting information.

Another area in which the board can be supported in its traditional decision-making process is through the use of big data and analytical tools. Forty-one per cent believe that digital tools will allow them to spot trends (hidden in data), 38 per cent that it will help them support management in the allocation of resources, while 36 per cent say that it will aid internal audit and risk management. The two areas cited by the fewest respondents, in terms of potential benefit to the organisation, were more insight on macro/micro trends and greater coverage of corporate transactions. However, overall, network security poses the greatest concern among directors, followed by systems integration, internal or employee-related risks, third-party risk and unsophisticated record keeping.

Board involvement in M&A

Before reaching a deal, executives confirm that their board plays a key role in overseeing the M&A transaction, ranging from confirming service and financing providers (44 per cent), monitoring deal metrics (38 per cent), gaining M&A expertise at board-level (35 per cent) or establishing a transaction committee (35 per cent). However, just under a third say that the board only gets involved once deals have reached a pre-set price or value trigger.

Succession planning

When boards play a role in succession planning it can have a profound effect on the valuation of the private enterprise. Currently, 48 per cent of companies, predominantly software companies, conduct annual reviews with senior leadership present whereas one in five of the companies surveyed hire external consultants and search firms to address succession planning. However, more boards should play a greater role when it comes to succession planning, with currently 17 per cent of companies having an ad hoc approach and 14 per cent work without any board input.

External auditor

Respondents value third-party involvement, such as accounting reviews and audits, as good practice, with benefits such as effective check on internal controls (45 per cent), benchmarking and best practices (39 per cent) and speeds time to transaction (32 per cent) cited as the top three benefits of using an external auditor.

Whilst governance at private companies is, by no means, 'broken', there is scope to enhance current practice.

For the full report go to: http://www.kpmg-institutes.com/institutes/global-enterprise-institute/articles/2016/02/private-company-governance-call-for-sharper-focus.html

Global News

Global business sustainability

'85 per cent of respondents stated that Corporate Social Responsibility (CSR) is becoming an increasingly important part of business strategy', according to a report by the Ethical Corporation. The report, *State of Sustainability & CSR 2016*, provides a comprehensive picture of global business sustainability, insight into the global state of CSR, the significance of sustainability, the organisation of sustainability operations, sustainability budgets and returns and future prospects.

Key findings

- Sixty-nine per cent of executives said their CEO is convinced of the value of sustainability.
- Just 53 per cent of respondents felt COP21 (Paris Climate Conference, December 2015) delivered the agreement needed to address climate change risk, though many stated it creates the impetus for both businesses and industries to change their behaviours.
- Fifty-five per cent of executives stated that sustainability is driving revenue for their business.
- Nearly 50 per cent of respondents report to their CEO or board, giving an indication that CSR is integral to mainstream business strategy.

Twenty-one per cent of respondents indicated sustainability as a source of competitive advantage as the single most exciting opportunity for their organisation in 2016.

Sustainability is regarded as very important to business strategy globally with 90 per cent of respondents in Asia Pacific, 85 per cent in Europe and 88 per cent in North America regarding it as increasingly important. Respondents also indicated the importance of corporate responsibility and sustainability to business strategy, 29 per cent of respondents reporting to the board, 27 per cent reporting to the CEO and 18 per cent reporting to the Head of Sustainability.

Overall 40 per cent of respondents did not want to reveal their budget for CSR activities. Of those that did, only five per cent said that they have a budget in excess of $1m – compared to the US and Asia where nine per cent of respondents stated a budget exceeding $1m – and one quarter of respondents stated low budgets, ie less than $10,000. Twenty-six per cent of respondents said that they expected their CSR budget to increase in 2016.

Sustainability is now becoming a core component of mainstream business and, in fact, respondents believed strongly in the integration of sustainability across the board. Ninety-three per cent of respondents agreed that sustainability should be involved in setting supply chain strategy, 86 per cent that marketing and communications should be involved, 85 per cent that research and development should be involved and 80 per cent that human resources should be involved.

Organisations recognise the importance of corporate responsibility and sustainability, but still struggle to revise their business strategy because of concerns that it will negatively affect revenues. Fifty-five per cent of respondents stated that CSR is delivering revenue for their organisation, representing a nine per cent increase on 2015. Of more concern, however, is that 23 per cent of respondents do not know if sustainability is in fact driving revenue, indicating more work is required on tracking and measuring CSR initiatives.

Twenty-one per cent of respondents cited sustainability as a source of competitive advantage as being the most exciting opportunity for 2016 followed by embedding sustainability and sustainable innovation, a culture of sustainability, cross-industry collaboration and supplier partnerships.

For more information go to: http://events.ethicalcorp.com/reports/state-of-sustainability/index.php

Corporate Japan opening up to outside directors

'Outside directors have become a sizable presence in boardrooms, ideally bringing a shareholder perspective to decision-making', according to the Tokyo Stock Exchange (TSE).

Introduced in June 2015, the new Japanese Corporate Governance Code urges companies to appoint multiple outside directors with a high degree of independence from management, as well as to provide reasonable arguments for potentially investor-unfriendly policies like cross-shareholding and takeover defences.

Data from the TSE shows that 6,200 listed Japanese company board seats are filled by outsiders, roughly 700 more than in July 2015, and this figure is expected to increase. Outside directors, some of whom serve on more than one board, made up nearly a fifth of all directors.

Only 37 of the 1,500-plus companies listed on the TSE's first section with February and March book-closings currently have no outsiders on their boards. Company resolutions on appointing outside directors will go before shareholders at 29 companies this year. In some cases, companies have merely gone through the motions, such as rebranding outside auditors as directors or picking people whose independence is questionable, such as executives at major suppliers, sometimes as a result of a lack of available talent.

Both sides have to make an effort to ensure that outside directors contribute to better governance: companies must provide them with the facts and identify challenges, while those picked for the job need to prepare well for board meetings.

Feature

The decline of publicly listed corporations

Recent research commissioned from London Business School by the All-Party Parliamentary Corporate Governance Group looks at the causes and consequences of the decline of the public corporation.

Every year the All-Party Parliamentary Corporate Governance Group (APPCGG) commissions a piece of research and this year they decided to look at the decline in the number of listed companies as there are significant gaps in the research in this area. Margarita Economides, Yannick Lakoue-Derant and Zhanna Smirnova of London Business School therefore undertook a research project on behalf of the APPCGG to try to get to the bottom of why this decline was happening and what the potential consequences might be.

'Public corporations became popular in the 19th century, and for a long time were seen as the dominant corporate form for successful enterprises. About 20 years ago, taking a company public represented the ultimate confirmation of a successful and enduring business model. Public equity markets constituted the primary funding source with a substantial element of prestige.'

However, since then the numbers of publicly listed companies has been declining, albeit that the average company at the top end of the market is much larger by market cap than 20 years ago.

As the data published in the research shows, the number of UK-listed companies on the Main Market of the London Stock Exchange (LSE) has continuously declined since 1997. The increase in the total number of listed companies on the LSE between 2003 and 2009 was mostly driven by an increase in the number of Alternative Investment Market (AIM) listed companies, which largely represents small-cap companies.

> The number of UK-listed companies on the Main Market of the London Stock Exchange (LSE) has continuously declined since 1997.

The total number of Main Market listed companies in 2015 represents only 46 per cent of the total in 1999 despite the economic expansion and the rise of market capitalisation observed in the UK since then.

Additionally, John Kay (in his *2012 Kay Review of UK Equity Markets and Long-Term Decision Making*) suggests that in the UK 'acquisitions have steadily reduced the number of publicly traded companies; some acquisitions of quoted companies have the express purpose of taking the business private. Obtaining a listing is no longer a natural step in the development of a new business. As a result, the number of publicly traded companies (ie Main Market plus AIM) has fallen steadily.'

In a survey of mid-sized businesses for the Department for Business Innovation and Skills, carried out in 2013, it is claimed that among these businesses, most of which are listed on AIM, 'the most frequently mentioned reasons for delisting were through a private buy-out, or because the exchange became too onerous and expensive to remain on'.

Interestingly enough, whilst there have been sharp declines in the US and UK main markets, the number of listed companies has risen in Japan and Germany and even more so in Asian countries particularly Hong Kong and China. The research authors suggest that this can be explained by company maturity, the evolution of industries and by some element of consolidation when compared to the growth of the Hong Kong and the Republic of China stock exchanges.

Jonathan Djanogly MP, Chair of the APPCGG, said 'We need to look at the impact that regulation has on companies choosing to be listed. Is it that the regulatory regime is more onerous in the UK than in the Eastern markets?'

Certainly the heavy burden of regulation imposed on UK publicly listed companies has been cited as a reason why companies may not choose to go for a public listing, or why they may decide to delist completely or move down from the Main Market to AIM. During the period covered by the research, analysis of data showed that about 300 companies moved from the Main Market to AIM as opposed to only 100 companies who moved from AIM to the Main Market.

Jon Moulton, founder of Better Capital LLP, has over 30 years' experience investing in portfolios of businesses which have significant operating issues and may have associated financial distress. He was one of the panel members at the launch of the research and feels that one area which may be overly burdensome to UK listed companies is the annual report. Everyone is aware how much the annual report has grown over the last 30 years. This generates huge amounts of work for the listed company and he questions whether reports are actually any better for being longer. 'Nobody wants pages and pages of reports to plough through', he said. 'It makes no difference to the value of the company. Drawing in data is not disclosure or transparency, it's often camouflage. Companies now have the option to disclose vast quantities of information on their websites rather than putting it all in the annual report. The annual report should have serious restrictions on length as well as on the language used.' Clarity should be the overarching principle.

Jon also thinks that the changing corporate tax landscape may have had something to do with the fall in numbers of public companies. In the 1960s the tax regime meant that it was significantly more advantageous to be a publicly listed company and the UK had lots of relatively small public companies, for example in 1965 there were seven publicly listed greyhound tracks. As time has gone on, the tax regime has become less favourable which, combined with the increase in regulation, makes a Main Market listing much less appealing.

In the 1960s the tax regime meant that it was significantly more advantageous to be a publicly listed company.

Another reason posited for the decline are capital market developments including changes in the structure of the economy, financing opportunities for companies and investor preferences. In particular the rise in Private Equity (PE) is often cited as a cause in the decline in listed companies. This is a world Jon knows extremely well and he thinks that the growth in PE will have had an impact but that the numbers aren't huge. He thinks you couldn't reasonably put more than a quarter of the decline in public companies down to the effect of PE. There are many people who argue that the PE model encourages better corporate governance as the interests of the shareholders and the management are more closely aligned than with a widely-held business.

However, public access to the private equity market is difficult. It is a risky business. Not all investments are successful, though there is a growing body of evidence that over the past few years PE firms have moved away from the practice of buying sub-standard businesses with a view to a fast turnaround and sale, to buying relatively high quality businesses with good growth potential. A private equity fund may find they make a loss in around one-third of the businesses they invest in. The remaining investments are very successful and buffer those losses, but it is not an investment which the man on the Clapham omnibus really has available to them, unlike retail shares in publicly listed entities.

Another area commonly criticised in the publicly listed sector is the fact that the need to respond to a quarterly reporting cycle means that it is harder for listed companies to take a longer-term view of their strategy. A particularly interesting element of the research carried out in this respect is the work they did with family companies. The most common reason for family companies not listing was not the increased level of regulation and reporting, it was concern about the loss of control by the family and the impact that would have on their strategic time horizon.

Some family businesses state that continued family control enables them to take a longer-term view of value creation and corporate social responsibility, unlike in public companies where investors may not be long-term holders of shares and may be more interested in short-term value creation, which possibly isn't the best way to preserve long-term sustainability for the business. Needing to ensure the financial wellbeing of future generations of the family is an excellent way to focus the mind on what strategy is best for the longer-term success of the business.

One of the case studies cited in the report is that of the Pentland Group which owns leading sports and leisure labels including Speedo, Hunter Boot and Berghaus. The company was founded in 1932, previously listed in 1964, and subsequently reverted to private family ownership in 1999. Andy Rubin is the current chief executive of Pentland brands, and has experienced the relative merits of public and private companies.

He is quoted in the research as saying 'all the evidence shows that family-owned companies outperform public companies over time. They might be more conservative in a boom, but they do better in a downturn'. Indeed, Rubin notes that Pentland did not make marketing/staff development cost cuts during the financial crisis that started in 2008. Additionally, Rubin says, 'we are working on a strategy until 2020. When you are listed you are just focusing on the next quarter's results.'

The research raises many important issues and provides some real food for thought but there is more work that needs to be done. As Jonathan Djanogly commented, 'the research provides the structure for what should be an ongoing debate'.

Feature

Programme Boards – room for improvement

Alex Cameron and **David Archer** argue that the boards responsible for delivering large public sector programmes could learn a lot and benefit from the experiences of UK plc in relation to evaluation and development.

The requirement for listed companies to have a regular external evaluation of their board against a common code of good practice has won a lot of support over recent years. So much so that many other organisations such as public bodies and large charities have adopted similar practices for their board development. But one type of board that has received less attention when it comes to evaluation and development is the Programme Board. You could argue that Programme Boards are very different beasts to a plc board, and indeed some are. Some preside over much simpler organisations, and have a well-defined set of objectives to deliver over a finite timescale.

Other 'Mega-programmes' and their boards share many characteristics with corporate bodies. Their budgets are certainly comparable. In the 2014/15 financial year the UK Government spent £22bn on what it classified as 'major programmes'[1] (there were 188 in their list) and the figures for the current year are likely to be larger. And programmes at this scale also share many of the complexities of a listed company. They are multi-disciplinary, have many stakeholders with different interests and risk appetites, their goals have to shift as the environment in which they operate changes, the financing has many uncertainties, and their life-span can be as long as that of many trading companies.

It's therefore no surprise that the management of such programmes has come under a great deal of examination of late. There are some good news stories to report – the construction of all the facilities required for the London 2012 Olympics was generally hailed as a great success and many lessons from this work have been transferred to the Crossrail programme which is now moving towards near successful completion.

But there are some very expensive failures too – the Queen Elizabeth class aircraft carriers under construction for the Royal Navy are currently two years behind schedule and £2bn over budget – and by the time they are ready the second of these may never see operational service as the MoD doesn't have the budget for the planes to fly from it. And that's just looking at UK examples, in the US the scale can be even bigger – the California High Speed Rail programme is currently struggling to hits its delivery plans within a budget of $64bn but has previously seen forecasts of up to $98bn.

So with annual budgets of some of these mega-programmes being larger than that of many listed companies, why are their governance structures not subject to the same scrutiny and external evaluation of their decision-making as plc boards? To date the focus on improving the management of these mega-programmes has largely been on the processes and reporting structures used to control them. However, in this article we want to view major programmes through a different lens – and to think of them as businesses, scrutinised by a board with many of the same challenges and requirements as those of plc boards.

Much of the best practice guidance for Programme Boards has evolved from, and built on the disciplines of, project management and there are well established bodies of knowledge to draw on. But these tend to focus on ways of managing risk and controlling change in the delivery of the content of the programme – rather than the qualities and effectiveness of the board that is in charge of that delivery.

Programme Board governance

The size and the roles represented on a Programme Board are not mandated but best practice guidance[2] from the Association for Project Management (APM) and others suggests that there are three key roles:

1. The Senior Responsible Officer (SRO) who is ultimately accountable for the programme and is responsible for providing approvals and decisions affecting the programme. This is somewhat analogous to a UK plc chairman but actually carries more authority and may be better compared to a US style executive chairman.
2. The Programme Director who is responsible for the delivery of the programme plan and so could be compared to the CEO.
3. Business Change managers (sometimes known as sponsors) who are responsible for aspects of the transition and benefits realisation.

Often these roles are supplemented by supplier and customer representatives and sometimes internal audit/ quality assurance. In a few cases there may be even individuals appointed in an advisory capacity equivalent in some ways to a non-executive director. And so you can see some parallels with a corporate board, but there the similarities end. These are not statutory roles with clear accountabilities and there is no corporate law or corporate governance code to control ways of working and the behaviours of all those involved.

In reality, the working of the average Programme Board is designed by those involved. This design will often be an amalgam of past experience and the particular requirements of the most powerful players in the programme. The evidence from successful Programme Board operation is not great as the examples of project failures outlined already shows, but all programmes of this size and complexity have challenges, conflicts and financial pressures. What distinguishes the successful programmes, just like successful companies, is how they respond to these difficult situations. This means effective decision-making at board level.

The California High Speed Rail Programme is currently struggling to hit its delivery plans within a budget of $64bn but has previously seen forecasts of up to $98bn.

In these situations, what makes the difference for effective Programme Boards is the same as for a plc. They need clear roles and responsibilities for each board member. Each board member should understand the expectations of their contribution and be held to account for their individual performance. However, clear roles are important but insufficient on their own. The Programme Board needs timely access to the necessary information to monitor performance and facilitate effective decision-making. This information needs to include easy-to-access lagging and leading indicators of performance. But perhaps the most important information that needs to be available to the board is the risk data. By this we don't mean a huge and impenetrable risk register so often prepared on such projects. We mean a short-list of the top sophisticated risks that will drive the overall performance of the programme. However, clear roles and good information won't deliver an effective board without strong relationships and positive behaviours around the board table. This is an area that is well-understood in corporate boards, but given less attention in the more informal Programme Board structures.

In recent years, the performance of corporate boards has been recognised as a key indicator of business performance. The reports on corporate failures whether at RBS or at the Co-operative Bank make clear the necessity to get the roles, information and behaviours right in order to avoid dysfunction and dangerous decision-making. The FRC, which publishes and updates the UK Corporate Governance Code, understands these issues and constantly develops the Code to push board behaviour and transparency forward. Notably, since 2010, there is a requirement for all corporate boards to be externally evaluated every three years along with annual internal reviews. But if you think of a major programme as an organisation in its own right, as many commenters are starting to do[3], wouldn't the disciplines of the Corporate Governance Code be as relevant and useful to Programme Boards dealing with pressures of the magnitude and complexity of many plcs?

There are signs that the most enlightened of Programme Boards are recognising the benefits of evaluation to improve board performance[4] and are increasingly turning to the requirements outlined in the Corporate Governance Code. After all, many of the stakeholders of these Programme Boards are plcs themselves, so are familiar with this way of working. Informed and experienced stakeholders in these programmes have the same requirements as shareholders. They want to see problems addressed quickly, performance effectively scrutinised and productive relationships between all the parties involved in the venture. For these large programmes this means that evaluating the capability and ways of working of their board should be just as much of a concern as is the evaluation of the delivery plan of the programme itself. And in our view, the principles and reputation of the UK Corporate Governance Code makes it a good place to start when it comes to designing a framework to direct this type of Programme Board evaluation work.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/438333/Major_Projects_Authority_Annual_Report_2015.pdf

[2] http://knowledge.apm.org.uk/bok/programme-management

[3] See for example this webinar from the Oxford Said Business School MSc in Major programme management https://www.youtube.com/watch?list=PLtXf43N26ZifXS2mqSB7_heT_7qLvNo4L&time_continue=12&v=U0QHY4TsiA4

[4] See this example from TfL http://content.tfl.gov.uk/operation-of-rail-and-underground-programme-boards.pdf

Alex Cameron and David Archer are Directors of Socia Ltd, a business focused on enabling Board and Business Leader performance through effective collaboration. See www.socia.co.uk

Feature

Private equity board audits

Dr Sabine Dembkowski provides insights into the state of play of board audits and board development in the world of private equity.

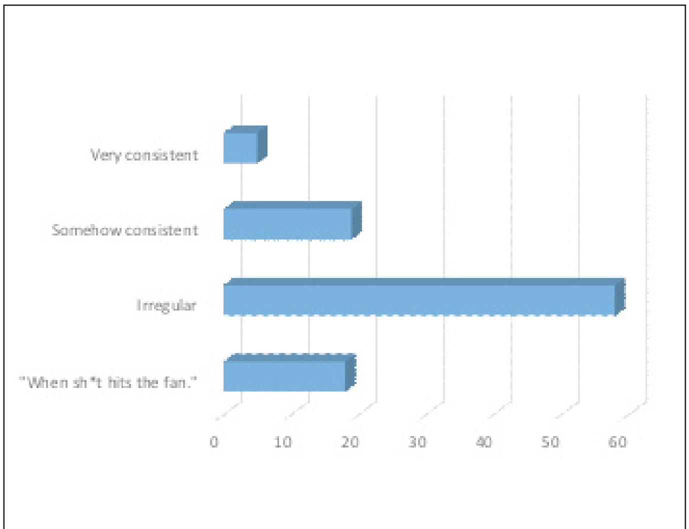
Private equity is widely seen as being an industry that is at the forefront of value creation. Some firms achieve well above average returns for their investors. In these days, this requires skills and expertise well and far beyond financial engineering. We wondered if and how the industry makes use of board audits and development programmes as part of the value creation process.

In this article, we bring together insights from conversations in the industry with a poll during the industries leading event for operating partners in London. Between January 2015 and May 2016 we conducted 100 in-depth conversations with professionals in the industry. In April 2016, we lead a panel discussion at Private Equity´s International Operating Partner Forum in London where another poll confirmed the learning of our conversations in the industry.

Operating partners in private equity are dedicated to working with the companies their firms are invested in to increase value. The role was initially created by large capitalisation private equity groups in acknowledgement of the importance of driving corporate change in building value as the realisation grew that the role of financial engineering is decreasing. Today mid-market private equity firms typically have dedicated operating partners too.

The Operating Partner Forum was attended by over 150 operating partners. At the time of the poll, there were 120 operating partners and 30 service providers in the room. Let´s first have a look at the poll question and the result:

How consistent would you describe your approach to board audits/development?



Operating partners thrive on challenges and are turning many screws to generate value for their firms. We know from many conversations behind closed doors that operating partners always wonder if there is a trick they missed.

These results reveal that while many levers may be pulled this particular lever of value creation is at the moment severely under leveraged. In fact, it is fair to say that there is a rather low adoption rate.

The big question is why? Why do we have such a low adoption rate in an industry that is all about value creation? In an industry where there are fierce measures and it is quite transparent if and to what extent the fund has managed to create value for its investors? Here the insights we gained in our in-depth conversations in the industry provide us with unique insights and help us to understand what really needs to be done.

Need for a properly instituted learning culture

The key reason that came up over and over in our in-depth conversations is first and foremost the concept of how such a measure can be ‘sold‘ to the chairman and CEOs of the portfolio companies. Would it not indicate that there is a certain doubt that they can do the job? The private equity firms rely on the skill of the chosen chairman and CEOs and the attractive performance reward structure. The investment managers and operating partners only start to step in if anything does not go to plan and key performance indicators clearly signal that the value creation process is behind the plan.

This practice results in the fact that a disproportionate amount of time is spent on companies that are not performing. One of the operating partners wondered what the returns could be if the good firms received the same amount of attention. He had experienced for himself how much time was taken to help struggling firms instead of helping already well-performing firms to become even better. This was counter to anything he had experienced in the world of professional sports and was his definition of insanity in the industry. Would it not be easier to make good firms great and achieve even greater returns from them? He wondered what could be achieved if there was a regular audit that provided all executive and governing boards with feedback on a regular basis.

A number of operating partners freely admitted that each time a board audit had been initiated in the past, there were real problems and at times the results were used to provide further evidence for difficult decisions ie firing a member of a board. Thus, they felt that by now such measures have a 'certain reputation' that is not helpful.

Our operating partner mentioned above was quite adamant that the industry leaves large sums on the table by focusing on those that are not performing and not making use of a genuine and systematic process for learning at the top of the organisation. In his mind, there should be a systematic institutionalised process in every firm with annual board audits. Any board should take regular time out and reflect the results. We could not agree more.

They would like to have a system that provides real data and less interpretation, a genuine evidence-based approach and one that can potentially be administered by themselves without taking up too much top executive time.

Cutting-edge organisations are always seeking a system, a system that has a basic structure at its heart: a mechanism that guides learning and self-correction. It is quite a surprise that given all the talk about governance, transparency and the pressure of creating value, private equity does not make greater use of this lever of value creation. This relates to the next reason stated by our conversation partners.

Need for board audits that facilitate genuine learning

Some professionals in the industry had recent experiences with headhunting firms that they described at best as 'sobering'. Behind closed doors they felt that the outcome did not warrant the expense. What is more, they did not see how the way the 'results' were presented facilitated any learning.

They would like to have a system that provides real data and less interpretation, a genuine evidence-based approach and one that can potentially be administered by themselves without taking up too much top executive time. Training is available and with new technology and platforms systems can be put in place that can avoid expensive consultancy fees. Over time, each firm can build up data that provides insights into 'what good looks like' and systematic training programmes can be put in place.

Need for a broader expertise in the industry

The third argument was that this 'soft stuff' is somehow difficult. The investment managers in the industry more often than not have an analytical mindset and started their career in investment banking and top management consultancy. It is not part of their traditional training and it is hard to find evidence and measure the value. It is far easier to do so with a cost-cutting project. Well, board audits and development programmes may be out of the comfort zone of professionals in private equity but if they want to realise superior returns in the future for their investors they need to broaden their repertoire of value creation tools, stretch and learn.

Miles Graham, a seasoned private equity professional and CEO predicted that a consistent approach to conducting regular board audits and subsequent board development programmes will in a few years time be part of the standard practise of leading firms in private equity.

These results demonstrate that even an industry that is widely regarded as being at the forefront of value creation is slow in integrating board audits and development programmes into their value creation process. In this article we uncovered the state of play in the private equity industry, provided some 'hard' data and uncovered reasons for the slow adoption. Trusted advisers, investment managers, senior HR professionals as well as chairmen, CEOs and non-execs face quite some challenges in introducing and institutionalising board audits and development programmes. We and some far-sighted professionals in the industry predict that an institutionalised process will in a few years time be part of standard practise of leading private equity firms. What hinders the introduction of institionalised processes more than anything else is a shift in the cultural mindset. In this the private equity industry is not different to any other industry. Studies will show us that the firms with institutionalised processes will be at the top of the performance league tables.

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