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Private Equity Lessons For Improving A Board's Effectiveness

Private equity firms give their ventures a strong governance start.

by Dr. Sabine Dembkowski

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STAFF

Editor	Ralph D. Ward
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Circulation	Ann K. Stocum

EDITORIAL OFFICE

The Corporate Board
4440 Hagadorn Rd.
Okemos, MI 48864

Phone: (517) 336-1700
Fax: (517) 336-1705
Email: info@corporateboard.com
Web site: www.corporateboard.com

Private Equity Lessons For Improving A Board's Effectiveness

by Dr. Sabine Dembkowski

Improving the makeup, role, structure and functioning of a corporate board can prove daunting for board members, especially when it comes to gaining buy in to push for changes. Private equity firms, however, are able to drive boardroom reforms at their portfolio companies by combining ownership muscle with acquired savvy on best practices. How do private equity firms shake up the governance of their companies? What lessons can they offer your board?

The realization is growing that financial engineering is only one way to secure good returns on an investment. Corporations are becoming increasingly aware of the pivotal role of management and people in ensuring superior returns. As we all know, "a fish starts to rot from its head," and investor attention is turning to the boards of portfolio companies. This playing field is currently underleveraged in the industry, and can be explored to achieve and secure returns in a challenging environment.

We have studied international best practice and identified seven areas private equity firms can review to enhance a board's performance.

- ☐ Composition of the board.
- ☐ Ability of the board to use the strength of its members.
- ☐ Clarity about roles and responsibilities.
- ☐ Joint vision.
- ☐ Ability to resolve conflicts between the board and its management.
- ☐ Structure and organization of the board's work.
- ☐ Regular reviews and reflection about the board´s work.

Composition of the board: Are headhunters the best way to find directors?

☐ *Composition of the board.* This is probably the most important leverage point for companies. The challenges vary according to the size of the company.

In large companies, we see private equity firms increasingly hiring headhunters to fill board positions. The profile of the candidate is crucial, and more often than not the exercise produces a highly experienced board full of "achievers" and "alpha animals." This is a well-meaning (but rather expensive) way to form a board that by no means guarantees superior returns.

Why? The selected candidates have indeed made their mark in their respective areas of expertise and industry and have relationships with important stakeholder groups. The involvement with a private equity firm provides candidates with a financial upside, and a challenge that motivates them to accept the offer.

However, once all the members are on board, they often fail to engage as a functioning team. The sum is less than the total of the parts. This has nothing to do with education or experience. Rather, it is a question of complementary personalities, complementary behaviors, and fit.

At one successful private equity firm, a partner takes a "greenfield approach" to governance—during due diligence, he is already thinking about the ideal board.

In many cases the board does not cover all the areas of expertise crucial for the development of the company. The missing know-how is bought in via consultants or complemented with people who are part of the management team. This can work, but the lack of strategic guidance and leadership carries risks.

In medium-size companies, the focus is on grow-

Dr. Sabine Dembkowski *is founder of The Coaching Center, based in London and Cologne. [www.thecoachingcentre.com]*

ing the business, and less attention is paid to proper corporate and regulatory functions. Here, private equity firms face the dilemma that board members may not have the skills needed for the next stage of the company's growth. However, it may be difficult to let these directors go. They still have in-depth understanding of the markets and products, and relationships with customers and suppliers.

The areas that determine the overall performance of the board are extent and gaps in knowledge, the roles members play in a board environment, personality structures, values and fit.

We know of one successful private equity firm where a seasoned investment professional adopts a "greenfield approach" to governance. That is, during the due diligence process, he is already thinking what the ideal board should look like.

The task he sets himself in this exercise is to describe in detail the expertise needed, the personalities that would make for a good fit with the company and the market, the specific roles that each member would have on the board, and their ideal personal value system. At this stage, he does not name names. He puts this information down on paper and, as his understanding of the business grows, he adds to the detailed description of his "dream board."

At the end of the due diligence process, he puts his notes aside until the deal is completed. At that point he turns to his notes again and considers how well the selected directors fit with his ideal, and initiates individual assessments. On the basis of the assessment results, gaps in the "ideal board" are identified and the next steps are determined.

A more optimal composition of a board can be achieved by combining some tried and tested interview techniques with validated psychometric tests. Private equity firms challenge headhunters to offer more than their "standard" approach to interviewing and selection.

Most of the leading search firms offer leadership and assessment services, and can propose an approach to board interviewing and selection that fits the specific needs of a company. This helps them to define clearly the personality types needed, their fit with the industry and culture, and to identify candidates who will be able to perform the roles needed on the board.

The new generation of directors has a different attitude, and is highly interested in personal development.

☐ *Ability of the board to use the strength of its members.* In our work with boards we have seen over and over again that the individual strengths of directors are often used badly. The interviews we conduct with boards reveal two root causes for this.

First, there is a lack of understanding of individuals' distinctive personal strengths. Most clients are aware of one or two stand-out qualities but these are often stated in such general terms that it is questionable if these candidates really make the most of their personal advantages.

Second, due to the complexity and stresses of governance today, board members often feel that they are merely "functioning." They use their own strengths more by chance than conscious decision.

Sadly, this means that the sum of the board is less than the total of its individual members. There are scientific instruments available that can help facilitate awareness of individual members' strengths. The use of these instruments, along with group sessions and interviews with board members, can awaken boards to the distinctive strengths of their members in terms of both know-how and soft skills.

Even experienced and seasoned board members are willing to learn. We find that the new generation of directors has a different attitude, and is highly interested in personal development. These development programs use interviews, tests (for example, the VIA Signature strength test by Martin Seligmann) and instruments that identify know-how and role preferences. The results can lay a foundation for ways in which the board can make better use of the individual strengths of its members.

☐ *Clarity about roles and responsibilities.* This is a classic area of conflict in almost any board. Roles and responsibilities are not as clearly defined as one may think. Some roles grow over time or are created by a specific board member who has a personal interest and motivation in doing so.

On many boards in the medium-size market, we see a substantial gray area that can cause conflict on a daily basis, and prevent company resources from being used to generate value. This can happen not only at the board level, but also below the board. Resources are blocked or, worse, value is destroyed.

Companies can add value by contributing to initiatives through which roles and responsibilities are clearly defined and rewards designed accordingly. It is essential to understand the history and the root causes of prevailing issues. Only when these issues are resolved with the genuine involvement of those involved can lasting solutions be put in place.

Nothing is more harmful to an effective board than disagreement about vision, strategy and subsequent action.

☐ *Joint vision.* It sounds so straightforward and obvious—the joint vision of the board. In practice, however, it proves to be a real challenge. Conflicts about the lack of joint vision frequently lead to the kind of forced exits that are usually described as "disagreements about the strategic direction of the organization."

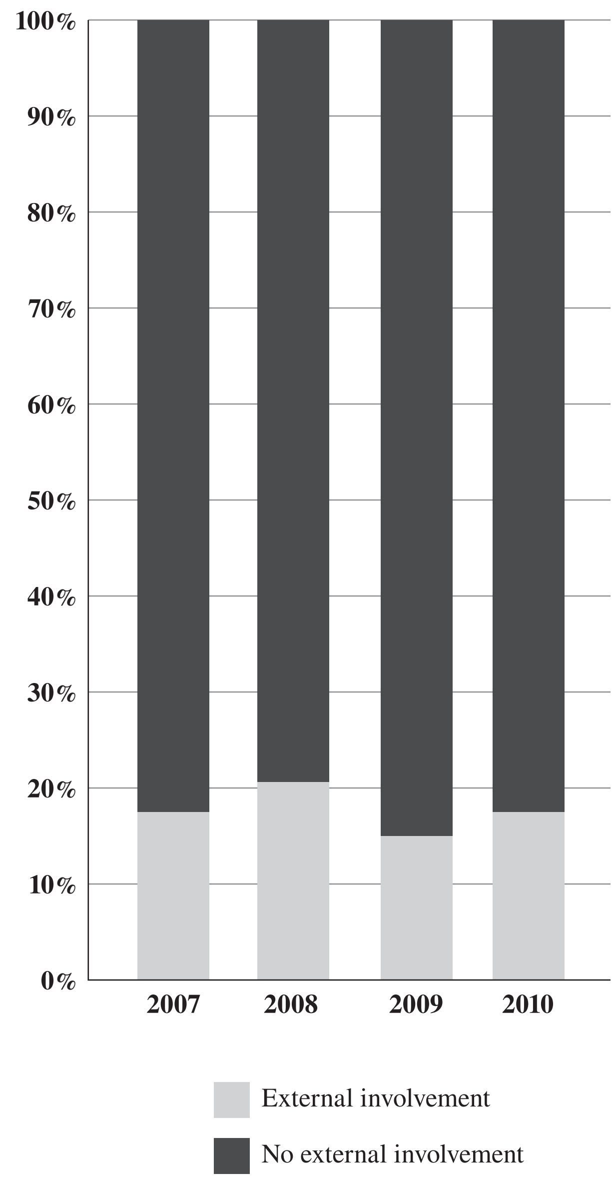
Achieving a joint vision is a process. To get there, it is helpful, if not essential, for the board to have a solid foundation of shared values. The communication of this joint vision is the point where the rubber meets the road. Nothing is more harmful to an effective board than disagreement about vision, strategy and subsequent action.

The board has to establish a solid foundation of ground rules. One of the ground rules should be that once a majority decision has been reached, a unified message goes out, and all board members then sing from the same hymn sheet.

Establishing a joint governance vision is seldom a single event. We have observed that the most successful companies use a vision creation process.

We worked with one telecom provider in Germany with a vision creation process that worked not only at board level, but throughout the organization. A series of vision creation events took several weeks, but the final result was remarkable. At the end of the process, not only was there a vision that everyone understood and adhered to, but everyone in the company also understood how they, through their daily actions, could contribute to realizing the vision and making it tangible for their stakeholders.

Calling In The Experts
Outside Board Evaluation Support



☐ *Ability to resolve conflicts between the board and its management.* In some organizations there is a real divide between the board and its management. One of our clients described this as "like driving a car with the handbrake on." More than ever, it is the challenge of a board to provide leadership for highly educated, high-potential employees.

Executives one or two levels below the board also have been to first-class universities and business schools, and have their own ideas about the firm and its direction. Directors must convince these executives with the quality of their arguments and their personalities. This is a real leadership challenge. Companies can provide and encourage their board members to participate in leadership development programs at leading business schools or to work with well-respected executive coaches.

Companies can make a significant contribution to boardwork by collecting and documenting what has worked in the past (or works elsewhere).

☐ *Structure and organization of the board's work.* One of our clients described becoming a board member as like becoming a parent. "Somehow everyone assumes that you know what to do." Many directors describe feeling "lost," and the work of many boards is badly structured.

Companies can make a significant contribution to boardwork by collecting and documenting what has worked in the past (or works elsewhere), and providing free advice or clear documentation about the things that make life easier for other boards.

These might include an annual meeting plan that ensures that all strategically relevant themes are discussed on a regular basis; rules about the distribution of an agenda in which information items, items for discussion and decisions to be made are clearly marked; and templates for directors' contributions that ensure that information is presented succinctly and clearly.

☐ *Regular reviews and reflection about the board's work.* In Europe, an increasing number of corporations engage in regular board assessments. Leading headhunting firms (for example Egon Zehnder and SpencerStuart) offer their services, as well as numerous smaller consulting boutiques.

A study in the UK indicated that in 2011-2012 about 38.5 percent of the UK's top 200 companies invested in board evaluation. Some chairmen and directors remain skeptical, often as a result of bad experiences. Others reported that they discovered things they had been unaware of.

A good evaluation can improve a board's effectiveness. External evaluation is better for exposing sensitive or difficult issues, particularly people issues. Directors generally will speak more frankly to an outside assessor. The results of these evaluations provide an excellent foundation for the board to reflect about its work.

This practice has yet not entered the world of most private equity firms and their portfolio companies. Board assessments remain rare. While a full assessment may not always be necessary, scheduled time at least once a year, where the board reflects about its achievements, what worked well and what "would be even better if . . ." should be the minimum. ■

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Okemos, MI 48864-2414, (517) 336-1700
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