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How Can I More Effectively Manage the Tension Between Private Equity Partners and CEO/Founders?

Consider the implications of this story:

> 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.

One must compliment the Queen of England for her good intentions. But did the Queen understand the implications of this offer?

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

A second problem is that Diana's mother-in-law had a busy life as Queen. Would Elizabeth be available for Diana if her daughter-in-law called for help?

A third problem:

> *Would Diana even call?*

Diana was young and full of self-confidence. Would the Queen have patience with someone who really doesn't want to confide in her? How many times would the Queen reach out to Diana before giving up?

Good Intentions Combined with Bad Execution.

Sally Bedell Smith relates this story and concludes that the Queen had good intentions combined with bad execution. What was missing was a thoughtful design. As a consequence, Diana stumbled her way through life in ways that proved tragic for herself and for her children. (Bedell Smith, 2012).

We see this story played out again and again when examining the dynamics between private equity partners and founders of acquired portfolio companies.

This CEO is often a Founder of a successful company. And that success is proven by the fact that the private equity firm has invested in the CEO's company. The CEO knows how to manage Boards of Directors. And that is part of the CEO's success.

> The CEO's previous Board consisted of friends, family, and true believers. The CEO is downplaying that the dynamics of a private equity dominated Board of Directors is different.

In our work with CEO/Founders we find an intellectual understanding that accepting the investment meant accepting a loss of independence.

Intellectual understanding does not necessarily result in behavioral change in managing the Board!

How Big a Problem is This?

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 has expired, the PE firm may find that it has 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 partner impatience 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 Founder behavior, they start biasing investment decisions towards serial entrepreneurs.

> Serial entrepreneurs understand the rules of the game and have demonstrated ability to conform to those rules.

When PE Partners bias investments towards serial entrepreneurs, institutional investors often pay the price.

Potentially attractive investment options are taken off the table when investments are biased in favor of serial entrepreneurs. There is a limited supply of successful serial CEOs, so there will be a premium on these investments.

This rest of this report will discuss practical techniques Private Equity partners can take with their new CEOs.

Rules of the Road.

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. You cannot help a Founder manage you. You can't be this Founder's coach and judge. Separate the coach and the judge roles.

In addition, outline a specific roadmap for how to work with the Board of Directors. Never assume the Founder "gets it."

Based on our work with helping Founders manage private equity dominated boards plus the assistance of some fabulous PE partners, we have come up with the following Rules of the Road as one model to consider:

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 that invested in you. You were a big fish in a small pond. You now report to a Board. 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 operations. 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. Do not surprise us with last minute crisis.

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!" before the Board

meeting.   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 does 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 at all times. That's just the way we are. 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.

Conclusions

The above eight steps will help Founders be more effective in managing private equity dominated boards.

These steps are not easy to accomplish because they involve unlearning past habits of Founder success. CEOs might benefit from outside coaching even when the Founder says, "I don't need it:"

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 is not the PE Partner. It is going to be an outsider who understands the dynamics of PE Boards.

Managing risk is about confronting difficult 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 Founders may be too proud to admit they need help.

Follow up good intentions with good execution.

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