Egon Zehnder and The Conference Board Governance Center

Governance Watch™ Webcast #4: The Role of the Independent Director on Private Equity Boards

Egon Zehnder and The Conference Board Governance Center are pleased to present a new Governance Watch webcast focused on the role of an independent director on private equity boards.

In this discussion, Matthew Levine, Partner at EQT Partners will speak about EQT Partners' approach to corporate governance, the role of independent directors on EQT portfolio company boards, as well as how EQT leverages its industrial advisor network to populate its boards with independent and seasoned business leaders. The webcast is moderated by Claude Shaw, Head of the Egon Zehnder U.S. Private Equity Group, and Judy McLevey, Assistant Director, The Conference Board Governance Center.

Judy McLevey: Hi, I'm Judy McLevey with The Conference Board Governance Center. Welcome to another Governance Watch presentation in partnership with Egon Zehnder. We're going to be talking today about private equity board governance and we're going to talk about how director independence factors into private equity boards and how the life cycle changes within a company might affect director independence.

I'm joined today by Claude Shaw, who is the Leader of Egon Zehnder's U.S. Private Equity Practice, as well as Matt Levine, who is a Partner with EQT Partners.

CHAPTER #1: Independents VS Deal Professionals

Claude Shaw: Thank you, Judy. Thanks for having us today. Matt, thanks for making time as well. It's good to see you. On the topic, I guess picking up where Judy left off, EQT does have a very unique approach, I think, based in its roots as an industrial company, family-owned, versus a traditional private equity fund. You have a unique approach to how you work with talent, your industrial advisor network and how you leverage that for boards. Maybe you can tell us a little bit about first, the industrial advisor network and second, how you leverage that to populate your boards with independents.

Matthew Levine: Sure, happy to. First, as you mentioned, EQT has a long history coming out of the Wallenberg family network, which started over 150 years ago out of Sweden. EQT came out of that family network, having seen an operational approach to building and growing businesses over the last 100-plus years. One of the ways in which the family and the subsequent companies were able to do that was by A, taking a very long-term perspective, but B, having a very significant focus on what the board composition was going to be.

That board composition, which is a bit different from traditional private equity, was very much grounded in taking a bit more of an operational approach. What that means in this context is filling a board not with a majority of private equity professionals who are bringing a bit more of perhaps the financial perspective, but bringing more of that operational approach, functional expertise, which is matched up largely based upon the strategic objectives of the company. That approach that the Wallenbergs had taken for building their businesses from largely the 1850s through today extends into the EQT model.

Claude: What is the typical composition of an EQT portfolio board? I know that your traditional private equity portfolio is the CEO of the company and as many deal partners as are relevant to the deal. Maybe an independent, maybe not. How does an EQT board look?

Matthew: Ours is almost a public company board dynamic in a private company setting. What I mean by that is we will have one EQT responsible partner on the board, we will have a chairman or chairperson of the board who is independent from EQT. This is one of our industrial advisors, one of the former CEOs or operating executives of a relevant business. Then we will have anywhere from 3 to 5 additional industrial advisors who bring that functional expertise.

If there's a business that we're looking at which has an opportunity to grow into China but has very little in the way of management expertise in that field, we can bring one of our industrial advisors who has that expertise to the board to help them understand the cultural dynamics, the regulatory environment or the supply chain dynamics of what they need to think about. If there's a business with a specific competence in sales composition, we can bring that capability in an executive who can really help not just the CEO, but their head of sales or their real functional experts within the company on not a day-to-day basis, but a bit more involved than your traditional board.

Claude: It sounds like it's more hands-on than certainly a public board might be. What about in terms of the structure of the board? Are there committee structures?

Matthew: We do have committee structures. What we all care first and foremost is making sure we have the right authorization policies in place. Making sure we have the right dialog going at the right times. We don't want to be managing the business on a day-to-day basis, but at the same time, we want to be a responsible investor. We have a very specific dynamic structure between the company, the board of directors, and EQT.

One way where we facilitate that interaction is what we call the Troika model. We have the Chairman of the board, we have the CEO of the company and the EQT responsible partner, who interact on a much more frequent basis than the board meetings that happen perhaps quarterly, perhaps maybe even a bit more frequently than quarterly. These Troika discussions, it's not a decision-making body, but it's an opportunity for the CEO to preview certain concerns that he may have or certain ideas that she may have to the chairman of the board and to the EQT responsible partner as a way of building relationships, but also maintaining that governance dynamic. Then it is the Chairman's responsibility to communicate back to the rest of the board. It is a very strict governance dynamic, which is quite a bit different than I think you would see in traditional private equity.

Claude: Very much so. That's very interesting. Can you describe a bit of the dynamic between the independent board members who may be out of your industrial advisory network, so maybe not truly independent but certainly not deal professionals, on the one hand and the typical deal partners on the deal on the other?

Matthew: Sure. I'm newer at this. We have made our inaugural investment out of our effort and that dynamic is actually working quite well, because I think what everyone understands is their roles and responsibility. Why are they there and what is the expertise that they are bringing to this board dynamic? For some, it's EQT governance. For others, it's a financial capability. For others, it is something very specific, whether it's technology or sales or marketing or otherwise.

What we do actually is we're very clear as to what we're expecting from our board members. So much that we actually have an annual evaluation process. Say, here were the expectations of why you joined the board. Are you delivering that value? Much in the same way that private equity firms will evaluate the management team members, we will do the same thing with our board members because these are very important positions. We expect a lot out of it from a value creation standpoint. If those board members are not delivering the value that we expected them to, then they shouldn't be there, and we have the opportunity, given the vast network within EQT, to replace them with someone who can.

Claude: Interesting. That's what we call at Egon Zehnder a Board Effectiveness Review. You actually have your own internal review process for your boards.

Matthew: Correct.

Claude: Are the deal professionals also evaluated as part of that?

Matthew: Everyone is evaluated.

Claude: Very interesting. Have you seen instances where, whether it's in your one portfolio company which may be too early to tell, or heard of stories in the broader EQT portfolio, where it didn't work, where you had to make changes because the dynamic wasn't right?

Matthew: It happens. It happens quite often, but not always for the reasons that you're describing. It doesn't necessarily have to mean that things aren't working out. If you think about how we started this conversation, which is trying to think about what are the strategic objectives of this business? Where does it want to go? Then matching up the board capabilities with those strategic objectives.

Almost definitionally, as the years move on and we enter year two and three, hopefully we are achieving some of those objectives and the new ones are coming up. It will be appropriate for us to then revisit the capability set at the board of directors as new objectives are coming about. Having that opportunity to bring new capabilities and take others off I think is something that's very refreshing and quite frankly is needed over the term of an investment cycle for private equity.

CHAPTER #2: Manage The Business As If You Will Own It Forever

Claude: You talked about the life cycle of the investment. A lot of times in our experience in private equity, the times where we are brought into hiring an independent is before an exit, typically when there's an IPO and you have to replace yourselves or start to think about replacing yourselves with an independent. How do you think about your board of directors over the life cycle of the investment? Are you looking at these individuals with an eye towards the exit as well, or is it more around the operational value that they bring, or both?

Matthew: Much like I think the Wallenbergs and their tradition of long-term investing, I think we take a very similar approach, which is, let's manage the business as if we're going to own it forever, knowing that we won't. To manage for an eventuality that may not be there based upon market cycles or otherwise, in my mind does not maximize value for our shareholders.

What we do is try to create a board construct and try to create value with a very long-term perspective in mind, knowing that we will not own the business forever. I do believe that taking that longer-term approach is the best way for us to maximize value for our limited partners with an understanding that whether it's 3 years, 5 years, 7 years, and every situation is going to be different, but we are not managing to that specific timeframe.

CHAPTER #3: The Differentiating Skills Of Independent Directors

Claude: It sounds like there's a big focus on operational value add, industry expertise, perhaps functional knowledge, geographic expertise as well, all of which can add value to the portfolio. What are the commonalities that make for a good board member under the EQT model? What are the things that you see consistently that make you say this is why this person is good and this is why this person would not have been good?

Matthew: I think its a few things. The answer is it's going to depend upon each situation, but I think first and foremost, there's a focus on culture, both within EQT, with our industrial advisors, and with our companies. Whether we're talking about a widget manufacturer or a services company or a healthcare business, at the end of the day, they're all made up of people. We have to figure out how to not just bring the right competencies to the board, but how to bring that value to the company in an effective way. That takes a certain people skill. Finding the right executives who understand that people dynamic is important.

Certainly, people who bring the right expertise of what we're looking for and that competence, but also an ability to not just execute on their own, but to teach. People who are more coaches than players is, I think what we're looking for. We are not trying to get involved in the day-to-day operations of the business, but we are trying to empower our board members to be more involved and to help drive value in their areas of expertise specifically.

I think the last is something that's part of the EQT culture as well, which is operating with a sense of urgency. Even as we were talking before, whether it's 3 years or 5 years or 7 years, we're trying to operate and get things done every day. Even if you take a 5-year time horizon, with the ambitious plans that we have of what we're going to help our companies achieve - and we use a phrase of helping our companies achieve their full potential - if you really want to help these companies achieve their full potential, you need things to happen every day, and there's a sense of urgency around that that, I think is, required in order to be an effective board member.

CHAPTER #4: Incentivizing Board Members With Early Engagement

Claude: Very interesting. It sounds very aligned in terms of the private equity model. How do you think about aligning incentives at the board and maybe through compensation as well?

Matthew: What's interesting about the way in which we form our board of directors and it requires maybe just a quick step back, because as you were mentioning when you run a search it's often after a company has made an investment or even immediately prior to making an exit.

Claude: Right.

Matthew: We get our industrial advisors involved in a project at the very earliest of stages, from even the time it's an idea. It might be even before process or before any conversations have started. They get involved with helping through the diligence process. As we are engaging third-party providers and drafting sculpt documents, they're helping to define the market set and helping to open doors for even our third-party providers to have the right conversations, to make sure we're getting the best answers that we possibly can through our diligence.

They're helping us to create a forecast model. Management says we can grow at X percent. Well, do you think that that's achievable based upon your experience in this marketplace? How you've seen this before? What do you think? Not just in a box where we're talking to them or in a vacuum on our own, we're sitting down with the management team during even a competitive process and saying, "What do we all think together?" Because at the end of the day, what we're going to do is at the time we're going to make an investment, we may be talking to 10 or 12 of our different industrial advisors all with different expertise and we're going to select the top 3, or 4, or 5 of them based upon not just their specific competence but the chemistry with the management team, going back to the culture point.

Of those 3 or 5 different industrial advisors, we're going to ask that they invest in the business. I'm going to ask the same thing of the management team. EQT's going to invest. We expect the management team to invest alongside us and the board of directors, each individual will invest. Not at the EQT level, but at the board level. We think that that creates alignment of interests. When we're all sitting around the table trying to think about what is best for this business, we are all on the same page economically and there's no question about alignment of incentives in that way.

Claude: That's very interesting. I suppose it helps to have this bench of industrial advisors that are endemic to EQT probably built and crafted over a long period of time that you can draw from to build your boards.

Matthew: It's quite helpful. What's most interesting for us here in the United States is the geographic diversification that we experience. We probably have over 250 industrial advisors now that we call part of our network. Those exist not just in the United States or in North America more broadly, but in Europe and in Asia. Especially even in the smallest of US companies, they have customers that are outside of the United States, or they have suppliers that are outside the United States or they have business today that is outside the United States.

Trying to figure out exactly how to bridge those gaps, how do we organize our sales force in order to be most effective? How do we organize our incentive compensation schemes to drive the right behavior and finding the right operational talent who can help us understand what is the most efficient footprint for this business and how do we actually drive growth most effectively, not just in the US but on a global basis? That's been extremely helpful, and for our size range, I think quite differentiated in this marketplace.

Claude: What is the time commitment on average for a board director in an EQT portfolio company relative to maybe a public company board director, because it sounds like it's a pretty hands-on and pretty involved role.

Matthew: There's a range and it depends upon the life cycle of a business and where they happen to be in their course of growth. What I mean by that is there are going to be certain instances where certain initiatives are more at the forefront of our agenda than others. There are going to be certain board members that are going to be more relevant for those initiatives, whether it's a new product introduction or entering into a new marketplace. The time commitment for those board members might rise during those periods of time.

What I would say is it's fairly typical, whether it's quarterly board meetings or slightly more than quarterly board meetings with an annual strategic review and an annual budget session, but I think outside of the chairman role, for the other directors, there may be some interim between board meeting discussions that happen, again, in your area of expertise. I think I would expect that. I have not heard from our industrial advisors that it's become an owner's responsibility relative to either expectations or compensation or otherwise.

I would agree that the expectation is probably more of a time commitment than you would traditionally see from independent directors within a private equity function. I would also distinguish that from the chairman position, which is a bit more of a time commitment, especially given the Troika model that we have and those interim discussions that we take.

Claude: Matt, one of the advantages of operating in the private equity model is that you can make longer-term decisions outside of the scrutiny of the public eye and the cadence of quarterly earnings calls. How would you think about applying the EQT board model towards a public company setting? What do you think public companies might derive as a valuable insight from the approach that you've taken within EQT?

Matthew: It's a good question. I think you hit on the key point, which is we have the benefit of being able to take a longer-term perspective. Even managing for quarterly earnings, there are many public companies, quite successful public companies, who do take a much longer-term perspective understanding that they have quarterly needs and shareholder dynamics. I think continuing to take that long-term perspective, investing in the businesses, developing the right people skills internally, I think, is the recipe for longer-term success than managing for short-term gains.

I think that has been the philosophy at EQT for a very long time. It's been the philosophy with the Wallenberg family and their investment arm for a much longer period of time. It has served us well in both the public company arena and the private company arena.

Claude: Terrific. As we've seen and the EQT model demonstrates that boards are living and evolving organisms and you review yourselves on a fairly regular basis to make sure you're getting the most out of your boards. That's a practice that we try to employ with some of our public company, our public board clients as well, to make sure that you have the optimum mix of directors and that the mix of skills is appropriate for the stage of the company. Congratulations to what you've built, you and your colleagues at EQT, over many decades of investing, and thanks so much for your time today.

Matthew: Great. Thanks for having me.

Judy: That concludes our program today. Thanks so much to Claude and Matt for joining us.

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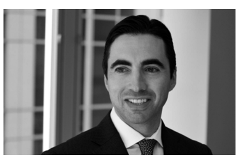

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