

# Laying the Foundation for Outside Board Directors to Add Value Inside PE Portfolio Companies



Based on a survey of senior investment professionals from dozens of funds, Notch Partners collected feedback from 50 respondents about how they compose, compensate, and utilize their portfolio company boards of directors. The investment professionals surveyed were leaders at funds ranging in size from \$200M to \$15B, with the majority in the upper middle market. 85% were control investors based in the US working across industries including consumer, healthcare, energy, business services, industrials, financial services, and technology.

Notch Partners conducted a survey of private equity investment professionals to better understand the use and impact of outside board members (OBMs) – members of the PE portfolio company board who are not PE investment professionals.

#### The survey addressed two topics

1. OBM selection criteria, role and compensation; and
2. Drivers of OBM satisfaction and success.

An interesting narrative and supporting themes emerged in our survey. Over a third of survey respondents were not satisfied with the performance of their OBMs; a surprise since OBMs were generally among the highest performing CEOs in their respective industries. Given the unique and critical value that OBMs are expected to bring, our analysis focused on drivers of satisfaction and success.

### 1. Outside Board Member Selection Criteria, Role and Compensation

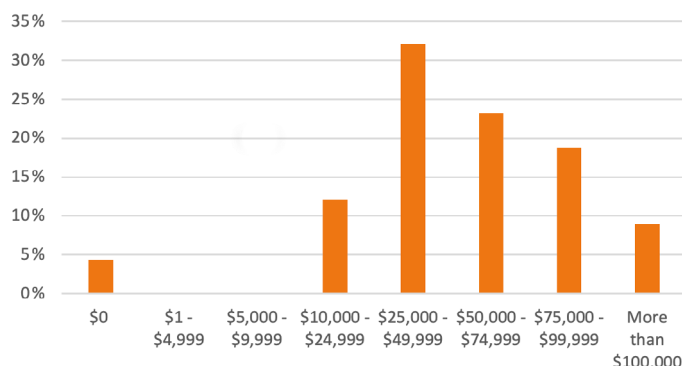
Below are summary findings from the survey

- 94% of PE boards consisted of 4-9 directors and were majority controlled by the PE deal team. 8% of funds surveyed had OBMs representing over 50% of their boards.
- OBMs (also known as independent directors) were typically ex-CEOs with deep relevant industry experience; over 93% of PE funds cited that specific sector expertise was critical when selecting OBMs. Respondents also noted that strategic vision (87%),

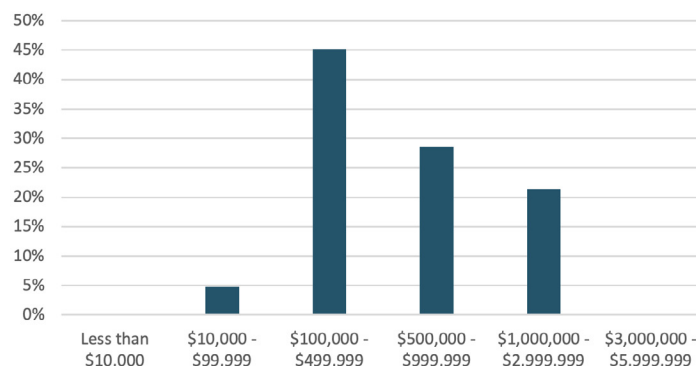
*operational expertise (67%) and business contacts (69%) were important criteria for their OBMs. Approximately half of OBMs were engaged as operating partners with a PE firm prior to serving as a director of the fund's portfolio company.*

- OBMs were most often called upon to help provide guidance on operational issues, open doors to new business contacts, and identify and diligence acquisitions. OBMs were rarely influential in exit strategy; 90% of respondents stated that the board's investment professionals were the sole decision makers on exit-related issues.
- Equity was the most significant component of compensation for OBMs. 85% of funds surveyed provided equity as part of compensation to outside board members, and 75% pay an annual salary or stipend.
- Over two-thirds of OBMs earned less than \$75K per year in salary or stipend.
- 28% were expected to make between \$500K and \$1M in equity and 21% between \$1M and \$3M in a typical base case return scenario.
- 36% of respondents stated that compensation for OBMs was customized for the individual.

Annual Cash Compensation



Director Equity Compensation by Exit



## 2. Outside Board Member Satisfaction and Performance

What are strategies that drive satisfaction on private equity boards? What adjustments can investment professionals make to maximize results?

OBFs are expected to play a vital role on PE portfolio company boards. Yet, while OBFs were hired to bring critical industry and operating expertise, they were frequently a source of dissatisfaction and confusion. **According to our survey, only two-thirds of PE board members were satisfied with the performance of their OBFs.** In our efforts to understand the sources of dissatisfaction and practices associated with effectiveness, several decisive themes emerged:

- *The level and frequency of interaction between OBFs and management teams is a significant driver of effectiveness.*
- *Compensation, particularly in the form of equity, encourages high levels of engagement from OBFs.*
- *Board members (e.g. Operating Partners) with pre-existing working relationships with the PE investor function more productively on their boards.*

**Our analysis shows that PE investors who create well-incentivized teams, with clear lines of responsibility and high levels of communication between all stakeholders, drive the most success from their portfolio investments.**

This hypothesis was based on the following findings:

**Satisfied investors encourage frequent and active dialogue between management, OBFs and PE Professionals.**

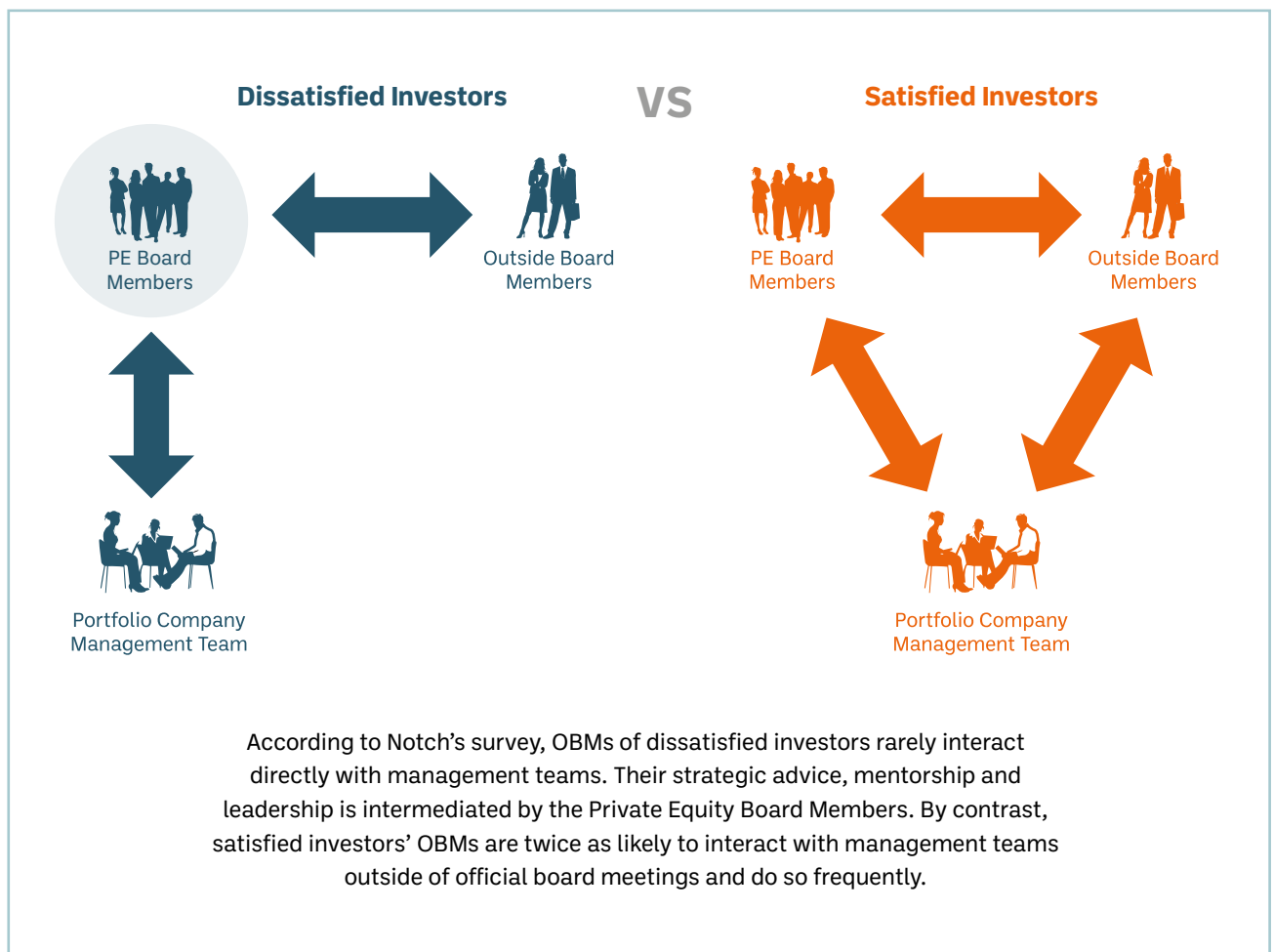
While 100% of PE firms surveyed cited frequent interaction between PE board members and management teams, OBFs on satisfied PE investors' boards were almost twice as likely to interact directly with management teams on a frequent basis. Less than a quarter of dissatisfied PE firms reported this type of interaction; some had none at all.

Lack of engagement by OBFs was the leading cause of dissatisfaction; almost 70% of dissatisfied PE firms cited this complaint and 56% criticized their OBFs for being unwilling to roll up their sleeves. Not surprisingly, 92% of effective boards with satisfied investors had OBFs interact and work with management teams onsite.

Why were less effective OBMs perceived to be failing to engage adequately? Were they truly unwilling to roll up their sleeves? We suspect that most were not as disinterested as the data suggests. Based on thousands of conversations with PE board prospects, we believe that appointed executives are motivated to serve on boards because they are eager to leverage their business networks and decades of experience to actively mentor, advise and work with management teams. Many are semi-retired executives who want to remain connected and engaged in business. We believe that in many cases their lack of engagement may be a consequence of investors' inattention to proactively and purposefully encourage and enable dialogue between the management team and the OBMs. In the absence of doing so, investors must intermediate the

strategic vision, operational know-how, and mentorship capacity of OBMs to management teams. Given that industry expertise was cited most frequently by PE firms as an important criterion for OBMs, it stands to reason that these industry veterans should work directly with management teams rather than relying on the PE investors to intermediate their dialogue.

However, PE firms may not be comfortable with OBMs interacting directly with management teams and may be concerned that the board must consistently deliver a unified message and strategy to the management team. It was no surprise then, that many satisfied investors appoint operating partners, with whom they have long and trusting relationships, to their portfolio company boards.





### Satisfied investors source outside directors through a variety of sources and cultivate long-term relationships with their OBMs.

The processes in place to source and evaluate potential board members is critical to ensuring relevance and fit. Satisfied investors develop their future directors over time and use a variety of channels to cultivate relationships with industry leaders. In fact, satisfied investors were 50% more likely to place long term operating partners as OBMs and one-third less likely to source through Executive Recruiters or their Personal Networks.

Satisfied investment professionals also tend to have a larger proportion of OBMs on their boards. 64% of satisfied investment professionals said that OBMs constitute over 25% of their portfolio company boards versus 16% of dissatisfied investors.

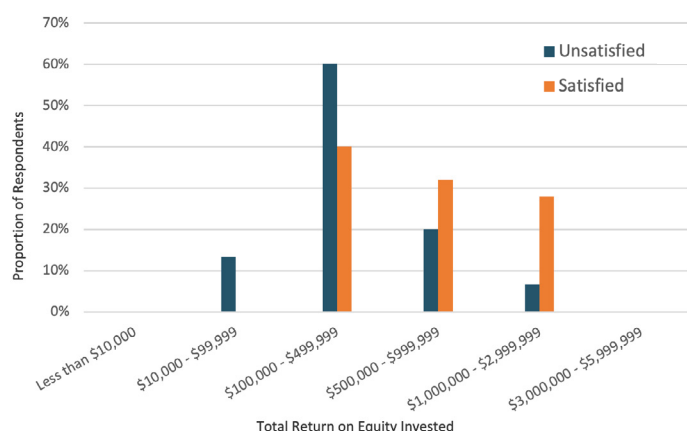
Based on results in our survey, we believe the most effective investors develop working knowledge of future OBMs over time. These investors engage with executives as operating partners or industry advisors during the acquisition phase and then call upon them to serve as OBMs after close. Conversely, these OBMs are able to use pre-close working opportunities to develop

and refine a PE “lens” for evaluating acquisitions and providing guidance on operational issues. When already engaged as operating partners, they also have an opportunity to learn and experience their specific firm’s approach and style to portfolio management. Thus, both sides are able to get a sense of the OBM’s strategic capacity and ability to interact with management teams before officially extending an offer to join the board.

### Satisfied investors pay their OBMs more.

Incentives are important. Irrespective of fund and deal size, satisfied investors were more generous with salary and equity compensation packages than their unsatisfied counterparts. Higher compensation encourages both stewardship and involvement on the part of the OBMs; those investors with the most generous compensation packages for their OBMs were less likely to complain that their outside board members were unwilling to “roll up their sleeves.”

As evidenced by the table below, 60% of satisfied respondents expected the total value of their OBM’s equity compensation to exceed \$500K, versus 26% of dissatisfied investors. (This higher expectation was not limited to the larger funds.)



### Annual retainers were also slightly higher.



## Conclusion

**Our research strongly indicates that PE investors who establish well-incentivized boards, with clear lines of responsibility and high levels of communication between all stakeholders, drive the most success from their portfolio investments.**

Frequent dialogue between all stakeholders and parties was key to realizing the most value from OBMs. Management teams benefit greatly from the strategic and industry expertise, as well as operational mentorship OBMs are hired to provide; OBMs are not just available to confirm or deny the suggestions management has made to the investment professionals. For the purposes of identifying and evaluating board members, PE funds are well-served if they work with operating partners and cultivate a robust talent pipeline of prospects for upcoming portfolio investments, and in all cases, take the time to evaluate and interview all candidates. Finally, you get what you pay for: higher levels of compensation with meaningful equity provide greater flexibility to investment professionals and encourage higher levels of engagement on the part of OBMs.

Notch Partners is the preeminent provider of CEO-level talent to private equity firms seeking competitive advantage through proprietary deal flow, industry insider knowledge, and superior management teams. Notch cultivates high-impact relationships that result in superior returns for investors and transformative career opportunities for executives.

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