

AQ

THE JOURNAL OF ALUMNI
WINTER 2012

PE VS LISTED COMPANY: HOW DOES
GOVERNANCE COMPARE?

VALUE EXCHANGE: WHAT PE AND NON-
PE FIRMS CAN LEARN FROM EACH OTHER

BOOK REVIEW: A BLUEPRINT FOR
CEO SUCCESS

IS PRIVATE EQUITY AN ENGINE OF GROWTH?



alumni

Part of the Harvey Nash Group

The human factor

Attracting the right calibre of leaders has become more of a challenge even for the PE sector.



Jan Hemmingson

Over the many years that we have been working with investors, boards and leaders in the private equity (PE) sector, we have observed a growing emphasis on the quality of human capital in portfolio companies. Some PE firms have a long tradition of including thorough human due diligence before making an investment, but others have introduced crucial processes such as management audits relatively recently.

All potential investors have more or less the same opportunity to analyse a prospective investment and its potential, so an important differentiator between the PE firms that are able to build extraordinary companies and

those that aren't is their ability to correctly assess, develop and support leaders in the companies they invest in.

But attracting the right calibre of leaders has become more of a challenge even for the PE sector. Just a few years ago the candidates we met looked mostly on the upside of the business case and were far less concerned with the potential risk in taking on a management role in a PE-owned company and, in most cases, committing some of their own money. Leaders looking to move into PE-owned companies today, however, not only scrutinise the business case minutely, but also evaluate the PE firm behind the investment.

So in addition to demonstrating their own track record in turning businesses around and making a strong business case for the current investment, PE firms now have to ensure that their brand stands for a sound and attractive leadership and governance approach in order to build the PE firm's reputation among top leaders and talent.

In our experience, the PE firms that do this most successfully strike a fine balance between supporting, developing and motivating management (and other key individuals) to build long-term mutual trust and commitment, and acting swiftly if management changes are needed. Furthermore, as much of the interaction and governance takes place in

between board meetings, having the right competences, values and internal culture helps to differentiate PE firms in the eyes of the leaders they compete for and want to attract.

Of course, one of the biggest concerns for PE firms (and others) in the current economic climate is the difficulty of assessing future

market developments. Making mistakes in this environment can have severe consequences for an organisation further down the road. This means it is more important than ever to select leaders who are able to manage uncertainty and change. Exceptional leaders and talent will always be in high demand. In-depth analysis of the critical leadership competencies and behaviours required to make an investment successful is, therefore, something that PE firms cannot afford to scrimp on.

Jan Hemmingson is managing director of Alumni Nordic.



About Alumni

Alumni is a leading firm within executive search and leadership consulting in North Eastern Europe. For more than 20 years we have been developing tools and services designed to strengthen the organisations and teams of our clients throughout the public and private sectors.

Through a service offering ranging from executive search and leadership services to high-level board advisory services, we support our clients' business success.

We have offices in Copenhagen, Gothenburg, Helsinki, Malmö, Oslo, Stockholm and Warsaw. Internationally we operate through our owner Harvey Nash Group, with more than 40 offices in Europe, the US and Asia.

Contact information for Alumni AB:

HQ Stockholm: +46 8 796 1700

Gothenburg: +46 31 60 42 90

Malmö: +46 40 35 48 70

Copenhagen: +45 77 99 32 60

Helsinki: +358 40 727 9727

Oslo: +47 22 40 40 80

Warsaw: +48 22 428 47 28

alumni@alumniglobal.com | www.alumniglobal.com

For queries regarding AQ:

Catharina Melin-Jones: catharina.melin.jones@alumniglobal.com

Editor: Jane Simms

Designer: Phil Shakespeare

Content must not be copied, distributed or sold without permission.

‘Attracting the right calibre of leaders has become increasingly challenging, even for the PE sector’

Are perceptions of PE rising?

Despite its bad press, research shows that private equity investment benefits companies, investors and economies – and these days it is more likely to do it through organic growth than asset stripping.

Private equity (PE) has no shortage of critics. Some see it as epitomising the worst excesses of the boom years, while others are concerned about its growing dominance of the European business landscape. But the evidence also suggests that rising PE ownership can benefit portfolio companies, investors and economies.

The traditional view of PE was that investors bought companies using high levels of debt, cut costs (not least people) ruthlessly, performed some clever financial engineering and sold the business to credulous buyers for a massive profit a few years down the road.

Not all PE firms were as rapacious as this caricature suggests, and the UK, arguably, was a worse offender than its Nordic counterparts. What's more, the recession has put a welcome check on the worst excesses of the PE firms: lower valuations mean

that they have had to extend their exit horizons and they are now investing in more sustainable transformational approaches.

In addition, wary investors are demanding compliance with the best environmental, social and governance (ESG) practice that has long been second nature to PE's publicly-listed-company counterparts.

The flow of executives from the public-company sector into PE underpins the trend towards balancing the focus on debt structuring with genuine operational improvements.

A report by Ernst and Young nails the lie that PE is all about asset stripping and financial engineering. 'Return to Warmer Waters: A study of 2010 European exits' found that not only is organic revenue the largest driver of profit growth in PE firms, but also that this organic revenue growth comes as much from making fundamental changes in portfolio companies as it does from investment expertise and choosing the right markets.

Yet the recession has also had less welcome effects on the sector. The flow of deals is very slow because of the shortage of funds from nervous backers who have had their fingers burnt. And there is a mismatch between the

price expectations of vendors and investors. Exits too are more difficult for similar reasons.

While such macroeconomic factors are largely outside PE's control, other factors – like how much tax they pay – are firmly within it. And while PE firms are not the only companies being pilloried for tax avoidance on a grand scale, the highly leveraged nature of many PE deals means that not only may taxable profits drop dramatically in companies that PE funds acquire, but also that these loans are often used to pay off investors through complex debt arrangements routed through offshore jurisdictions.

Should such practices persist, they will inevitably compromise both the sector's efforts to clean up its image and the financial and economic benefits it can bring (see 'How PE can benefit business', below).

“The flow of executives from the public-company sector into PE underpins the trend towards balancing the focus on debt structuring with genuine operational improvements”

Sweden is one of the biggest players in the European PE market, alongside Britain. Seven per cent of private sector employees in Sweden work in PE-owned companies, and these companies' turnover amounts to eight per cent of GDP.

But the Nordic region as a whole has become increasingly attractive for foreign PE investors. A report for the Swedish Venture Capital Association

(SVCA) and its Norwegian equivalent, the NVCA, found that Finland has the second highest number of PE-backed investments, followed by Norway and then Denmark.

Europe 2020, the EU's growth strategy for the coming decade, aims for the EU to become a smart, sustainable and inclusive economy. One of its five objectives is innovation, and it will propose actions to develop innovative financing solutions, including the creation of an efficient European PE and venture capital market. While the sector needs to ensure it complies with best ESG practice, the evidence suggests that it may be time for the sceptics to embrace PE.

How PE can benefit business

- The funding and support PE provides help small and medium-sized enterprises (SMEs) to become more efficient and professional.
- PE tends to be less volatile than public markets, and its longer-term nature better matches the longer-term liabilities of institutional investors.
- PE has a positive impact on employment – particularly in the Nordics, where PE-backed companies have seen employment rise by 41 per cent (the equivalent of 30,000 jobs) since 2000.
- The financial participation of managers and employees in the long-term success of the company contributes to above-average growth in the sector.

Source: Adveq (Winter 2012/2013)



The grass is (nearly) the same co

How does governance in public listed companies and PE-backed companies differ? A

THE EXTERNAL BOARD DIRECTOR



Monica Caneman

Independent director, Sweden, Norway and Iceland

‘There is a much higher degree of co-operation between the management, investor and external board in PE companies than there is in listed companies,’

When it works well, investor, board and management are united and work as a team. We are helped by the fact that management and external board members have a financial stake in the company. But my role, as an external board member, is to act as a bridge between the PE backer and the management team. Sometimes, for instance, the investors might be pushing for faster progress than management thinks is realistic, and I would mediate between them.

There are two main differences between governance in public listed and PE-backed companies. In the former you have to adhere to the quarterly reporting structure that the stock market requires, and you therefore place a lot of focus on meeting shorter targets. Also, each country has its own corporate governance rules, and listed companies spend a lot of effort complying with those. These two things make up a large part of a typical listed-company board's work.

By contrast, PE has a longer-term perspective. An investor is likely to be involved from between three to seven years. However, everyone in a PE-backed business is working towards a very clear and explicit goal – exit. You have to meet staged financial targets along the way of course, not least to meet bank covenants; and PE-backed firms also observe corporate governance rules. But executives in PE firms spend more of their time working on improving the business than listed-company executives are typically able to. It's probably fair to say that they are better able to balance the short and the long term than their listed-company counterparts.

It's difficult to say whether or not PE companies are more successful than public listed companies. But PE firms do have a very big focus on growth, whether geographical expansion, targeted acquisitions or whatever. And both managers and employees are very clear about where the company is going and their role in helping it to get there. That line of sight is often absent in public listed companies.

But there are different business models within PE. For example, some owners are very involved at a management level, on a daily basis; they might be experts in acquisitions, for example. Other owners will be more hands-off, leaving

the operational side of the business to the managers, but they are still very involved at a strategic and financial level. There is a much higher degree of co-operation between the management, investor and external board in PE companies than there is in listed companies.

This level of involvement means that if you are the kind of CEO or CFO who likes making their own decisions and setting and pursuing their own targets, working in the PE arena could be difficult. You need to be very receptive to investors' help, advice and demands.

If you are coming in from the outside as a potential CEO or CFO, you need to know how involved the owners are going to be, what form their involvement will take, what freedom you and the management team will have, what form they anticipate co-operation between the three parties will take, whether the philosophy of the PE backer suits you, and so on.

In some PE companies I have worked in, when it comes to acquisitions the PE firm plays a really big role, particularly in the due diligence stages. They involve management, but the acquisition is driven by the investors. That might not suit the kind of CEO who is used to running his or her own show.

In terms of performance culture, though, I don't see significant differences between PE- and public listed companies. In PE companies there is constant dialogue with the owner, with clear – and often very blunt and direct – feedback, whereas in public companies that kind of feedback comes from the board. But performance and evaluation are important in both.

And all companies need a positive culture, strong values and a high degree of trust and employee engagement. It is increasingly important to have your people behind you – and PE-backed companies, where the pressures to perform are so intense, are no exception. The external board member has an important role to play here: because we usually have leadership experience gained in public listed companies, where values, culture, trust and engagement are well embedded, we can share best practice.

And in my experience, PE investors take this on board.

colour on both sides of the fence

er? AQ asked two senior executives with considerable experience of both sectors.

THE CHIEF EXECUTIVE OFFICER



Otto Drakenberg
CEO Arcus Group, Norway

‘It is paradoxical that PE is often accused of being short-term focused, yet I have never worked with a company that is as determined as Ratos is to build long-term value’

In addition to the investor, board and management, we also have a fourth variant of stakeholder here – ‘the troika’, which comprises the chairman, the CEO and a representative from Ratos, our major shareholder. Because Ratos is a very active owner, there is frequent interaction among the troika members between board meetings. Typically, Ratos and the management, including me, work together on specific projects where Ratos have particular expertise – mergers and acquisitions, for example – which obviates the need to go outside for consultancy advice. In addition to regular board meetings, Ratos also tends to get involved where we have major financial developments. But we also respect the role of the board of directors, and the troika doesn’t make any major decisions without the involvement of the board.

As CEO I run the company day to day, but I keep my chairman and investor very regularly updated, which is different from my experience in several of the public listed companies I have worked in. When I was at Carlsberg and Goodyear, as long as I kept tracking towards my budgets and my overall yearly commitments, I would typically talk to the parent company once a month and then only with a short update. Even had I been CEO of the whole group, rather than a subsidiary, I don’t think I would have had the level of involvement with the chairman of the board that I do here.

There is even more urgency for step change here than there is in many public listed companies because of the pressure to improve the position as much as possible to drive the annual internal rate of return. That is enabled by aligning the interests of management and the PE owner by allowing management to invest in the company. In public listed companies, incentives programmes are commonly connected to movements in the share price, which isn’t necessarily the best recipe for long-term value creation.

It is paradoxical that PE is often accused of being short-term focused, yet I have never worked with a company that is as determined as Ratos is to build long-term value. We have gone through some tough times here and made some significant investments, such as building our new headquarters and factory in Norway. But Ratos has proved far

more level-headed, understanding and long-term oriented about some of the inevitable challenges we face than I would have expected from a PE company. And that is despite the fact that it is listed on the Swedish stock exchange. They are far more interested in industrial and operational competence than they are in financial engineering expertise, and that characterises the way they run the business too.

You need some very distinct traits to operate successfully in this environment and some people will have them and some not. If you have them, they add up to a good formula for success. I took this job (in Norway) 18 months ago, leaving my family in Sweden, and although there are big challenges, it has been a fantastic journey and I am even happier with my assignment now than when I joined.

Operational challenges arise, as they always will, but never governance challenges. That has been a pleasant discovery: I had naturally read up on PE before I took the job and had a number of presuppositions. But although I wouldn’t describe the board and investors as ‘lenient’, I have experienced more empathy and understanding about commercial realities here than anywhere else I have worked.

But to determine whether or not the environment will suit you, you need to draw up your own balance sheet. For example, how much are you prepared to invest in the success of the company? It is not an exaggeration to say that here, at least, you are expected to do everything in your power to succeed. That means proposing and following through on step changes, not incremental changes, in multiple areas in a short space of time. I spent 23 years as a competitive fencer, which honed my ability to focus, and my twin focus is work and keeping my family sane. Everything else has virtually been cut out, and you have to make such trade-offs.

Also, if you are going to thrive in the PE environment, you need to enjoy and feel very comfortable with the active involvement from the chairman and owner, and with volunteering updates. For me, the relationship with my chairman is critical, because we are going to be working together intensively for several years. You need to establish that you get on well together, or you won’t last the course.

A two-way street

The clear exit horizons in private-equity firms concentrate the minds of managers. What can public and PE companies learn from each other, asks Christoffer Lindblad.

Over the past few years management practice and governance in the private-equity (PE) and publicly-listed company arenas has started to converge. Even recently, PE firms focused largely on the numbers. But they have come to recognise that these on their own give no insight into the human side of the business, and that, increasingly, it is the 'softer' attributes such as culture, values and engagement that differentiate sustainably successful organisations.

Yet there remain differences between the typical PE-company CEO or CFO and their listed-company counterparts. The former thrive on intense pressure, enjoy rigorous accountability, are highly performance-driven and action-oriented and have a healthy appetite for risk. Communications with investors can be very direct and blunt, and they have to deliver or they're out.

But they are also free from much of the politics that can make life so difficult for public-company executives, and the need to communicate with just a few key people speeds up decision-making. What's more, as PE executives typically have an equity stake in the business, the clear line of sight between performance and reward is highly motivating.

However, the tough economic and market conditions of recent years have forced PE firms to revise their exit horizons and, as a result, many have augmented their financial focus with more traditional strategic transformation and restructuring approaches. This trend has been reinforced by some of

PE firms are right on the money when it comes to succession planning,

the negative publicity PE has recently attracted in the Nordics, along with the fact that PE companies are increasingly buying consumer-oriented businesses, where public

trust is at stake, and highly-regulated businesses, where government is likely to be a stakeholder. So despite their tight ownership structure, PE companies themselves are having to be more accountable to a wider group of stakeholders.

The consequence is an even greater focus on management, markets, customers and other macro factors in pre-acquisition due diligence of target companies. And it is not unusual now for the CEO of a portfolio company to discuss strategic plans,

proposed acquisitions and potential new hires with his or her principal investors on a weekly basis. While such developments clearly play to the strengths of the traditional CEO or CFO, these individuals also benefit from the wisdom and experience of the investors, their wide network of contacts, and fellow executives in other portfolio companies. It adds up to a wealth of support that is denied to most public-company executives.

But while PE companies are starting to think and act longer term – with the help of growing numbers of experienced public-company executives – it is perhaps family-owned businesses that provide the best model.

In many cases, the founders and their families run multi-million-euro businesses, and one of the primary reasons for their continuing success is that they are driven by a bigger purpose than just 'flogging the next product' or making ever more money. And that bigger purpose is to hand something down to the next generation – perhaps the ultimate sustainability strategy.

However, PE firms can teach their public-sector counterparts a thing or two about performance. Public companies aspire to 'a performance orientation', but most struggle to implement it. Making managers more accountable and providing a clearer line of sight between performance and reward would get them a long way down the path. Speeding up decision-making would also help.

Also, despite their still relatively short time horizons, PE firms are right on the money when it comes to succession planning. Having the right people, in the right roles, from the outset is a critical success factor in PE firms, and being ruthless about who makes the grade and who doesn't, and acting swiftly to address under-performance, is in their DNA.

PE firms and publicly-listed companies have sometimes been characterised as polar opposites of each other, but that's no longer true – if it ever was. In reality each side has much to learn from the other, and macroeconomic and societal shifts, underpinned by the growing number of public-company executives joining PE firms, will blur the boundaries further still. The result should be better businesses all round.



Christoffer Lindblad is a partner and country manager designate for Sweden at Alumni



A formula for CEO success

Most companies – and commentators – focus on the wrong measures of CEO success, says private-equity investor William Thorndike. His new book provides an important – and challenging – new blueprint.

William Thorndike's new book, *The Outsiders: Eight unconventional CEOs and their radically rational blueprint for success*, turns received

wisdom on its head. The founder and managing director of Housatonic Partners, a US private equity firm, has provided a fascinating account of how eight iconoclastic leaders helped their companies to achieve exceptional performance over several decades. On average their total return outperformed the Standard & Poor's 500 index by over 20 times, and their peers by over seven times, over a period of 25 years.

Thorndike identified these leaders (who include Warren Buffett of Berkshire Hathaway, Dick Smith at General Cinema and Katharine Graham at The Washington Post Company) after an extensive trawl through the library at Harvard Business School, his alma mater. Only these eight companies satisfied his twin criteria of beating (in terms of relative market performance) both their peers and the legendary Jack Welch, who delivered a compound annual return of 20.9 per cent during his 20-year tenure at GE, making him, as Thorndike says, "a de facto gold standard for CEO performance." Thorndike then set about establishing what differentiated these leaders and what, therefore, others could learn from them.

His findings were about as far from the traditional measures of success as it's possible to imagine. As he points out, in the absence of a single, accepted metric for measuring CEO performance, the business press generally focuses on growth in revenues, profits and people in the largest, best-known companies – "which is why the executives of those companies are so often found on the covers of the top business magazines."

The approach is akin, he continues, to "*Sports Illustrated* [putting] only the tallest pitchers and widest goalies on its cover."

By contrast, none of Thorndike's eight leaders sought or attracted the spotlight. "Rather, they labored in relative obscurity and were generally appreciated by only a handful of sophisticated investors and aficionados." Frugal, humble, analytical and understated, they were devoted to their families and didn't relish the outward-facing part of the CEO role. "They were not cheerleaders or marketers or backslappers, and they did not exude charisma." And they shared a predilection for nondescript head-office locations, at a remove from the din of Wall Street.

What's more, all were first-time CEOs, most with very little prior management experience, and all but one were new to their industries and companies. They came from

a variety of backgrounds. One was a former marketer, one an astronaut, one a widow with no prior business experience, one inherited the family business, two were highly quantitative PhDs, one an investor who'd never run a company before and one a consultant.

But crucially, while all these people were iconoclasts, "they were iconoclastic in virtually identical ways." In essence, concludes Thorndike, they thought more like investors than managers. They shared what he calls "a genius for simplicity, for cutting through the clutter of peer and press chatter to zero in on the core economic characteristics of the business. In all cases this led them to focus on cashflow and to forgo the blind pursuit of the Wall

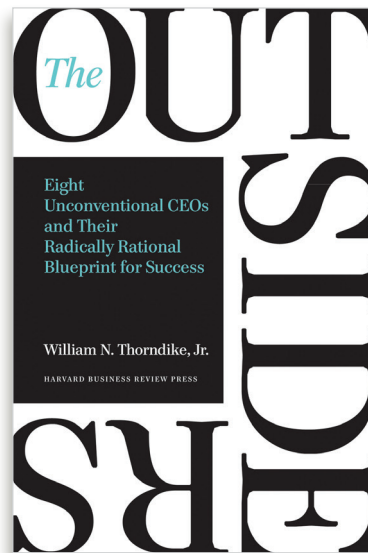
Street Holy Grail of reported earnings."

The lessons of these iconoclastic CEOs, says Thorndike, "suggest a new, more nuanced conception of the chief executive's job, with less emphasis placed on charismatic leadership and more on thoughtful deployment of firm resources."

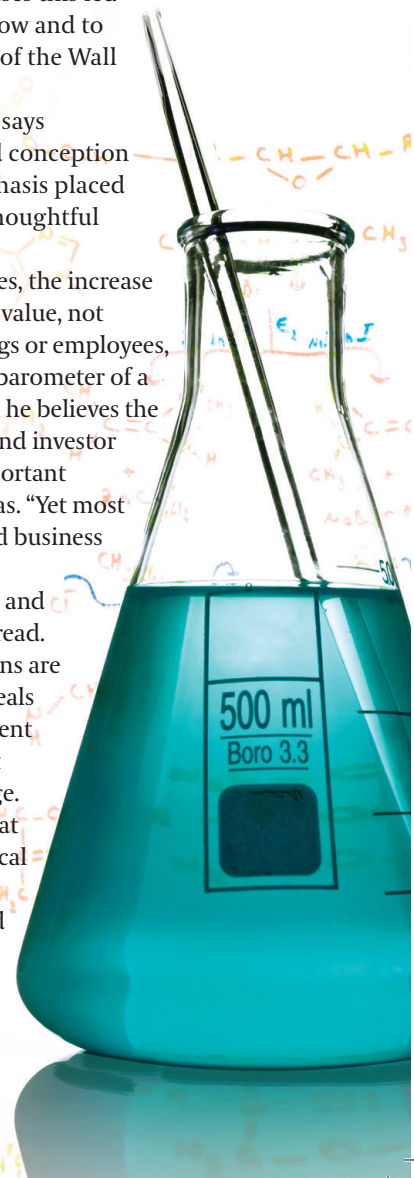
It is, as he demonstrates, the increase in a company's per share value, not growth in sales or earnings or employees, "that offers the ultimate barometer of a CEO's greatness." As such he believes the role of capital allocator and investor is probably the most important responsibility any CEO has. "Yet most are unprepared for it, and business

schools don't teach capital allocation."

The Outsiders is thoughtful, illuminating and full of insight. It is also an extremely good read. Despite its focus on US companies, its lessons are universally applicable. And although it reveals the deep fissures running through the current system, it is, ultimately, optimistic – at least for those brave enough to act on its message. Thorndike concludes: "The good news is that you don't need to be a marketing or technical genius or a charismatic visionary to be a highly effective CEO. You do, however, need to be able to understand capital allocation and to think carefully about how to best deploy your company's resources to create value for shareholders."



The role of capital allocator and investor is probably the most important responsibility any CEO has,



Making board reviews count

To be valuable to an organisation, board reviews need to be robust, qualitative, objective and transparent. For this reason growing numbers of companies are seeking external help, says George Forsman.

In the past the chairman would usually conduct a board review using some sort of questionnaire. But many such reviews have proved neither reliable nor useful. For one, board members may be reluctant to be honest, doubting their anonymity will be protected. Second, self-assessments frequently show that the board's work and performance is sufficient and in no need of improvement. Over the past few years we have noticed growing numbers of companies choosing to work with external partners in order to generate objective and transparent reviews.

A quantitative questionnaire might suffice if a company wants to compare a board's performance from one year to another, or to highlight specific areas of interest. However, to gauge more qualitative measures of performance – including board composition – businesses need a more robust process. Most chairmen – and nomination committees – want to evaluate compliance and risk issues, the contribution of individual board members, the internal climate, and, last but not least, the effectiveness of board composition and strategy work. The company also needs to assess the chairman's performance as perceived by the rest of the board. All of this requires qualitative interviews with individual board members, including the CEO.

At Alumni, our experience and knowledge of best board practice make us a valuable partner when it comes to conducting board reviews and analysing and

communicating the resulting insights. Recognising that every board and every situation is unique, we tailor our approach.

Our process may start with a questionnaire in order to identify areas of common ground and divergent thinking. But in almost every case we and our clients find that the interviews with individual board members add the most value. These one-to-one interviews encourage open and candid discussion and allow us to probe specific issues and gather complementary perspectives.

Conducting a board review is one thing. But you also have to make it count, and we have a process for ensuring the results are embraced and acted on. Typically, we first discuss the feedback with the chairman (including personal feedback on him or her). We follow this with presentations to the nomination committee and/or the owners, and then with a workshop for the full board, in which we bring the insights to life.

How can a 'good' board become 'great'? How can a faltering board improve? How equipped is the board to face future challenges? To find the answers to such critical questions requires the experience, objectivity and structured approach that a partner like Alumni can bring.



George Forsman is partner and head of board services at Alumni.

Merry Christmas
and a Happy New Year

This year we are making a donation to 'Hand in Hand'

