



Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

The rise of
“Governance
Correctness”

How public markets have
lost entrepreneurial ground
to private equity

WHITE PAPER 2018



Steffen Meister
Richard Palkhiwala

WHITE PAPER

This paper provides a practitioner's perspective on the increasing divergence between the corporate governance regimes of public and private markets and the resulting impact on value creation for investors.

Important information

This material has been prepared solely for purposes of illustration and discussion. Under no circumstances should the information contained herein be used or considered as an offer to sell, or a solicitation of an offer to buy any security. The information contained herein is proprietary and may not be reproduced or circulated in whole or in part.

All information, including performance information, has been prepared in good faith; however, Partners Group makes no representation or warranty, express or implied, as to the accuracy or completeness of the information, and nothing herein shall be relied upon as a promise or representation as to past or future performance. This material may include information that is based, in part or in full, on hypothetical assumptions, models and/or other analysis of Partners Group or any of its affiliates (which may not necessarily be described herein), and no representation or warranty is made as to the reasonableness of any such assumptions, models or analysis. The information set forth herein was gathered from various sources which Partners Group believes, but does not guarantee, to be reliable. Unless stated otherwise, any opinions expressed herein are current as of the date hereof and are subject to change at any time. All sources which have not been otherwise credited have derived from Partners Group.

The projections, forecasts and estimates of Partners Group contained herein are for illustrative purposes only and are based on Partners Group's current views and assumptions, which are subject to change at any time. Such projections, forecasts and estimates involve known and unknown risks and uncertainties that may cause actual results, performance or events to differ materially from those anticipated in the summary information. Partners Group expressly disclaims any obligation or undertaking to update or revise any projections, forecasts or estimates contained in this material to reflect any change in events, conditions, assumptions or circumstances on which any such statements are based unless so required by applicable law.

Private market investments are speculative and involve a substantial degree of risk. Private market investments are highly illiquid and are not required to provide periodic pricing or valuation information to investors with respect to individual investments. There is no secondary market for the investors' interest, and none is expected to develop. In addition, there may be certain restrictions on transferring interests. Past results are not indicative of future performance, and performance may be volatile.

All Partners Group investments mentioned herein were made on behalf of the firm's clients, not on behalf of Partners Group Holding AG or any of its affiliates.

Material notes to readers based in the United States of America: this is a publication of Partners Group AG and is for informational purposes only. It is not an offer to sell or solicitation of an offer to buy any security. Products or funds mentioned in this publication are not available to U.S. based investors.

For use with institutional investors only. Not for use with retail investors.

All images are for illustrative purposes only.

Copyright © 2018 Partners Group.

Contents

Foreword	6
Introduction	8
Section 1: The evolution of corporate governance	15
Section 2: “Governance correctness” in public markets today	26
Section 3: The private markets framework for governance	45
Section 4: Effective entrepreneurial governance in practice	51
Outlook and conclusion	66
Contacts	75

Foreword

Academics and other industry observers typically attribute the outperformance of private equity over public equity to a combination of capital structure, illiquidity and operational effectiveness. However, it is our view that this analysis misses the most pertinent point of all, which is superior corporate governance.

Over the past two decades, the private equity industry has evolved significantly, moving away from financial engineering and toward value creation as the primary driver of growth at portfolio companies – and ultimately therefore of returns to its investors. In doing so, it has been supported by a corporate governance regime that enables entrepreneurialism in its purest form.

During the same time period, a worrying trend has emerged in parts of the public markets, where the requirement to adhere to corporate governance codes and industry “best practice” seems to be overshadowing the need to direct and enforce a value-enhancing strategy at many major corporations. We believe that public markets have lost entrepreneurial

ground to private markets due to an excessive focus on a corporate governance regime that, in many jurisdictions, has evolved far beyond its original mandate to protect shareholders, a phenomenon we have christened “governance correctness”.

By the same token, we observe that governance structures in private markets have transitioned to a format resembling the very original spirit of corporate entrepreneurialism, which enabled many firms in the earliest days of public companies to find success. In this sense, we assert that governance, more than any other factor, is the true catalyst for the outperformance of private equity-backed companies.

As a private markets investment manager, Partners Group has an obvious and vested interest in this topic. However, in writing this paper, our aim is not to put forward new evidence of private equity’s outperformance over public markets – we believe that this has already been well-documented by other, more independent actors within the financial markets sector or the academic world.

Nor does this paper try to assert that private companies are inherently superior to public ones. In fact, Partners Group itself listed on the SIX Swiss Exchange in 2006, but continues to apply a corporate governance philosophy that balances entrepreneurial growth over the long term with the interests of all of its stakeholders. Equally, many listed family businesses, or firms with a concentrated shareholder base, follow a very similar entrepreneurial approach to private equity-backed firms.

The objective of this paper is to draw on Partners Group's own experience, as a direct investor in over 100 private companies¹ to date, on behalf of our clients, and those of other companies active in private and public markets, to describe in largely anecdotal and qualitative terms what we believe is a noteworthy trend – namely the increasing divergence between the governance regimes of private versus public companies and the resultant impact on returns for investors.

¹ And indirect investor in thousands of companies and assets.

In that sense, this paper is as much about governance driving underperformance within public markets as it is about the outperformance of private markets.

We hope you find it thought-provoking.

Steffen Meister
Richard Palkhiwala

Introduction

The original public corporations were a tremendous leap forward in the history of capitalism. Dotted throughout history before they became a mainstay in the early 20th century, corporations had the ability to spread risk and empower entrepreneurs to build corporate empires, railroads, and canals.

However, with the development of the public corporation came a question that has not been satisfactorily resolved, even to this day: how can a diffuse and diverse group of owners oversee their investment while still allowing the company's management the freedom to drive forward the business?

Over time, public market governance has become even more complex. Shareholders of large corporations can number in the hundreds of thousands across the globe, each with their own set of expectations. Moreover, the complexity of many businesses has significantly increased over the last century. Multiple business lines, global supply chains, and international subsidiaries make it an ever-greater challenge for boards to oversee large corporations on behalf of their investors.

Attempts to address the implicit tension between managers and owners, the so-called "principal/agency problem,"² have resulted in successive waves of laws and codes designed to improve governance. While governance standards have undoubtedly become more consistent, in reality these increasingly restrictive standards often have the unintended side effect of diluting a board's decision-making capabilities and thus stifling its entrepreneurial spirit.

Today, a company's blanket compliance with corporate governance codes and other sets of industry standards is often monitored and enforced by the efforts of proxy advisors. These advisory agencies, whose membership encompasses huge numbers of institutional investors, wield significant influence over large blocks of voting shares and ultimately therefore over corporations themselves.

As a result of all of this, many public company boards today spend large amounts of precious

² The principal/agency problem has been sufficiently explored in a large number of academic and other research papers spanning several decades. It is therefore not a specific focus of this paper, although references are made to it and to certain seminal papers on the topic.

time on control-related topics, often putting discussion of business strategy in second place. Meanwhile, there is a risk that directors beholden to the short-termism of Wall Street investors, including many institutional investors, may overlook or postpone long-term value creation initiatives in favour of short-term metrics like quarterly earnings.

In contrast, the governance structure of private equity enables a focus on long-term growth at its investee companies that has led the asset class to consistently outperform stock market benchmarks over the past decades.

The academic and business community frequently credits this private equity outperformance to an illiquidity premium, the use of leverage, and operational effectiveness. However, in our view, they miss the obvious point that all of these contributing factors have been enabled by one overriding catalyst: private market governance.

Private equity investors and the management teams of their portfolio companies do not need to be as concerned with adherence to sometimes arbitrary governance codes and so-called “best practices” as their public market peers. That’s not to say that the private equity industry is not concerned with good corporate governance – it absolutely is – but rather that it has relatively more freedom to find the most appropriate structure and set of controls for

the business in question. Building a better firm is the primary objective of the processes and checks that are put in place.

Moreover, private equity directors tend to spend more time with – and get more deeply involved in – a business, creating and enforcing bespoke value creation strategies for the benefit of both the owners and the employees of their portfolio firms as well as their clients. Ultimately, of course, they do this for their own benefit and that of their own investors, whose investment outcome depends on the success of their active strategies in growing the companies they are invested in.

“Many public company boards today spend large amounts of precious time on control-related topics, often putting discussion of business strategy in second place.”

Yet, private equity is occasionally still lumped together with hedge funds in the “alternatives” bucket. We would argue that the approach – and specifically the governance – could not be more different. Hedge funds – even the activist

kind – tend to invest in public companies for short-term gains based on an event-driven hypothesis, not on long-term value creation. In hedge funds, investment objectives are typically achieved through public communication of these single one-time events, as the actual percentage ownership – and therefore control – tends to be very limited. In contrast, in private markets, the investment outcome of a fund results from a portfolio of growth strategies carried out over several years. Due to this significant difference in approach, we naturally disregard the hedge fund industry in our paper.

This paper will therefore compare the fundamental differences between the governance practices of private equity with those commonly found in public markets. Moreover, it will describe how private market governance practices enable long-term value creation for shareholders in a way that would be challenging for many firms in public markets, given the pressures public companies face from external forces such as regulation, proxy advisors, and governance codes as well as short-term investor communities.

A guide to reading this paper:

Section 1: The evolution of corporate governance

By reviewing key moments in history from the Industrial Revolution onwards, we show how early corporate entities, such as The East India Company, balanced risk management with strong entrepreneurial aims. We look at key milestones in corporate history and legislation and explain how we arrived at the corporate governance codes and common public markets practices of the present day. The section ends by describing the emergence of private equity, in which the common governance practices share parallels with the entrepreneurialism of the earliest corporate ventures.

Section 2: “Governance correctness” in public markets today

This section examines the systemic phenomenon that we refer to as “governance correctness” in public markets: where governance practices may under-prioritize the long-term entrepreneurial aims of a firm in favour of focusing on internal controls and the management of downside risk. We focus on three key areas where we believe the symptoms of governance correctness are most prevalent and potentially most damaging. In section 2.1, we look at the general obsession in public markets with board independence and explore how this can undermine a board’s

ability to create value for shareholders. In section 2.2, we examine the increased short-termism among investors in public markets and the influence this has on corporate strategy. We argue that proxy advisors may exacerbate the pressure on boards and management teams to focus on short-term performance at the expense of long-term value creation with their “one-size-fits-all”, “tick box” approach to shareholder recommendations. In section 2.3,

we look at the typical board and management compensation structures found at public corporations and assert that they can reinforce a misalignment of interests with shareholders. Lastly, in section 2.4, we highlight the example of certain private markets firms, including Partners Group, and Silicon Valley tech companies that have found ways to list publicly without ceding to governance correctness.

Explaining the term “governance correctness”

We coined the term “governance correctness” to describe a systemic phenomenon we have observed in parts of the public market, where governance practices may under-prioritize the long-term entrepreneurial aims of a firm in favour of focusing on internal controls and managing downside risk. Its most prominent features/symptoms are:

1. An overemphasis on independence at the board level in nearly all matters – choosing and utilizing directors with the main aim of ensuring oversight, while making it difficult for boards to direct strategy.
2. Short-term pressure from Wall Street – without strong strategic convictions, boards are easily pressured by Wall Street to adopt short-term outlooks, while proxy advisors, with increasing power in the face of passive investing, encourage adherence to often mechanical governance codes.
3. Compensation schemes – incentivization at the executive and board levels places a continuous focus on ongoing earnings and stock price development, which may hamper longer-term transformational change and sustainable growth, while the perception of increased liability and reputational risks encourage risk-aversion to the detriment of long-term value creation.

Section 3: The private markets framework for governance

In this section, we contrast the governance structure of private markets with that of public markets, arguing that private markets governance generally balances the entrepreneurial aims of a firm with its oversight responsibilities, which we refer to as “entrepreneurial governance”. In section 3.1, we examine the role of the board in private equity-backed companies, illustrating that their composition, conduct, and even mandate can make them a distinguishing enabler of value creation compared to their public market equivalents. In section 3.2, we look at how the alignment of interests between the private equity owner and its beneficiaries and the management team and board of a company allows a longer-term focus on growing sustainable cash flows over short-term earnings gains. In section 3.3, we assert that the typical compensation structure and four- to seven-year holding period of a private equity investment reinforces the alignment of interests and increases accountability amongst all stakeholders.

Section 4: Effective entrepreneurial governance in practice

While the previous two sections explained the limitations and strengths of the governance frameworks in public and private markets, respectively, this section examines how these governance frameworks specifically impact the

ability of public and private corporations to actively create value for shareholders. In section 4.1, we explain the private equity approach to value creation, which is ultimately the generator of the asset class’ outperformance over public markets. In section 4.2, we look at mergers and acquisitions, which are among the most consequential strategic actions a board can take. In public markets, a consensus shows that mergers and acquisitions are more often than not dilutive – they fail to produce value for shareholders. In contrast, in private equity, mergers and acquisitions are usually smaller and considered a key part of the normal value creation plan, with potential add-on acquisitions usually identified during due diligence on an investment and commercial and cultural integration made a key focus. In section 4.3, we compare public and private market action on environmental, social and governance issues and assert that, despite adopting ESG frameworks later, the private equity industry has likely surpassed public markets on ESG performance due to its mandate to create value over a long time horizon and the proximity of its boards to its businesses. In section 4.4, we look at effective capital structures, making the point that public markets can use debt too cautiously in their capital structures as boards and management teams fear being labelled as irresponsible risk takers. By virtue of its longer time horizons, private equity is able to use financing strategically in a way that maximizes the value

of the buyout company. Lastly, in section 4.5, we assert that the acceptance of secondary buyouts as a legitimate – and even potentially preferable – exit route for private equity is proof of concept that private equity governance can enable superior value creation. Throughout the section, we have included several case studies from Partners Group’s own private equity portfolio to illustrate some of the points made.

Outlook and conclusion

In the outlook for this paper, we assert that the era of private markets investors being able to buy private assets more cheaply than those in public markets has come to an end and that the current high valuation levels are indicative of a structural – not cyclical – shift in market dynamics. In this context, the ability of private markets managers to actively create value – enabled by a governance framework that supports entrepreneurialism – will become the primary driver of returns. This will in turn have a structural impact on the industry as a whole, favouring those managers with scale. We believe longer-term investment vehicles or approaches will become a more common feature of the private markets industry, driven by demand from its long-term investors for ongoing private markets governance. We see two potential approaches emerging for long-term private markets ownership: an extended ownership model, which involves the

private markets firm retaining an influential stake in a company after exiting an initial buyout, and a long-term “core” asset model, which involves investing from the outset with a 10- to 15-year investment horizon. In our conclusion to this paper, we look briefly at the decline in the number of public companies in the US and UK in the past two decades and assert that “governance correctness” may be one reason behind this. We believe that “governance correctness” has become so entrenched through laws and codes that it is likely to persist indefinitely; in contrast, private equity firms will continue to emphasize entrepreneurial governance models as they refine and specialize their value creation skillset. We predict that private equity will continue to outperform public equity, even as the industry becomes more competitive and valuations remain more directly comparable to those in public markets.

“Governance correctness’ under-prioritizes the long-term entrepreneurial aims of a firm in favour of managing downside risk.”

Notes and acknowledgements

Independent of the discussion about governance in this paper, as an active long-term direct investor in more than 100 companies since our inception in 1996, we acknowledge that sector dynamics and market forces can often have a much stronger impact than that of entrepreneurial governance alone. As such, while an entrepreneurial board and management team can clearly make a significant difference in the development of a company, they will never be operating completely free of the influence of the market. However, for the purposes of this paper we have focused only on the factors that leadership can control.

Additionally, while there are many different models and regimes for corporate governance globally, this paper is predominantly focused on those of the US and the UK. This is not because they are the only markets where we see symptoms of “governance correctness”, nor is it necessarily because we perceive them to be the most important markets from an

investment perspective. In fact, corporate governance is such a vast topic that the focus on the UK and US was necessary simply in order to narrow the scope of this paper and focus our argument.

In this paper we use the terms “private equity” and “private markets” largely interchangeably to refer to the practice of professional private markets investment managers with a growth-focused mindset acquiring companies or assets.³

Lastly, there is already an immense body of literature and academic research on the broader topic of corporate governance and its shortcomings, and we acknowledge our debt to the seminal works which have been referenced in this paper. Additionally, we are immensely grateful to the colleagues and peers who gave their time generously to provide counsel and feedback throughout the drafting of this paper.

³ Besides the “traditional” private equity model, focused on the acquisition of corporates, the scope of this paper also extends to the acquisition of corporate-style entities or platforms in private infrastructure (e.g. renewables or midstream energy platforms) or private real estate (e.g. logistics or hospitality groups) with the intention of generating returns for investors through organic and acquisitive growth. Not included within the scope of this paper is “turnaround”, “special situations” or “distressed” private equity, which although sharing the same governance, employs a different approach to achieving returns for its investors.

Section 1

The evolution of corporate governance

1.1 The earliest days of corporate governance

The publicly traded corporation is ubiquitous today. It is a distinct legal entity, with the right to employ workers, own property, and sue in court. In other words, corporations have all the rights of an individual citizen while remaining distinct from their owners.

This model of ownership has always faced a fundamental problem – how can owners retain control of their investment while employing outside managers? The shareholders of public companies are widely dispersed, inhibiting their ability to collectively take action and supervise the firm. Furthermore, individual shareholders may wish to defer to specialists on matters in which they lack expertise themselves. Corporate governance seeks to address these concerns. It is the programme by which directors, acting on the behalf of shareholders,

oversee management, create internal controls, and decide major corporate issues.

In its original iteration, corporate governance provided the minimum structure necessary to achieve entrepreneurial goals while giving investors a say in the running of their enterprise. Corporations were created as basic entities that would allow investors to pool capital in order to give entrepreneurs tools to accomplish their goals. In turn, investors required some basic assurances – they were concerned that their money was being used to fund the entrepreneurial endeavour – and demanded directorships in order to have some oversight over their investments. Simply stated, basic corporate governance structures allowed investors to feel secure in their investments while giving entrepreneurs the ability to succeed.

As the original joint-stock company, The East India Company (EIC) first discovered the difficulty of separating ownership from control. The EIC was founded in 1600 by a royal charter from Queen Elizabeth I, granting the company a monopoly over trading routes east of the Cape of Good Hope and west of the Straits of Magellan.⁴ Meeting at the Nags Head Inn in the City of London, the founders of the EIC devised a system whereby shareholders would gather for an annual general meeting in order to elect directors and discuss critical issues, starting a governance convention that exists to the present day. The purpose of this basic governance framework was to give investors a voice in the management of the company while financing ships that would cross oceans and building an infrastructure to trade with distant lands.

There was a powerful alignment of interests between shareholders, directors, and management at these early annual meetings. The merchants of the City of London made up the bulk of the ownership, and directors were chosen from the body of existing shareholders. While they did not receive outright compensation, they necessarily had considerable skin in the game. The management came in the form of captains and traders, who risked their lives for a chance at fortune. As an incentive, they would receive a

portion of their spoils, called divisions (or “dividends”), which would be distributed throughout Europe by London’s merchants (likely to be EIC shareholders). All of these groups had an interest in ensuring the long-term growth of the company.

However, joint-stock companies like the EIC were uncommon as their formation required a charter from a royal court or parliament, typically to act on behalf of government in a specific activity for a set period of time. In fact, until the development of the corporation in the early 19th century, the vast majority of commercial enterprises were structured as either a partnership or as a sole trader-ship. These structures had their limitations, especially when it came to raising capital. The law did not differentiate between financing and managing partners and a primary failure of this structure was that it carried unlimited liability. In the event of a bankruptcy, the partners of these firms could find themselves in a debtor’s prison, and their family sent to workhouses, until their obligations had been met. As it applied equally to managing and investing partners, this draconian punishment served as a major deterrent to investing in the equity of a firm.

⁴ Basic historical facts about the East India Company were taken from *The Honourable Company* (2010) by John Keay and “The East India Company – A Case Study in Corporate Governance” (*Global Business Review* Vol 13, Issue 2, pp. 221-238) by Vijay K. Seth.

New forms of capital fuel the Industrial Revolution

Change came at the beginning of the early 19th century. The Industrial Revolution had greatly expanded the need for capital, especially in the UK, as entrepreneurs sought to build factories and facilitate major infrastructure projects.

The merits of the limited liability corporation became evident to Parliament, and in the mid-19th century Parliament passed a series of laws that would create the modern public company structure, with all the rights of personhood and limited liability. In 1844, the Joint-Stock Companies Act created a register of joint-stock companies and allowed individuals to incorporate a venture through a simple registration process rather than having to seek the permission of Parliament. Some years later, the Limited Liability Act of 1855 allowed for some measure of limited liability for the first time in history.⁵ These laws enabled individuals to easily form corporate entities that would limit their downside, freeing them to take risks. Now, entrepreneurs were free to raise capital from investors to build factories or experiment with new technologies without worrying about landing their families in workhouses. This added fuel to the fire of the Industrial Revolution, watering the seeds of innovation and entrepreneurship.

⁵ Graeme G. Acheson et al. "Corporate Ownership and Control in Victorian Britain," *Economic History Review*, 68(3), pp. 911–936, 2015.

1.2 From government monopolies to multinationals

Across the Atlantic, the formation of corporations was a matter for the states, whose legislators handed out charters of incorporation rather than royal courts and national parliaments. New York State was the first to allow for the creation of limited liability firms, but restricted them to the manufacturing sector as it was considered a serious moral hazard for banks and insurance companies to be able to escape their debts.

The true unshackling of the corporation occurred in 1896, when New Jersey became the first state to adopt an "enabling" corporate law,⁶ with the goal of winning business away from neighbouring New York. Enabling statutes essentially allowed corporations to follow their own protocols without restrictions on a line of business and to design their own governance structure. This inevitably led to the present "one vote per share" model advocated by the industrialists and bankers of the gilded age. In 1899, the state of Delaware copied New Jersey by adopting enabling corporate statutes, becoming by far the most liberal in the US.⁷

⁶ Theresa A. Gabaldon, Christopher L. Sagers. *Business Organizations*, 2016.

⁷ J. Kaufman. "Corporate Law and the Sovereignty of States," *American Sociological Review*, 73(3), pp. 402–425, 2008.

1.3 Corporations grow distant from shareholders

In many ways, those who devised this system of governance could not have anticipated the scale and complexity of modern corporations. With the development of stock exchanges in the early 20th century, ownership became increasingly diffuse. As a result, shareholders became progressively more detached from the business. The development of liquid stock exchanges enabled a culture of speculation rather than ownership, which further lessened shareholder engagement. Major corporations such as Coca Cola, Ford, and Standard Oil came to count hundreds of thousands of shareholders on their rolls.⁸ As corporate control increasingly reflected the interests of major shareholders, these firms were often dominated by concentrated owners or bankers, who would prop up the board with their agents, dictating the direction of the firm.^{9,10}

However, the early days of the securities markets had growing pains. Repeated bubbles, panics and crashes exposed fraud and mismanagement in the corporate world. The industrialists and “robber barons” of the Industrial Revolution had come to be viewed as stock manipulators, enriching themselves while

8 Coca Cola Authorized Share History, Coca Cola corporate website.

9 Frederick Lewis Allen. *The Great Pierpont Morgan: A Biography*, 2016.

10 Marco Becht, J. Bradford DeLong. “Why has There Been so Little Block Holding in America?” *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, 2005.

controlling the fate of the average minority shareholders. Following the Crash of 1929, populist fervour grew in the US, and the financially shattered public called out for increased legislation of corporate control. This resulted in several landmark pieces of legislation that would come to define corporate governance. In particular, the Securities Act of 1933 was designed to protect the interests of minority shareholders. The Act also created the US Securities and Exchange Commission (SEC), mandated the audited reporting of financial statements and barred insider trading.¹¹

1.4 The era of the CEO: Management eclipses shareholders

The term “corporate governance” first entered common usage during the 1970s.¹² It is no coincidence that this was a challenging decade for American corporations.

The conclusion of the Second World War began a period of American corporate dominance. With Germany and Japan incapacitated by war, and debt-burdened Great Britain managing the dissolution of its empire, the US operated virtually without major global competitors. Moreover, the war had vastly increased the country’s industrial capacity, and millions of returning soldiers provided an abundance of

11 CJ Simon. “The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues,” *The American Economic Review*, 79(3), pp. 295–318, 1989.

12 Bob Tricker. *Corporate Governance: Principles, Policies and Practices*, 2012.

skilled labour.¹³ This led to the remarkable figure that by the conclusion of the war the country had a 50% share of world GDP.¹⁴ However, the lack of global competition led to excesses by management at America's major corporations. Low interest rates and a mantra of diversification emanating from the academic fields of management and finance led to the conglomerate boom of the 1960s. CEOs became eager to expand their power through empire building, using diversification as an excuse. They created colossal corporations, composed of vastly different businesses, through mergers and acquisitions. As interest rates climbed rapidly in the 1970s, many conglomerates were forced to sell or spin off businesses at deep losses, exposing serious managerial incompetence.¹⁵

13 Yuzuo Yao. "Historical Dynamics of the Development of the Corporate Governance in Japan," *Journal of Politics and Law*, 2(4), pp. 167-174, 2009.

14 Kent Hughes. "Small Business is Big business in America," The Wilson Center, January 2014.

15 Alan Dignam and Michael Galanis. *The Globalization of Corporate Governance*, 2016.

“Those who devised the public company system of governance could not have anticipated the scale and complexity of modern corporations.”

While the conglomerates fell apart, the agency problem remained. The sheer size of post-war corporations had heightened the problem as increasingly numerous and geographically dispersed shareholders lacked the ability to organize against all-powerful CEOs. This enabled management teams to run companies for maximum personal benefit with virtually no checks and balances in place to ensure they created value for shareholders.

However, a major scandal would dent the de facto rule of CEOs and lay the foundation for shareholder activism. The abrupt collapse of the major railway company Penn Central in 1970 sent shockwaves through the American financial system, requiring an intervention by the Federal Reserve and highlighting problems with governance.¹⁶ The SEC found the board of Penn Central had utterly failed in its duties to oversee management. They revealed that board meetings were “formal affairs”, not conducive to proper discussion of the business. They reported that this widely reflected the board culture of the time, which resembled a “gentlemen’s club” where friends would have a quick lunch and rubber-stamp the proposals of management. Indeed, it was broadly found to be the case that management was appointed from a close network of friends and colleagues,

16 Mark A. Carlson and David C. Wheelock. “The Lender of Last Resort: Lessons from the Fed’s First 100 Years,” *Federal Reserve Bank of St. Louis Working Papers*, 2013.

who likely had close personal ties to upper management.¹⁷ The “managerialist” model had come to dominate the composition of boards, whereby directors were handpicked by the CEO – exactly the opposite of how the system should operate.

This led the SEC to recommend audit committees composed of independent directors at major publicly traded firms. In 1977, under pressure from the SEC, the NYSE mandated that all its US-listed companies have audit committees with a majority of independent directors.¹⁸ This marked the beginning of the independent director as a key feature of corporate governance. Broadly defined, an independent director is a non-executive director who does not have any kind of relationship with the company that may affect the independence of his/her judgement.

The precise mandates of boards became further defined following a number of court cases related to takeovers during the 1980s. Through a series of important cases, Delaware corporate law expanded the scope of the board from hiring officers and overseeing financial statements to the reviewing and vetting of major strategic decisions.

¹⁷ *The Financial Collapse of the Penn Central Company*. Staff Report of the Securities and Exchange Commission to the Special Subcommittee on Investigations, 1972.

¹⁸ New York Stock Exchange. *Statement of the New York Stock Exchange on Audit Committee Policy*, 1977.

1.5 Corporate governance codes shape board discussions

The first specific set of recommendations on good corporate governance came out of the UK and was outlined in a report called “The Financial Aspects of Good Corporate Governance” by a committee made up of the Financial Reporting Council, the London Stock Exchange, and various accountancy associations. Chaired by Sir Adrian Cadbury, the “Cadbury Report” then came in response to a wave of corporate scandals in the early 1990s – principally, the highly publicized collapse of Maxwell Communications.¹⁹

By and large, the findings of the Cadbury Report recommended practices already prevalent in the US, such as the wider use of independent directors as well as the introduction of audit and remuneration committees. However, crucially, the Cadbury Report went further by calling for companies to follow a detailed code of best practices. Its suggestions were implemented by the London Stock Exchange in 1993.²⁰

Following this development, the overall idea that a board should be guided by best practices and industry standards spread globally. Most developed nations issued their own versions of

¹⁹ Adrian Cadbury. *Corporate Governance and Chairmanship: A Personal View*, 2002.

²⁰ Jean Jacques du Plessis, Anil Hargovan, Mirko Bagaric. *Principles of Contemporary Corporate Governance*, 2010.

the report, which echoed many of the Cadbury Report's suggestions. Several global agencies such as The World Bank and IMF also released codes along these lines.

As they became more established, governance codes promoted sameness of thinking and approach. They made the jobs of directors simpler by allowing them to fall back on prescribed, "one-size-fits-all" solutions, depending on the country or regional jurisdiction. Since then, the over-dependence of boards on these governance codes and best practices has become increasingly common – these were the beginnings of what we have termed "governance correctness".

Sarbanes-Oxley Act: Increasing the liability of directors

Corporate governance codes and best practices guided boards, but they were not strictly embedded in law. This allowed some leeway for directors to exercise their own judgement without facing legal consequences. Starting with the US, governance best practices were increasingly mandated by regulators and governments. With directors now legally liable for enforcing governance codes, public company boards started dedicating more time to checks and balances than to strategy.

The US was widely viewed as having an effective corporate governance framework, regulated by a combination of federal and state

laws, financial regulators such as the SEC, and private stock exchanges like the NYSE. Throughout the 1990s, institutional investors and shareholder associations pushed US-style corporate governance in new markets like Japan and Germany.²¹ However, this changed following the bursting of the dot-com bubble in 2000, when a rapid series of major collapses threatened faith in the US corporate governance framework.

In quick succession, it was discovered that Enron and WorldCom had reported false earnings. Arthur Andersen, one of the world's premier audit firms, dissolved after revelations that it had turned a blind eye to these frauds in order to maintain major accounts. Other major firms like Tyco and Waste Management also fell due to accounting irregularities.

While the public was still reeling from the bursting of the dot-com bubble, which had affected millions of retail investors, Congress swiftly passed the largest overhaul of corporate legislation since the Great Depression. The Sarbanes-Oxley Act (SOX) was designed to increase trust in financial statements and improve overall corporate governance at US-listed public companies. It addressed issues from auditor independence to enhanced financial disclosures.

²¹ Helmut M. Dietl. *Capital Markets and Corporate Governance in Japan, Germany, and the United States: Organizational Responses to Market Inefficiencies*, 1998.

“The governance model and event-driven investment strategy of early private equity investors is far-removed from today’s private equity model.”

In terms of corporate governance, one of the core elements of the law is the requirement that CEOs and CFOs sign off on any filing containing financial statements. Under the law, all senior executives are individually responsible for the accurateness and completeness of reported statements. Furthermore, they must personally ensure that all statements are fully compliant with applicable securities laws and provide a fair representation of the financial health of the company. SOX stipulates harsh penalties, including imprisonment of up to ten years, if this certification is made fraudulently.²²

This increased liability extends to the board: SOX placed the ultimate onus for fair reporting – and the requisite internal controls to ensure fair reporting – on the shoulders of public

company directors. The Act allowed for director liability if the board failed to exercise the appropriate oversight. The purpose of this was to increase board proactivity in the oversight of a firm. However, it has also increased the prevalence of “governance correctness” as greater personal liability has made directors more risk averse, more focused on compliance, and more likely to play it safe by following “one-size-fits-all” governance codes rather than engaging in entrepreneurial change and long-term value creation.

1.6 Private equity emerges as an alternative to public markets

Many returning US soldiers opened businesses upon their arrival home after the Second World War. As children of the Great Depression, they feared debt and created solid, cash-generative businesses with lots of unlevered assets. By the mid-1960s, the founders of many of these regional industrial firms were looking to cash out. Their businesses were in many cases too small to list on a stock exchange, and they were too proud to sell to competitors.²³

The investment bank Bear Stearns & Co. offered a solution: it would purchase these companies for a good price. As these thrifly run businesses had a high number of unlevered assets and steady cash flows, the bank could

²² Sanjay Anand. *Essentials of Sarbanes-Oxley*, 2010.

²³ Harry Cendrowski, Louis W. Petro, James P. Martin. *Private Equity: History, Governance, and Operations*, 2012. Also, Douglas Cumming. *The Oxford Handbook of Private Equity*, 2012.

easily make a small down payment and borrow the rest against the company, optimizing the capital structure by adding debt. Secondly, they empowered the management of these companies by offering incentives to improve their bottom line. A few years later, they would sell off the firms or consolidate them with competitors and then sell the new company to the market.²⁴ These crude transactions were called “bootstrap deals” and would evolve into the modern private equity industry.

In time, the deals got bigger and more ambitious. Looking beyond local, family-owned industrial businesses, investors increasingly targeted large conglomerates, which activist investors had forced to break up. The bootstrap deal evolved into the leveraged buyout, and by the 1980s virtually every major financial institution had a dedicated LBO team.²⁵

The growth of the junk bond market further contributed to the LBO boom. Previously, buyouts required a co-investor, usually a cash-rich insurance company, to supplement the investor capital and bank loans required to execute a transaction. Gaining approvals from the co-investor was time consuming for private equity investors, and insurance companies and pension funds generally avoided hostile transactions. With junk bonds, LBO firms could make bids on companies before competitors

and management could put together competing bids. Furthermore, there was no restriction on size – junk bonds opened up an enormous pool of capital and enabled some of the largest and most notorious deals of the 1980s, such as KKR’s acquisition of RJR Nabisco.²⁶

While early private equity investors typically empowered management with enormous performance-related incentives, their deals were still primarily focused on achieving returns through financial engineering – that is, by borrowing against assets or breaking up large conglomerates. There was some discussion of how debt brought discipline to a company, but that was a secondary motive at best. It is important to note that at the time of the RJR Nabisco buyout, KKR had only seven permanent members of staff,²⁷ demonstrating how little involvement the firm could realistically have had in the daily operations of its portfolio companies.

Interestingly, the governance model, small-scale set-up and event-driven investment strategy of these early private equity investors could be said to mirror that of today’s activist investment (hedge) funds, but it is far-removed from today’s private equity model.

²⁶ Bryan Burrough and John Helyar. *Barbarians at the Gate: The Fall of RJR Nabisco*, 1989.

²⁷ *Ibid.*

²⁴ *Ibid.*
²⁵ *Ibid.*

Private equity embraces value creation and entrepreneurial governance

Following the boom of the mid- to late-1980s, the private equity industry experienced signs of strain. The collapse of Drexel Burnham froze the high-yield market. Management teams adopted defence mechanisms like the poison pill to ward off buyouts and takeovers. Raising funds also became difficult as several large transactions conducted during the heyday of the late 1980s, such as the buyouts of Federal Stores and Revco pharmacies, ended very publicly in bankruptcy. In parallel, the private equity space saw new competition: more and more skilled investors were able to spot opportunities for financial engineering and other forms of arbitrage. Public markets reacted by streamlining their companies before private equity could do it for them. As the industry matured, the cash flow multiples of target companies increased sustainably.

A resurgence of private equity occurred in the 1990s as private equity firms began to radically alter their approach. Without the ability to borrow up to 95% of the purchase price of a company, as had been common practice during the 1980s,²⁸ private equity firms began looking at ways to shape and develop businesses over the long term. Increasingly, rather than taking a hostile approach, private equity investors began making attractive offers to shareholders and management teams, promising to use their

capital base/funds and skillset to fuel growth. This approach also attracted pension funds and insurance companies to invest more in private equity, which was becoming a more mature and respectable industry, by pooling their capital in commingled private equity funds.²⁹

The industry experienced a further temporary slowdown after the dot-com bubble, as many private equity investors had bought telecommunications and other technology-related assets at excessive prices during the period. Default rates rose, and once again the high-yield and leveraged loan market shut down, blocking private equity's access to capital. However, suddenly, in the wake of the Enron and WorldCom scandals, the Sarbanes-Oxley Act radically increased the compliance costs of running a small- or mid-sized company in public markets, and the number of privatizations grew considerably.³⁰ The boom in private equity was significant because these companies were unlikely to IPO as a means of exit. In this extended middle-market, however, pure arbitrage was in most cases no longer a viable means of generating returns. Instead, private equity firms had to adapt and focus on developing strong businesses for sale to strategic buyers or other private equity firms. As a result, private equity firms turned their eye to creating value. Many initially began by hiring leagues of consultants with specific

²⁹ Cyril Demaria. *Introduction to Private Equity*, 2010.

³⁰ United States Government Accountability Office. *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, 2006.

²⁸ Mark J. P. Anson. *Handbook of Alternative Assets*, 2003.

industry sector knowledge. But with skin in the game being a crucial philosophy in private equity, firms ultimately started directly employing senior executives with relevant careers in industry and deep sector knowledge to help create value from within their portfolio companies – indeed, hiring dedicated teams of such professionals became the norm for many of the larger firms.

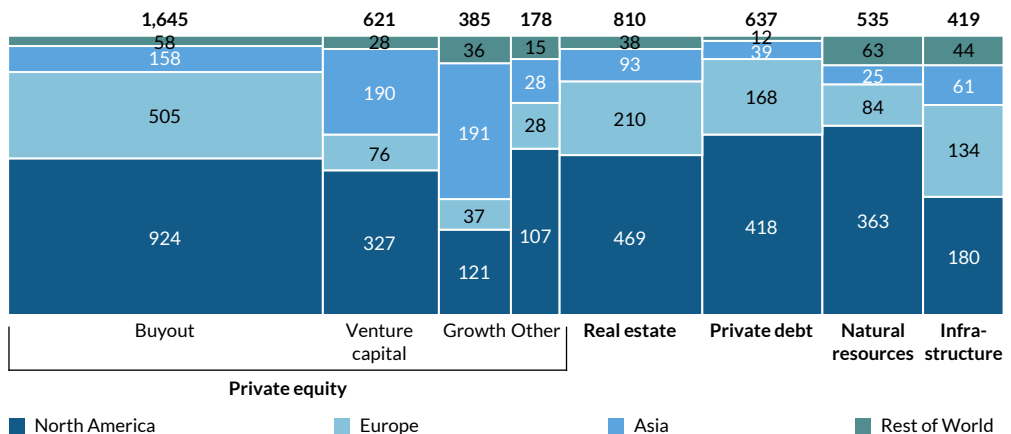
While a wave of old-style megadeals appeared in 2005 and 2006, just before the Global Financial Crisis, the industry overall had radically fleshed out its value creation abilities as increased competition in the space meant that opportunities for financial engineering had become rather rare.

As private equity firms were forced to generate returns for their investors by utilizing their strategic toolkit and deep industry knowledge to fundamentally improve the businesses they own, active and entrepreneurial governance has become extremely relevant to private market investors.

In many ways, the governance approach of public and private markets firms has moved in opposite directions: in public markets we have witnessed a shift from the entrepreneurialism of early corporate ventures to “governance correctness”, while in private markets an initial lack of interest in governance has developed into an entrepreneurial approach to it.

Private market assets under management now total USD ~5.2 trillion

Private market assets under management 2017 (in USD billion)



Source: McKinsey Global Private Markets Review 2018.

Section 2

“Governance correctness” in public markets today

2.1 The obsessive focus on board independence

Following scandals like Penn Central during the 1970s, regulators largely came to view non-executive directors as puppets for powerful management teams as too often they found a close financial or social relationship between them. As a consequence, they fought to increase the number of “independent directors” on public company boards: these directors, who are defined by having no prior connection to the company or its management, were deemed more likely to be able to challenge management teams when necessary, in the interests of shareholders.

Over the past few decades, independent directors have come to dominate the boards of American listed companies. The EY Center for Board Matters found that among S&P 500

companies, 85% of directors were classified as independent.³¹ Given the typical representation of the CEO and an additional C-level management team member at the boards of S&P 500 companies based on the unitary US board structures, this essentially means that nearly all non-executive directors are independent these days. The notion that independent directors better represent shareholders has become nearly ubiquitous on Wall Street, with majority independent boards widely accepted as best practice by proxy advisors and major institutional investors.

The driving force behind this call for “board independence at any price” in the last few decades is obviously the avoidance of the potential conflicts of interest that can arise when boards are dominated by executive directors and non-independent directors.

³¹ Ann Yerger, “Corporate Governance by the Numbers,” Harvard Law School Forum on Corporate Governance and Financial Regulation, August 2016.

The composition of public boards

While historically directors were largely drawn from a pool of major shareholders, legislation and stock exchange rules now dictate the composition of boards.

A **unitary board**, where a single board contains both executive and non-executive members, is the most common structure for boards in the US, UK and other common law countries.

Continental European countries such as Germany favour a **dual board system**. This involves a strict separation between a supervisory board of (independent) directors, with a mandate to monitor the direction of the business on behalf of shareholders, and a management board of executive directors, who are responsible for the running of the business and operational issues.

The Swiss system is notably more flexible as companies, in theory, can choose the board structure that suits them best, although the board of directors retains clear responsibility for the strategic direction and management of the firm (as defined by the Swiss code of obligation). In practice, however, Swiss boards mostly tend to

follow the stricter dual system, likely due to public corporate governance pressure.

In general, boards are composed of **three different kinds of directors**, as follows:

Executive directors serve on the board but also hold executive positions within an organization. Typically, the CEO and CFO serve on the unitary boards and provide a vital link to the management of a firm.

Non-executive directors (NEDs) are those who do not hold managerial positions in a business. NEDs have been a feature of boards since the earliest days of the corporation. They serve the vital purpose of bringing outside expertise to the firm in the form of new industry knowledge, finance or regulation. NEDs can include former executives or those with close business ties to the firm.

Independent directors are NEDs who differentiate themselves from ordinary NEDs by having no prior relationship with the company or management. In theory, this gives independent directors the ability to more freely challenge management's assumptions and strategies than non-independent NEDs, who may have a greater personal allegiance to management.

Equally, a majority-independent board should allow for effective challenges to be made within strategic or management discussions, which should allow more subjective discussions on board matters. Especially in cases where shareholders have a legitimate concern about such conflicts or one-sided board discussions, the call for independence is understandable.

The significant, additional regulation (such as SOX) and best practice codes for directors that have been introduced in recent decades should though go a long way towards preventing inappropriate behaviour by directors. Given this, the question arises today as to whether the remaining risk of conflict of interest and board-bias should continue to be given greater weight than the concern that a company's board is not sufficiently shaping and pacing its business strategy. In our view, a failure to do the latter would also come at a very high price for shareholders. Specifically, we believe that two principal issues may arise when the significant majority of a board is composed of independent directors, and *at the same time* a company's governance is heavily driven by the call for "good oversight through board independence".

Firstly, although a largely-independent board probably means that conflicts are less likely to arise, which can be positive for shareholders as indicated, it does not guarantee that the board has the relevant collective experience,

familiarity with the business, or ability and motivation to lead the company strategically. In order to achieve this, independent directors must not only be selected very carefully based on their expertise, but equally they need to be fully on-boarded into the business. In reality, the latter seldom occurs where the focus is mostly given to checks and controls and maintaining the separation of board and management. In other words, the appointment of independent directors ensures the initial and desired distance between board members and the business, as well as management, but if this distance and lack of familiarity sustains, then the long-term added value of these directors is likely to remain low.

The second issue is simply one of balance. If the board is dominated by outsiders, who remain relatively unfamiliar with the critical insights of the business, board discussions will naturally focus on high-level topics. Though the implied neutrality of this board should be positive, neutrality in itself does not build and develop good businesses. In the absence of strategic leadership from the board, the most relevant strategic suggestions regarding the future of the company may therefore come instead from management teams and consultants. This not only goes against the "strategic mandate" of the board, but potentially even contradicts the presumed advantage of a majority-independent board – that is, its ability to act as a check on management teams.

Defining independence

“Best practice” in public markets corporate governance calls for the independence of selected board members as an important element of its quality and integrity. However, defining independence is challenging. Having reviewed a series of possible criteria from different sources, ranging from financial market authorities to stock exchanges, codes of best practice, proxy advisors, foundations and independent asset managers with a focus on a sustainable corporate development, Partners Group recognizes significant differences in their definitions of board member independence.

Some apply more formal criteria while others tend to focus more on substance. For example, more formal criteria for the definition of independence assess direct compensation received from the firm within a certain period of time or focus on the current employment status with the firm, whereas an assessment that focuses more on substance also takes into account the specific circumstances, such as other functions performed for the firm, to determine independence.

In addition, many of the criteria suggested follow formal legal or financial concepts that do not necessarily reflect a substantive independence in the background, perspective and judgement of board members that is conducive to high levels of quality and integrity in corporate governance. Finally, each company has its specific characteristics in terms of its business model and its governance and ownership structure as a result of which certain criteria take precedence over others.

In this section, we do not attempt to set out a universal definition of board independence, but rather write about the general obsession with board independence – however it is defined – prevalent in parts of public markets today.

Additionally, our criticism of the obsession with board independence is absolutely not directed at independent directors themselves or at their typical skillset or potential. On the contrary, it is directed at the governance framework, which often dictates the suboptimal use of experienced, skilled independent directors.

Here is an observation that legal scholar Larry Ribstein made: “Independence has done little to prevent past mismanagement and fraud. For example, 30 years ago the SEC cast much of the blame for the collapse of the Penn Central Company on the passive non-management directors. No corporate boards could be much more independent than those of Amtrak, which have managed that company into chronic failure and government dependence. Enron had a fully functional audit committee operating under the SEC’s expanded rules on audit committee disclosure.”³²

The fundamental point is that independent directors, by definition, may lack a deep understanding of the company of which they are a board member. Their distance from management may not, therefore, automatically make them better at overseeing a company’s activities. In fact, in matters of directing and enforcing strategy, it may make them less effective than other directors. In particular, their gap in familiarity may induce many independent directors to embrace more blanket corporate governance codes as a substitute for customized solutions and strategies, which require a more thorough understanding of a firm and its culture. What is more, the wide-ranging business and leadership experience and deep knowledge of human capital management of many

independent directors may never be truly utilized during their tenures in public firms, despite the clear need of day-to-day management teams to benefit precisely from these types of skills, which they will often not yet have gained to the same extent.

So why are independent directors not always better on-boarded to their companies? For a newly appointed independent director of a public company, learning the ins and outs of a firm can be very time-consuming and challenging. Often, independent directors sit on various boards and dedicate only a few days a month to their directorship responsibilities. With such limited time dedicated to these responsibilities, in most firms, it is almost impossible for independent directors to become fully familiar with the company’s deep industry sector dynamics and the details of its organization and leadership teams.

How independence can lead to lack of insight, especially in board committees

We also believe strict adherence to board independence rules may sometimes end up disqualifying the best potential directors. For example, in certain specialist industries, the board members best-placed to drive forward strategy and business development can in fact come from the previous or current ranks of the company itself, or from former subsidiaries or business partners.

³² Larry E. Ribstein, “Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002,” *Journal of Corporation Law*, 28(1), 2002.

Case study: Making good use of independent directors in public markets

With the right governance mentality, the insight and experience of independent directors can greatly enhance the strategy of a company during transformational periods.

For many decades, The Walt Disney Company, which was founded in 1923, has enjoyed huge success as a dominant power in the production of feature films and theme parks. However, over the last decade, the company has faced new challenges from streaming services and online media like Netflix and Amazon Prime, which have disrupted its legacy film and television production business.

This was a high-level problem and required a major strategic pivot. In order to chart a strategy for these disruptive times, Disney

recruited independent board members with strong operational experience in the most relevant sectors outside of its core business: tech and new media. These included Jack Dorsey, founder and CEO of Twitter, and Sheryl Sandberg, COO of Facebook.

With their input, Disney devised a strategy that would focus on leveraging the company's tremendous library and ability to produce original content to build a formidable streaming service. As part of this plan, Disney acquired another major content production company, Twenty-First Century Fox, in a deal worth more than USD 52 billion at the end of 2017. This carefully considered acquisition was intended to create a powerhouse of original content creators to rival the newer Silicon Valley firms.

In this case, it seems fair to say that the input and advice of independent directors with specific knowledge and experience have helped position Disney to meet new and unfamiliar business challenges.

Another area where we believe an insistence on all members being independent can in fact work against shareholder interests is in certain board subcommittees, such as risk, audit and compensation committees. In particular, we believe a non-independent NED can provide crucial insight to independent directors serving on a compensation committee. Independent directors, who clearly desire to take a neutral view and make objective assessments of business matters, may otherwise often rely on external consultants or management teams for guidance. While the former tend to operate with generic industry compensation models, the latter could be a source of potential conflicts of interest; both would have a tendency to drive compensation upwards. While a compensation committee dominated by independent directors will help to ensure fairness, the presence of an insider can illuminate the rest of the committee on the precise internal dynamics of a company and provide a more comprehensive and qualitative assessment of management that could escape more formulaic evaluations. After all, each company has a unique organizational structure and culture.

An audit committee provides a more nuanced case. With the regulation that exists today in most countries, board members – whether independent or executive – are generally open in sharing any issues they become aware of as

the costs of doing otherwise are high. While independence is important in an audit committee and should certainly help the committee to take unbiased and different perspectives, without the presence of at least one director deeply familiar with the company, the committee could become more susceptible to reports from the management team that may lack real insight and play down critical issues. Again, as with the compensation committee, this reliance on the management team could present a larger conflict. Therefore, we must weigh the benefit of a totally independent audit committee against the special ability of an insider to fully see all the underlying risks and concerns. Also, we believe the most valuable discussions occur when people involved in the business can share their observations of issues and risks in frank discussions with independent directors.

“In certain industries, the board members best-placed to drive forward strategy can in fact come from the previous or current ranks of the company itself.”

Independent directors on the board of Partners Group Holding AG

When searching for an additional external member of its board, Partners Group looks for accomplished and distinctive personalities who are respected based on their achievements, contribute relevant and specific professional skills, commit substantial capacity and add to the diversity of the board in terms of background, perspectives and views.

Partners Group's board of directors currently has ten members, of whom six are classed as independent. Though independent, each of these six was carefully selected with a very specific idea of how they could contribute to the business, based on their prior experience. All of the

independent board members play a very active role within the firm, and all sit on or chair at least one board sub-committee. Among other things, these board members contribute to Partners Group's growth and development by creating investment opportunities, networking with senior business leaders on behalf of the firm, working alongside client-facing teams on business development and key client relationships and actively contributing to the firm's corporate and cultural development.

The resulting familiarity that our independent directors build with the business makes both strategic and control-focused discussions extremely proactive and productive. In other words, it is the combination of their prior experience, their understanding of our business and the type of engaged dialogue in board meetings that makes the independent directors so valuable on Partners Group's board, but not their independence *per se*.

2.2 Short-termism and investor influence on strategy

With the rise of professional fund management in the 1970s and 1980s, “Wall Street” started to disproportionately focus on measuring the performance of publicly traded companies by ongoing quarterly reported earnings and has never stopped. Often, this short-termism is further encouraged by the real-time reporting of the business and finance media.

In parallel, the holding periods of institutional investors within the public equity markets have shortened considerably from a peak of eight years in 1960 to roughly eight months in 2016.³³ Consequently institutional investors have become increasingly impatient with business strategy.

The treatment of capital expenditure (capex) provides a good illustration: ideally, capex and investments should be made regularly in order to maximize a company’s long-term success. However, with a few exceptions (often in perceived high-growth sectors), including prominent companies such as Amazon, Netflix and Tesla, markets typically strongly favour low and decreasing capex in public companies. Fund managers, under pressure to meet their own quarterly and annual targets, can pressure management teams into making decisions that

are counterproductive over longer time horizons. Given that these investors are typically – combined – the largest shareholders of public companies, their voices are difficult for boards to ignore.

This can lead to decision-making that prioritizes short-term earnings maximization, rather than long-term shareholder value creation. After all, earnings are a present financial reflection and accounting figure and ultimately not always fully representative of the strength of a business, especially its future business potential. Yet, generating smooth quarterly earnings growth has become the dominant focus of management teams and boards, and this can have a negative effect on the long-term health of a company. One survey found that 80% of CFOs would make material changes such as cutting decisive spending on research and advertising, just in order to meet short-term earnings expectations.³⁴

As another example, in 1999 the Financial Accounting Standards Board (FASB) – the US accounting regulator responsible for overseeing Generally Accepted Accounting Principles (GAAP) – proposed changes to the treatment of the “pooling of interests” method. Essentially, goodwill (the price an acquirer paid over a target’s book value) would be written

³³ Michael W. Roberge et al. “Lengthening the Investment Time Horizon,” *MFS White Paper Series*, 2017.

³⁴ John R. Graham, Campbell R. Harvey and Shiva Rajgopal. “The Economic Implications of Corporate Financial Reporting,” *Journal of Accounting and Economics*, 40(1-3), pp. 3-73, 2005.

down against earnings for several years. As goodwill is simply an accounting item with absolutely no effect on cash flow, these changes should have had little impact on corporate strategy. However, a study by Bain and Company at the time found that approximately one-third of deals were abandoned because boards worried about the way investors would react to headline earnings figures.³⁵ Another report concluded that managers may not undertake mergers and acquisitions, even if ultimately value enhancing, in cases where reported earnings would be adversely affected in the short term.

Proxy advisors add to the pressure

Adding to the pressure, many investors faithfully follow the guidance of shareholder advisory services such as proxy advisors, which aim to help shareholders exercise their ownership rights, such as voting at AGMs and in proxy contests. Institutional investors make up the largest proportion of investors advised by proxy advisors, but their guidance is also often followed by mutual funds and passive investment vehicles, which seek to keep their fees competitive by outsourcing governance research, as well as by brokers and independent financial advisors, who serve as fiduciaries for retail clients.

³⁵ David Harding and Phyllis Yal. "Discipline and the Dilutive Deal," *Harvard Business Review*, July 2002.

Proxy advisors provide a valuable service to these busy investors by analyzing the voting options of proxy contests and offering recommendations in line with their idea of "best practice". Given the sheer enormity of the public market universe and the volume of proxy votes held every year, proxy advisors have though – unsurprisingly – evolved a systematic approach to making their recommendations.

As such, their guidance often derives not from analysis of the specific issues relevant to a particular company, but from an assessment of the company's compliance with a prescribed set of corporate governance best practices; recommendations may be reached via a tick-box, "one-size-fits-all" approach rather than through qualitative judgement.

Clearly, this approach can be beneficial to shareholders. For instance, proxy advisors frequently take a harsh stance on director non-attendance of board meetings and will recommend voting against directors that attended less than 75% of board or committee meetings in a given year.³⁶ Proxy advisors also recommend against "over-boarding" – when directors sit on five or more boards.

However, at other times, this systematic approach can, in our view, be detrimental to the interests of shareholders. For example, proxy

³⁶ *Ibid.*

advisors most often issue a negative recommendation on the election of a particular director because of issues surrounding his or her perceived independence, whether this concerns the balance of the board or individual independence. Often, proxy advisors' criteria for this qualification are even significantly more stringent than legal or stock exchange definitions.³⁷ As an example, proxy advisors strongly denounce the presence of any non-independent directors on compensation and audit committees by default, no matter the particular circumstances. However, in our view, as explained in the previous section, without pertinent insights into a company, many of these committees risk becoming overly formulaic in their supervisory role.

Another area of potential concern could be the treatment of major corporate actions. Mergers and acquisitions, restructurings, and reorganizations require particularly detailed analysis, making them especially unsuitable to "one-size-fits-all" screens. After all, these corporate decisions are complex by nature, often requiring considerable man-hours internally in addition to advice from outside consultants, investment bankers, and accountants. While shareholders have an interest in obtaining digestible recommendations on these major corporate events, proxy advisory firms with limited staff

and resources are often not adequately equipped to reach conclusions on these issues and are reluctant to seek detailed discussions with management or to review more complex proposals. As a result, they may consider the impact on medium-term earnings above other factors. As discussed more extensively in section 2.3, earnings, especially over shorter time horizons, are not representative of meaningful value creation for the long term.

In today's complex business world, many of the issues facing shareholders are not straightforward. In fairness to proxy advisors, they should be able to rely on the strategic involvement and business understanding of a company's board to shape their views on these issues – it is not their role to compensate for the shortcomings of a board. However, the concern is that proxy advisors may end up reinforcing "governance correctness" practices by focusing on their rules and not on entrepreneurial objectives when recommending votes.

Given their reach, the recommendations of proxy advisors can have a significant impact on the results of proxy contests. Many investors piggyback on proxy recommendations without paying for them by voting alongside more established institutional investors, magnifying their impact; one study showed negative recommendations from proxy advisors attracted an additional 20% of negative votes

³⁷ Glen T. Schleyer, "Impact of Negative ISS Recommendations," *Insights: the Corporate & Securities Law Advisor*, 31(9), pp. 8-15, 2017.

at AGMs on average.³⁸ As a result, proxy advisors wield considerable influence over the governance of public companies.

2.3 Compensation structures can contribute to a misalignment of interests

The manner in which board directors and management executives are compensated is highly relevant to their leadership approach. In our view, increasing wealth through well-structured equity holdings encourages value creation and innovation in alignment with shareholders' and other stakeholders' interests. On the other hand, fixed, cash-based compensation or outsized plain-vanilla options packages can lead to passivism or undue risk-taking, with self-interest taking priority over shareholders' interests, as we explain.

Board compensation

Often today, director compensation is about half equity and half cash,³⁹ with the equity-based compensation coming in the form of restricted shares, which are vested over a number of years. In addition, many companies require that directors hold three times their annual remuneration in equity value within five years of joining the board. We welcome this bid at greater alignment as, ideally, directors should share the ups and downs of equity

performance with the long-term shareholders they represent, also aligning them with the other stakeholders such as clients and employees of the firm. However, in practice, receiving free shares in limited amounts may not be sufficient to achieve this important alignment of interest – especially when public company directors tend to hold multiple directorships, which spreads their ownership across a portfolio. Indeed, the present regulatory environment, and an increasingly powerful class of activist investors, have led to an incentive structure in which the interests of independent directors may not truly align with those of ordinary shareholders.

For example, regulatory changes such as Sarbanes-Oxley and Dodd-Frank have placed a greater onus on directors to vouch for the accuracy of financial reports. As part of this responsibility, directors must create oversight mechanisms to ensure truthful conduct throughout all levels of an organization. The consequences of misreporting could result in severe financial penalties for the board member as well as the company in the form of lawsuits brought by regulators or shareholder groups. Though in reality, the increased personal liability faced by directors is almost always covered by directors and officers liability insurance, paid by the company; the theoretical assumption is that directors could risk their entire net worth if breaches occur in

³⁸ Angela Morgan Annette Poulsen, Jack Wolf and Tina Yang. "Mutual Funds as Monitors: Evidence from Mutual Fund Voting." *Journal of Corporate Finance*, 17(4), pp. 914-928, 2011.

³⁹ Yaron Nili. "Trends in Board of Director Compensation." Harvard Law School Forum on Corporate Governance and Financial Regulation, April 2015.

the areas of compliance and reporting – not to mention their reputation if these breaches are discussed in the public domain.

On the other hand, the upside potential of equity ownership is unlikely to make a material difference to an independent director’s overall wealth. As many generalist independent directors sit on multiple boards, equity ownership in an individual company probably comprises only a minor portion of their total wealth. This skewed incentive structure can lead independent directors of public firms to focus heavily on managing downside risk through internal controls and risk management systems. These factors could influence uninvolved independent directors to pay less attention to the entrepreneurial goals of value creation, which would only result in a small increase in their overall wealth, even if wildly successful.

Given their concern with mitigating downside risk, as well as the difficulty of gaining a thorough understanding of a new company, it is our belief that *with the wrong governance spirit and focus*, independent directors may be particularly prone to defer to corporate governance codes and “best practices” rather than consider and enforce more creative, long-term focused value creation initiatives. Similarly, this could also occur in cases where the compensation for board members is so

attractive that their main motivation in renewing a directorship is to maximize earnings for as long as possible.

“Typical incentive schemes in public markets often fail to entirely focus executives on the long-term health of their firm.”

The misalignment caused by the incentive structure of independent directors has serious implications for corporations. After all, each director has an equal vote, whether that director has specialized knowledge or comes from an entirely different industry. With the proliferation of governance codes and best practices, it is easier than ever for independent directors to fall back on the “one-size-fits-all” solutions they offer, which can rob a company of potentially value-enhancing strategic plans.

The role of proxy advisors in influencing compensation

Proxy advisors often rely on mechanical approaches to issue recommendations on issues of management compensation. They primarily weigh up three factors when arriving at their recommendation: pay-for-performance of the CEO, quality of disclosures, and alignment over time. While sound in principal, this methodology ultimately ends up judging performance based on more immediate financial figures and stock returns at the expense of other more pertinent factors. Consequently, a skilled executive may be disadvantaged when leading a company through a period of transformational change, when earnings are likely to suffer, even if the overall reorganization runs smoothly. A single screening process to evaluate all compensation plans simply cannot take into consideration the complexity of a business and differences in human capital management between sectors.

Unfortunately, this practice has had a meaningful impact on the way directors

create compensation plans. There is considerable evidence showing that boards alter their compensation plans in line with the viewpoint of proxy advisors in order to avoid negative recommendations.⁴⁰ The duty of a board, and the compensation committee in particular, is to create compensation schemes that bring out the best performance in the business they oversee after thoughtful analysis. By ceding this duty to proxy advisors with “one-size-fits-all” voting recommendations, boards may not be acting in the best interests of the shareholders they represent.

This has become increasingly relevant in recent years. Since the financial crisis, regulators around the world have put greater emphasis on “say on pay” rules, which would entitle shareholders to input on issues of executive compensation. The added votes mean increased scrutiny by proxy advisors, who must issue recommendations. Various studies have shown no meaningful impact though on levels of executive compensation; some have even pointed out that pay levels have increased among companies that adopt “say on pay” measures.⁴¹

⁴⁰ David Larcker, Allan McCall and Gaizka Ormazabal. “The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies,” *SSRN Electronic Journal*, 2012.

⁴¹ Peter Iliev and Svetla Vitanova. “The Effect of Say-on-Pay in the US,” *Management Science*, 2015.

Management compensation

Properly used, options can be an effective tool to motivate management to enhance the value of a firm – but only if balanced out by the existence of meaningful downside risk in the form of a personal investment. On the other hand, a poorly devised options scheme can create a dangerous incentive structure and moral hazard. In this case, a strongly performing stock (or even just a rallying equity market) would encourage management to wait more passively until their options vest – without necessarily striving to achieve truly sustainable results. Conversely, in times of distress, management teams may start taking undue risks, even “betting the firm” in order to reach a stock price level where options can be exercised, especially where the board does not wield a very active influence in strategic matters.

As a result, in more recent years, many companies have begun to issue restricted shares. These are essentially ordinary shares that only achieve full value after a vesting period. For companies, restricted shares avoid some of the pitfalls of options-based compensation. Namely, they provide alignment with shareholders over the vesting period without targeting a particular share price within a set timeframe – doing the latter can encourage a “past the finish line at any cost” mentality, resulting in aggressive short-

termism. However, restricted stock schemes, especially if they are too short-term oriented, still promote a single-minded focus on more immediate earnings development, typically to the detriment of more fundamental metrics designed to ensure the long-term success of a business. In our view, this too often encourages passivism, where executives are rewarded for “playing it safe” rather than devoting energy to real value creation. Under these restricted stock arrangements, employees still benefit from the arbitrary movements of the markets and are rewarded for simply maintaining their position long enough for their shares to vest.

Whether incentivizing a single-minded focus on stock price in the case of options or management careerism in the case of restricted shares, the typical incentive schemes found in public markets often fail to entirely focus executives on metrics that truly stimulate the long-term health of their firm.

“In our view, increasing wealth through well-structured equity holdings encourages value creation and innovation.”

Partners Group's experiences with "governance correctness"

Partners Group listed on the SIX Swiss Exchange in 2006. It maintains a significant employee ownership and its ten-person board contains its three founders and a former CEO. In terms of board composition, the independent directors have been selected based on their ability to contribute in specific ways to the business. By the standards of public markets, the directors are unusually engaged with the firm's investment arm and corporate development team.

Partners Group's view is that directors with a deep knowledge of the firm's nuances and culture can provide crucial insight, which

can be essential to building value over the long term.

Partners Group makes every effort to remain focused on building a sustainable, entrepreneurial business over the long term for the benefit of its clients, employees and shareholders – taking the same approach to its own governance as it does with its portfolio companies and investments rather than getting caught in the trap many public companies find themselves in. In spite of the fact that Partners Group has outperformed comparable private and public market financial firms since its IPO in 2006, proxy advisors still regularly question our private markets governance approach based on their own more formulaic governance rules: despite consistent positive results for cost management and strong value creation for over a decade, the same objections still continue to arise based on notions of "governance correctness".

2.4 Going public without governance correctness

Over the past decade, many private equity firms have themselves chosen to list on stock exchanges globally, with motivating factors including the additional liquidity this can provide for a firm's employees in relation to their stakes in the management company.

However, with a strong understanding of incentive structures and effective governance practices gained through experience with countless portfolio companies, public private equity firms have typically been careful to keep sufficient control in the hands of employees and founders. They understand that a stock exchange listing *per se* does not necessitate adherence to excessive governance practice and that with the correct corporate governance framework and leadership approach, a listed company can surely remain competitive and enterprising.

The pushback against “governance correctness” from the tech sector

Outside of private markets, there is an increasing number of entrepreneurial companies, particularly in Silicon Valley, which have recognized the limitations imposed by public company corporate governance and the influence of shareholder associations and proxy advisors. While embracing public markets to stabilize capital, they have sought to find alternative corporate governance arrangements that allow them to focus on long-term value creation.

Beginning with the IPO of Facebook in 2012, many publicly listed tech companies have chosen tailored governance structures that enable entrepreneurialism and long-term value enhancement. These Silicon Valley firms grew largely through the guidance of skilled founders and venture capital investors, who understand the importance of entrepreneurial corporate governance. As such, these IPOs were designed to retain substantial control in the hands of founders and employees by issuing non-voting shares – or shares with less voting power – to public investors.⁴²

Concentrating control in the hands of founders and employees through voting shares ensures that firms can retain their original entrepreneurial spirit. Of course, this in itself is no guarantee of continued success, but should ideally mean that these founders and employees remain proactive and engaged creators of value on behalf of all shareholders. However, in these cases, the holders of common stock have close to no say in the governance of these firms: these shareholders take full equity risk, participating in the upside or downside as an owner, but without any meaningful control whatsoever. Meanwhile, they are not entitled to the same bankruptcy protections as a debtholder.

Ironically, in this situation, the market has accepted a governance setup that essentially deprives the shareholders of their most basic rights merely to avoid the costly trappings of governance correctness.

⁴² Pierre Vernimmen, Pascal Quiry and Maurizio Dallochio. *Corporate Finance Theory and Practice*, 2017.

Case study: Dell

Perhaps no example better illustrates the difficulty of undertaking entrepreneurial, transformational change in public markets than that of Dell.⁴³

Dell was a market leading PC manufacturer, which had continually reported strong earnings. However, by 2011, the market for Dell's products had become commoditized, and the firm's margins were steadily tightening. While the company remained highly profitable, its CEO, Michael Dell, saw the need to safeguard the company's future by entering new markets with stronger potential for growth and devised a radical plan to transform the company into a provider of software, networking, services, and security.

Dell proposed selling PCs cheaply, even as a loss-leader, in order to make inroads with business and enterprise clients. After establishing this foothold, the company would be well-placed to market its lucrative software and services. Dell explained that the PC had reached the end of its lifecycle, and growth would only come out of new areas.

For a company that still received the majority of its revenue from PC sales, his

⁴³ Information gathered from Dell press releases and articles such as "Going Private Is Paying Off for Dell" by Michael Dell (NYT, 24 November 2014) and "Why Michael Dell Really Had to Take Dell Private" by Ashlee Vance (Bloomberg, 5 February 2013).

proposal, a major restructuring of the business, was bold. Dell explained that the transformation would result in lower earnings for several years, a prospect that proved deeply unpopular with worried investors, who feared both declining dividends and the effect earnings reports would have on share prices.

By Dell's last quarter as a public company, net income had dropped 72% from the previous year. However, software and service revenue had risen by 9%. Investors were focusing heavily on shrinking PC sales and were frustrated by Dell's acquisitions of IT services firms. Activist investors including Carl Icahn and Southeastern Asset Management pushed for the company's board to be replaced for not properly following corporate governance guidelines and advocated for a leveraged recapitalization, which would transfer its cash to shareholders.

Dell determined that the only way to properly restructure the company into a software provider would be by taking the company private. Using his own net worth and the support of private equity firm Silver Lake, Dell ultimately came to control 70% of the privatized firm, stating: "We are the largest company in terms of revenue to ever go from public to private. Now we will be the world's largest start-up."⁴⁴

⁴⁴ Connie Guglielmo. "Dell Officially Goes Private: Inside the Nastiest Tech Buyout Ever," *Forbes*, 30 October 2013.

Unshackled from the demands of quarterly reporting, Dell made tremendous strides. By mid-2014, the company had begun offering bundles designed for small businesses that combined server, storage, networking and management technology. It dedicated considerable resources to its cloud operation and, by bundling the service with PC sales, was able to capture large clients like Barclays, which uses Dell to run its mobile banking services.

The restructuring of Dell took several years and involved cancelling dividends in order

to invest in new business lines. This transition was ultimately successful in private markets, but would have been highly unlikely in public markets.

Dell announced in early 2018 that a potential IPO was among the options being considered for the future of its business. If the IPO does go ahead, it will be interesting to see if and how the company can maintain its entrepreneurial culture, although it could possibly follow the alternative corporate governance arrangements of the public tech giants.

Section 3

The private markets framework for governance

3.1 The role of the board

It is our view that the differences in the composition, conduct, and even mandate of private equity-backed boards can make them a distinguishing enabler of value creation compared to many of their public market equivalents.

Experience and impact valued above independence

Director independence is generally much less of a priority in the boards of private equity-owned companies – what is critical instead is the ability of each board member, individually and within the entire board team as a combined leadership group, to actively contribute to defining and driving forward strategy and ultimately achieve ambitious business objectives together. It is the single-minded focus on value creation that is perhaps the most significant difference between public and private boards. Private equity boards typically

view their role as leading the development of a company's strategy and then directing its execution by top management.

Portfolio company boards are usually composed of key members of the private equity firm's investment team, in-house operational experts, and one or two C-level leaders of the portfolio company as well as a handful of independent or non-independent external NEDs with extensive, relevant experience. The latter are also selected based on their ability to contribute to strategic growth in a specific way and not merely to act as a counterbalance to the executive directors and deal team representatives. Private equity boards tend to meet more often than public boards too: one comprehensive study found that they met on average 12 times per year as well as having a considerable amount of informal contact.⁴⁵

⁴⁵ Viral V. Acharya et al. "Corporate Governance and Value Creation: Evidence from Private Equity," *The Review of Financial Studies*, 26(2), pp. 368-402, 2013.

NEDs of private equity-owned companies typically sit on fewer boards than their public markets counterparts, whose time is often spread thinly across many investments.⁴⁶ They are expected to dedicate themselves to engaged oversight and value creation while fully exposed to the upside and downside of the investment. To facilitate this, board directors at private firms are typically free to interact with management and other company employees in whichever way they feel will add value. Because they are chosen for a specific skillset, it is not unusual for NEDs to lend their expertise to a particular project and get actively involved in management initiatives. The results-driven nature of private equity perpetuates this culture of cooperation and teamwork.

3.2 Investor alignment behind one strategy

Instead of representing myriad investors with infinitely different expectations and investment horizons, private equity boards have the privilege of directing with a mandate from one active owner. This is the private equity sponsor (or sponsor group), which in turn represents the interests of multiple beneficiaries (the investors in the fund and ultimately the pension scheme members or other beneficiaries these institutional investors represent).

⁴⁶ Francesca Cornelli and Ouzhan Karaka. "Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?" AFA 2009 San Francisco Meetings Paper, March 2008.

Right-sized for action

Private equity boards are typically smaller than public company boards. A recent study by PwC found that private equity boards averaged eight members, while public companies averaged eleven members.⁴⁷ Furthermore, the same study found that private equity directors spent far more time at the company premises and on their directorship duties – especially during the crucial onboarding period for a new investment.

⁴⁷ "Annual Corporate Directors Survey," PwC, 2017.

With this full alignment of owners and managers as to objectives and timeline, private equity firms can focus on metrics that really matter for the long-term success of a firm. In most cases, the long-term goal of private equity managers is to create strong, sustainable cash flows. As a result, changes in accounting standards have never had a meaningful impact on the approach of private equity firms, for instance.

Private equity firms typically evaluate management teams on a monthly basis against a set of carefully designed KPIs that move them towards their strategic goals. These KPIs may include various top-line and bottom-line operating figures as leading business indicators. Using the example of Dell from the previous section, a potential KPI would be its share of the cloud computing business. Crucially, the KPIs tracked will often not result immediately in greater earnings or cash flow, but they allow private equity firms to monitor the progress of management toward certain specific goals over the course of their investment.

When carried out by skilled and experienced managers, this private equity approach can create a strong, sustainable business over time.

“With the alignment of owners and managers, private equity firms can focus on metrics that really matter for the long-term success of a firm.”

3.3 Compensation structures align interests

Board compensation

As outlined above, private equity firms would normally expect all of their portfolio company directors to actively participate in developing value-enhancing strategies. True to the predominant view in private equity that there must be meaningful downside risk as well as significant upside potential, NEDs are typically expected to invest a meaningful portion of their own net worth into the company alongside private equity funds. In order to encourage engagement in value creation, incentive schemes may allow for significant upside through options – but only if directors materially share in the downside risk.

Management compensation

Private equity performance relies on strong management team incentivization. Ever since the bootstrap deal was pioneered in the 1960s, private equity investors have sought to align management teams with the interests of owners by awarding them equity. After all, while the board takes responsibility for devising and directing strategy, management is ultimately responsible for its implementation. Therefore, it is vital that CEOs and management teams participate in the financial upside of a successful private equity exit.

Private equity's three-way alignment on financial performance

One of the primary characteristics of private equity is the overall alignment between the general partners of the private equity firm, the limited partners in private equity funds, and the management teams at portfolio companies in terms of risk and reward.

While they receive compensation linked to the success of an investment (so-called “carried interest” or “performance fees”),

general partners also typically invest significant proportions of their own net worth into the private equity funds they manage in order to share downside risk with their limited partners. After all, investors potentially risk the loss of their entire investment if the fund fails. In order to achieve true alignment, general partners should stand to lose as well.

In much the same way, board members and management teams at private equity-owned companies are also expected to invest significant portions of their wealth into the company alongside the private equity fund. This alignment between different levels of stakeholders is a powerful incentive for value creation.

In the spirit of alignment, most private equity firms also require senior management team members to invest large parts of their own net worth into a company in order to qualify for these potential rewards. This reward system motivates management with the potential for larger upside, but staves off complacency with the presence of material downside risk.

Timeline increases accountability

Time is also a critical factor in aligning interests and ensuring successful outcomes in private equity. The board, owners, and management all understand that they have a defined period of four to seven years to accomplish certain targets or else miss out on financial incentives. This creates an atmosphere of cooperation between the various stakeholders and focuses them uniformly on the finish line. Management teams in particular know that they have a

limited time period in which to achieve success. This is a contrast to parts of public markets, where, in extreme cases, the only time-related pressure that a management team experiences in relation to compensation is the need to wait long enough for their options to vest or for their cash pay to accumulate to significant amounts.

We have observed that today, the typical tenure of a public company CEO is often longer than the private equity investment cycle altogether, up to ten years according to one recent study.⁴⁸ This is good for stability and good for shareholders if the CEO in place remains the right one to steer the business throughout the length of their tenure; however, we suspect that there is a risk that underperforming CEOs are not replaced simply because the board is too unengaged to take action. This suspicion is deepened when you compare this tenure with the rate of replacement of CEOs in private equity-backed companies. Dismissal is a very real possibility at a private equity-owned company for managers who are not perceived to be sufficiently driving forward the overall strategy. On average, private equity firms replace 73% of CEOs during the investment lifecycle (typically five years), and 58% are replaced within two years.⁴⁹ This adds another layer of personal accountability for management teams.

In contrast, the perpetual nature of public markets can create an atmosphere of ambiguity and a lack of personal responsibility. The ownership structure of public corporations is rather fluid, with a constantly changing shareholder base. Management teams at all levels of the corporation come and go, and the board is often no different. As a result, the responsibility for running strategic initiatives and long-term plans can change hands, sometimes several times, and it can be tempting to blame the lack of progress on predecessors and peers or pass responsibility on to successors.

“Time is a critical factor in aligning interests in private equity. There is a defined period to accomplish targets or else miss out on financial incentives.”

⁴⁸ Matteo Tonello and Jason D. Schloetzer. *CEO Succession Practices: 2016 Edition*, October 2016.

⁴⁹ “Annual Private Equity Survey: Replacing A Portfolio Company CEO Comes at A High Cost,” Alix Partners, May 2017.

Table: Typical governance characteristics of different types of ownership

Ownership Type	Alignment of Interests	Governance	Timeframe / Focus	Value Creation
Private equity	Strong alignment as managers and board members must invest meaningful amounts in the enterprise to ensure they share the upside and downside.	Deeply active directors with a focus on value creation; the board shapes and directs strategic efforts.	Value creation plans typically span four to seven years. Companies often extend private equity ownership via successive buyouts or extended private equity ownership models, utilizing the same entrepreneurial governance.	Highly focused on specific value creation plans. Use of smaller-scale M&A to grow non-organically in addition to organic growth. Focus on free cash flow generation.
Traditional public markets	Shareholders, owners, and managers may have differing incentives.	Independent directors dominate boards. Major focus is on oversight; directing strategy is often secondary.	Perpetual ownership structure: individual managers and directors have varied timeframes, making accountability difficult.	Corporate development driven by earnings and other accounting metrics at the highest level. Use of larger-scale M&A to build scale.
Traditional family businesses	Typically, family members sit on boards and can even act as CEO. Profit participation is common for management, though equity ownership remains highly concentrated.	Many family members on the boards; often the focus is on maintaining the business in family hands. Risk averse, but incentivized to focus on and invest in long-term value creation.	Very long-term oriented, perhaps with a multi-generational focus.	Risk averse, but actively engaging in long-term value creation plans that ensure continued success. Expansion is often a secondary focus. Cash flow and dividend focused.
Activist hedge funds	Alignment is not necessary.	Oftentimes, little interest in long-term, fundamental governance improvement; highly concerned with influencing boards on specific corporate actions.	Until their advocated corporate action happens or is defeated; campaigns can last months or years.	Expect rising share price as a result of influencing the board to accept a corporate action, replace management or otherwise return cash to shareholders.

Section 4

Effective entrepreneurial governance in practice

4.1 The private equity approach to value creation

Successful governance is geared towards enabling proactive and hands-on value creation, led top-down from the board. It is this intensity and the dominant focus on value creation, rather than financial engineering or valuation arbitrage, which is the ultimate generator of private equity's outperformance over public markets.

While value creation is a ubiquitous term in private equity nowadays, there is no "one-size-fits-all" approach to its implementation and no guarantee of success. Private equity firms must come up with a bespoke strategy to produce value in each of their investments, and this requires private equity teams to have both relevant operational knowledge and a track record of experience.

Though each strategy is unique, there are elements that are common to all value creation plans. These include the so-called "100-day plan", which in reality is a map of the concrete actions a firm wishes to take during an initial period of often up to one year of an investment, including leadership team changes and capturing potential low-hanging fruit in terms of performance gains and curtailing any recognized drags on performance. More importantly, though, the 100-day plan also outlines a program of initiations of longer-term, strategic value creation initiatives to be implemented during ownership. The latter make the real difference to performance.

Because high-performing private equity investors put a priority on being ready to take action on day one in order to gain momentum and maximize the buy-in from employees, this plan is typically formulated early in the deal

process. A study by Grant Thornton found that 79% of private equity investors design a “100-day plan” prior to completing a transaction, and 62% do so as early as the due diligence phase.⁵⁰

As a result, throughout the holding period, there will be a series of individual board- and management-led value creation projects running in parallel or consecutively, each with a different focus specific to the needs of the company. Organic growth strategies will usually be balanced against growth through (often smaller) acquisitions, which are typically a key part of a private equity toolkit (see section 4.2). Some value creation projects will target top-line growth, for example, product development, sales team build-out or expansion into new markets. Others will focus on the bottom line, for example, efficiency programs, lean manufacturing initiatives or supply chain optimization.

These are precisely the types of strategic initiatives that are at the centre of board-level discussions. They require the board’s experience – which is likely to be more significant than that of the management team – insight and deep involvement with the business. It is often this level of involvement in

strategic initiatives which may be under-prioritized at public company boards in favour of a focus on oversight.

“Involvement in strategic initiatives may be under-prioritized at public company boards in favour of a focus on oversight.”

To give an idea of the scale of value creation at the portfolio level, there were more than 200 value creation projects ongoing within Partners Group’s direct private equity portfolio in 2017,⁵¹ with more than 70 realized within the year. During the year, Partners Group board representatives attended more than 200 formal meetings with a focus on strategic projects, complemented by regular informal contact, which can often even become daily contact for certain more demanding projects. These value creation efforts resulted in 20% revenue growth and 18% EBITDA growth, respectively, across the portfolio and created more than 13,000 jobs.

⁵⁰ “What can be Done in 100 Days?” Grant Thornton, October 2013.

⁵¹ Value creation in 2017 across all active non-listed, Partners Group Direct Investments 2012 (EUR), L.P. Inc. and Partners Group Direct Investments 2016 (EUR), L.P. Inc. portfolio companies acquired before 31.12.2016. Data as of 31 December 2017.

Case study: VAT Group AG

The case of VAT Group AG (VAT) highlights how a private equity board can actively engage with management to create value over the private equity holding period.

VAT is the leading global developer, manufacturer and supplier of high-end vacuum valves that are mission-critical components in the advanced manufacturing processes required to produce products such as portable electronic devices, flat-screen monitors and solar panels.

Partners Group acquired VAT on behalf of its clients in February 2014, together with its investment partner Capvis. Prior to this, the company had been in family hands since its inception in 1965.

At the time of the acquisition, VAT was already the market leader in its category based on the strength of its technology, but it was less mature in non-technical areas.

The value creation strategy that was devised during the due diligence period therefore focused on providing VAT with a road map for growth that would institutionalize the company by strengthening its organizational, process and financial capabilities.

Partners Group and Capvis put in place a new board with three highly experienced external NEDs in addition to their own board appointments. They also appointed a new CEO, CFO, COO and Head of Corporate Development to the management team.

Through the board, Partners Group worked together with VAT's new management team to successfully execute a series of growth and restructuring initiatives focused on expanding VAT's product offering, increasing sales in adjacent markets and growing the after-market business in spare parts, valve repair and valve upgrades/retrofits. The board also successfully implemented a strategy to substantially increase sales in Asia by entering the market with a new local sales force.

VAT was able to grow its revenues by a CAGR of 11% between 2013 and 2015, eventually listing on the SIX Swiss Exchange in April 2016 (ticker: VACN) with an offer price of CHF 45. By the time Partners Group sold its remaining stake in VAT in January 2018, the company's shares had tripled in value, and it had doubled its employee count to 2,000 from over 1,000 at the time of Partners Group's initial investment. Partners Group's exit of VAT Group generated a gross return of 6x the original investment.

4.2 Mergers and acquisitions: Private equity looks at smaller, more accretive deals

Mergers and acquisitions are among the most consequential strategic actions a board can take. The manner in which private equity and public corporations handle these transactions says much about their differing approaches to value creation.

In public markets, a consensus shows that mergers and acquisitions are more often than not dilutive – that they fail to produce value for shareholders. In one of the most wide-ranging surveys on the subject, KPMG found that 30% of deals failed to produce greater value for shareholders over a ten-year period, while an astounding 53% actually destroyed value.⁵² The majority of academic studies agree with these conclusions, the most notable being that by Agrawal and Jaffe (2006), which examined 30 years of merger data and found the long-run return negative for shareholders. While, of course, you could never know exactly how the companies involved would have developed if the transaction had not taken place, the general consensus appears to be that the larger the deal, the worse the result for shareholders.

So why do boards of public firms continue to approve so many mergers and acquisitions? These deals are frequently driven forward by ambitious management teams who see more

upside than downside. For CEOs and top-level managers, expanding the size of their business can often mean significant upside in terms of standing and compensation. This desire to expand their power is recognizable from the conglomerate boom of the 1960s and still remains a motivation today. More directly, management contracts often reward management teams for negotiating mergers and acquisitions. On the other hand, there is hardly any incentive or reward for declining a bad deal.

“In public markets, a consensus shows that mergers and acquisitions often fail to produce value for shareholders.”

During the due diligence for mergers and acquisitions, management teams will generally cite fairness reports by management consultants and investment banks that show accretion and a high likelihood of increasing earnings in order to support deal proposals. These agents often have an inherent bias towards the company taking action. Yet despite the vested interests at play, these third-party endorsements provide a safety net for boards,

⁵² “Unlocking Shareholder Value: The Keys to Success,” KPMG, 1999.

and especially for less involved independent board members, allowing them to approve these deals in good faith.

Indeed, mergers and acquisitions can offer a way out for boards during periods when a stock is sluggish or earnings are disappointing. Wall Street and activist investors can put immense pressure on boards to take action, especially by threatening proxy contests. When presented with a merger and acquisition strategy by management that has been thoroughly vetted and explained by consultants, bankers, and accountants, boards often come to see these deals as the dramatic action required to relieve this pressure.

However, mergers and acquisitions are about more than financials and balance sheets. Integrating systems and facilities, managing culture clashes between different corporates and dealing with political pressure from all tiers of management is a daunting task. These vital qualitative factors can be very difficult to see from the detachment of the boardroom.

In stark contrast, the private equity industry generally views mergers and acquisitions as a key part of its normal value creation plan. Private equity-led mergers are generally smaller and less visible than those in public markets, and, as a result, the successful ones

have fewer issues with integration and cultural clashes. Private equity boards are more hands-on and typically view integration as a major, rather than a secondary, factor when weighing up a prospective deal.

“In private equity, portfolio acquisitions must fit a defined strategic goal that results in increased cash flow.”

Mergers and acquisitions are such an integral part of the private equity “toolkit” that potential acquisition targets are usually identified by high-performing managers during their due diligence on an investment. Often referred to as “roll-ups” or “add-ons”, these portfolio acquisitions must fit a defined strategic goal – for example, expanding a company’s reach geographically or in terms of product coverage – that results in increased cash flow over the long term. Importantly, cultural and other integration aspects are carefully weighed in that process too.

Case study: Universal Services of America (today Allied Universal)

Partners Group's investment in Universal Services of America (USA) provides an example of how add-on acquisitions can be a central part of a value creation strategy.

USA is an American security services firm, which provides a diverse mix of security and facility services ranging from traditional manned guard services and janitorial services to cutting-edge technology systems. Partners Group initially invested in USA in 2011, when its private debt team provided a mezzanine loan to the company. In 2013, at the recommendation of the exiting debt team, Partners Group's private equity team invested in the company, acquiring a majority ownership stake and partnering with the company's dynamic CEO and shareholder Steve Jones.

At the time of the private equity investment, the security services industry in the US was extremely fragmented, made up of many small companies with a primarily local focus. USA's ambitious management team – supported by Partners Group – saw an opportunity for consolidation. The profitable and well-run company was

already a regional leader, but needed support in order to carry out its acquisition-focused growth strategy.

In total, Partners Group worked closely with USA to complete over 20 acquisitions while ensuring that the impact of these acquisitions would not cannibalize the organic growth or jeopardize the cultural development of the firm. Acquisition targets were carefully screened to ensure they could be easily integrated into USA's already successful corporate framework and culture. In addition, cultural workshops aimed at reducing turnover in a notoriously high-turnover industry were one of the key focus areas of our ESG-related value creation strategy.

Over two years, the number of USA employees increased from 27,000 to 44,000 while revenues increased by 80%. By 2015, USA was the fourth largest security services company in the US and in a strong position to launch the next phase of its growth. In the middle of that year, the majority of the company was sold to Warburg Pincus to take the company through this next growth phase in a consolidating industry. The sale generated a gross return of 3x the original investment for Partners Group's clients. Following a major merger with another security services firm, USA changed its name to Allied Universal.

4.3 Action on environmental, social and governance issues

Since the UN Principles for Responsible Investment (UN PRI) were launched at the NYSE in 2006, the active consideration of environmental, social and governance (ESG) factors in investment management has become increasingly mainstream. Investment manager action on the topic has been nudged forward by investors, which in terms of UN PRI signatories includes some of the world's largest and most influential pension funds.

In the early days of the UN PRI initiative, the focus in terms of asset class engagement was the public equity market. As we have already seen in previous sections, the governance framework of public markets, and the influence wielded by large investor groups such as proxy advisors and shareholder associations, meant that it was relatively easy for investors to force large public corporations to make ESG an important topic. But while ESG frameworks and best practice codes were adopted into the mainstream of public equity relatively quickly, the risk today – given the distance between management teams and public market investors – is that they may become a reporting exercise for many companies and not always a lever for real and continued change.

This is partly due to the factors outlined in section 2.2. In particular, the shorter investment horizons of many public equity

investors may mean that they lack motivation for sustained engagement with a company on a particular point, especially as ESG issues generally have limited (positive or negative) impact on short-term earnings outside of a major ESG-related controversy. Additionally, public equity investors lack real tools for engagement with companies beside proxy votes – in fact, their most powerful weapon is either not to invest at all, or to divest.

In contrast, though formal engagement on ESG issues came relatively late to private equity compared to public equity (and even later for other private market asset classes like infrastructure and real estate), the industry has quickly caught up to – and likely surpassed – public markets on ESG performance. While to a certain extent this is because it is easier for private equity managers to take action on ESG topics as portfolio companies tend to be smaller on average than public companies, it is also because the movement formalizes what growth-focused private equity investors are already doing.

Given private equity's mandate to create value over a long time horizon, much of the common-sense ethos of responsible investing was already consistent with best-practice in the private equity approach. Because material ESG measures are highly connected to reputation in the long run, poor performance on a critical environmental, social or governance issue over

a period of four to seven years can only be detrimental to a company – and therefore to the outcome for the private equity firm and its investors. On the other hand, having a strong ESG framework can lead to a higher multiple on exit as ESG measures are increasingly core to the optimal operational structure of a portfolio company. Moreover, given the deep and extensive due diligence of companies in private market transactions, ESG issues are typically more transparent for future owners, which is, in itself, a strong motivation for current owners to tackle them early and seriously.

Crucially, the governance framework of private equity and the proximity of the board to the business means that private equity investors have both the power and the mandate to take the lead on ESG improvements within a portfolio company. While most private market firms would exclude a company that was found to be materially under-performing in its ESG practices during the due diligence process, unlike in public markets, they also often make use of the option to invest in and engage with companies that are only moderate under-performers, making improvement of these practices a focal point of the value creation plan. In fact, in private equity, a company's ESG practices are not only assessed in terms of their potential risk, but also in terms of their value creation potential. This is why, at Partners

Group, the Responsible Investment team is fully integrated into the Industry Value Creation team.

As a result, from slow beginnings, formalized action on ESG topics has become increasingly widespread in private equity. A recent PWC report found that 88% of private equity firms now formally monitor the ESG activities of their investments.⁵³ At Partners Group, for instance, every investment that reaches the due diligence stage is subject to a stringent ESG assessment, with a view to mitigating any possible reputational risks that stem from ESG factors and identifying opportunities to increase the value of an asset during ownership through improvements to ESG factors.

Private equity and job creation

Commonly portrayed in the media as a destroyer of jobs, private equity has a troubled public reputation when it comes to job creation. As with many of the negative associations with the asset class, this has resulted from a handful of high-profile private equity investments which have ended in bankruptcy or major redundancy programs.

Even putting these outlying cases to one side, it is though fair to acknowledge that private equity has an ambiguous historical track record of job creation. In 2014, a major study of

⁵³ "Global PE Responsible Investment Survey," PwC, 2013.

employment changes in 3,200 private equity-backed companies between 1980 and 2005 showed that employment at the companies declined on average by 3% over the first two years post-buyout and 6% over five years. However, overall, net employment was nearly unchanged as a result of private equity ownership once firms had reshaped their portfolio companies through selective acquisitions.⁵⁴

Since then, we believe that much has changed. In parallel with the asset class' transition towards a focus on value creation, growing portfolio companies' employee bases has become the norm for most growth-focused private equity firms, which seek to build strong, sustainable businesses that will become successful employers for the long term. Private equity-backed companies are today major employers representing an increasingly vital part of the real economy. A recent study by BCG found that the top five US private equity firms employed nearly a million people in their portfolio companies, more than the US postal service and second only to Walmart. The figures are similar in Europe and Asia.⁵⁵

Based on our own data, we believe the real figures on private equity-backed employment may be even higher. At Partners Group, our top 25 largest private equity investments alone

employ more than 100,000 people. In 2017, we increased that workforce by creating more than 13,000 net new jobs through organic growth.

There is also increasing recognition from the best private equity firms that the topic of employment goes deeper than net job creation and that providing career development opportunities for employees is crucial for maintaining and retaining talent. Another study found that value creation initiatives could have a significant positive impact on the careers of workers at private equity-backed companies. For example, the employees evaluated for the study typically had higher compensation potential and long-term employability as a result of the enhanced IT and production-technology skills they had acquired in their jobs.⁵⁶

⁵⁶ Ashwini Agrawal and Prasanna Tambe, "Private Equity and Workers' Career Paths: The Role of Technological Change", *The Review of Financial Studies*, 29(9), pp. 2455–2489, 2016.

"The governance framework of private equity means investors have the mandate to take the lead on ESG improvements."

⁵⁴ Steven J. Davis et al. "Private Equity, Jobs, and Productivity," *American Economic Review*, 104(12), pp. 3956–90, 2014.

⁵⁵ "Capitalizing on the New Golden Age in Private Equity," Boston Consulting Group, March 2017.

Case study: Action Nederland BV

Partners Group's investment in Action Nederland BV (Action) demonstrates how acting on ESG factors can enhance value. Action is a Netherlands-based discount retailer offering a range of stationary, household goods, cosmetics, food stuffs, toys, textiles, glass, chinaware and pottery, decoration accessories and do-it-yourself products. The company aims to offer around 150 new articles in its stores on a weekly basis, sourcing from dozens of countries.

In early 2014, Partners Group, together with its investment partner and Action's largest shareholder 3i and Action's management team, decided to undertake a review of Action's supply chain in the context of rising ethical standards. They recognized the investment and reputational risks posed by potential damage to brand and reputation, staff morale, and exposure to legal risks.

Action subsequently commissioned an ethical sourcing "health check" to benchmark Action's performance relative to peers and industry best practice, pinpoint the areas of greatest risk, and prioritize intervention areas in its responsible sourcing strategy.

The "health check" showed that Action needed to establish a stronger ethical sourcing culture. Following this evaluation, the board established a more robust ethical sourcing policy and supplier code of conduct. The new guidance articulated Action's expectations around strictly preventing child labour and paying fair wages and made membership of the Business Social Compliance Initiative (BSCI) compulsory.

Action Nederland BV followed this step by asking its domestic suppliers to complete an ethical sourcing self-assessment through an online portal designed to generate a risk rating subject to data validation from an independent third party. Action then sent each supplier a tailored set of recommendations based on each individual risk rating, with deeper engagement planned for higher-risk suppliers.

With this foundation in place, Action has now set its sights on the next phase of its ethical sourcing initiative. Priority next steps include developing a formal escalation process and determining a set interval for how often to reassess suppliers in order to monitor progress. They will also look to take full control of the ethical, safety and social conditions of the factories their domestic import partners use to manufacture and supply their private label goods.

4.4 Creating effective capital structures

Effective capital structures come as the result of a focus on the total net value creation of equity. In other words, good corporate governance should consider the appropriate use of “expensive” equity in order to avoid unduly diluting returns when debt could be used more effectively.

In public markets, capital structures can often use debt too cautiously as boards and management teams fear being perceived as risk-taking and irresponsible. Thus, listed firms often benchmark their level of debt against other companies in their sector rather than making objective judgements based on the specific position of a firm.

This can lead to patterns of debt becoming firmly entrenched within certain sectors. In some cases, this leads companies to experience unduly low levels of leverage, as was the case with consumer staples in the early 2000s. At other times, entire sectors can become systemically overburdened by debt because companies fear underperforming against their more aggressively levered peers. This occurred in the banking sector in the run up to the Global Financial Crisis of the last decade.

Private equity-owned firms do not generally feel the same pressure to design capital structures that look the same as their competitors. By virtue of their typical four- to

seven-year holding period for each asset, private equity is able to use financing strategically in a way that maximizes the value of the buyout company. In choosing the right amount of debt for a particular investment, a responsible private equity firm will consider the overall picture of the business – the availability of funds and the need for capital for potential mergers and acquisitions as well as value enhancement initiatives – before tailoring a capital structure strategy around these factors and stress-testing it against adverse risk scenarios.

“In public markets, capital structures can often use debt too cautiously as boards and management teams fear being perceived as risk-taking and irresponsible.”

Obviously, this debt strategy also depends on the state of the debt markets. Bank appetite to lend to sponsor-backed acquisitions has ebbed and flowed throughout different market cycles. In the current market, for example, though debt is very available and on terms favourable to the

borrower, the regulated bulge-bracket investment banks have been unable to offer financing beyond 6-6.5x EBITDA due to regulator-imposed lending restrictions.

In that context, it is worth noting that private debt markets can often offer more flexible solutions than those available in the public debt markets for two important reasons. Firstly, public debt markets are beholden to the overriding market sentiment. For example, bond markets typically freeze when capital is most needed. In contrast, one of the key merits of private markets is that they are not as impacted by temporary market extremes.

Secondly, given the high level of regulatory transparency in public markets, investors lack the ability to investigate companies in the same way as they do in private markets. They must settle for a somewhat more surface-level understanding of financial positions and business strategy, potentially missing important insights. This lack of visibility can result in arrangements that do not properly align with the strategic needs of a firm.

Besides maintaining freedom from corporate peer pressure, private equity has an additional advantage. Firms can provide capital directly to portfolio companies to shore up their investment and support new debt financing.

“Private equity-owned firms do not generally feel the pressure to design capital structures that look the same as their competitors.”

From financial leverage to value creation leverage

Private equity outperformance is often attributed to financial engineering. The sector has struggled to shake off the perception that its *modus operandi* is to load its portfolio companies with debt, often to the brink of collapse.

This reputation stems from the earliest days of the asset class – those of the “bootstrap deals” described earlier in this paper – when firms relied on financial engineering to achieve outsized returns, and high leverage levels were a cornerstone of their approach.

During the boom years of the 1980s, leverage levels of 10-12x EBITDA were not unusual in acquisitions. While this would be unthinkable today, both from a risk perspective and in terms of finding a lender prepared to finance such a deal, it worked then as there were fewer active private equity firms, meaning deals were less competitive, and there were bargains to be had.

As a result, the history of private equity is unfortunately marred by the spectacular bankruptcies of several well-known companies due to excessive leverage, which has left a bad taste with the general public.

However, irresponsible leverage is largely a feature of the past. As the private equity industry has grown and matured into a mainstream asset class, it has become more crowded and competitive. This competition, among other things, has driven up valuations, meaning the only safe route to returns today is proactive value creation.

Despite this, debt still has an important role in the capital structure of a private equity-backed company when applied responsibly. In the same way that most people would take out a mortgage to buy a house, a private equity firm would see debt as a fundamental feature of a buyout acquisition.

However, just as mortgage-lending today has generally sanitized after the peaks and crashes of the Global Financial Crisis, so have the capital structures used in private equity acquisitions. Today's debt packages are generally better adapted to cash flow profiles and feature better interest coverage ratios and equity cushions as well as better terms for equity investors. In fact, given its attractive risk/return profile, buyout debt has become a significant target in its own right for institutional investors, serving as further evidence that these debt packages are deemed appropriate today.

4.5 Secondary buyouts offer proof of concept for private equity governance

As we have already discussed, one of the merits of the private equity approach is the pressure to exit investments profitably within a fixed timeframe. This puts general partners and management teams under pressure to accomplish certain goals before that deadline. In the past, private equity firms essentially had two options when it came to exiting an investment: list on a stock exchange or find a strategic trade buyer.

Over the past two decades, another alternative has emerged – to sell the company to another private equity firm. Known as a secondary buyout, this type of exit was exceedingly rare before 2000, but has since come to make up around a third of all buyouts.⁵⁷

The secondary buyout initially increased in popularity as an exit route due to the closing of the IPO markets; simply put, firms had few alternatives. However, the increasing prevalence of the secondary buyout illustrates two key points. The first of these is the institutionalization of the private equity asset class, driven by appetite from investors on the one hand and the growing universe of private companies on the other. The second of these key points is that for secondary – and even tertiary and quaternary – buyouts to become

so prevalent in the market, the private equity model must be working. In other words, the fact that the same company can pass through successive rounds of private equity ownership is in itself proof of concept of the ability of its governance model to support continued value creation.

This runs exactly counter to the original criticism levelled at secondary buyouts, which is that a second private equity owner cannot add as much value as the first. This may have been true in the 1990s, when private equity owners relied on financial engineering and the most basic of operational improvements to increase value. However, today's private equity firms have become specialists in value creation, often with expertise in different sectors, regions or phases of growth.

In this way, it is entirely feasible that the same company could pass through successive private equity ownerships, with each firm bringing a new value creation strategy suited to its stage of development. For instance, a small, regional private equity firm could be very successful at growing small companies – instituting best practices and making operational improvements – but may lack the ability or network to manage a company's international expansion. At this point, a larger, global private equity firm could take the reins, building on the previous owners' success locally to enable an expansion into international markets.

⁵⁷ According to Preqin (accessed on 31 January 2018), secondary buyouts accounted for 26% of all private equity exits by value and 32% of all exits in terms of number of transactions in 2017.

The fact is that good companies provide fantastic bases on which to add value. Companies that have already had a private equity owner have the advantage of already having effective corporate governance structures in place to help propel value creation initiatives, enabling the next owner to hit the ground running. Indeed, looking at today's private markets universe, there are many

examples of companies that have grown from local to regional to global players or from niche businesses to sector leaders to category winners over multiple private equity ownership cycles. This has resulted in investors being more interested in the continued ownership of assets instead of the one-off buyout, as will be discussed in section 5.

Case study: Trimco

Partners Group's investment in Trimco International Holding Limited (Trimco) is a good example of how a secondary buyout can create value. Trimco is a Hong Kong-headquartered apparel-labelling producer, which manufactures a full range of garment labels, tags and trimming products for blue-chip global apparel companies.

Trimco was first acquired by a private equity firm, Asia-focused Navis Capital, in 2005, when its operations were still entirely local. Navis successfully expanded the company's regional footprint by expanding it into other manufacturing bases, such as Thailand, Singapore, Malaysia and India. By 2012, Navis was ready to sell, and the company was ready to expand beyond Asia. Partners Group, with its global network and track record of helping companies with cross-border expansion, was the right partner for this next phase of growth.

Following its acquisition of Trimco, Partners Group focused on building out dedicated client relationship teams in key markets and on expanding its manufacturing footprint in key apparel hubs across Eastern Europe, Turkey, China, and South and Southeast Asia. Notable add-on acquisitions during the five-year holding period included the 2015 purchase of Denmark-headquartered A-Text, also a global provider of brand identity products for leading European and US fashion brands.

Over the next five years, the company quadrupled its business and became a global leader in its field, serving more than 500 clients worldwide. It grew from 400 employees in 2012 to more than 1,450 employees. In January 2018, Partners Group agreed to sell Trimco to funds advised by Affinity Equity Partners, which became its third private equity owner, generating a 3.4x return on its original investment.

Outlook and conclusion

Outlook for private markets

In private markets, the era of buying assets more cheaply than in public markets came to an end many years ago; in our view, the current high valuation levels for private markets assets are indicative of a structural – not just cyclical – shift in market dynamics.

Several factors have contributed to this new reality. After decades of steady outperformance, private markets have been recognized as key components of institutional investment portfolios, albeit as a less liquid form of equity. Allocations have increased, resulting in more capital coming into the market. Relatively newer investors to the asset classes, such as sovereign wealth funds, have also earmarked significant amounts of capital for private markets investment.

On the investment side, as a result of these capital inflows, the sheer scale of private markets has grown dramatically, as has the

number of investment managers active in the space. As competition for good assets has increased, so has the speed of execution in acquisitions. To remain competitive, firms must intensely monitor hundreds of potential private companies and assets in order to, where possible, pre-empt the market or gain an edge in a managed sales process. This involves not only defining a clear investment hypothesis, but also assessing an asset's value creation potential.

In this environment, investment managers with larger, more comprehensive private markets platforms have a clear advantage. These bigger firms can leverage their scale not only to source more investments and arrange more attractive financing terms, but also to identify the potential for synergies among their various portfolio companies. Equally, they can use the knowledge gained from their substantial portfolios to help create value in other investment holdings. The increased maturity of

the industry has already resulted in the emergence of several such key players, which straddle multiple private markets asset classes and offerings.

With all of this in mind, we expect the prices of private assets to more consistently compare to those found in listed markets going forward. Within the public equity market, buyers will often pay a significant premium above the actual share price to take control of a firm. Known as the control premium, these higher prices reflect the buyer's valuation for the company after taking into consideration control over potential upside and synergies. In much the same way, asset pricing in private markets has come to reflect such premia, acknowledging the potential for long-term value creation. This is a trend that is unlikely to reverse.

Structurally higher valuation levels will pose a continued challenge for the private markets industry. In this market, to achieve attractive returns for their clients, firms have no option today but to excel in their value creation capabilities, becoming, in many cases, ever more specialized.

Though we expect decreased absolute returns in private markets in coming market cycles, we also anticipate that their relative

outperformance against public markets will remain very solid, as the Partners Group Expected Return Framework shows.⁵⁸ As this paper has explained, this outperformance is primarily enabled by the entrepreneurial governance structure of private equity.

Long-term private markets ownership and governance

In the history of the asset class, the structure of its approach has changed very little: four- to seven-year investment holding periods have been a hallmark of private markets investing for decades. This is often a sufficient length of time to allow private equity firms to fundamentally develop an asset through value creation initiatives, good governance practices, and entrepreneurial strategy. The high returns that have been generated by this approach reflect the often more “transformative” nature of traditional private equity ownership, with its highly active “change” strategy carried out within a concentrated period of time.

However, as a downside, many investors are consistently falling short of their target allocations. Due to the structure of private markets funds and investments, investors must hold cash on the sidelines before and after the

⁵⁸ Please see the “Portfolio Perspectives” section in Partners Group’s Private Markets Navigator, Outlook 2018, “Leveraging the winds of change,” <https://www.partnersgroup.com/en/news-views/research/current/>.

investment holding period – it is exceedingly rare that an investor’s commitment is ever fully invested. Furthermore, when exiting, private equity managers are often divesting assets with continued, strong future growth prospects that they would rather hold onto for longer.

A longer-term private equity investment approach will therefore be of interest to certain types of investors, which benefit from having no short- or medium-term liabilities. These include sovereign wealth funds and certain pension funds as well as, in some cases, insurance companies, family offices, foundations, and endowments. To combine the benefits of the entrepreneurial governance style found in private markets with the longer-term investment needs of these clients, we believe that two models are emerging within the private equity industry.

Two models for long-term private markets ownership

The first model involves the private equity firm extending ownership of a well-performing portfolio company or asset beyond the traditional four- to seven-year holding period. This could be by re-acquiring a reduced stake in the company following the exit of the original buyout transaction. This approach, sometimes referred to as a “rollover” investment, can be achieved by participating as a joint investor in a

successor investor consortium, which as a whole has a controlling stake. This also brings benefits to the other members of the successor investor consortium as the rollover investor has built a deep familiarity with the business, management team, and ongoing value creation projects. Such arrangements also often lead to a better alignment of interests in the discussion of the transaction valuation for the exit of the original buyout, without implying compromise as control is given up by the original investor.

“New private equity models are emerging to combine the entrepreneurial governance found in private markets with clients’ longer-term investment needs.”

Alternatively, in this first model, a private equity firm may maintain a controlling – or otherwise highly influential – stake in a portfolio company after an IPO, should a public listing be the best exit route for the company in question. This approach provides the advantage of continuously available liquidity while maintaining a private markets-oriented governance model during the period of significant ownership. The goal of a private equity firm, in this case, is to continue to use its value creation approach to support the asset.

One example of this approach in practice is Partners Group's exit from VAT Group AG (see section 4.1 for a case study of the investment). VAT was listed on the SIX Swiss Exchange in April 2016, but Partners Group continued to hold a significant shareholding until January 2018 and play an active role in the company's value creation efforts through its board membership. VAT's adjusted EBITDA grew 24.7% and 32.9% year-on-year in 2016 and H1 2017, respectively.

Importantly, in the case of extended ownership by means of maintaining a controlling stake in a firm following an IPO, this approach remains fundamentally different from that of activist hedge funds, which aim to create value by driving specific corporate actions like dividend re-caps and divestments. This event-driven approach typically involves proxy vote

campaigns or publicly pressuring a board in order to influence these changes. Rarely do these hedge funds own controlling stakes, and their investment horizon is not sufficiently long that they are concerned with fundamental governance.

The second longer-term model involves adapting the buyout model altogether to a longer-term time horizon and a different type of acquisition target: successful companies, typically large or mega caps, which in many cases are already the dominant company in their segment. Often, these companies have had several former private equity owners, which have achieved market share growth and margin expansion at rates no longer possible.

Nonetheless, these are firms with strong fundamentals and attractive growth prospects. Once upon a time, these companies would typically have listed on a stock exchange as a natural next step in their corporate trajectory. However, having had the benefit of private equity ownership in earlier stages of their corporate history, many management teams become accustomed to an entrepreneurial governance style and are loath to exchange that for the public markets model.

Unlike a traditional buyout target, these “core” companies or assets would typically not undergo the same “transformative” type of

buyout program, but would still benefit from continued and proactive value creation. The management teams of these companies are often seeking commitment from investors to their long-term goals, with value creation efforts likely to be focused more on the optimization of the existing business in terms of securing and building out their franchise, network or market shares as well as margins.

“We expect the trend towards longer-term investment to accelerate and become a significant proportion of private market investment.”

Others may need more “transitional” longer-term projects, including multi-year capex programs to allow for larger technology projects. When successful, such longer-term capex projects may secure the leadership positions of companies for many years to come. To facilitate this kind of investment, private equity firms may factor in a holding period of a minimum of ten years.

These longer-term models will likely feature lower leverage and a greater emphasis on regular dividend payments. Overall, the returns to investors are expected to be modestly lower than typical private equity returns, but so is the risk. Additionally, they benefit from extended periods of compounding and less dilution due to reduced cash needs. As such, we expect that this kind of longer-term private markets investment will still compare very favourably to public equity on a risk-adjusted basis.

The development of longer-term investment vehicles will be subject to fluctuations in economic conditions and financial markets. With the continuation of the current attractive market conditions, we expect the trend towards longer-term investment to accelerate sooner rather than later, becoming a significant proportion of private market investment.

On the other hand, a meaningful downturn would likely lead to a preference for liquidity after the typical holding periods of four to seven years and therefore a renewed focus on more traditional private market investment approaches. Changes to the regulatory environment could naturally impact these developments in either direction.

Table: Potential future models for private market governance and ownership

	Traditional private market fund	Extended ownership model	Long-term "core" asset model
Type of company/asset	Companies with significant mid-term value creation potential; often with transformative private market ownership.	Established companies with significant mid- and long-term value creation potential; often category leaders following a phase of private market ownership.	Successful, mature companies that define their segment, led by entrepreneurial management teams with long-term aspirations.
Acquisition route	Traditional control buyout; purchase of asset as spin-off, take-private, generational shift family sale or secondary buyout.	Traditional control buyout followed by influential stake retained after an IPO or through co-ownership in a controlling consortium.	Long-term control ownership with concentrated investor base, often using somewhat more prudent debt levels compared to traditional buyouts.
Typical holding period	Four to seven years.	Four to seven years initial buyout, followed by "extension" to ten to 15 years through continued co-ownership.	Ten to 15 years.
Size of investment target	Extended middle market (and small caps), selective large cap.	Extended middle market, selective large cap.	Typically large cap or mega cap, selectively extended middle market.
Value creation approach	Bespoke value creation strategy, traditional buyout toolkit (see section 4.1).	Bespoke value creation strategy, traditional buyout toolkit; often with ambition to become longer-term area category leader.	Bespoke value creation strategy focused on franchise optimisation and/or maintaining/securing market leadership through long-term capex.
Exit route	Sale to other corporate or private market owners or public market listing.	Sale to other corporate or private market owners or public market listing/share sale.	Sale to other long-term corporate or private market owners or public market listing.

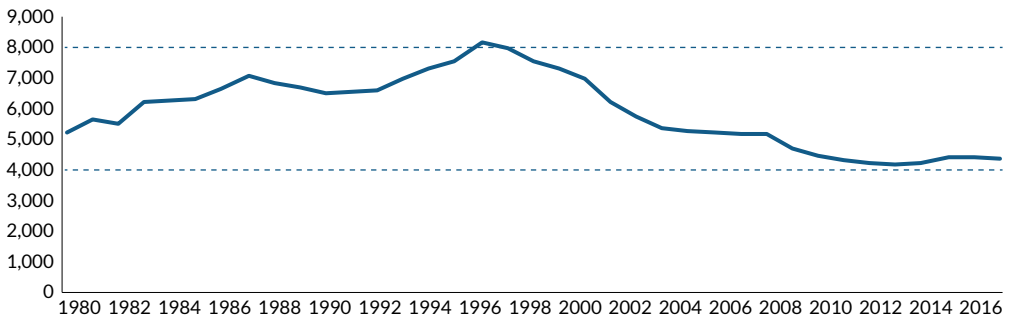
Conclusion

The fundamental problem with public market corporate governance was recognized as early as 1989, when the paper “Eclipse of the Public Corporation” appeared in the October issue of the Harvard Business Review.⁵⁹ In it, Professor Michael Jensen made the point that the corporation was an effective structure for some types of businesses, but that most of the time the agency problems of divided ownership and management caused deep problems. He suggested that if the trend of privatization continued, the public company would disappear by 2005.

⁵⁹ Michael C. Jensen, “Eclipse of the Public Corporation”, Harvard Business Review, (September–October 1989).

Public companies still exist today. However, the total number of public companies has slipped over time; in fact, the number of public firms on US exchanges reached its peak in 1997 and has dropped by around half since then (see chart below). This may in part be because the costs of complying with regulation have become punitive for smaller businesses. An equally relevant reason is likely to be that investors and entrepreneurs are increasingly weary of the corporate governance forces triggered when going public, especially during more entrepreneurial stages of corporate growth and development. Today, there is even less reason for them to go public as there is plenty of capital in private markets to fund the growth of attractive corporations and assets.

The number of public companies in the US is in decline



Note: Listed domestic companies in the US.
Source: World Bank.

For those companies that still wish to go public, many have found ways to avoid the trap of governance correctness altogether. For instance, they maintain a large percentage of ownership in the hands of employees and founders – some have even created different classes of shares in order to maintain control amongst long-term owners. Recently, many tech companies, which face a greater competitive struggle to stay relevant and cutting edge, have followed that model.

Nevertheless, there are many larger, mature companies still mired in the web of “governance correctness.” Overzealous governance practices have become so entrenched through laws and codes that they are likely to persist for the foreseeable future. Meanwhile, these companies will still be subject to the pressures of short-termism, with Wall Street pushing for quarterly earnings growth as investors seek quick gains. Many of them may, as a result, continue to underperform their long-term potential.

In contrast, successful private equity firms will continue to emphasize entrepreneurial governance models as they refine and specialize their value creation skillset. In this context, it stands to reason that private equity

will continue to outperform public equity, even as the industry becomes more competitive and valuations in private markets become structurally higher and more directly comparable to capital markets across the cycles. New or adjusted formats of private markets investment may even increase the proportion of companies shifting from traditional capital markets to a more owner-controlled governance model in the coming years. Sustained demand from institutional investors for a risk-adjusted alternative to public markets is expected to promote the adoption of longer-term investment horizons within the asset classes.

In the meantime, the enterprising mindset of private equity captures the spirit of those early venture capitalists who pooled money to build canals and railroads. With a governance system that encouraged an ownership mentality and incentivized success, their ultimate goal was to create value through growth, success, and innovation, realizing the full potential of market opportunities.

Contacts

Client relations contact

Andreas Uhde

T +49 89 383 892 51

andreas.uhde@partnersgroup.com

Investor relations contact

Philip Sauer

T +41 41 784 66 60

philip.sauer@partnersgroup.com

Media relations contact

Jenny Blinch

T +44 207 575 2571

jenny.blinch@partnersgroup.com

partnersgroup@partnersgroup.com

www.partnersgroup.com

Follow us on LinkedIn 

Follow us on Twitter 

ClimatePartner^o
climate neutral

Print | ID 53232-1802-1008





Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS