McKinsey & Company

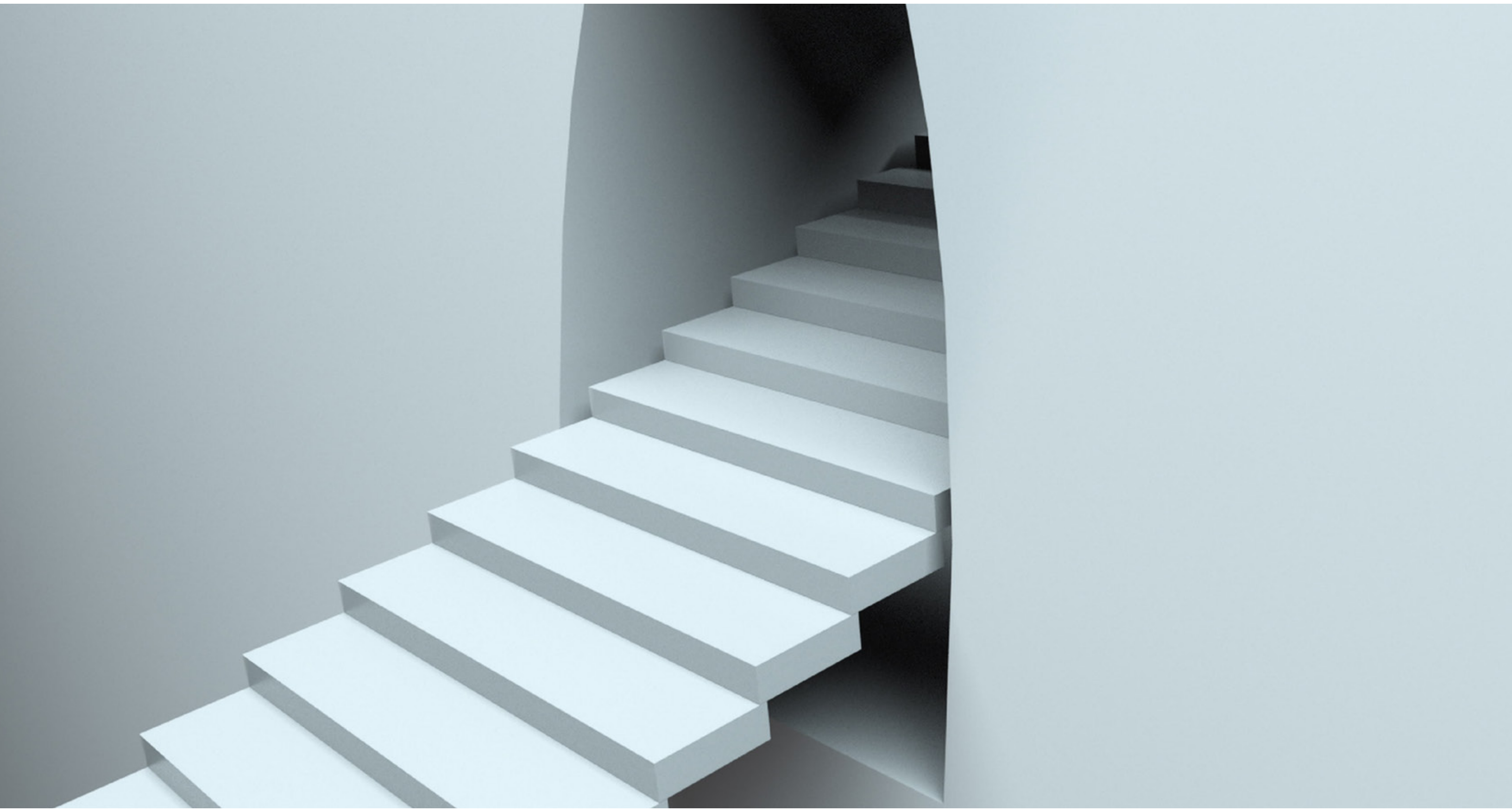
Strategy & Corporate Finance Practice

Climbing the private-equity learning curve

Commentary

CEOs who are used to engaging with public-company boards need a different playbook when it comes to private-equity boards. Here's what they can expect.

by Conor Kehoe and Tim Koller



May 2021

Successful executives from public companies may be eager to take on the new challenges of leading a private-equity (PE) firm's portfolio company. However, they may not realize the differences in approach between the boards of public companies, which often view themselves as stewards, and the boards of PE portfolio companies, which frequently take a far more active role. As a result, C-suite leaders who are making the switch face a learning curve—which, based on more than 30 interviews conducted with CEOs of PE-owned companies over the past few years, typically spans three phases: the initiation, a realization of benefits, and full integration. It's an adjustment that may require the experience of several PE-ownership cycles, but here we describe the stages mapped onto one deal cycle.

The key differences

Our research has shown that public companies and PE portfolio companies alike can have engaged boards. However, boards of PE portfolio companies tend to systematically take a coleader role with the CEO on important topics; engaged directors not only help set strategy and manage performance but also master the details needed to stress-test, push back on, reset, and dramatically improve the business.

Indeed, PE board members feel like owners themselves. Senior managers of the portfolio company typically own about 5 to 8 percent of the company stock, and the PE firm votes the rest of the shares, which are owned by the PE fund (in which the PE firm is a major investor). While there is no uniform board size or lineup, the boards of PE portfolio companies usually include the "deal partner," who is typically a midcareer financier, and one other member of the PE firm. There is typically a chair, who is frequently an ex-CEO, often from a much larger company than the portfolio company in question. Additionally, the boards will include one or two other nonexecutives—for example, experienced external nonexecutive directors with specific know-how in the company's core sector or in a functional topic, such as digitization or artificial intelligence, that is key to the company's future.

PE portfolio company boards are generally younger and smaller than public-company boards, thereby increasing each individual's engagement. This engagement and PE company board members' bias toward active ownership are what drive much of the "alpha"—outperformance relative to quoted peers—in any deal.

The learning curve

The active ownership of PE boards can take some getting used to. CEOs accustomed to working with boards of publicly traded companies typically go through three stages to climb the PE learning curve.

The first phase, *the initiation*, can last about six months. During this period, PE portfolio company executives come to realize that the PE board's approach is both hands-on and focused on the medium and long term. Short-term earnings targets, particularly in the first two years, matter far less than robust value creation by year four.

Right from the start, the board will be geared to engage. As part of their diligence in acquiring the portfolio company, the incoming nonexecutive board members often will have spent three or more months steeped in due-diligence reports, including reviews of management plans and projections. The board's commercial due-diligence team will have reported back on 50 to 100 interviews of suppliers, large customers, regulators, former employees of the company and of rival companies; other due-diligence teams will have delved deeply into financial accounts, legal commitments and liabilities, and environmental, social, and governance (ESG) risks. It adds up to the incoming board having a considered, research-based viewpoint on the company and its industry.

Almost certainly, the members will have developed their own multiyear value-creation strategy for the company as part of their investment plans.

Moreover, they know the plans can change: the new board members expect that the management team will have ideas they had not thought of and that new facts will come to light. The same will apply for CEOs when they present their plans to the PE board. They should be ready for detailed scrutiny and a robust back-and-forth.

PE boards have a determined focus on performance management and associated key performance indicators to meet longer-term strategic plans. This longer-term approach should, of course, apply for publicly listed companies as well—thoughtful public-company board members also recognize that a focus on short-term earnings-per-share targets is usually detrimental to long-term value creation. The reality is, however, that outside-driven, short-term targets can distract even the most conscientious public companies. These distractions are less of an issue in the PE context.

Indeed, new CEOs of PE-held companies may find that they need *less* time for formal board meetings overall because board members will already be highly engaged between meetings—visiting sites, customers, and suppliers and conducting ad hoc calls to advise management on opportunities or threats arising between board meetings.

The second phase of the learning curve is when PE portfolio company executives begin to *see the benefits* of working with PE boards. For example, should an executive need to fire a senior member of her team, it can be quite a lonely spot. With an active board, however, CEOs aren't alone; they have full thought partners on their board who know the company inside and out. An actively engaged board also helps inoculate CEOs against second-guessing; directors are right there, making the hard decisions, too.

The pace of decisions is quicker as well. Business isn't run at the artificial pace of board-meeting dates. Senior executives come to realize that the quality of their proposals to the board is higher; this, when combined with well-informed decision making, can be a double step-up.

With this realization, PE portfolio company executives are at phase three: *fully up the learning curve*. At this point, they find themselves enjoying the flow of ideas and encouragement from the chair and nonexecutives and from the deal partner. Based on anecdotes we've heard, at this stage, transitioning executives often feel like they are becoming better managers. In their public-company experience, they may have grown used to putting

With a deeply engaged private-equity board, members not only grasp the business circumstances immediately but also vote the stock and can be an almost 'instant shareholder meeting,' if need be.

their ideas for enhancing the company through two filters: first, how hard it would be to explain this idea to their board, and, second—should they succeed with their board presentation—how hard it would be to convince a dispersed set of shareholders. In the process, they may weed out good ideas too early. That is not the case with a deeply engaged PE board. Its members not only grasp the business circumstances immediately but also vote the stock and can be an almost "instant shareholder meeting," if need be.

The lessons of longer-term orientation, open dialogue, and support for bold moves are ones that successful public companies can internalize, as well. In fact, companies of all types can learn from what makes good boards even better.

As senior executives confront the transition to PE ownership, experienced PE board members can let them know that they understand how discomfiting a manager's experience can be, particularly at the start. For their part, CEOs who are transitioning to PE-held companies should understand what awaits them and how they can expect the experience to unfold. As in value creation itself, it's a process for the longer term.

Conor Kehoe is a senior partner emeritus and senior adviser in McKinsey's London office, and **Tim Koller** is a partner in the Denver office.

Designed by McKinsey Global Publishing