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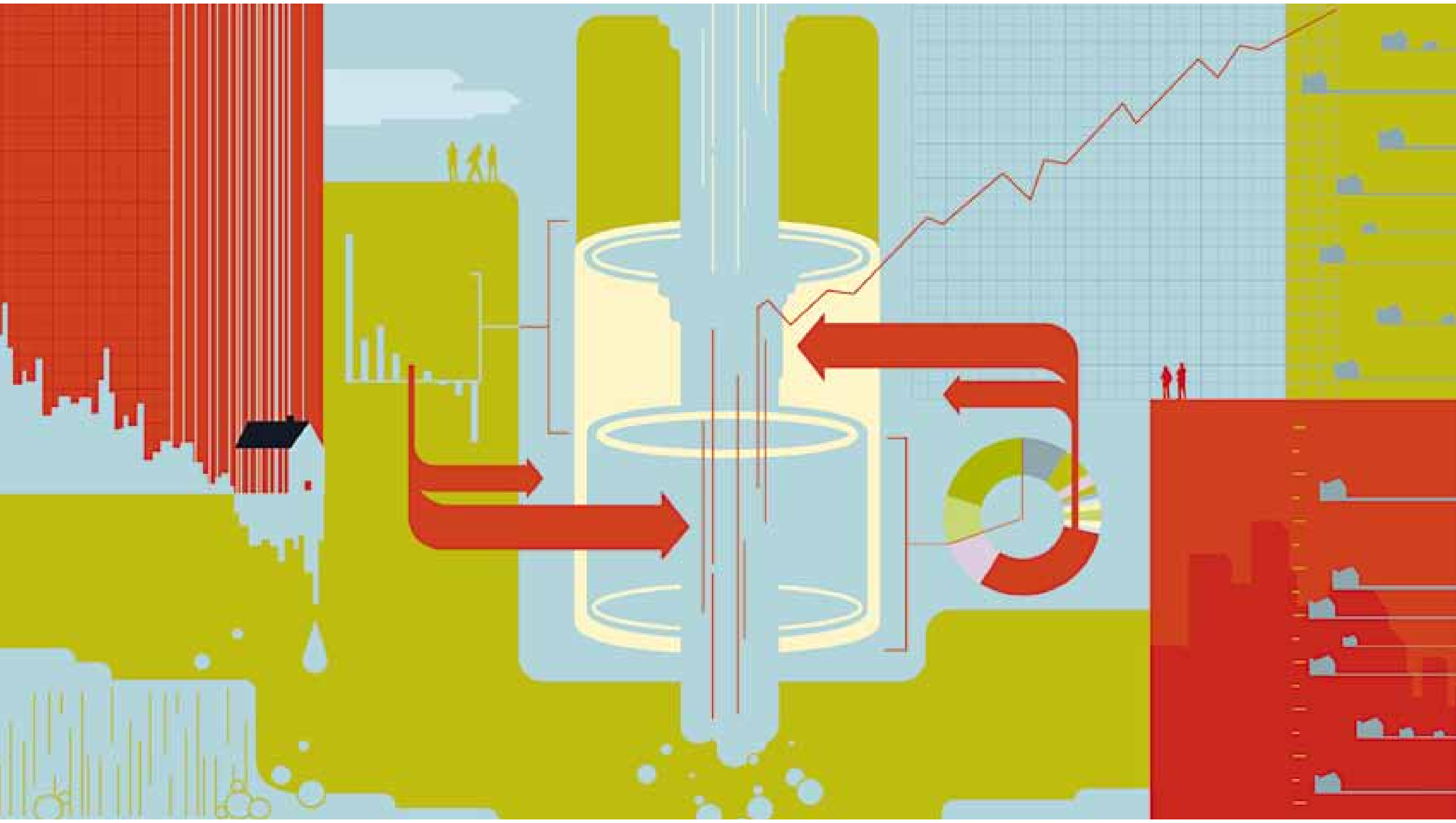


Board directors and experience: A lesson from private equity

Independent directors contribute an outside perspective to governance, but analysis of private-equity firms suggests they need relevant managerial expertise too.

Viral V. Acharya and Conor Kehoe

Independent directors are very much in fashion. Many companies, particularly in Europe, are looking to fill openings on their boards with professionals they hope will bring close oversight, renewed enthusiasm, and broader perspectives on strategy.

Similar attributes—such as independence and deep engagement in setting strategy and managing performance—are often cited as the primary reasons for the success of the better private-equity firms. Indeed, our own past analyses have found that these firms persistently outperform the S&P 500 because their partners are active directors of the businesses in their funds. They are more engaged with setting strategy and managing performance as their own interests are tied to the success of a business.[1]

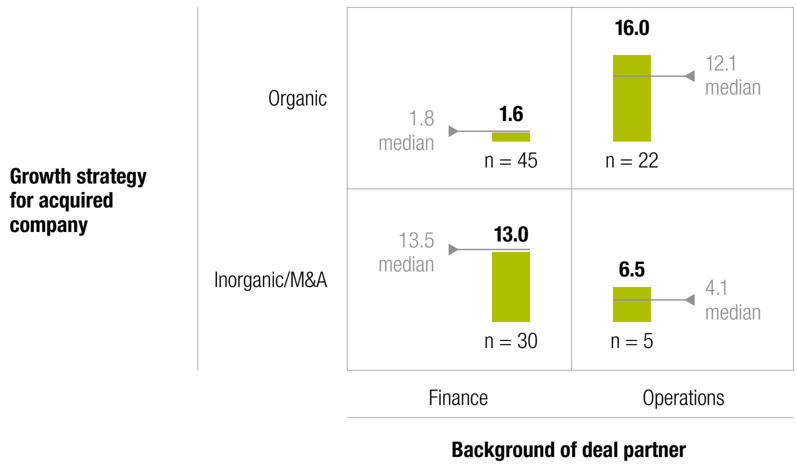
Yet greater involvement is apparently not the whole story. Our new research on private-equity firms shows that deals generate the greatest value when the skills of the lead partner are directly relevant to the business strategy of the portfolio companies to which they are assigned.[2] Partners with a finance background, for example, do best when acquisitions are central to a value creation strategy, and partners with managerial backgrounds do better with companies whose chosen route to value is organic development (exhibit). And both strategies led to outperformance: companies that developed organically grew sales in line with

Exhibit

A good match

The deals that generated the greatest value involved deal partners whose skills were directly relevant to the business strategy for the acquired company.

Outperformance[1] for 110 of the largest European deals from 1996 to 2005, simple average, %



[1]Rate of return on equity (ROE) of a deal minus that of quoted peers and excluding the effect of debt.

their public-company peers but improved their margins more rapidly through faster improvements in productivity. Companies that grew through acquisitions improved their value by increasing expected future profits[3] more than quoted peers did—for example, because of higher expected margins once acquisitions are properly integrated.[4]

For public companies, these findings raise interesting questions about the expertise and experience they should be seeking even from independent directors—and their ability to match the strengths of a board to their overall strategies. The challenge goes beyond finding directors who will dedicate enough time to the company and who understand it (perhaps as the result of experience in its industry). The findings suggest that directors might also be chosen for their experience in having executed similar strategies elsewhere—perhaps in industries that have evolved further.

For private-equity firms, our findings raise questions about how they assign partners to deals. Do these firms consider the way value will be added to an acquired company? Should they deploy small teams of partners with different backgrounds for deals requiring more complex strategies? Are the firms doing enough to develop and expand the skills of partners beyond what they learned before entering private equity? ○

[1] See Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe, "What public companies can learn from private equity," mckinseyquarterly.com, January 2007; and Viral Acharya, Conor Kehoe, and Michael Reyner, "The voice of experience: Public versus private equity," mckinseyquarterly.com, December 2008.

[2] We looked at 110 of the largest European deals in the decade from 1996 to 2005.

[3] Expressed as the multiple of current profits at which they were valued.

[4] The companies in our sample typically started out with average margins—so they were not turnarounds.

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