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In his keynote speech delivered at the Private Equity Analyst Conference in New York City on September 22, 2004, Henry R. Kravis, the founder of the investment banking firm Kohlberg Kravis Roberts & Co. (KKR), indicated that he was proud of his industry by declaring that no private equity firm had been involved in any of the major corporate scandals of the past 25 years. Why? Because, he believes, the general partners of a private equity fund are vigilant in their role as owners and protect shareholder value through management ownership, value creation, and talent management.[1]

Private equity provides corporate governance in a less bureaucratic and more hands-on way than public companies do through proactive management ownership, close monitoring of value creation at board level, reliance on financial indicators, performance-based incentives, high levels of shareholder activism, insistence on transparency in disclosure, and balancing risk-taking and diligent governance.

EMPHASIZING MANAGEMENT OWNERSHIP

Private equity funds offer money to companies in return for a stake in their ownership. As a result, private equity firms become co-owners, or even sole owners, of the companies they invest in. Private equity firms hire executives for these companies who act as owners rather than administrators. They create a proactive agent-principal relationship by granting equity to management, with an option to ratchet up the level based on subsequent performance. The private equity firms look for top talent not only in terms of skills and track record but also in terms of attitude. They seek executives with operational experience, hunger for success, a zest for taking up the challenge of transforming a company, and the discipline required for strong value-creating governance activism. The general partners of private equity firms also act in the manner of owners of the portfolio companies by making tough decisions and acting rapidly. They replace the poor leaders in their portfolio companies without hesitation.

The general partners need to execute investment governance discipline in all investment stages, from due diligence evaluation of a business for its prospects for growth and future profitability to valuation of the worth of the company, monitoring and harvesting throughout the three to five years, and paying numerous visits to the company's sites and interacting with its management team. As they sit on the boards of the underlying companies and participate in making key decisions such as capital budgeting and selection of the management team, to be successful the general partners of private equity funds need to be able to build rapport with entrepreneurs, scientists, executives, limited partners, and others.

DRIVING VALUE CREATION

Private equity firms have a reputation for investing in problem companies, making operational improvements, and seizing revenue

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opportunities to create value in their portfolio companies before selling their stake at a profit some three to five years down the road either through an initial public offering (IPO) of the company's shares or through a private sale.

The principals and partners in private equity funds involve themselves in nurturing the investment by taking a position on the company board and steering through a strategy that will lead to higher profitability and increase the value of the fund's stake. They develop a clear investment plan laying out the fundamental changes needed to transform a company and concentrating on the two or three critical issues that will determine a portfolio company's full potential performance over a three to five year time frame.

This business planning process is different from the internal planning process based on most public companies' incremental approach of an *x*% increase over the previous year. In addition, most public companies tend to focus on either the short-term goal of meeting Wall Street analysts' expectations or the long-term goal of delaying real value creation in the enterprise. In contrast, private equity firms always exhibit a sense of urgency, efficiency, and effectiveness, knowing that within five years they must be in a compelling position to be able to sell the company for more than they paid for it.

FOCUSING ON KEY FINANCIAL INDICATORS

In contrast to the numerous balanced scorecards prevalent in public companies, private equity firms' metrics are not complex. They simply focus on a few key financial indicators. Since approximately 60% of private equity firms' assets are financed with debt, compared with the 40% that is typical for public companies, the high debt to equity ratio prompts managers to view cash as a scarce resource and allocate capital accordingly.[2] The top private equity firms select cash as one of their few key metrics to help them keep track of a portfolio company. They focus on cash rather than earnings, and on returns on capital rather than on sales.

Private equity firms also treat the balance sheet as a dynamic tool for growth rather than as a static snapshot scorecard. They rapidly redeploy or cut off unproductive capital, be it fixed assets or working capital, through selling or shutting down underperforming companies or cutting pieces out of the business. They observe and react to market conditions proactively and vigilantly rather than spend much time on trend analysis or historic data analysis. They create new ways to convert traditionally fixed assets into sources of financing and manage their capital aggressively.

CREATING PERFORMANCE-BASED INCENTIVES

A general partner of a private equity fund is responsible for the management of a partnership and bears the full risk of partnership debts and liabilities, making a small contribution of capital, commonly agreed at 1%. Limited partners put up the balance. Limited partners are institutions or individuals that contribute capital to a private equity fund; they typically include state and private pension funds, university endowments, insurance companies, asset management firms, and fund of fund investors.

Compensation for the general partner in a private equity firm is primarily paid in the form of a profit participation, referred to as carried interest or "carry" and generally ranging from 20% to 25% of the profits the general partners receive from the investments made by a fund, realized when the underlying companies are sold. For example, a $10 million fund raised from limited partners is invested into a portfolio of investments now worth $50 million. Assuming profits from proceeds of $5 million, limited partners would receive $4 million and the other $1 million would accrue to the general partners as their carried interest.

Under the carried interest compensation structure, the financial interests of the general partner are aligned with the underlying company's performance. The carried interest compensates the general partner for helping to increase the value of the companies in the private equity fund through active ownership and management, including working with the individual private companies by serving on their boards of directors, helping them to develop long-term strategies, annual budgets, and business plans, and ensuring that management is held accountable for and motivated to achieve business objectives and financial targets. Typically, carried interest is paid only after a minimum rate of return to the limited partners is achieved and after the original investment amounts are returned to the limited partners.

In addition, the general partner usually draws an annual advance of 1.5-2.5% of committed capital as management fees used to cover the basic costs of running and administering a fund. However, the carried interest, rather than the management fee, serves as general partners' chief incentive tool for strong performance.

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ADVOCATING SHAREHOLDER ACTIVISM

Shareholder advocacy work with portfolio companies focuses on issues such as environment, diversity, corporate governance, and social responsibilities. Shareholders start to act like owners of the company to influence the company's conduct with regard to areas such as the environment and human rights as well as overall corporate governance areas, including the independence of board audit committees and compensation committees.

Shareholder activism shows that a company's board is not a club selected by management but is supposed to be independent, representing shareholders and providing oversight. The investors in companies funded by a private equity fund have ample opportunities for constructive dialogue with the management on the company's operations and social sustainability. The sustainable investment approach in the private equity industry advocates corporate sustainability that will impact the long-term performance of the investment portfolio companies.

CONDUCTING TRANSPARENT DUE DILIGENCE

Before investing, private equity firms go through a thorough due diligence process and sign contracts to align the interests of shareholders with those of investors. The private equity investor plays a role similar to that of the independent board member on behalf of public investors, independent of the entrepreneur and looking after the interest of the limited partners of the fund. According to Jim Furnivall, a Wharton alumnus and venture capitalist, he will say "no" to 99 companies for every 1 "yes." Private equity firms will select only 1 business plan out of 250 proposals.[3]

Throughout the investment period, all of the activities in private equity firms are carried out transparently. The general partners of the private equity firm participate in the board of the portfolio company, scrutinizing, criticizing, and reviewing their strategic and financial planning and investment discipline and identifying opportunities for alliances, mergers, and acquisitions. Good corporate governance is prevalent within the private equity industry, reflected in better transparency, more credibility, and greater accountability.

TAKING RISKS USING A BIG LEVER

Private equity firms are willing to take calculated risks as long as they see the bigger scheme in the venture, which means an opportunity to solve a major problem, apply a big technology solution, get multiple people involved, and add tremendous value in the end when all these things come together. One big lever gives enough motivation to these private equity firms, convincing them that it will make a difference if they get this right. Venture capitalists realize the failure rate of their ventures. For every 10 investments they make, 3 will fail, 4 will have a mediocre outcome, and 3 will be successful. However, those successful 3 will reward them bountifully—financially and emotionally.

To secure a higher success rate in this risky business, private equity firms apply laser-focused strategy to each of their portfolio companies by targeting only one goal that will add tremendous value instead of multiple goals that may well stretch them thin. Quite opposite to the conventional diversification investment strategy of putting eggs in several baskets, the investment theme of private equity firms is to focus on one big scheme. As one of the industry insiders said, "It's OK to put all your eggs in one basket, just watch that basket very carefully."[4]

FINAL THOUGHTS

As a McKinsey study indicated, the key success factors for private equity firms are creating value through active ownership, management, and governance by 1) encouraging management ownership through proactive agent-principal relationships, 2) developing dynamic value creation plans and executing them aggressively, 3) managing the performance of the venture and the resources to establish strategic priorities, 4) focusing on performance incentives for talent and requiring CEOs to invest personally in the venture, 5) supporting shareholder activism, 6) insisting on transparency in management, accounting, and operational information formulation, and 7) being resilient in risk-taking and striving for sound governance.[5]

Today, the directors of public companies are taking their responsibilities to shareholders more seriously because of the Sarbanes-Oxley Act of 2002, enacted following various corporate scandals. One potential consequence, however, is that they could also become more conservative and risk averse, spending enormous time on legal process rather than pushing innovative ideas. In some

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cases, this could cause long-term detriment to the business. It is easier to say "no" to any risk and play it safe than it is to examine the risk closely to weigh the pros and cons of pursuing a potential business.[6]

On June 2, 2005, President Bush nominated Rep. Christopher Cox as chairman of the Securities and Exchange Commission to succeed the departing SEC chief William H. Donaldson. The president reassured us that "as a champion of the free enterprise system," the new SEC chairman will "follow in the footsteps" of his predecessor to enforce the rules and laws that "guarantee honesty and transparency" in "dynamic and vibrant capital markets" and corporate boardrooms in order to "build a better America."[7] Now is the time for public companies to follow the new corporate governance leadership and learn good corporate governance lessons from the private equity industry to strike an optimal balance between healthy risk-taking and compliance with governance rules in order to bring economic prosperity and technical innovation to the nation.

ENDNOTES

[1]Henry R. Kravis, Keynote Speech at the Dow Jones Private Equity Analyst Conference in New York City (September 22, 2004).

[2]Pierre Lavallee and Paul Rogers, "Private Lessons: Top Private Equity Firms Often Deliver World-Beating Results. Here Are Five Ways They Pull It Off," *Canadian Business,* October 27, 2003.

[3]Wharton Entrepreneurial Programs, "From Pong to Private Equity," *Getting It Started Newsletter* (Spring 2004).

[4]Ibid.

[5]London Business School, Private Equity: How Can It Continue to Outperform?, presentation at the "Global Leadership Summit" sponsored by the London Business School, June 27, 2005.

[6]Henry R. Kravis, Keynote Speech.

[7]Office of the Press Secretary, "*Immediate Release: President Nominates Congressman Chris Cox as SEC Chairman,*" June 2, 2005.

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