Grant Thornton

# Private equity: the directors' view

**Directorbank report** 2008

### Summary of participants

We received 261 responses to the questionnaire with respondents varying in age between 41 and 77. All but 3% were men. 49% of those responding had been involved in deals in London and the South East, 23% in other parts of England, just over 11% in Scotland and Wales with the remainder abroad.

Respondents had been involved in deals across a wide range of sectors, but the largest numbers were involved in manufacturing (23%) and business services (18%).

The value of deals which respondents were involved in totalled £13.6 billion with an estimated workforce of 152,000. The most frequent size range for those deals was between £10-100 million making this a predominantly mid-market survey.

Many deal types were represented but MBOs were involved in 42% of cases, with BIMBOs and MBIs accounting for another 34%. At the time of their involvement, 45% were managing directors, 23% finance directors, 20% chairman with the rest being a mix of other executive and non-executive directors.

Most impressively, there were many serial deal-doers represented in the example. 64% had been involved in two or more private equity deals with 18% claiming five or more. These serialists were especially well represented amongst those reporting on MBI deals – 55% had done three or more deals compared with fewer than a third of those reporting on MBOs.

## Contents

02 Summary of participants
03 Executive summary
04 Securing backing
05 Due diligence
06 Building the company together
08 Change management
09 Exit stage left
10 Risk and reward
11 About Grant Thornton and Directorbank

# Executive summary

The private equity industry has become a fundamental driver of the UK economy, with a presence in almost every sector, targeting businesses from start-up to the largest Plcs. While billion pound deals draw the lion's share of the headlines, PE-backed MBOs, and MBIs have driven innovation and growth in every part of the economy.

While the focus is often on the motivations and methods of the private equity investors themselves, the people they back the company directors, are absolutely fundamental in creating value and their collective views are less well heard.

Therefore this research sets out to offer a voice to those directors that have experienced private equity deals often several times over. It examines how the private equity industry interacts with management teams pre, during and post-deal from the directors' point of view, and explores the risks and rewards of becoming part of such a process.

The report offers an insight into the deal process for those directors looking to work with private equity for the first time, or simply better understand the industry through the experience of others. Deal fundamentals have been examined in detail, from approaching private equity houses through due diligence and the investor/director relationship while businesses are under PE ownership, to examining whether expectations were met.

"Increasingly fortunes are made, and sometimes careers stalled, through partnering with private equity houses, and this research offers valuable insight for directors wanting to explore the risks and rewards of MBOs and MBIs from those who have already travelled that path,"

**David Ascott**
Head of Private Equity
Grant Thornton

"Private equity backed companies now employ 21% of the UK's private workforce; three million people. Therefore the greater the understanding of how private equity operates by all parties looking to partner with private equity, the greater the overall economic benefit to the UK,"

**Jonathan Hick**
Founder and Director
Directorbank

# Securing backing

**Director considerations:**

- Expect to contact a large number of different private houses for deal backing
- Seek the help of advisers to organise finance effectively
- Private equity firms are generally good at keeping in touch and are very management friendly initially
- Seek clarity on investment expectations both from a private equity and management perspective

Half of those directors involved in MBOs met with at least five separate investors about the opportunity they were pursuing, while a third spoke to at least seven. MBI candidates needed to be even more persistent, with two thirds (67%) speaking to seven or more investors. Private equity houses also often used the filter of a third party adviser to organise pre-deal discussions (55% for MBOs, 42% for MBIs), highlighting the need for established contacts in the financial advisory community, particularly for those who were looking for their first private equity backed deal.

"My strongest impression was that the investors had very strong, maybe rigid, criteria which defined their willingness to become involved."

Almost half of directors involved in both MBOs and MBIs said three or more of the PE houses they had met with initially made the effort to keep in contact. However, the process was time consuming, with 43% of those who had participated in an MBI searching for the right opportunity for more than 12 months, and 6% seeking deal opportunities for more than two years.

"PE firms were happy to see people and let them do a lot of work on deals without any real commitment from them although they expected/preferred that you worked exclusively with them."

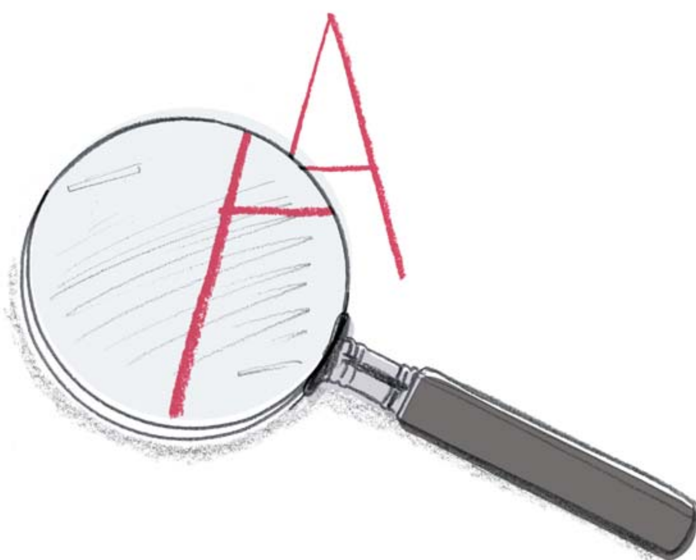
At this pre-deal stage the majority of private equity houses encountered were viewed as management friendly by more than three quarters (77%) of directors, something that the research demonstrates tends to become less positive post-deal.

However, PE houses were viewed far less favourably in terms of laying out pre deal expectations around management performance and reward. Just 20% of directors felt investors' expectations had been fully communicated, while 48% found this communication adequate. A full third said communication was either limited or non-existent.

# Due diligence

**Director considerations:**

- Despite huge personal effort and involvement in due diligence, directors were largely unimpressed with the value of these efforts
- The majority of directors felt investors didn't have a full understanding of the business post due diligence
- Only 20% of management received useful insights from the due diligence process
- Management interviewing and referencing was particularly patchy and lightweight



Most directors reported spending a long time involved in the due diligence process, many reporting hundreds of hours of meetings spread over weeks and sometimes months.

However, 80% of directors felt that investors had at least adequate understanding of the relevant commercial and strategic issues. This then dropped to 65% who understood the strengths and weaknesses of the management team, and fell to 60% who had a handle on the wider organisation, including only 9% that believed investors fully understood these issues.

"The process takes twice as long as you expect!"

One of the weakest areas was the process of interviewing management as part of the due diligence process, which was often patchy while referencing was found to be lightweight. This was largely due to the surprisingly low levels of referencing, with a third of respondents unaware of any references being taken and a further 40% indicating that only one or two had been taken. Fewer than half of respondents (45%) felt that they had been assessed adequately, while only 40% saw other directors (executive or non) as adequately assessed. This included just 2% who felt their fellow directors had been assessed fully.

Outside specialists brought in to assist in the due diligence process were not used at all by 59% of investors despite the fact that there was no strong feeling against such a process. There was disappointment regarding useful feedback – just 20% got useful insights though due diligence. A total of 60% of directors assessed by a third party wanted more feedback on opportunities for organisation development.

"Given the time and costs involved in diligence, directors should insist that advisers not only scrutinise the past but generate future value for the business."

Mike Hicks

# Building the company together

**Director considerations:**

- Investors largely retain a focus on financial performance with little emphasis on organisational issues
- The chairman's role is a critical success factor to the investment balancing the interest of investor and management
- Management are keen to work with the same investors again if chairman/non-executive directors' relationships were successful
- 70% of directors found investors were active board participants

Experienced private equity investors talk of a time when their relationship with investees was almost exclusively financial in its orientation. In recent years more emphasis has been placed on understanding and improving operational and commercial issues.

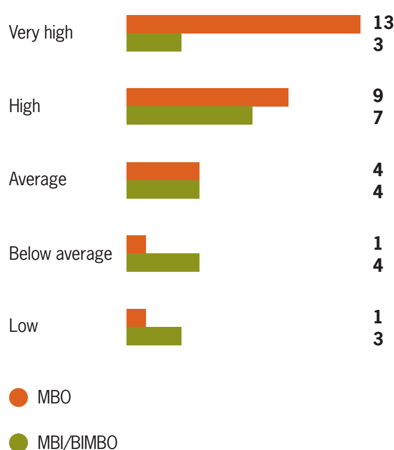
> "The board meetings were dominated by detailed financial analysis and progress to the exit."

In the boardroom, more than 70% of directors found investors were active participants. Outside formal meetings, only 40% of investors were actively involved with a higher proportion waiting for contact to be initiated by the executive team or chairman.

Most investors relied on their chairmen to help set the tone and frequency of the relationship with the rest of the board. Of those respondents who had served as chairman of PE backed businesses, all but 20% claimed to have spent three or more days a month involved in the business, outside board meetings. But other directors suggested that 60% of chairmen spent less than three days a month. Interestingly, directors rated the effectiveness of chairmen significantly higher when they were more active in the business.

Getting the right chairman is crucial and it is no coincidence that ratings of investor effectiveness were closely correlated with ratings of chairmen. 84% of directors rated their chairmen as good or excellent – a figure which fell to just 61% for other non-executives.

**Ratings of chairman effectiveness**

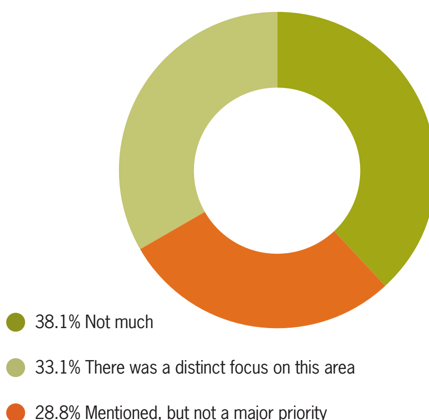



MBO

MBI/BIMBO

Source:

**Q71: If there was a '100 day plan' post-deal, how much emphasis did the investors place on getting management and organisation issues right?**



38.1% Not much

33.1% There was a distinct focus on this area

28.8% Mentioned, but not a major priority

Source:

One of the factors which explains whether or not directors would happily work with the same investors again is the perceived quality of other non-executives on the board. Directors are also more likely to want to work with private equity investors when the person they meet on the board is someone they rate. It may seem obvious, that the quality of the non-executive board members is seen as an important contributor to results and the willingness of directors to work with investors again – but both data and anecdotal evidence suggest that many investors fail to achieve the desired standard.

In terms of what value investors are seen as contributing post-deal, directors refer to a number of factors including an understanding of the business model, related business/financial advice and a constructive approach to rewarding success as the key areas. Chairmen are prized for their business advice, but are also seen as offering moral support and are better at grasping the 'spirit' of the organisation.

Critics of the level of value added – typically managers – sought "Better understanding of what motivated management", "Flexibility and support in the dark days" or "Listening to someone other than the chairman."

A difference between the experiences of respondents involved in MBIs versus MBOs, is that the latter are more likely to be positive about the effectiveness of the chairman. We may speculate that more of those involved in MBOs were experiencing their first exposure to a private equity and so appreciated a guide to the process and buffer from the investors more than MBIs who are more likely to have been involved in multiple transactions.

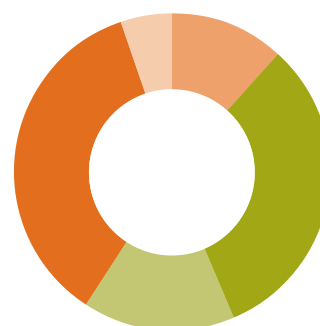
"A good chairman anchors the deal – they should drive the management and business plan enthusiastically but firmly, and keep the investors informed and happy."

**Q76: How were any non-executives (including the chairman) brought onto the board?**

- 40.0% Regular interaction initiated by both sides
- 36.0% Management could express preferences but had little actual influence
- 24.0% Management had a strong influence over the decision
- 20.0% Management had no say in the matter

Source:

**Q73: How active were the investors in the company outside of board meetings?**



- 35.6% Regular interaction initiated by both sides
- 31.9% Occasional calls from them
- 15.6% Active only when we needed them to be involved
- 11.9% We only spoke if we contacted them
- 5.2% Frequent to the point of overdone

Source:

# Change management

## Directors' considerations

- 70% of deals saw management changes
- 28% of financial directors were changed during the deal process, compared with 24% of MDs and just 12% of non-executive directors
- Most directors felt these removals were at least somewhat justified
- Non-executives were much more likely to deal with the same private equity firm again. A small but substantial percentage of executive directors who would never work with private equity again

By the end of deals 59% of companies had met or exceeded their objectives. One in five experienced 'significant problems' and more than 70% of deals saw some management changes before exit.. Two thirds of directors felt investors were fully justified in removing managers. Underneath this generally positive picture, however, there are significant differences between executive and non-executive directors. None of the non-executives felt removals were unreasonable whereas, a full third of chief executives and slightly fewer finance directors thought the justification was suspect.

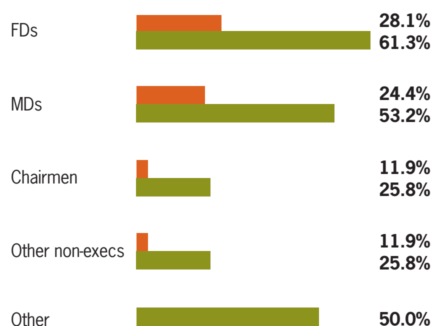
This difference in attitude towards removals correlates with the pattern of management changes by position.

Whereas just 12% of non-executives were removed post-deal, this rose to almost a quarter (24%) of chief executive officers and 28% of finance directors. Finance directors appear to suffer from several risk factors: a significant change in financial sophistication due to the demands of new leverage; investors scrutinising their work more closely than that of other executive directors; and finance directors skills being seen as more of a commodity. On the other hand, anecdotal evidence suggests that those finance directors who are successful in one deal, are then highly prized for future assignments.

> "You have to accept the harsh reality of a short timeframe – if things are going wrong, a football chairman fires his manager. And there are is a growing queue of talent waiting on the touchline to wear your boots."
>
> **Jonathan Hick**

Executive directors are also less likely to have their financial expectations met or exceeded, to feel treated fairly by investors (about 60% compared with over 80% of non-executives), or want to deal with the same investor again (about 54% want to versus almost 90% of non-executives).

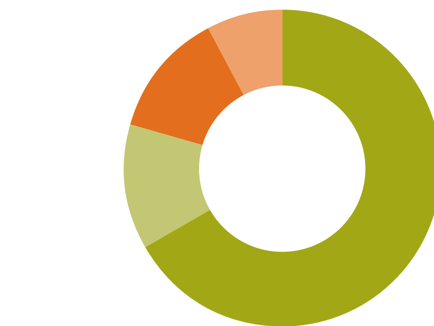
**135 firms still responding to survey at this stage**




- Link to absolute number of changes by position
- Minimum percentages of various positions who were changed in deals covered in the research

Source:

**Q94: How active were the investors in the company outside of board meetings?**



- 66.7% Fully justified
- 12.8% Arguable but probably justified
- 12.8% Some reasons but erring towards subjectivity or panic
- 7.7% Mostly unjustified

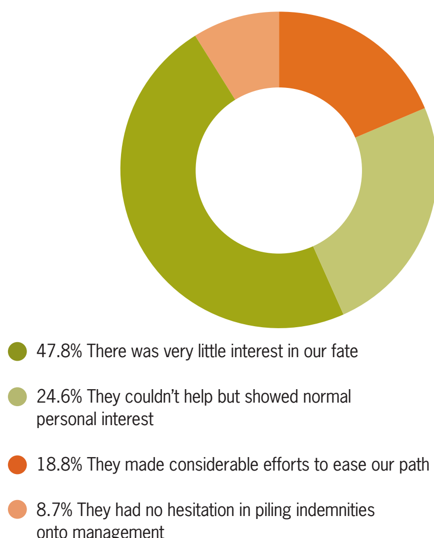
Source:

# Exit stage left

### Directors' considerations

- Two thirds of directors felt they had been treated fairly and would be happy to deal with same investor again
- There is often little contact post-deal, with just 20% reporting any subsequent investor effort to establish another working relationship
- Twice as many respondents thought the PE model was better than listed Plc
- The most negative experiences were when the investors methods were almost completely financially focused, rather than also working closely on people and process

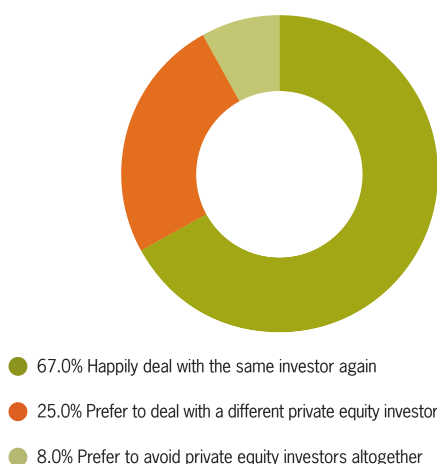
**Q100: To what extent did the investors show interest in the fate of management post-exit?**



- 47.8% There was very little interest in our fate
- 24.6% They couldn't help but showed normal personal interest
- 18.8% They made considerable efforts to ease our path
- 8.7% They had no hesitation in piling indemnities onto management

Source:

**Q109: Given the choice would you:**



- 67.0% Happily deal with the same investor again
- 25.0% Prefer to deal with a different private equity investor
- 8.0% Prefer to avoid private equity investors altogether

Source:

When it comes to exiting investments, two-thirds of investors worked with managers as a joint team while another fifth made the decision alone but kept managers in the loop. Reflecting on their experience, most managers felt they had been treated fairly and two-thirds would be happy to deal with the same investors again. However, just a fifth of managers reported any efforts to assist their paths thereafter.

The investor/management relationship is primarily financially driven that only rarely becomes personal/longer term. Consequently the quality of relations depends to a significant degree on financial performance, and a minority of directors felt investors were excessively focused on achieving their own objectives, even at the expense of their partners.

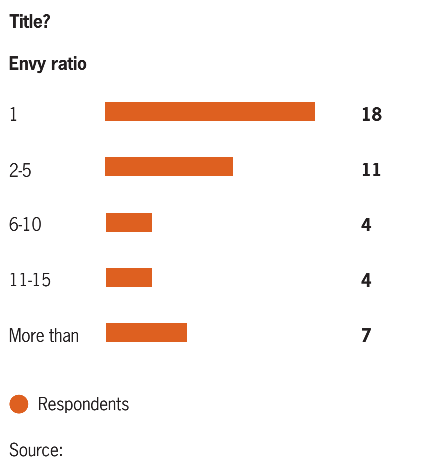
> PE are "More focused and straight forward there are no hidden agendas or politics" "PE investors do not understand organisational issues and that success is people based. They are too focused on leveraging and spreadsheets."

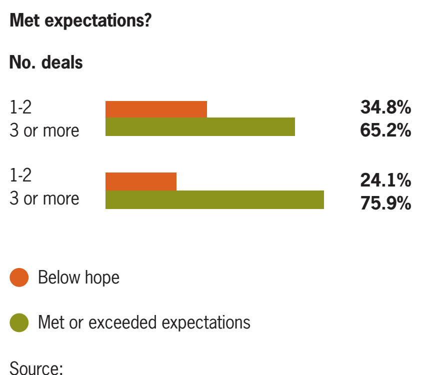
Forty percent of directors felt that boards under private equity were more effective than boards of listed firms, more than twice the number who felt listed boards were superior. Those who were enthusiastic typically referred to the energies released by high ambition, clear objectives and rewards linked to a definite exit. By contrast, those who were negative pointed towards a focus that was obsessively financial and offered limited substantive support.

# Risk and reward

**Directors' considerations:**

- There is now a well established and growing group of directors that have become private equity 'serialists'
- The average time from acquisition to exit is now four years
- Satisfaction was probable but not guaranteed, with 68% of respondents' financial expectations met or exceeded – the average return for directors (based on limited data) was £1.53 million




One of the major findings of this research has been the continued emergence of the private equity 'serialist' in the UK, ie. directors involved in four or more deals. 38% of those surveyed in this UK-based research fell into this category, a significant proportion.

In terms of risk, the financial exposure of directors doing deals was identified as significant by 57%, but only 14% felt seriously at risk. Indeed, when deals were concluded, management teams typically received equity at lower cost than investors. The average level of that 'envy ratio' was around 10 times, but with wide variations depending on circumstances, while the average total management stake was a third (33%). The average time it took to complete a private equity buyout or buy-in from acquisition to exit was four years.

Reinforcing the positive outcome of private equity deals, a full 68% of respondents felt their financial expectations in doing the deal were met or exceeded. A significant minority, however, either made nothing or even lost money. Data on absolute gains was incomplete as there was a smaller sample who were willing to reveal monetary gains, but of those that made a gain and provided a figure, the average was £1.53 million. Whichever way it is examined, the rewards can be viewed as substantial. The top reported return on one deal was £10 million and many directors reported their gains as 'significant', suggesting the average deal return of £1.53 million was considerably lower than the market reality. Serialists are the most likely to have both their expectations met and also be more successful financially.

"Whether you become a large millionaire or a small one, money is still the key reward at the end of this journey. No wonder the majority are returning to the model time and again."

**Jonathan Hick**
Directorbank

# Directorbank report

**Grant Thornton UK LLP:**
Grant Thornton UK LLP is the fifth largest accountancy and business advisory firm in the UK with over 300 partners, 4,100 staff (including partners) based in over 30 locations in the UK, Cayman and British Virgin Islands. Through our international affiliation we can also deliver a comprehensive range of business advisory services in 110 countries covering every major financial jurisdiction.

Services Grant Thornton provides include corporate finance, recovery & reorganisation (includes restructuring and turnaround), taxation, assurance (includes external and internal audits), risk management services, litigation and disputes, project finance, financial planning and private client services.

**Private equity services:**
The Private Equity team at Grant Thornton provides a full range of private equity related services and delivers advice to meet the needs of management teams seeking private equity investment and management buy-in candidates looking for an investment opportunity as well as private equity-backed companies and private equity houses.

We provide advice and implementation support on management buy-outs and buy-ins, M&A, due diligence, valuations, transaction support, pre and post-deal services, synergy planning, M&A integration and carve-out, fund structuring including advice on personal and corporate tax issues and exit strategies including IPOs.

In terms of deal-flow, during 2007, our corporate finance team advised on more than 215 completed UK deals with a value in excess of £2.5 billion. Our national private equity team is consistently ranked in the top five for UK deals completed by accountancy firms.

**About Director Bank**
Directorbank Executive Search Ltd is the UK's leading provider of directors to private equity backed companies. Established 10 years ago, the firm employs 40 staff between its London and Leeds offices. It also has representatives in Scotland and the North West.

The company operates a unique business model, unreplicated in Europe or beyond.

- Directorbank members comprise around 2500 Chairmen, Non-Execs, Chief Executives and Finance Directors
- All are immediately available to provide consultancy and due diligence advice or to fill full-time, part-time and interim roles
- Full career and contact details of the members are available online 24/7 to subscribing clients
- Directorbank is retained by over 70 private equity and venture capital firms, as well as a handful of legal firms and corporate finance advisers (including Grant Thornton)
- Over 1000 client executives have password access to the database and, on average, conduct around 1000 online searches a month
- A team of Account Directors and Managers support each client, attaining a thorough knowledge of their sector and deal preferences
- Regular CV Alerts highlight new members to the client base
- Directorbank places a great emphasis on networking and community and, as such, organises over 35 conferences, seminars, dinners and other events a year – hosting over 1000 guests and delegates
- Clients are both national and international firms, including Permira, Candover, Warburg Pincus, Cognetas, Barclays, ISIS, Advent International, LDC, Duke Street, Dunedin, Electra and ECI

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