2015

LAYING THE FOUNDATION FOR *OUTSIDE* BOARD DIRECTORS TO ADD VALUE *INSIDE* PE PORTFOLIO COMPANIES

In early 2015, as part of a survey of 167 senior investment professionals from 74 funds, Notch Partners collected feedback from 50 respondents about how they compose, compensate and utilize their portfolio company boards of directors. The investment professionals surveyed are leaders at funds ranging in size from $200M to $15B, with the majority in the upper middle market. 85% are control investors based in the US and work across industries including consumer, healthcare, energy, business services, industrials, distribution, financial services and technology.

Notch Partners 2015 Private Equity Board of Directors survey focuses on understanding the use and impact of outside board members (OBMs) – members of the PE portfolio company board who are not PE investment professionals. OBMs are most often former industry executives: CEOs who are tapped for their industry knowledge, experience, contacts and strategic vision. Based on answers to 38 questions covering a range of board-related topics, an interesting narrative and supporting themes emerged. **Notch's survey revealed that over a third of survey respondents are not satisfied with the performance of their OBMs: a surprise since OBMs are generally among the highest performing CEOs in their respective industries.** Given the unique and critical value that OBMs are expected to bring, our analysis focuses on drivers of satisfaction and success. (See ***Outside Board Member (OBM) Satisfaction and Performance).***

Below are summary findings from the survey:

- **94% of PE boards consist of 4-9 directors, and are majority controlled by the PE deal team.** 8% of funds surveyed have OBMs representing over 50% of their boards.

- **OBMs are typically ex-CEOs with deep relevant industry experience; over 93% of PE funds cited that specific sector expertise is critical when selecting OBMs.** Respondents also noted that strategic vision (87%), operational expertise (67%) and business contacts (69%) are important criteria for their OBMs. Approximately half of OBMs are engaged as operating partners with a PE firm prior to serving as a director of the fund's portfolio company.

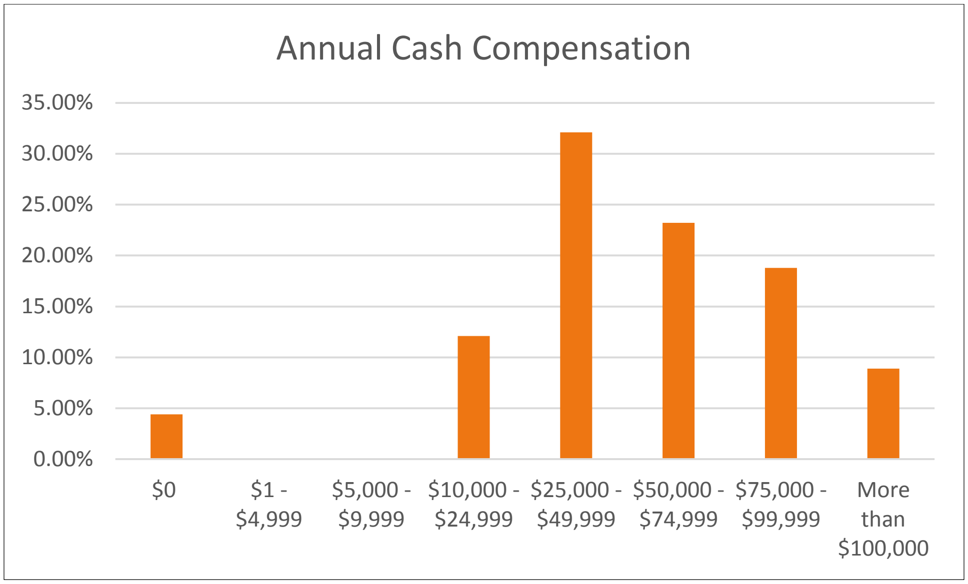
- **OBMs are most often called upon to help provide guidance on operational issues, open doors to new business contacts and identify and diligence acquisitions.** OBMs are rarely influential in exit strategy; 90% of respondents stated that the board's investment professionals are the sole decision makers on exit-related issues.

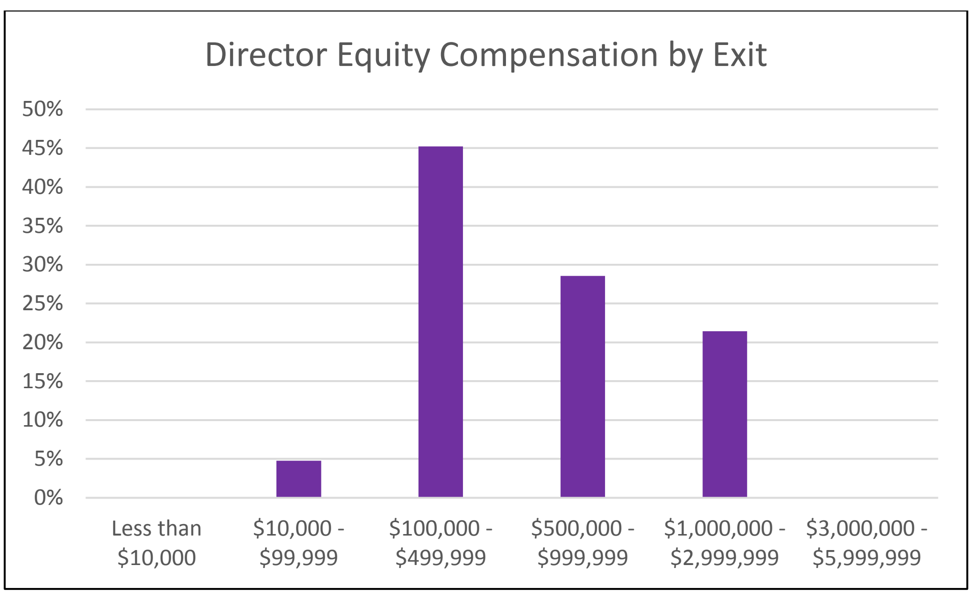
- **Equity is the most significant component of compensation for OBMs. 85% of funds surveyed provide equity as part of compensation to outside board members, and 75% pay an annual salary or stipend.**

    - Over two-thirds of OBMs earn less than $75K per year in salary or stipend.

    - 28% are expected to make between $500K and $1M in equity and 21% between $1M and $3M in a typical base case return scenario.

    - 36% of respondents stated that compensation for OBMs is customized by individual.


Annual Cash Compensation
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
$0
$1 - $4,999
$5,000 - $9,999
$10,000 - $24,999
$25,000 - $49,999
$50,000 - $74,999
$75,000 - $99,999
More than $100,000


Director Equity Compensation by Exit
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
Less than $10,000
$10,000 - $99,999
$100,000 - $499,999
$500,000 - $999,999
$1,000,000 - $2,999,999
$3,000,000 - $5,999,999

Outside Board Member (OBM) Satisfaction and Performance

What are strategies that drive satisfaction on private equity boards? What adjustments can investment professionals make to maximize results?

OBMs are expected to play a vital role on PE portfolio company boards. Occasionally they take more than half the seats. Yet, while OBMs are hired to bring critical industry and operating expertise, they are frequently the source of dissatisfaction and confusion. ***According to our survey, only two-thirds of PE board members are satisfied with the performance of their OBMs.*** In our efforts to understand the sources of dissatisfaction and practices associated with effectiveness, several decisive themes emerge:

- The level and frequency of interaction between OBMs and management teams is a significant driver of effectiveness.
- Compensation, particularly in the form of equity, encourages high levels of engagement from OBMs.
- Board members (e.g. Operating Partners) in pre-existing working relationships with the PE investor function more productively on their boards.

Our analysis shows that PE investors who create well-incentivized teams, with clear lines of responsibility and high levels of communication between all stakeholders, drive the most success from their portfolio investments.

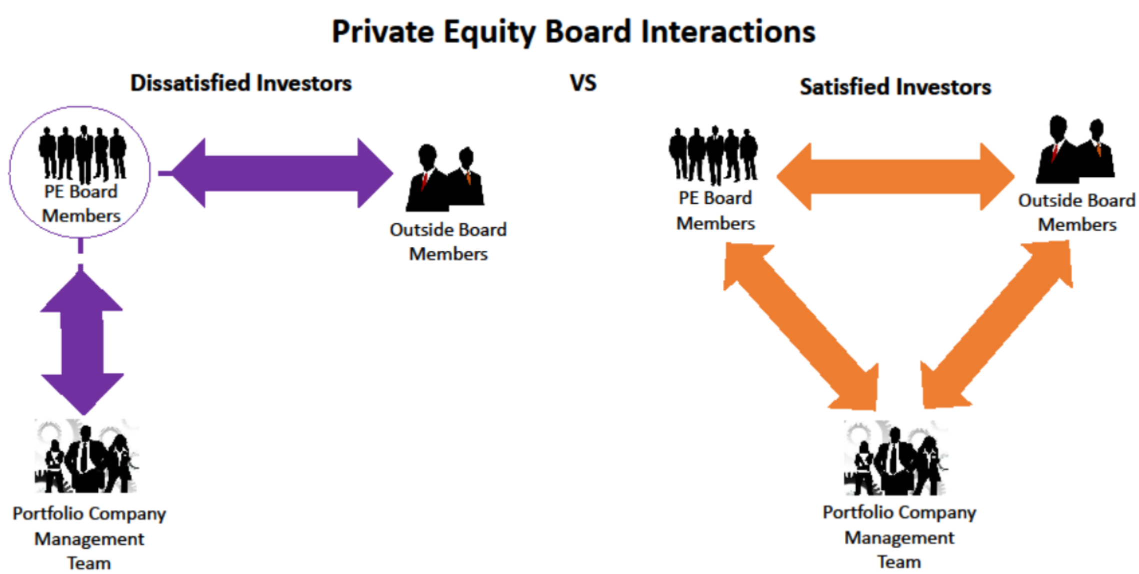
This hypothesis is based on the following findings:

Satisfied investors encourage frequent and active dialogue between management, OBMs and PE Professionals. While 100% of PE firms surveyed cited frequent interaction between PE board members and management teams, *on satisfied PE investors' boards, OBMs are almost twice as likely to interact directly with management teams on a frequent basis.* Less than a quarter of dissatisfied PE firms reported this type of interaction; some have none at all.

Lack of engagement by OBMs is the leading cause of dissatisfaction; almost 70% of dissatisfied PE firms cited this complaint and 56% criticized their OBMs for being unwilling to roll up their sleeves. Not surprisingly, 92% of effective boards with satisfied investors have OBMs interact and work with management teams onsite.

Why are these OBMs perceived to be failing to engage adequately? Are these executives truly unwilling to roll up their sleeves? We suspect that most are not as disinterested as the data suggests. Based on thousands of conversations with PE board prospects, we believe that appointed executives are motivated to serve on boards because they are eager to leverage their business networks and decades of experience to actively mentor, advise and work with management teams. Many are semi-retired executives who want to remain connected and engaged in business. We believe that in many cases their lack of engagement may be a consequence of the board's inattention to proactively and purposefully encourage and enable dialogue between the management team and the OBMs. In the absence of doing so, investors find that they intermediate the strategic vision, operational know-how, and mentorship capacity of OBMs to management teams. Given that industry expertise is cited most frequently by PE firms as an important criteria for OBMs, it stands to reason that these industry veterans should work directly with management teams rather than relying on the PE investors to intermediate their dialogue.

However, PE firms may not be comfortable with OBMs interacting directly with management teams and may be concerned that the board must consistently deliver a unified message and strategy to the management team. It is no surprise then, that many satisfied investors appoint operating partners, with whom they have long and trusting relationships, to their portfolio company boards.



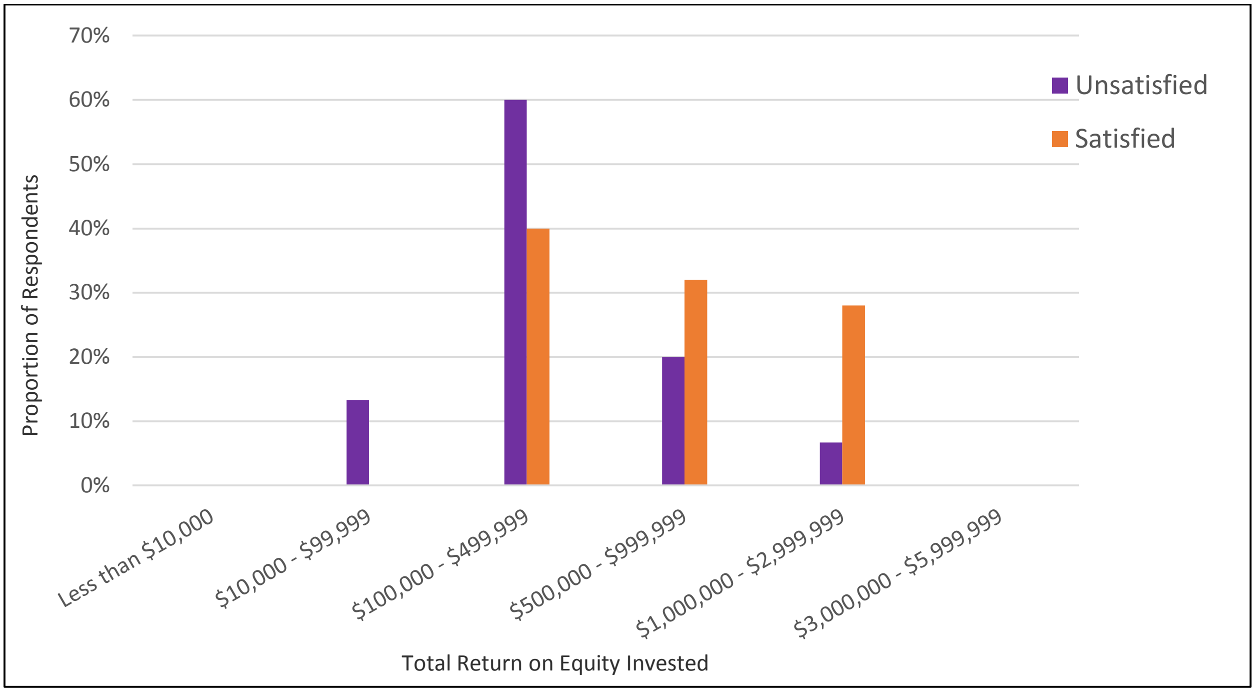
According to Notch's survey, OBMs of dissatisfied investors rarely interact directly with management teams. Their strategic advice, mentorship and leadership is intermediated by the Private Equity Board Members. By contrast, satisfied investors' OBMs are twice as likely to interact with management teams outside of official board meetings and to do so frequently.

Satisfied investors source outside directors through a variety of channels and cultivate long-term relationships with their OBMs. The processes in place to source and evaluate potential board members is critical to ensuring relevance and fit. Satisfied investors develop their future directors over time and use a variety of channels to develop relationships with industry leaders. In fact, satisfied investors are 50% more likely to place long term operating partners as OBMs and one-third less likely to source through Executive Recruiters or their Personal Networks. Not surprisingly, satisfied investment professionals have a larger proportion of OBMs on their boards. 64% of satisfied investment professionals said that OBMs constitute over 25% of their portfolio company boards versus 16% of dissatisfied investors.

Based on results in our survey, we believe the most effective investors develop working knowledge of future OBMs over time. These investors engage with executives as operating partners or industry advisors during the acquisition phase and then call upon them to serve as OBMs after close. Conversely, these OBMs are able to use pre-close working opportunities to develop and refine a PE "lens" for evaluating acquisitions and providing guidance on operational issues. When already engaged as operating partners, they also have an opportunity to learn and experience their specific firm's approach and style to portfolio management. Thus both sides are able to get a sense of the OBM's strategic capacity and ability to interact with management teams before officially extending an offer to join the board.

Satisfied investors pay their OBMs more. Incentives are important. Irrespective of fund and deal size, satisfied investors are more generous with salary and equity compensation packages than their unsatisfied counterparts. Higher compensation encourages both stewardship and involvement on the part of the OBMs; those investors with the most generous compensation packages for their OBMs were less likely to complain that their outside board members were unwilling to "roll up their sleeves."

As evidenced by the table below, 60% of satisfied respondents expect the total value of their OBM's equity compensation to exceed $500K, versus 26% of dissatisfied investors. (This higher expectation is not limited to the larger funds.)



Annual retainers were also slightly higher.

Conclusion

Our research strongly indicates that PE investors who create well-incentivized teams, with clear lines of responsibility and high levels of communication between all stakeholders, drive the most success from their portfolio investments. *Frequent dialogue between all stakeholders and parties is key to realizing the most value from Outside Board Members (OBMs). Management teams benefit greatly from the strategic and industry expertise, as well as operational mentorship OBMs are hired to provide; OBMs are not just available to confirm or deny the suggestions management has made to the investment professionals. For the purposes of identifying and evaluating board members, PE funds are well-served if they work with operating partners and cultivate a robust talent pipeline of prospects for upcoming portfolio investments, and in all cases, take the time to evaluate and interview all candidates. Finally, you get what you pay for: higher levels of compensation with meaningful equity provide greater flexibility to investment professionals and encourage higher levels of engagement on the part of OBMs.*

Established in 2002, Notch Partners LLC is the pre-eminent provider of leadership capital and management-led buyout strategies for private equity firms. Our mission is to maximize our clients' returns in every stage of the investment process through high impact relationships with industry-leading C-level executives.

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