



The voice of experience: Public versus private equity

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Advocates of the private-equity model have long argued that the better PE firms perform better than public companies do. This advantage, these advocates say, stems not only from financial engineering but also from stronger operational performance.

Directors who have served on the boards of both public and private companies agree—and add that the behaviour of the board is one key element in driving superior operational performance. Among the 20 chairmen or CEOs we recently interviewed as part of a study in the United Kingdom, most said that PE boards were significantly more effective than were those of their public counterparts. The results are not comprehensive, nor do they fully reflect the wide diversity of public- and private-company boards. Nevertheless, our findings raise some important issues for public boards and their chairmen.

When asked to compare the overall effectiveness of PE and public boards, 15 of the 20 respondents said that PE boards clearly added more value; none said that their public counterparts were better. This sentiment was reflected in the scores the respondents gave each type of board, on a five-point scale (where 1 was poor and 5 was world class): PE boards averaged 4.6, public boards 3.5.

Clearly, public boards cannot (and should not) seek to replicate all elements of the PE model: the public-company one offers superior access to capital and liquidity but in return requires a more extensive and transparent approach to governance and a more explicit balancing of stakeholder interests. Nevertheless, our survey raises many questions about the two ownership models and how best to enhance a board's effectiveness. How, for example, can public boards be structured so that their members can put more time into managing strategy and performance? Moreover, can—and should—the interests of public-board members be better aligned with those of executives?

How both models add value

Respondents observed that the differences in the way public and PE boards operate—and are expected to operate—arise from differences in ownership structure and governance expectations. Because public companies need to protect the interests of arm's-length shareholders and ensure the flow of accurate and equal information to the capital markets, governance issues such as audit, compliance, remuneration, and risk management inevitably (and appropriately) loom much larger in the minds of public-board members. Our research did indeed suggest that public-company boards scored higher on governance and on management development. However, respondents saw PE boards as more effective overall because of their stronger strategic leadership and more effective performance oversight, as well as their management of key stakeholders.

Strategic leadership

In almost all cases, our respondents described PE boards as leading the formulation of strategy, with all directors working together to shape it and define the resulting priorities. Key elements of the strategic plan are likely to have been laid out during the due-diligence process. Private-equity boards are often the source of strategic initiatives and ideas (for example, on M&A) and assume the role of stimulating the executive team to think more broadly and creatively about opportunities. The role of the executive-management team is to implement this plan and report back on the progress.

By contrast, though most public companies state that the board's responsibility includes overseeing strategy, the reality is that the executive team typically takes the lead in proposing and developing it, and the board's role is to challenge and shape management's proposals. None of our interviewees said that their public boards led strategy: 70 percent described the board as "accompanying" management in defining it, while 30 percent said that the board played only a following role. Few respondents saw these boards as actively and effectively shaping strategy.

Performance management

Interviewees also believed that PE boards were far more active in managing performance than were their public counterparts: indeed the nature and intensity of the performance-management culture is perhaps the most striking difference between the two environments. Private-equity boards have what one respondent described as a "relentless focus on value creation levers," and this focus leads them to identify critical initiatives and to decide which key performance indicators (KPIs) to monitor. These KPIs not only are defined more explicitly than they are in public companies but also focus much more strongly on cash metrics and speed of delivery. Having set these KPIs, PE boards monitor them much more intensively—reviewing progress in great detail, focusing intently on one or two areas at each meeting, and intervening in cases of underperformance. "This performance-management focus is the board's real *raison d'être*," one respondent commented.

In contrast, public boards were described as much less engaged in detail: their scrutiny was seen at best as being on a higher level ("more macro than micro," one interviewee said) and at worst as superficial. Moreover, public boards focus much less on fundamental value creation levers and much more on meeting quarterly profit targets and market expectations. Given the importance of ensuring that shareholders get an accurate picture of a business's short-term performance prospects, this emphasis is perhaps understandable. But what it produces is a board focused more on budgetary control, the delivery of short-term accounting profits, and avoiding surprises for investors.

Management development and succession

Private-equity boards scored less well on their development of human capital—both absolutely and relative to public boards. PE boards do focus intensely on the quality of the top-executive team, in particular the CEO and the CFO, and are quick to replace underperformers. But such boards invest little or no time exploring broader and longer-term issues, such as the strength of the management team, succession plans, and developing management. "Their interest in management development is frustratingly narrow," one interviewee said.

Public boards, by comparison, were seen as more committed to and effective for people issues. Such boards insist on thorough management-review processes, discuss not only the

top team but also its potential successors, debate the key capabilities needed for long-term success, are more likely to challenge and influence management-development processes, and play a more active role in defining remuneration policies and plans. There are weaknesses, however: public boards can be slower to react when change is needed, and their voice on everything but the CEO succession tends to be more advisory than directive. Remuneration discussions are thorough, but public boards can seem more concerned about the reaction of external stakeholders to potential plans than about their impact on performance. Overall, however, public boards are more focused on people, tackle a broader range of issues, and work in a more sophisticated way.

Stakeholder management

Our respondents felt that PE boards were much more effective at managing stakeholders, largely as a result of structural differences between the two models. Public boards operate in a more complex environment, managing a broader range of stakeholders and dealing with a disparate group of investors, including large institutions and small shareholders, value and growth investors, and long-term stockholders and short-term hedge funds. These groups have different priorities and demands (and, in the case of short-selling hedge funds, fundamentally misaligned interests). The chairmen and CEOs of public companies therefore have to put a lot of effort into communicating with diverse groups.

The challenge for PE boards is more straightforward. Their effective shareholders (the investors in PE funds) are locked in for the duration of the fund. The shareholders' representatives (the PE house) are in effect a single bloc (or a very small number of blocs in a club deal) and so act in alignment. Furthermore, these representatives are more engaged than board members in the public world are—they are literally “in the room” with executives and are much better informed about business realities than are investors in public companies. Unsurprisingly, therefore, the burden of investor management is much less onerous for PE boards and the quality of the dialogue much better.

Yet PE boards are much less experienced in engaging with broader stakeholders, such as the media, unions, and other pressure groups. This inexperience was evident in the initial response of these boards to the greater scrutiny they attracted in 2007. The Walker Report² and the changes PE houses subsequently made to increase the frequency and transparency of their communications do go some way in addressing the shortcomings, but public boards typically are still more sophisticated and effective in this area.

Governance and risk management

Public boards earned their best scores in governance and risk management, a result that reflected the drive to improve governance standards and controls in the wake of the various scandals that led to the Sarbanes–Oxley legislation and the initiatives suggested in the Higgs Report. The typical board subcommittees (audit, nomination, remuneration, and corporate social responsibility) are seen as conducting a thorough, professional scrutiny of the agreed-upon areas of focus, while the overall board supervises effectively and can draw on a broad range of insights and experiences to identify potential risks. Compliance with the United Kingdom's Combined Code on Corporate Governance is high—an important factor in building investor confidence.

Yet there are important underlying concerns. Unsurprisingly, many respondents held that some elements of governance are overengineered and, as a result, consume much time while generating little value. Of greater concern, perhaps, many respondents felt that, in emphasizing governance, public boards had become too conservative. “Boards seek to follow precedent and avoid conflict with investors rather than exploring what could maximize value,”

commented one respondent. “The focus is on box-ticking and covering the right inputs, not delivering the right outputs,” said another.

Private-equity boards scored lower on governance, reflecting their lower level of emphasis on it and their typically less sophisticated processes for managing it. In every case, governance efforts focused on a narrower set of activities, though almost all PE boards embraced the need for a formal audit committee. Interestingly, though, PE boards in general were seen as having a deeper understanding of operational business risks and financial risks. They were also perceived to be more focused on, and skilled in, risk management as opposed to risk avoidance.

Sources of difference?

Since our respondents felt that PE boards were typically more effective than public ones were in adding value, we sought to learn why. The comments of the respondents suggest two key differences. First, nonexecutive directors of public companies are more focused on risk avoidance than on value creation. This attitude isn’t necessarily illogical: such directors are not financially rewarded by a company’s success, and they may lose their hard-earned reputations if investors are disappointed.

Second, our respondents noted a greater level of engagement by nonexecutive directors at PE-backed companies. The survey suggested that PE directors spend, on average, nearly three times as many days on their roles as do those at public companies (54 versus 19). Even in the bigger FTSE 100 companies, the average commitment is only 25 days a year. Respondents also observed differences in the way nonexecutive directors invest their time. In both models of ownership, they spend around 15 to 20 days a year on formal sessions, such as board and committee meetings. However, PE nonexecutives devote an additional 35 to 40 days to hands-on, informal interactions (such as field visits, ad hoc meetings with executives, phone calls, and e-mails), compared with only 3 to 5 days a year for nonexecutive directors at public companies.

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