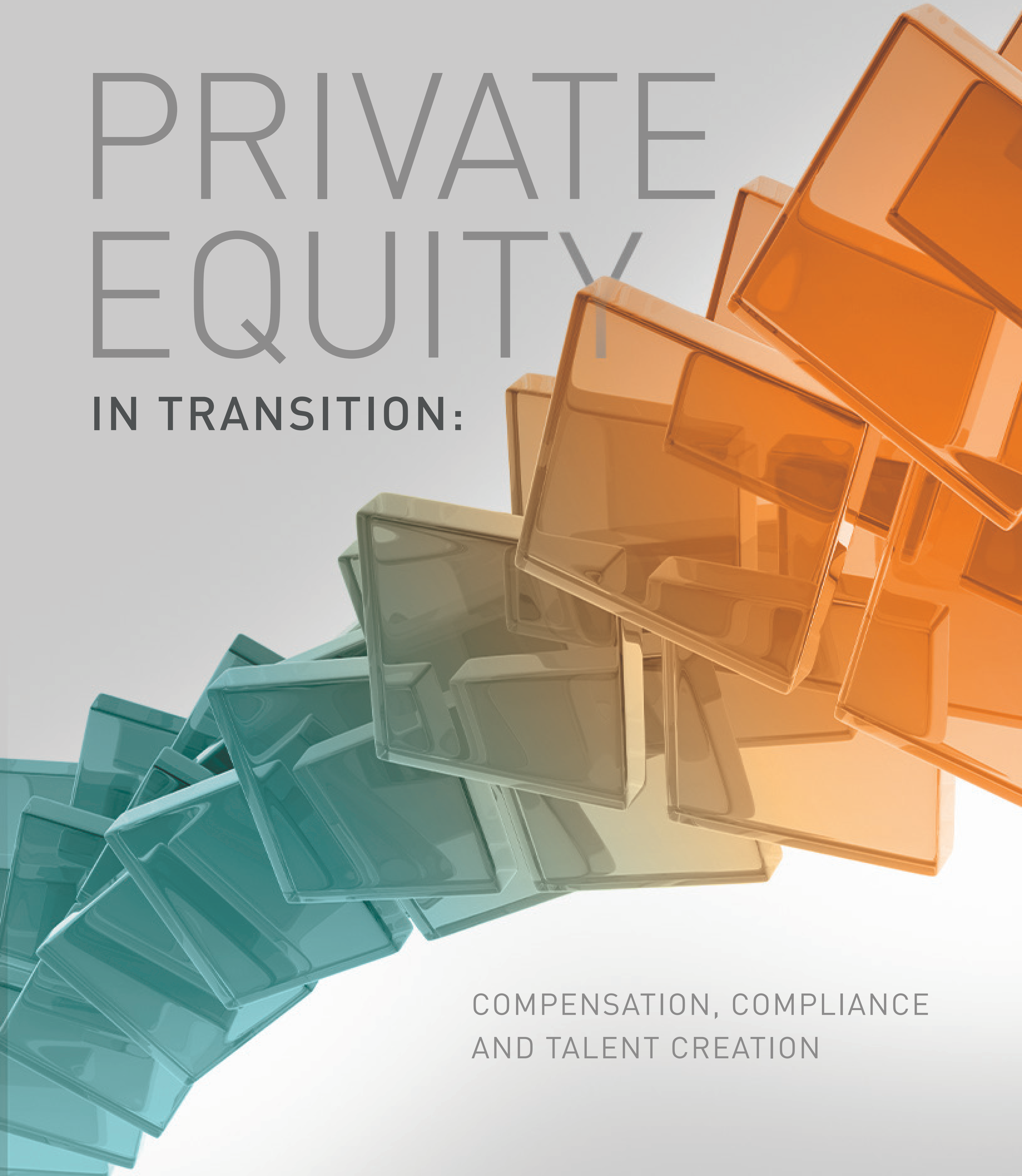
PRIVATE EQUITY
IN TRANSITION:



COMPENSATION, COMPLIANCE AND TALENT CREATION

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Introduction

The role of the operating partner has been around for decades in private equity. Over the past several years and particularly after the 2008 financial meltdown, more private equity firms have been recruiting operating partners — particularly those who provide industry and/or operating expertise. The hiring of Operating Partners has risen as private equity firms have had to work harder to squeeze value from their portfolio companies. There is the belief that to be competitive private equity firms need to not only pick promising companies — they should also be hands-on in the operations of those companies to help increase value to the portfolio and speed the return on investment to investors.

In May 2014, Andrew Bowden, then director of the Security Exchange Commission's Office of Compliance, Infractions, and Examinations (OCIE), gave a speech entitled "Spreading Sunshine in Private Equity"[1] in which he gave a detailed review of the practices the SEC was observing in the private equity world. Bowden was most critical of practices that showed an inconsistency between the information funds disclosed to their Limited Partners (LPs) concerning fund activities, and the actual management activities of the funds.

This speech put private equity firms on notice that OCIE expects them to be more transparent across the board, including improving reporting on how Operating Partner compensation, funding, and organizational structure is being communicated to investors. While the scrutiny has been uncomfortable, it should be seen as a lever for companies to delve into their existing rationale and determine where adjustments need to be made to be in compliance with OCIE requirements, and an opportunity to revisit compensation and organizational structure in order to develop a competitive advantage.

In this guide we'll look at SEC requirements for transparency in private equity (PE) compensation, today's challenges in structuring PE Operating Partner models, and how traditional recruitment for private equity is falling short. We'll discuss why the private equity landscape has an opportunity to develop a disruptive approach to Operating Partner compensation and conclude with top talent recruitment strategies for establishing a deep, on-demand bench. We believe you'll find this guide informative and useful in navigating the current more transparent and demanding environment.

[1] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, *Spreading Sunshine in Private Equity*, at Private Equity International (May 6, 2014)

CHAPTER 1

SEC Requirements for Transparency in Private Equity Compensation

While the private equity industry has been evolving in many ways, the last few years have held significant changes. From 1979 to 2010, private equity advisers (General Partners) were excluded from the requirement that they register with the Securities and Exchange Commission (SEC) and meet the SEC's reporting requirements. In 2010 that changed with the passage of the Dodd-Frank Financial Reform and Consumer Protection Act. On October 31, 2011, the SEC adopted final rules for reporting requirements; initial forms were required to be filed by August 29, 2012. General Partners, (GPs) in most PE funds — who are also partners in the PE firm that sponsored the fund — must now register as private equity fund investment advisers with the SEC and file reports on their operations and finances.

> We are beginning to glimpse shifts in an industry that for decades has epitomized "private."

Among the changing landscape in private equity, interesting developments have arisen at the fund level. In the last year or so, we are beginning to glimpse shifts in an industry that for decades has epitomized "private."

Because the reporting requirements for private equity fund advisers are thin compared with what publicly traded companies must disclose to the SEC, and the probability that an SEC inspector would examine a particular private equity fund adviser appeared slim, Bowden' 2014 remarks at Private Equity International (PEI) got the attention of attendees. No one expected the new regulatory scrutiny of private equity fund advisers to yield information about improper practices. Yet in his talk, he revealed just that, enumerating several areas that were of concern to the SEC including:

- The allocation and disclosure of expenses;
- The use of consultants (i.e. operating partners) and how their compensation is funded;
- Limited Partnership agreements often lacking clearly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

In OCIE's review of more than 150 private equity firms, some results of their examination showed:

FEES AND EXPENSES.

Bowden reported that fund investors did not always receive full disclosure with respect to how fund managers are allocating expenses between funds inside a family of funds or fund complex. This includes both expense shifting and hidden fees. And in some cases, a fund disclosed one thing while managers did another, giving rise to an SEC action against that particular fund.

In a May 2015 speech[2] at Private Equity International, Acting Director of OCIE Mark Wyatt revealed the Sunshine Speech has, not surprisingly, caused investors to increase their focus on fees and expenses, emphasizing transparency, governance and access to information. While encouraged that private equity advisors have made improvements in disclosure, including modifying their responses to Part 2A of Form ADV to be more detailed with regards to fees and expenses, Wyatt shared that disclosure is not sufficient remedy. Private fund advisers should in some cases — with the consent of Limited Partners — amend their Limited Partnership Agreements (LPAs) to reflect current practices.

The SEC's 2015 exams found many advisers still have inadequate methodologies, policies and/or disclosure relating to fund expenses and expense allocation. Expense shifting remains prevalent — whereby expenses are shifted away from parallel funds created for insiders, friends, and preferred investors to the main co-mingled, flagship vehicles. "Frequently, operational expenses, broken deal expenses, and even the formation expenses of the side-by-side vehicle are borne by investors in the main fund."[3]

The relationship between the funds and investors is changing — Limited Partners have become more sophisticated, demanding, and vocal. Case in point, thirteen public pension executives, representing $1T in assets sent a letter to the SEC in July 2015 asking them to make it mandatory for GPs to disclose fee and expense information quarterly, and to make them adhere to one industry reporting standard. While the SEC has not commented on this, this could become a reality in the not so distant future.

OPERATING PARTNER COMPENSATION.

Since the 2008 financial meltdown, it is more common for a fund's portfolio company to hire consultants, more often called Operating Partners, to provide industry expertise. The most compelling advantage to having full-time, in-house operating partners is they can find and realize more value because they have a primary focus on adding incremental value. So the funds and portfolio companies all benefit.

Some SEC exams found that at times, the portfolio company has paid the fees for the Operating Partner. This means the fund has been indirectly paying those expenses, and subsequently the Limited Partners have indirectly borne those expenses. Bowden criticized this practice, saying that this setup makes Operating Partner expenses a disguised 'backdoor fee' that should be paid or borne by the management company.

Under normal circumstances, when the management company hires a consultant, the management company pays the consultant's fees and expenses. However, when a fund manager has the *portfolio company* retain the consultant/operating partner, the manager has pushed those expenses down to the fund level, and the Limited Partners then bear those costs.

[2] Mark Wyatt, Acting Director, Office of Compliance Inspections and Examinations *Private Equity: A Look Back and a Glimpse Ahead* at Private Equity International (May 13, 2015)

[3] *Private Equity: A Look Back and a Glimpse Ahead* at Private Equity International (May 13, 2015)

In rare cases, the fees for an Operating Partner or consultant are charged in more than one place. If compensation is being charged twice and not properly disclosed, that form of double dipping would be seen as breach of contract to the Limited Partner Agreement, (LPA).

Over a year later, SEC exams show improvements in disclosure on several private equity websites, including more clearly defining the role of Operating Partners. In addition, Wyatt observes that more robust disclosures are being made to Limited Partnership Advisory Committees.

MONITORING FEES/ACCELERATION PROVISIONS.

In the past, many of the big funds have imposed on their portfolio companies a regular monitoring fee that is paid by the portfolio company during the lifespan of the investment. And these agreements commonly have acceleration provisions based on a long-term fee payment arrangement. An investment agreement may have a ten-year term, with an acceleration of the remaining payments due if there is an exit by the private equity fund during that time. The SEC notes a pattern of insufficient disclosures made to Limited Partners about these acceleration provisions, which puts large amounts of money into the pocket of the fund manager.

For example, assume a private equity firm has an agreement with its portfolio company with a ten-year term providing for an annual monitoring fee equal to 1 percent of the equity invested by the private equity firm. If the firm invested $400 million, there would be an annual fee of $4 million, plus other fees potentially for merger and acquisition or capital markets transactions. If the portfolio company is sold to a strategic investor in year six, the fees due for the remaining four years of the agreement would be accelerated, and an additional $16 million would fall due in year six. If you assume the sales price for the portfolio company is reduced by $16 million, and if the General Partner has a 20 percent carry, 80 percent of the sale proceeds would have been paid to the Limited Partners. Instead 100 percent of this amount goes to the private equity firm. In a typical sales transaction, this fee would be more normally seen as a closing or selling expense.

Earlier this year Wyatt was encouraged that the SEC saw a decline in the use of portfolio company monitoring and similar fees, which may be accelerated upon the sale, or initial public offering of the portfolio company.

In light of the SEC's focus on these issues, private equity advisers should review their existing disclosure and compliance policies and procedures to ensure that their practices in these areas match their disclosure and are consistent with their fiduciary obligations to their clients.

There are indications that this is already happening. Jason E. Brown, a partner with the private investment funds group at law firm Ropes & Gray in Boston, said: "Private equity firms are taking these matters seriously. The SEC and now investors are interested in the fees and expenses in their agreements. While the historic industry practice was to provide more general information about fees and expenses, the trend (now) in private equity is toward greater transparency about fees and expenses in the fund documents."

Other examples include KKR and Oak Tree Capital who earlier this year announced they have gone through internal processes to be in compliance with SEC calls for better disclosure.

Next we'll look at how private equity firms are wrestling with questions surrounding how to structure Operating Partner models and Boards to be most effective.

CHAPTER 2

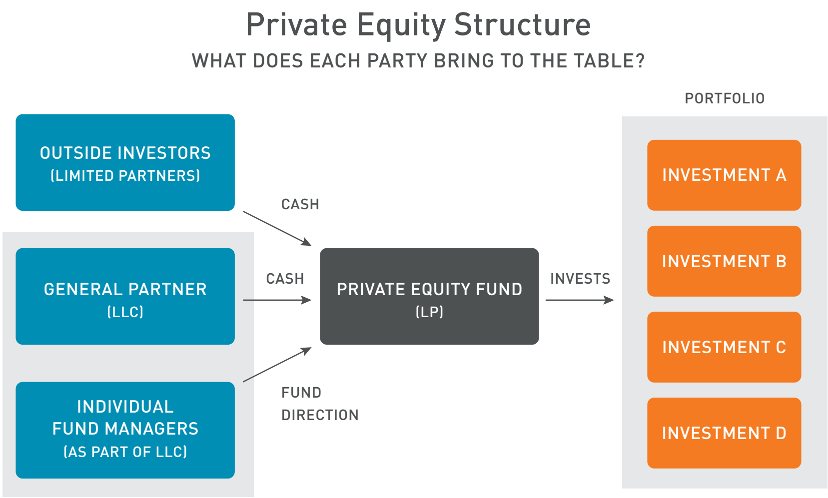
Today's Challenges in Structuring Private Equity Operating Partner and Board Models

There are a number of ways to classify the strategies private equity firms use to grow their investments. These vary by stage of investment, target geography (country) or market type — emerging markets versus developed markets. And while some firms focus on a growth equity approach, identifying high value companies, others employ a restructuring or turnaround investment strategy. While the target methodology and engineering type PE firms use may vary, one common thread is their ability to use advisors, operating partners and portfolio leadership teams to increase value and revenues, improve incentives, and facilitate a high value exit within well-developed capital markets.

However, the private equity space is not without its challenges. Partners who are running teams of Operating Partners are grappling with questions like:

1. **How should the Operating Partner model be structured?**
    - What should the compensation look like?
    - SEC scrutiny has pushed to the fore the need to revisit who should be footing the bill—the firm, the fund or the portfolio company they advise?
    - Also related to SEC examination, how should Operating Partner compensation be disclosed?
2. **How do we build better, more independent Boards?**
3. **How do we find the top talent we need for leadership, Operating Partners and Board positions?**

Figure 1 Illustrates the private equity structure



COMPENSATION

By design the compensation of Operating Partners at private equity firms present strong incentives to generate high returns. Private equity investors use financial engineering to provide lucrative equity incentives to the management teams of those portfolio companies.

The Council of Institutional Investors endorses "reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company's investment horizon."[4] Long-term is generally considered to be five or more years.

Carried Interest, or "carry" is incentive compensation provided to private equity fund managers to align their interests with the fund's capital-providing investors. In simple terms, carry is a percentage of a fund's profits that fund managers get to keep on top of their management fees, and is a significant component of private equity compensation. While the typical carry averages about 20% of the fund's profits it can float as high as 50% in exceptional cases to as low as in the single digits.

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What about carry and the role of fund managers? Fund managers receive carry and a management fee, which private equity executives feel is justified because each investment requires a lot of work to generate a profit. Fund managers do a lot of due-diligence prior to making an investment because they invest massive chunks of capital, typically to acquire majority ownership. Post-investment, fund managers are very involved in strategy, financial management and restructuring, to generate higher returns, or to unlock hidden value all the way through a liquidity event — an acquisition, an IPO, or a recapitalization. Carry is typically vested over anywhere from 1 year (in very rare cases) to 6 years (on the high side), with three to four years being the average. Historically investors have shown a preference for multi-year vesting periods to keep fund managers focused on long term profitability.

Is carry safe or under fire? There is growing concern that regulators may be re-tackling Section 956 of Dodd-Frank, which was originally designed to prevent firms from offering key decision makers so much incentive-based compensation that it distorts their risk appetite. At the same time, amid the creation of more private equity funds there is increasing downward pressure on carry as fund managers compete with each other to attract investor capital.

[4] The Council of Institutional Investors, *Corporate Governance Policies* (April 2015)

Typically, the General Partner only receives carry when the fund generates profits above a certain hurdle rate. The hurdle rate is a specific internal rate of return (IRR) – an annualized, compounded return rate that Limited Partners must get before the General Partner gets carried interest profits. The thought is by investing in a private equity fund, Limited Partners take on higher-than-market risk and therefore want a minimum rate of return (hurdle rate) before sharing profits with the General Partner.

Bowden's Sunshine speech shed a light on the lack of transparency for investors on *who* is funding operating partner compensation. Investors might expect that the PE manager is absorbing these expenses out of the management fee. After all, the PE manager pays the salaries and bonuses of partners, associates, and analysts. So the assumption might be it would include Operating Partners as well.

However, it should be acknowledged that the PE manager has a built-in conflict. Paying Operating Partners out of the management fee means there is less money for salaries and profits for the senior executives and owners of the PE firm. Which is why it's more attractive to offset those expenses to investors. If the private equity manager can charge the expense of consultants to the fund or a particular portfolio company, the Limited Partners absorb those expenses.

It seems unlikely that firms can avoid dealing with this by not clearly disclosing the source of Operating Partner compensation. Whether portfolio managers and companies choose to change where that compensation is funded is up to fund managers, General Partners and portfolio companies to work out.

Private equity advisers should, at a minimum, develop compliance programs that address governance at the adviser level, and cover and apply to each fund manager.

BUILDING BETTER BOARDS

Traditionally, some of the top responsibilities for boards are to provide CEO succession planning, strategy , governance, risk and compliance oversight. Finding the right candidates to ensure board makeup has the right set of competencies, remains 'independent' and has the right culture fit is important for creating high-performance boards. A 2014 Heidrick & Struggles study[5] on boards defines independent in three ways:

1. An individual from outside the company
2. Board member appointed by Board, not by the CEO
3. Board member with a tenure under 10 years

[5] Heidrick & Struggles, *Heidrick & Struggles On Boards, Governance Letters* (2014)

While the first two criteria are self-explanatory, the last criteria exists to stem the likelihood of a board member becoming too "cozy" with CEO and thus becoming less impartial.

The right set of competencies should take into account age and knowledge of technologies that older board members have less experience with — big data, cloud, mobile, social, digital marketing and cyber security are a few examples. Setting term limits to allow for "board refreshment" is one mechanism that would facilitate younger board members with more diverse skillsets in these technologies to contribute and help ensure high performance boards.

Board members who are able to accurately assess target company culture are better positioned to help fine-tune the weighting of necessary C suite leadership qualities. For example a company whose culture or behavior was less aligned with innovation and collaboration — contrary to stated company values — would be better served by a new CEO who had demonstrated the softer skill of influencing culture change within an organization.

These examples all serve to highlight the importance of finding the right top talent, the right fit for private equity leadership positions. Historically, the existing executive search model has not met private equity's unique needs very well and we'll discuss this in more detail in Chapter 3.

CHAPTER 3

Shortfalls of Traditional Private Equity Recruitment

Private equity firms seek executives with industry and operating track records to help add value to their portfolio companies.

One value creation method private equity firms use to improve returns on companies they have invested in is operational engineering. Private equity firms seek executives with industry and operating track records to help add value to their portfolio companies. Traditionally they have relied on executive search firms to fill C suite positions albeit with mediocre results.

The current failure rate of new executives hired from outside an organization is approximately 58% within the first 18 months according to published research by former Harvard Professor, author of *The First 90 Days*, and industry guru, Michael Watkins.

Former Heidrick & Struggles CEO Kevin Kelly revealed results of an internal study of 20,000 executive searches conducted by his firm: "We've found that 40 percent of executives hired at the senior levels are pushed out, fail or quit within 18 months. It's expensive in terms of lost revenue. It's expensive in terms of the individual's hiring. It's damaging to morale."[6]

There are a number of reasons that retained executive search models are failing to provide companies with leaders that meet expectations.

1. Retained executive search firms have typically used a leveraged model, which is ineffective. While a senior partner often pledges to lead the search to win the engagement, that rarely happens.
2. There is an over-reliance on existing candidate databases and less motivation to dig beyond for candidates that have proven operational track records within the private equity industry.
3. The costs are high, typical arrangements include one third of total compensation — carry, equity and salary — a minimum of $100K with no guarantee the right candidate will be placed.
4. LinkedIn has been a disruptive technology application that weakened the value of the executive search firm industry.
5. The use of in-house recruiters to fill open executive positions has risen.

[6] Financial Times (March 30, 2009)

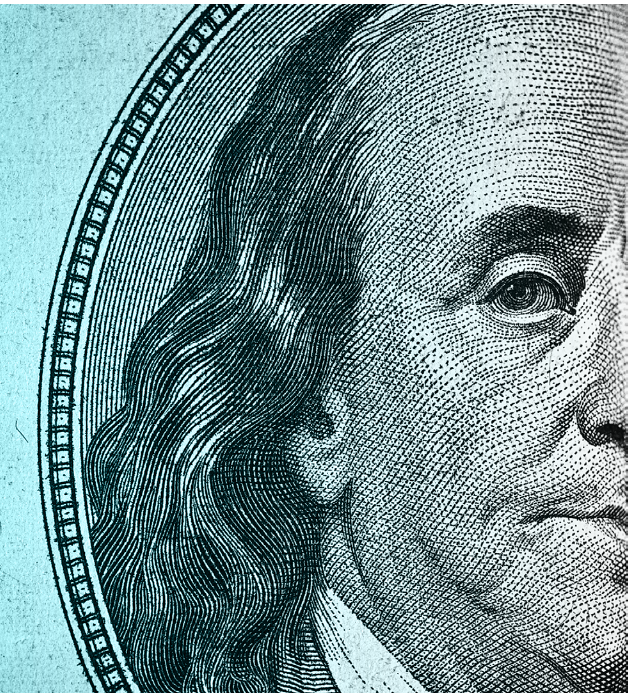
POOR FIT.

Junior employees who have not met with leadership and boards of the portfolio company and therefore have no insights into the company's culture or understanding of their requirements and strategic plans are tasked with delivering appropriate candidates. Is it any wonder that there is often a lack of culture fit or candidate misalignment?

Some users of executive search firms take issue with their "off-limits" clauses, in which they promise existing clients that they will not poach staff from them. That keeps many of the best candidates off new clients' shortlists.

TIME.

A leveraged executive search model that pulls from a stale database of executive talent causes searches to drag on. The average search can take up to a year to fill. A portfolio company that is absent a leader for a significant amount of time causes uncertainty, forestalls growth initiatives and can prompt other senior leaders to lose focus and look for new opportunities— all of which extend the time for a private equity firm to start realizing a positive return on their investment.



COST.

The cost of getting CEO placements wrong is high. The 2014 Strategy & study *CEOs, Governance, and Success* examined CEO succession among the world's top 2,500 companies. They found one financial impact of forced CEO turnover (CEOs leaving unexpectedly or being removed without an obvious successor), is a drop of -13 percent in median shareholder returns in the year leading up to the CEO change and a return of -0.6 percent in the year after.[7]

The Strategy & study also found large companies that underwent forced successions would have generated, on average, an estimated $112 billion more in market value in the year before and the year after their turnover if their CEO succession had been the result of planning.

LINKEDIN.

The disruptive effect of LinkedIn is apparent. Outsourcing for top talent placement was no longer the only choice. Suddenly companies could search hundreds of millions of profiles for a fraction of the cost. This is an excellent example of how the most successful disrupters are ones that recognize the gaps, challenge the status quo and seek to solve problems with new methods, technologies and frameworks.

[7] Per-Ola Karlsson, Gary L Neilson, 15th Strategy & study *CEOs, Governance, and Success* (2014)

IN-HOUSE RECRUITERS.

In-house Recruiters. The last condition demonstrating the need for a more evolved executive search model is the rise of in-house recruiters, a trend that has swelled in popularity within the last few years. A 2013 survey[8] by HSZ Media, which studies the recruitment industry, found that in-house recruiting has increased by a quarter over the past five years. Scott Scanlon, HSZ's managing director, estimates that this trend is costing recruitment firms $650M a year.

All of these conditions set the stage for a need for a disruption. Extended search periods, and high costs coupled with poor executive retention rates clearly indicate that the old model is not meeting private equity talent needs. A new model for creating a more evolved, disruptive private equity compensation and talent model is overdue.

[8] HSZ Media *The Executive Search Review 2013* rankings study

CHAPTER 4

Disruptive Approach to Private Equity Operating Partner Compensation

Generally private equity investors create value pre- and post-investment using a combination of financial, governance and operational engineering.

A Harvard Business School study[9] of 79 private equity investors with combined AUM of over $750B assessed their practices in firm valuation, capital structure, governance and value creation. The private equity investors in that study were asked to identify both expected sources of value creation and *who* in their organization was involved in identifying pre- and post-investment value sources. While it was no surprise that members of the deal team were involved the most — 98% pre-investment versus 93% post-investment — operating partners were involved in finding value 45% and 51% of the time. Further emphasizing the impact the right operating partners can have on portfolio companies.

Private equity firms use financial engineering to provide lucrative equity incentives to the management teams of those portfolio companies. In this chapter we'll focus on the financial incentives and strategies PE firms can use to attract and retain the talent they need to achieve growth and exit profitably within the desired timeframe.

ALIGNING REWARDS WITH PERFORMANCE

Private equity investors prefer a pay-for-performance structure that includes salary, bonus, carry and equity compensation. A PricewaterhouseCoopers private equity portfolio company stock compensation study[10] reveals that financial sponsors are tying a greater portion of equity compensation to exit-based performance conditions.

Over 80% of the companies surveyed in this compensation study required executives to make a 20–50% investment, with the CEO often investing at 50% or above. Performance based vesting conditions are common, with PE firms tying 50–75% of the total award to the portfolio company's financial return on exit.

One financial engineering adaptation that was announced last year by Apollo Global Management might be an indicator of a trend, at least for the largest private equity firms. Apollo confirmed that a change in their compensation structure whereby they would use stock to pay partners in its private

[9] Paul Gompers, Steven N. Kaplan, V. Mukharlyamov, Harvard Business School *What Do Private Equity Firms Say They Do* (2015)

[10] PwC *Driving Portfolio Company Performance in a Changing Private Equity Environment* (2013)

equity business a portion of their cut of the profits from the firm's latest buyout fund. Their intent — to focus people on the success of the overall business — as opposed to rewarding employees based on gains in their specific business lines or deals.

On a May conference call, Apollo Chief Financial Officer Martin Kelly told investors that the firm was including more stock-based compensation for investment professionals in an effort to emphasize the entire firm's profitability over that of particular funds or deals. "We think that aligns shareholders, employees and the fund together in the most appropriate manner," Mr. Kelly said.

FINANCIAL ENGINEERING METRICS

Choosing the right performance metric is essential to aligning the incentives of C Suite leadership and Operating Partners. Prior to 2008, PE firms were more likely to use internal rate of return (IRR) metrics. Following the financial crisis which resulting in longer holding periods and lower IRR, there was a shift to use a Multiple of Invested Capital (MOIC) metric as the primary return measure. The PwC study looked at both metrics at year of exit and concluded that using a combination of the two, using MOIC as the key return measure but having a minimum IRR threshold as a vesting condition, can produce better alignment between management and investors.

LEADERSHIP PAY LEVELS

Finding the right formula for compensation is tricky. In the past, more attention has been given to creating attractive packages to lure top talent. Now that need must be balanced with more investor scrutiny on compensation.

PwC's compensation study analyzed the expected value of equity grants to CEOs of portfolio companies compared to awards for CEOs in the broader public market using published compensation and proxy data. Even using a conservative 2.5X MOIC, the median expected payout from equity incentives for PE executives surpassed public firms by 3.0x. This suggests that PE may be overpaying for talent.

Sponsors can benefit from applying more structure to determining equity grants and looking more closely at key reference points to assist in sizing their equity grants. Specifically a review of the following data points:

- Historical grant date fair value
- Market compensation awards
- Value realized

Instead of 'back-solving' where funds target a specific compensation level for executives and back into the grants need to achieve it, PE firms can consider adopting a more disciplined approach on compensation to be competitive without overpaying.

CHAPTER 5

Top Talent Recruitment Strategies for Establishing a Deeper Bench

One of the top concerns in private equity right now is sourcing the right leadership talent. Ideally firms are proactively creating a bench of people that can be called on for the C Suite or the boardroom either prior to the deal or post-deal.

Generally, PE firms will utilize any of the following three value creation methods to grow their investments:

- Operational engineering
- Governance engineering
- Financial engineering

In all of these methods, the right talent plays an integral role. In operational engineering private equity firms develop industry and operating expertise that they put in place to give guidance and add value to a particular portfolio companies.

In governance engineering private equity investors use the boards of their portfolio companies to more actively guide than their public company counterparts. Private equity managers often adjust incentive compensation to better align incentives of management by increasing managerial equity ownership.

Private equity investors use financial engineering to provide lucrative equity incentives to the management teams of those portfolio companies. These first two require strong talent selection for C Suite leadership, operating partners and boards. Getting the right fit matters.

According to a Harvard Business School study[11] on firm valuation, capital structure, governance and value creation, 70% of private equity investors will keep the existing management team before the investment. However, post-deal, about half of PE firms will recruit their own senior management team. If you combine investors who recruit their own teams before, after or both before and after investing, the study found 58% of investors are recruiting for top spots within their portfolio companies. This illustrates how an "on demand" bench could help expedite operational and governance engineering efforts.

[11] Paul Gompers, Steven N. Kaplan, V. Mukharlyamov, Harvard Business School *What Do Private Equity Firms Say They Do* (2015)

In order to build a bench that is deep in the expertise needed to lead private equity portfolio companies, we need to look at several factors.

1. Identifying the proper skillset for C Suite
2. Identifying the proper skillset for Board members
3. Screening for culture fit

C SUITE SKILLSET:

The ideal profile of a CEO in a private equity portfolio company is situational – highly dependent on the investment type. Value creation in a turnaround is markedly different with a more stable company looking to expand via new markets, products or M&A versus an add-on acquisition shaping into a roll-up.

The size of the company also impacts which engineering skillset can yield the best results. Larger companies, especially those with sizable production costs, would likely benefit from an executive with a track record of producing significant cost savings to drive profit — whether through product line focus, process reengineering, or lean/six sigma.

The most successful CEOs foster a results-oriented mindset within the company and measure the core areas that drive real value. These CEO are aligned with the private equity sponsors — they think and act like an owner. In addition to robust equity compensation tied to their efforts to meet financial metrics, they have a personal ownership position in the company. This is an effective level for maintaining a sharp focus on achievement of the value creation plan.

In some cases, fund leadership and their past investment targets can provide clues toward industry and engineering preferences for value creation.

C SUITE CULTURE FIT:

Has the existing culture worked well for the portfolio company? Or is there a need for a culture transformation in order to achieve targets? A misalignment on culture prevents the new executive from the necessary advocates and buy-in to move growth initiatives forward and sets them up for failure. The answer to these questions will help round out executive requirements and help determine the relative weight each should have to meet a company's unique situation.

BOARD SKILLSET:

One soft skill that is useful for board members to possess is the ability to use culture assessments to keep companies on track. For example, the Heidrick & Struggles' board study looks at how board members that are able to judiciously assess culture are better equipped to uncover if the degree of risk taking that leaders perceive to exist in a company is in line with the board's tolerance for risk. This type of focused governance oversight helps reveal any behaviors that signal a problem with accountability or integrity *before* they cause serious financial or public relation damage.

Conclusion

The most successful PE firms are focusing on creating operating value within their portfolios in a more systematic way than their competition.

Private equity firms that choose to see SEC scrutiny into compensation and disclosure as an opportunity to rethink and reformulate how they are paying operating partners and C suite executives can create evolved models that meet their own needs better as well as compliance requirements.

Firms that don't shy away from the discipline and time investment to do this work, will be rewarded with a structure that can withstand both investor and regulatory examination.

Fund advisors that also put their attention to the critical directive of sourcing the right talent for their portfolio companies, early and often can build high performance boards and companies that are laser focused on value creation.

"The single most important thing is to make sure you have the right leadership for the business. In a world economy that remains prone to macro shocks, the firms we work for are looking for expertise and a successful record, but equally important, CEOs who really want to make a difference transforming a company."

– Hugh MacArthur, Head of Bain's Global Private Equity Practice, author of *Bain's 5th Annual Private Equity Report*, February 2014.