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CENTER FOR
HIGHER AMBITION LEADERSHIP
Helping purposeful leaders build high performing organizations and a better world.

Center for Higher Ambition Leadership Working Paper:

"Higher Ambition Leadership" in Private Equity An Oxymoron?

Research Findings

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Introduction

To state the obvious, the job of the CEO is to deliver superior financial returns for the shareholders. For public companies, Wall Street's never-dimming spotlight on quarterly earnings ensures that they don't forget it. Yet, not all leaders are satisfied with that job description. They understand driving economic value for shareholders is *necessary*, but it's *not sufficient*. These leaders are driven by a sense of purpose and mission that goes beyond making the quarterly numbers. Purpose tells the world what the company is trying to do and how it creates value in the world. Purpose provides meaning for employees, serves as a focal point for their strategy and how they drive economic value.

These leaders are committed to generating economic value and creating enduring institutions built on a strong "balance sheet" of intangible assets, such as distinctive capabilities and cultural strengths, and high trust / high commitment relationships with all of their stakeholders. They view companies as both *economic* and *social* institutions. They understand that a company is made up of a web of social relationships between people within the organization, that stretches into their customer and supplier organizations, their communities, and across society more broadly. So, they aspire to generate value for all of the stakeholders, not just the shareholders, simultaneously. This is their "higher ambition".[1]

So what does "higher ambition leadership" have to do with private equity?

To answer this question, it's important to note that the primary purpose of private equity investing ("PE") is to maximize returns for investors. PE firms raise capital from investors, commonly referred to as Limited Partners ("LP") such as pension funds, university endowments, and family offices. Typically, the PE firm pools the capital into a fund and, over time, invests the capital in a portfolio of companies. When the PE firm sells a given portfolio company, they generate investment returns – assuming the portfolio company's value has increased over the investment period. Simply put, PE firms drive returns for investors and for themselves by transacting successful deals.

Given this, many people would say that "higher ambition leadership" in private equity is an oxymoron. Since the 1980s and 1990s, when PE financial engineering, particularly in the form of the "LBO" (Leveraged Buy Out), was the dominant ways PE firms made money, the PE industry has been shrouded in a veil of negativity. It's not uncommon to hear, "PE firms make money by slashing and burning a company. They don't care about the people, just their returns". One of our interviewees was even more pointed in his attributions, "Greed is the primary driver in private equity people, I think. They measure their self-worth and success by how many millions of dollars they have, as opposed to what value they create in a business." Coming from a former CEO of several multi-national companies and a Board Director of a PE-backed business, this is pretty damning.

Mainstream media reinforces the view that PE is purely a transactional business. For example, this is a quote from the New York Times: *"Private equity firms are essentially savvy bargain hunters. They make money by buying up businesses they consider to be underperforming, looking to maximize profits and eventually sell them off."*[2]

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[1] These concepts are explored in detail in the book Higher Ambition How Great Leaders Create Economic and Social Value (Michael Beer, Flemming Norrgren, Russell Eisenstat, Nathaniel Foote, Tobias Fredberg).

[2] Source: "A Primer on Private Equity", June 25, 2016 New York Times.

[3] Total AUM for the PE industry neared a record $2.5tn as of June 2016. In 2015, there were more than 14,000 PE-backed firms in the U.S. alone, employing 11.3mm people. Sources: Preqin, American Investment Council.

[2] Source: "A Primer on Private Equity", June 25, 2016 New York Times.

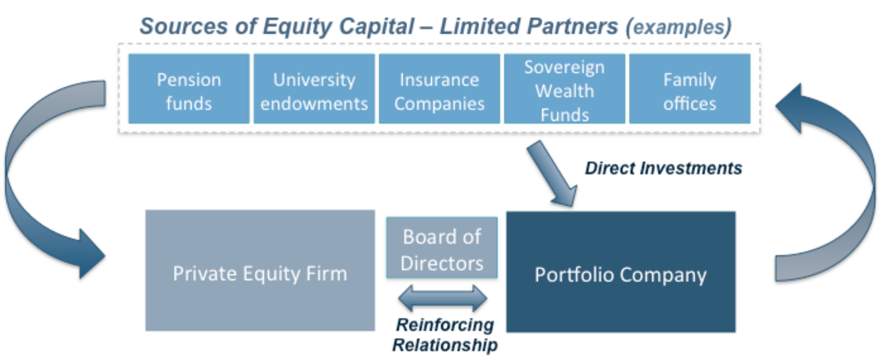
[4] According to Preqin, there are more than 6000 PE firms, up from ~25 in the early 1980s.

Given this backdrop, it's fair to be skeptical that higher ambition leadership exists within PE. It's fair to ask whether purpose and mission matter when the objective is to generate superior financial returns for investors. Similarly, while PE investors are acutely focused on portfolio company balance sheets, do they care about a "balance sheet" of *intangible assets* (trust, capabilities, culture)? Finally, given the typical investment hold period is five to seven years, why would investors care about the long-term health of a business beyond their own investment period (after they've made their money on the exit)?

Certainly, there are many examples of very successful PE firms whose investment strategy is purely transactional – "Buy Right. Sell Right." Their clear and sole purpose is to generate economic value by providing a return for investors and to create value within their investment horizon, regardless of whether the actions they take will create future value. They own the companies and view them assets to be optimized during the ownership period.

This characterization, however, overlooks other strategies to drive returns, strategies based on different motivations and different assumptions about how long-term value is created. Indeed, given the dynamics of the PE industry, we believe players across the PE ecosystem *(see Figure 1)* should take note of alternative investment strategies, specifically the one we describe in this paper.

Figure 1: PE Ecosystem



PE Industry Context

Over the past forty years, the PE industry has continually morphed, from its roots in venture capital, to the early KKR "bootstrap deals", to the rise of leveraged buyouts. Today, PE plays an important role in the global economy, both in terms of its position within the financial markets, and its impact on employment.[3] However, despite the prominence of PE, in many ways it's a mature industry, with all the challenges that brings. Specifically:

1. **There are more PE firms chasing fewer, harder to find, opportunities.**[4] More PE firms and funds mean more competition for deals. At the same time, many PE firms have become quite sophisticated in deal sourcing and company diligence, enlisting operating executives, hiring consultants, and commissioning highly targeted customer and brand-related market research. The result is highly competitive selling processes, driving up company valuations.

2. **Levels of "dry powder" – money raised by PE funds, but not yet invested – continue to climb.** With the combination of high rates of capital inflow, few attractively valued deals, and a

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limited time horizon to invest, PE firms are trying to gain an advantage through sourcing (e.g., proprietary deals) and finding ways to create sufficient value to justify the high prices. Meaning, they need to add real value to the company during the investment period, not just make money through financial engineering. To add to the pressure, LPs are often being charged 2% on assets under management, even while their capital sits idle.

3. **Sources of differentiation for PE firms are diminishing.** Financial engineering and transaction expertise, historical sources of advantage, can be easily acquired. Equity incentive programs, originally designed to motivate portfolio company managers to act as "owners"(a revolutionary concept when first introduced), are now considered "table stakes". Operational capabilities, while valuable, are no longer a point of differentiation and not even sector-focused strategies, which many firms are pursuing, necessarily provide a source of advantage.

4. **The traditional PE economic model is under pressure**. A number of prominent LPs have been publicly questioning whether PE firm "value add" justifies their fees and, in an number of situations, they building internal staffs and making direct investments, by-passing the PE firms all together and essentially dis-intermediating them. There are a number of well-known examples of family offices and pension funds that have done this.

5. **PE firms continue to face public scrutiny and pressure.** The media, unions, and community activists continue to aggressively question the underlying values of PE firms.

Given these industry dynamics, PE firms must demonstrate they can add value beyond acting purely as a financial intermediary for the LPs. They need to change their view of the "acquirer – acquiree" dynamic and be open to being "reverse diligenced" by target portfolio companies. Finally, they must develop and execute transformative strategies within the portfolio companies that will drive sufficient value creation to justify the prices that the market is demanding.

We interviewed more than sixty players across the PE ecosystem to identify *if, where, and how* higher ambition principles play a role in value creation strategies.[5] We found that two of the key principles – having a dual focus on generating economic *and* social value, and leading with a sense of purpose – are embodied across the ecosystem. We identified:

- A segment of high performing PE firms whose investment strategy rests on these principles;
- Prominent LPs that look for such PE firms (e.g., pension funds and family offices);
- Successful CEOs who lead with higher ambition; and
- Experienced Board Directors who play a pivotal role, skillfully managing the predictable tensions that arise between the PE firm and the CEO and leadership team.

In this paper, we describe the approach that these PE firms pursue and, in doing so, we provide a framework for an integrated higher ambition PE firm's investment strategy, governance model, and organizational design. We also provide a perspective on the critical leadership skills and characteristics that higher ambition CEOs in PE exhibit, which go above and beyond what one would consider "table stakes" in PE. We lay out the pre-requisite elements of an engaged governance model that drive alignment between the PE firm, Board and company leadership, including the "value added"

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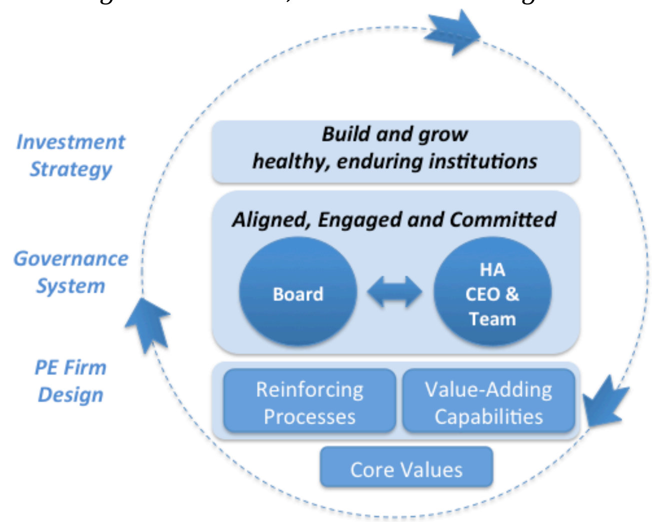
[5] This paper draws upon more than sixty interviews, conducted over the course of 2016 and 2017, with a wide range of PE firm leaders, CEOs and Directors of PE-backed companies, as well as investors in PE funds (the "Limited Partners"). All interviewees have had at least 20 years of experience (most have 30+), spanning private and public company arenas, and represent a broad experience base (e.g., CEOs of public companies who moved into Director roles for PE-backed businesses, Managing Directors who worked for multiple PE firms).

Director role. Finally, we provide some early insights into how "like minded" LPs view the concept of higher ambition when evaluating whether to invest in a given PE firm.

Higher Ambition PE Firms

Looking across these PE firms, we identified a set of consistent beliefs, behaviors and organizational design choices, which, when combined, create a self-reinforcing model that incorporates (1) the investment strategy; (2) an engaged partnership approach to governance: (3) and an approach to managing their own firms. We refer to this as an "institution building" model and higher ambition principles are central to the model. We describe each of these elements in turn. (*See Figure 2*).

Figure 2: "Higher Ambition", Institution Building PE model



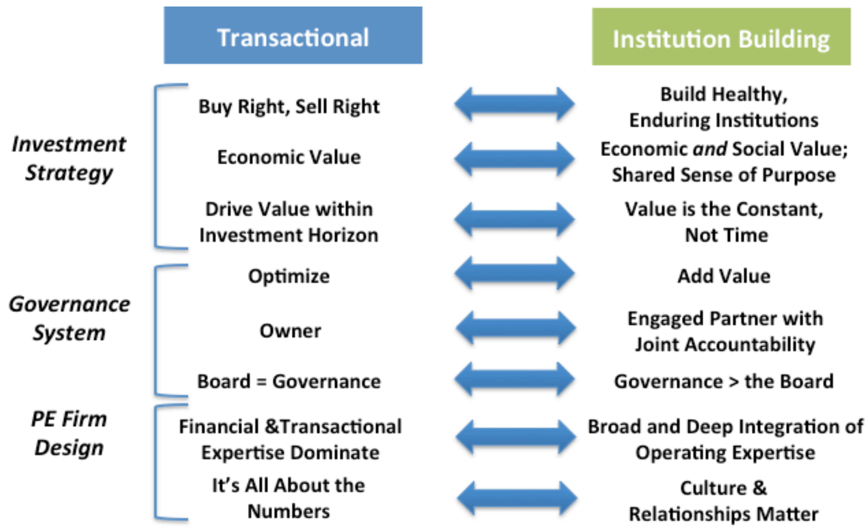
1. **Investment Strategy**
   These PE firms have a clear strategic focus on building healthy, enduring companies and believe economic and social value go hand-in-hand in doing so. Because of this approach, they tend to invest in company transformations and family-owned businesses, situations where consideration of both economic and social value is critical. They invest behind CEOs who lead with a "sense of purpose". And, because they understand it takes time to build enduring institutions, they focus on value creation goals first, *and then* consider the time it will take to achieve their goals.

2. **Governance System**
   These PE firms view their role as *active partners* not *passive owners* and employ a highly engaged, "tri-focal" approach, which extends beyond the Board, integrating multiple parties across the PE firm and portfolio company. They support and enable the CEO and leadership team to deliver on the vision, not monitor and manage the CEO's decisions and activities.

3. **PE Firm Design**
   The firms' processes and organization reflect a consistent set of values centered around the importance of a creating a healthy culture, ensuring alignment of purpose, building trust based relationships, and valuing a mix of capabilities (beyond financial expertise). These values are embodied in processes from deal sourcing to exit and reflected in the way the firms develop, measure and compensate their people.

This approach stands in stark contrast with the traditional transactional PE model. (*See Figure 3*)

Figure 3: Comparison of the Traditional Model versus the Institution Building Approach



We describe the model as "self-reinforcing" because if the various dimensions aren't aligned, the model just doesn't work. For example, it's disingenuous for a PE firm to say that it's focused on building sustainable institutions, but then systematically deprioritize investments in creating or enhancing key portfolio company capabilities. Or, if incentives for PE investment professionals are overly weighted to the success of the financial aspects of deal transactions, versus emphasizing active support for the portfolio company in driving operational or market value creation, the concept of an "engaged" partner, focused on adding value, rings hollow.

1. The Investment Strategy

The PE firms that fit this model focus on building and growing healthy, enduring companies that should hold their intrinsic value *long after the PE firm's investment period*. They are conservative in their use of debt, which provides them greater flexibility (i.e., they're relatively less constrained by debt covenants). They believe their fundamental role is to *add value* to the companies in which they invest, "We're clear our mission is to build great companies and to create value. That's why we exist. But it's also to build a great institution, a great franchise [referring to his PE firm]. And we think the way you do that is to do the right things for your companies, communities and people."

They understand that long-term value is created not only by generating economic value based on sustainable competitive advantage, but also by creating a strong foundation of social capital, represented by deep employee trust and customer loyalty. A seasoned PE leader, now leading the internal PE group for a family office, described their philosophy, "Economic and social value are intertwined. To create sustained economic activity and progress, you have to have the right team with the right culture, with the right value system." These PE firms invest behind higher ambition CEOs who lead with "shared sense of purpose" that unites both economic and social value.

It's important to underscore these firms aren't being altruistic. They believe their strategy results in higher company profitability over the investment period and may provide higher exit multiples. They're focused on building sustainable businesses, with a strong culture, committed and engaged employees, loyal customers, and capabilities that can be leveraged into new customer segments and/or new geographic markets. This strategy positions them as both "preferred sellers" and "preferred acquirers". Given the industry dynamics, this is an enviable position to be in.

They're strategic in finding "like minded" LPs. A PE leader explained, "I'm lucky. I'm empowered with other people's money and all that the LPs want me to do is to do smart deals and 'do good'. It gives me a very broad charter to do the right thing by the businesses." An LP that invests in PE firms that share this philosophy reflected, "When you create a successful business, you create jobs and professional advancement opportunities for the staff. When you insist that the company honor its obligations to customers, suppliers, and employees, you create a positive environment – the *right* kind of world."

Typically, PE hold times are three to seven years, driven in large part to maximize the internal rate of return (IRR) on the investment. Generally, the IRR is higher if the company is held for a shorter period (assuming that the same return multiple is achieved). In addition, there's generally a pre-set time frame for the PE fund to sell their portfolio company stakes, and therefore the closer to the end of the fund time frame, the higher the pressure to sell, especially if the PE firm is looking to raise another fund. As a result, time frame pressure can be an obstacle to pursuing a transformative investment strategy. As one of the long time PE firm leaders put it, "So, time is always your enemy because when things take longer, it means you're spending more money, you're not where you want to be to try to get the next round of funding. And a lot of PE firms die, not necessarily because they weren't on the right track, but they couldn't get there fast enough to make the investors comfortable enough to sustain the company. And people walk. Investors walk. So, time is just so critical."

Because of these dynamics, most PE firms approach investments asking, "What can we get done in the next three to five years"? In contrast, the firms that employ the institution building model understand it takes time to build-up social capital through investments in people, capabilities. This doesn't mean that the firms necessarily hold the investments for a long time or disregard compelling market opportunities to sell a company. Rather, they're deliberate in articulating value creation goals and try to take a realistic, measured view of the time required. Many of these firms assume investment time horizons beyond the commonly viewed average holding period. The head of a PE group within a large institutional investor shared, "We have very patient capital; it's not permanent capital, but it's very patient capital. We have a 10-year fund life, and many years beyond that, to harvest our investment. It gives us a tremendous amount of flexibility. So, from our standpoint, we have a simple goal, which is that we try to create value over the long-term – not quarter to quarter."

The approach fits well with several segments of the PE space, such as family offices and partnerships of a few people with significant personal capital, where investment horizons range anywhere from five to fifteen years (and longer in some instances). Often, capital is proprietary and investment goals tend to focus on absolute wealth generation, amassing wealth for future generations, and risk diversification. Proprietary capital tends to provide more flexibility in time horizon, approach to value creation and transaction structuring. "I might only double or triple my money over ten years. It may be a crappy IRR, but I'll do that all day long. I can accept an 8% return over a longer period of time and be perfectly happy with it. I have the luxury of not having to be as demanding and thinking it's a failure if I only double my money. But, if I had $4 million in the investment and I double my money, that's better than a poke in the eye with a sharp stick. So I can be patient and play a little bit of a different game than the 'time and return' pressures that I'd have to live with if I had LPs."

Time becomes important when you consider the business contexts that these firms target:

1) **Companies pursuing transformative strategies** where social capital can be leveraged to drive economic value; and
2) **Family-owned businesses** where protecting and sustaining social capital is critical to generating economic value.

When we talk about “transformative strategies”, we mean wholesale changes to strategy, operations and mindset. This may involve rejuvenating a business carved out of a big conglomerate, reinventing a product company into a provider of solutions, making strategic acquisitions to serve more sectors, or using a company as a the national platform for consolidation of a highly localized industry. These strategies typically require building new capabilities, retooling the organization, closely managing potential customer and supplier turbulence, and, most importantly, paying close attention to the culture during the transformation period. This makes being able to manage all stakeholder needs at the same time, through the transformation, a critical skill.

Often by necessity in these situations, while the CEO focuses on gaining competitive advantage to ensure long-term economic value, she also must foster a positive culture by maintaining trust based relationships with key stakeholders, generating social value. A healthcare-focused PE investor shared, “When we’re doing the right things from a clinical standpoint, we’re adding value and we’re creating an efficient center of care for the payers to take cost out of the system. When we do those things, it begets more volume, happier patients, and coincides with creating something that has more financial value as well.”

In the case of many family-owned businesses, the founder has shaped the ethos and values of the company. It’s common to find they’ve focused both on driving financial returns and taking good care of employees, customers and the communities. These founders may need to go to outside parties for money, but they fear putting at risk their most important assets – employee trust and commitment, customer loyalty and their reputation in the local communities. They worry about investors forcing change and ruining the culture. They want investors who will respect their company’s history, honor customer relationships even in tough times, and support investments in their communities.

PE firms that focus on family-owned businesses need to understand this. “We sit down with the families and Grandpa’s name is on the door. Of course they want full and fair value, but they also want someone who will steward the business, honor their legacy, care about the employees, the culture, and the communities. They’re afraid to sell to someone knowing that three or four years later the company might get flipped and they won’t really know who they’re selling to.”

These companies expect the PE partner to invest in capabilities and bring a “value add” beyond capital – things that the company doesn’t have, or can’t do on their own. For example, professionalize the business by upgrading systems and processes, open up networks to tap for talent, and provide M&A support. PE investors see the same opportunity, “Almost invariably the finance person is more of a controller than a strategic CFO and, as a result, the related processes and procedures within the finance area are weak. Usually they’ve got a budget, not a strategic plan. Even though they’re leaders in their space and they’re generating attractive margins, you can make them better.” Another pointed out the challenge for the CEO founder, “Oftentimes a CEO has grown a bit, but has plateaued because he’s also the chief salesperson and the chief operating officer, and at some point, you can't do much more.”

Demonstrating the firm cares about the founder’s legacy, company’s reputation and employees, and brings relevant “value add”, can be more important than offering the highest price. “The family either wants to leave the business in hands that they're comfortable with and there's no next generation for them, or they want to stay in the business and stay involved on some basis. So the chemistry is really critically important – it’s the most important thing in a lot of ways, maybe more than the price you’re willing to pay.” Given the current PE environment where attractive opportunities are hard to find, target company leadership is often in a position to perform “reverse diligence” and choose a “preferred acquirer”. In the words of a CEO of a physical therapy business, “When it came time for a PE sponsor, we were in a position to choose our partner. I laid it out. 'This is who I am, this is what I believe in, and I'm not going to let anybody talk me out of the DNA that runs through our business.' " The PE firms had to demonstrate to him why they would be the best partner.

Higher Ambition Portfolio Company CEOs

The lynchpin in making this investment strategy successful is, of course, having a highly capable CEO who can inspire, motivate and lead with a genuine vision and purpose. These firms see their role, in part, as supporting and enabling the CEO and leadership team. The head of an internal PE group within a large pension fund shared, "If you look back at the 150 +deals we've done and you run correlations around things like the leverage we used, the multiples we used, the macro environment – you'll find that two of the highest determinants of success are the quality of the management team and the culture that the CEO and the management team create."

Successful CEOs in the PE environment possess a set of critical leadership competencies, ranging from "hard" competencies in areas such as strategic acumen, operational execution, and a results-orientation. They also excel in "softer" areas such inspiring confidence, developing people, and constituency management. For higher ambition CEOs, the bar – and therefore their "value add" – is higher. Higher ambition PE CEOs take a multi-stakeholder view – focusing on generating value for the shareholders *and* employees, customers, partners, and local communities. They align everyone from front-line employees to Board members around a shared sense of purpose and they're clear about how the purpose delivers economic performance. They're committed to capability building for long-term competitiveness and sustainable performance. *(See Figure 4)*

Figure 4: Critical Leadership Competencies – Table Stakes and Higher Ambition Value Add (next page)

Critical Leadership Competencies	Private Equity 'table stakes'	Higher Ambition value add
1. Strategic acumen and leadership	• Focused on strategic value drivers • Tirelessly articulates 'true north' • Fact-based, analytical, probing • Understands how PE works	• Defines strategic value across key stakeholders • Crystallizes higher purpose • Views lasting institutional capability as strategic imperative
2. Operational leadership and execution	• Deep working knowledge of operational performance management; builds strong team • Able to mobilize change and continuous improvement	• Strives for enduring advantage through capability building for the longer term • Builds healthy organization capable of innovation and self-renewal
3. Value and results orientation	• Customer-oriented • Obsessed with cash flow, growth, value, scorecards • Balances short-term, long-term for best path to exit	• Takes broad, multi-stakeholder view of value, not only economic • Insists on results delivery for all key stakeholders • Drives for sustainable performance
4. Performance ethic and ownership mentality	• Speed, urgency, hunger for success • 'Over-communicates' expectations • Predisposed to act as an owner	• Connects performance mandate to higher purpose so others buy in • Builds intense commitment and shared purpose across stakeholders • 'Role models' ownership mentality that others adopt

5. Inspires confidence, buy-in, performance	• Self-confident, determined, passionate • Attracts 'right team' early (pace, ability to work with PE) • Inspires, earns loyalty of high performers	• Takes broad, multi-stakeholder view of value, not only economic • Crystallizes higher purpose • Views lasting institutional capability as strategic imperative • Inspires team purpose, commitment
6. High performance people development	• Builds small, talented, focused team that delivers • Steps up talent aggressively in key roles, e.g., CFO, COO, CHRO	• Attracts and retains top performers through their desire for higher purpose • Leads with humility, allows top performers space, visibility, credit • Cultivates values-based leaders
7. Artfulness / effectiveness in managing up	• Encourages active, intense engagement of owners as partners in major decisions • Embraces owners' input – inquisitive not defensive • Diplomatic, mature in intense interactions • Understands owners' urgency and cadence	• Engenders alignment and sense of purpose among owners and other stakeholders • Inspires owners to engage as active partners in enabling success • Strives for sustained, high-quality governance, including role clarity, positive interaction between management and active owners

Clearly, central to leading with higher ambition is the ability to articulate a genuine and compelling vision which serves as a guide for decision-making, as one of the CEOs stressed, “Without clarity around the longer-term vision of what we're trying to create, why we exist, people will define their job with this insane multi-tasking media barrage of email, text, and on and on, where the work is defined as the activities they perform, not *why* they are doing what they do.” In a PE setting, keeping the organization focused on the end game is a paramount.

The vision is not just necessary for keeping focused on a day-to-day basis, it serves as a “true north” across PE ownership changes. The CEO of a safety products business selling into the dental health market shared, “Keeping the beacon of where we're going enables the organization to weather storms. As ownership changes and as people change out, the longer-term sense of purpose we’re focused on remains – that we’re here to make dentists' lives better, to make them safer and to extend their careers. If we can get people thinking in this way, it’s much more exciting and motivating for them and it gives this sense of long-term purpose.” The CEO successfully led the business through three PE ownership changes over a decade.

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However, without a compelling link to economic returns, the vision can end up as nothing more than a slogan. The CEO must translate the vision into clear economic logic. For example, will the company offer new services to induce customers to buy more from the company, implement technology to reduce the total cost of delivery, or enter a new segment of the market and attract new customers?

Does the vision fundamentally change the nature of the business – for example, transforming a product company facing commoditization to a solutions business that can command a premium?

Understandably, holding steady to a long-term vision can challenge even the best CEO. The intensity of the PE environment exacerbates the situation. The CEO must remain confident, courageous and committed to their vision. In the words of one of the CEOs, "It starts with a selfless view. I've seen a lot of leaders try to figure out, 'what can I do while still being in the good graces?' You have to start with 'I don't care if they fire me'. Look at the organization and ask, 'what will make the organization successful?'" Another CEO provided a similar view, "It has to be *authentically* about more than money. It's more than just a job. You need to feel absolutely accountable to that higher purpose. If you have a short-term focus, it probably falls apart. You have to be willing to lose your job over it."

The CEO must have this conviction early on in the investment. "You've got to come in with a clear view of what matters, because if you just respond to what people ask for, you're going to get a lot of 'asks' for financial targets and near-term thinking. You've got to say clearly, 'This is what matters, and these are the metrics that matter, and in this order. Here's the kind of growth rate we can generate reasonably with long-term value creation, and not more.' Don't overpromise. If you don't grab the agenda, you're lost. Once you get in a doom loop where you've underinvested in culture – maybe you spend your first year pounding on cost – now you've formed a view of you. At some point it gets to be too late. You can't be 'Mr. Purpose' three years in, after hammering to the contrary."

These CEOs understand that leading in this way inspires employee loyalty, leading to increased retention, and in turn, lowering recruiting, hiring, onboarding and training costs. In addition, employees tend to be more willing to put in the extra effort or extend themselves beyond their strict job description. Similarly, when faced with financial challenges, honoring customer commitments by extending contracts or retaining a customer's key account rep engenders customer loyalty, helping to retain business, leading to lower new customer acquisition costs.

2. The Governance System

The institution building PE firms view themselves as *active partners* not *passive owners*. Governance is certainly about responsible stewardship and minimizing risk, but more importantly, it's about maximizing the likelihood that a *great investment idea* will become a *great investment.* They stress mutual trust and respect and two-way communications. They jointly develop a value creation plan with company leadership including the end state, financial goals, and what it will take to deliver on the goals. They support the company through tough times, even if it means taking a near-term hit. They add value by providing resources beyond capital such as expertise in strategy, operations, talent assessment, and M&A, at critical points during the investment period.

In this type of partnership, governance is dynamic. Interactions take place across a wide range of settings, extending beyond formal Board meetings, and involve many players across both the PE firm – analysts, Senior Partners, Operating Partners, outside Board Directors, to name a few – and the portfolio company. After the deal closes, the PE firm and the company immediately turn to developing the value creation vision and plan. Many PE firms employ a standard process for developing and kicking off the plan (e.g., "100 day plans"), an intense effort to set up financial and operating dashboards, determine critical investments, and align teams around key initiatives. It's an "all hands on deck" effort and sets the tone for the investment period. There is a "tri-focal" approach:

1. **Executional Intensity**: given the laser focus on value creation and the joint ownership over the plan, there is intense activity around execution of the value creation plan and measurement against the plan.
2. **Transformational Shift**: since the value creation thesis often involves some level of major change or shift in the strategy of the investment company, it's critical to ensure alignment around the desired end state and what it will take to achieve that end state.
3. **Leadership and Adaptive Capacity**: the high level of executional intensity, coupled with the need to stay aligned, requires a different type of leadership on the part of the investors and the Board. People and processes must be flexible so that they can adapt based on new information and unexpected changes.

There are typical governance practices and a different type of engagement in a higher ambition setting. For example, the value creation plan is centered on building a strategically advantaged, sustaining institution, not just on how value will be created during the investment period. The plan reflects the PE firm's deliberate consideration of, and commitment to, investing in strategic capabilities. The shared purpose of the portfolio company aligns and motivates company leadership, the Board and PE firm. Performance dashboards include metrics beyond the income statement and balance sheet to shed light on how well the company is delivering against the shared purpose. *(See Figure 5).*

Figure 5: Typical and Higher Ambition Governance Practices

Focus Areas	Typical Practices	Higher Ambition Focus
Executional Intensity	• Financials reviewed directly with PE firm staff • Quarterly operating budgets; 100 day plans	• Executional intensity around both performance and capability-building • Shared purpose drives intensity of commitment
Transformational Shift	• Shared view of exit and value creation thesis • Alignment on key capabilities, investments required • Strategic metrics, leading indicators	• Robust view of creating a strategically advantaged, healthy enterprise • Rigor in strategic metrics linked to capabilities and to engagement of key stakeholders
Leadership and Adaptive Capacity	• Close-in coach, sounding board for CEO • Bad news early; 'no surprises' • Horizon-scanning for potential blindspots • Proactively 'calling the question' • Commitment to upgrading talent	• Partnership between CEO and Chair/Lead Director based on shared assumptions re HA • Developmental dialog reflecting commitment to personal learning and business success

These focus areas come to life in three important dimensions of governance:
1. Focused, purposeful Board processes
2. "Value Adding" Directors
3. Open Communications

Focused, purposeful Board processes
Typically, PE board meetings are about reporting results, presenting forecasts and highlighting risks to near-term financial performance. In contrast Board meetings in the higher ambition, institution building, model are about strategic dialogue. The agenda focuses on the most important strategic initiatives and how the board can help the business deliver results. As one PE investor shared, "It's

never been that the CEO is reporting up to me. Of course we have a corporate governance function we take very seriously, but we're all there to support the CEO. When you have a great CEO and management team, you have to figure out how the Board can be helpful, not just create an information flow or a bunch of questions that don't add value."

The majority of detailed financial reporting is done outside of the Board meeting through monthly reporting calls with PE staff and pre-Board meeting sessions. Only the most important financial issues are addressed at the Board meeting. "We spend 10% of our meetings looking at historical financials, and 90% talking about issues the CEO is thinking about." Of course they look at the typical PE financial numbers (e.g., revenue growth, EBITDA, leverage metrics) but these are lagging indicators. A CEO explained, "One of the big challenges with Boards is that they want to see how you are doing, but they're not there every day, so they can't see things changing. It's important to come up with metrics that help show we're making progress because financial metrics have a lag."

The institution building PE firm Board relies on operational dashboards with metrics that are leading indicators such as those that:

1. **Provide visibility into potential operational issues before they surface in the financials** (e.g., revenue declines and / or cost overruns due to product quality issues can be flagged by looking at metrics such as non-conforming material rates, production yields, product returns).

2. **Show the company's progress in effectively and efficiently building strategic capabilities** (i.e., the collective skills, abilities and expertise of the organization) required in the value creation plan. Examples include the ability to innovate, the ability to respond to changing customer needs, quality management, talent management, or business solutions delivery.

3. **Tie to the shared purpose** of the company to understand how well they are delivering for key stakeholders (e.g., employee engagement, customer loyalty)

A health care focused PE investor provided a good example, "The first thing we do in the Board meeting is go through the clinical situation – all of the metrics around negative things that might happen such as infections, burn rates, patient falls, that sort of thing. That's always the first thing because that's really where the business starts. Certainly historical results have an impact on future results, but things like teammate satisfaction and the ability to recruit new physician partners is at the center. How many physician partners were we able to recruit last quarter? How many have left? What does that imply about what we're doing well or not so well? Those, to me, are much more leading indicators, indicators of the health of the business, rather than the financial metrics."

A number of PE firms go beyond financial and operational metrics and track metrics related social value creation such as net new jobs added or created, R&D investments, and capex/revenue. In addition, increasingly, PE firms are tracking performance against "ESG" (Environmental, Social and Governance) metrics, which have become mainstream in investment analyses and often required by prominent LPs. Examples include the company's impact on climate change, its sustainability practices, its diversity record, consumer protection performance, and employee relations.

"Value Adding" Directors

Many PE firms hire seasoned executives as Operating Partners who serve in a variety of roles including Board Director. Before agreeing to serve on a Board, the Director should get a clear understanding of the PE firm's expectations around the level and type of engagement. Director within a PE setting can be multi-faceted, and it's not always clear how to be effective especially since expectations differ across firms. A Director can provide valuable leadership, complementing the leadership of the PE Board members. For example, the laser focus on value creation and the PE firm's active participation, it's common for CEOs to look for outside guidance and counsel. The Director can serve as a sounding board, mentor and coach for the CEO.

The role requires a high level of trust with the CEO and PE firm. The Director must have astute political instincts and strong interpersonal skills. "Try to get to know the CEO on a personal basis. The Board meeting shouldn't be your only contact. The same holds true for the key principals on the PE side. Figure out who are the alpha players and get to know them on a more personal level." Armed with this trust, Directors can serve as a bridge between the PE firm and CEO. For example, both sides speak different languages. The PE firm wants things expressed in quantifiable terms that can be tied back to the investment valuation. The CEO wants to discuss operational dynamics that drive revenue and costs, but it may be hard to tie the dynamics directly to the income statement. Often a young PE analyst or two sit in on the Board meeting and, wanting to get the best numbers for the "deal model", push for precision in situations that require a more nuanced discussion. Frustration can build up on both sides. The Director can diffuse frustration by helping with the mutual translation.

"The role of the Board is to support the CEO. In my capacity as Chairman, I would spend a lot of time pre-meeting and post-Board meetings with the CEO, just to make sure that they had ample opportunity to share their thoughts with someone in a way that they felt safe. I thought the role, particularly as Chairman, was to serve as a mentor, someone who would lend an ear, offer opinions, and be stern when called for."

Open Communications
Due to the high level of executional intensity, the need to stay aligned on strategy and execution, and no time to waste, this model requires a different type of leadership. It's critical that people and processes can adapt based on new information and unexpected changes. As such, it's important that both organizations commit to surface difficult issues quickly, which in turn, requires a foundation of mutual trust and respect. The PE firm expects that there won't be any surprises and that management won't hide bad news. "Our philosophy is open communication and transparency so we expect that bad news goes up fast. We hear about it." In return, management expects that the PE firm will listen and help solve problems, rather than "punish" them if they raise issues. Both organizations look for strategic and operational blind spots and everyone is expected to call the big questions when they see them. Without this foundation of mutual trust and respect, rather than "partners in value creation", management may hide problems, PE staff play "gotcha", and the management team become resentful of the questioning and the time the PE firm is taking away from operating the business. The model becomes dysfunctional.

Given the level of engagement and expectations of each party, there will be challenges. For example, if there's ambiguity and inconsistency in process (for example, unstructured and unfocused Board meetings, it's difficult to ensure alignment within the PE firm, let alone between the PE firm and the portfolio company. Overlapping and conflicting roles among the PE financial and operational Partners, Directors, junior partners, and analysts, creates confusion and results in wasted time. Management can become distracted with an overload of communication demands from the PE firm. Finally, the urgency and number of initiatives can overwhelm the management team and interfere with delivering on the value creation plan.

3. PE Firm Design

There's no shortage of skepticism around the viability of this more transformative approach in PE. Our interviewees described a number of barriers they've experienced, including their view of PE people with whom they have worked (e.g., "they're focused on their own personal wealth generation", "they lack business experience"), the PE firm profit motive (e.g., "they make their money on fees, not improving company performance", "the senior guys make all of the money"), and the nature of fund structure (e.g., the need to raise the next fund forces them to sell companies before they should"). In addition, interviewees noted the industry has been poorly portrayed in the general media, which affects their credibility with portfolio companies.

However, within PE firms that pursue institution building strategies, we found several core values that play out consistently across processes from deal sourcing, diligence, to exit. *(See Figure 6 for summary)*

The PE firm leaders stress the importance of:
1. Fostering a **healthy culture** within portfolio companies and their own firms;
2. Reinforcing **alignment around purpose and approach**;
3. Cultivating **trust based relationships** with their key stakeholders (LPs, CEOs, buyers); and
4. Ensuring the firm has the right **mix of capabilities** to add value to portfolio companies.

Culture
These firms believe the cultural health of a company is inextricable from its inherent future value and look beyond market and financial analysis during due diligence to assess the target company's leadership and culture, often bringing in specialists. They interview former employees and analyze company data to identify potential organizational dysfunction or cultural issues (e.g., employee engagement studies, turnover rates over time, management tenure across key functions, organization charts over a period of time). They gather perspectives from other key stakeholders, as noted by an Operating Partner, "When you're looking at an organization, one of the key elements you're trying to assess is organizational culture and how they operate, how they interact with each other, how they treat their customers, how they work with their suppliers. All those things are critical. Often if you don't do that, you find surprises that can be serious."

The PE leaders care about the cultural health of their own firms and some hire outside specialists to assess their own firm's culture. The leader of a long-standing PE firm described, "For the firm to be sustainable, the leaders need to be deemed successful by the people who are underneath them because those people will follow and emulate them. If that person believes that what they're doing ultimately is not about making money, but rather about adding value across the board – that means to the LPs, the portfolio company employees, and the employees of the investment firm itself – it's very powerful."

A Director captured a common sentiment, "There's no team in PE. They're individual partners and the guy you're actually competing with is the guy in the office down the hall." In contrast, these firms create a culture where people want to stay because their values are aligned, views are respected, and they see promising career paths. "There's a social contract with our people. When we hire young people, we tell them we want them to spend their entire career with our firm. If they perform, they're going to be well compensated. We don't want to churn people. There are some firms that very successfully operate with a model of churning young people. That works. You can generate returns for your LPs. That's not our model. We think of ourselves as a team, not a star system."

An important reflection, and driver, of a firm's culture, is how they compensate their people. The standard compensation model in PE includes salary and a bonus based on individual contribution, but is heavily weighted toward deferred compensation in the form of carried interest (a percent of profit) within a given fund. This aligns people around what should drive the overall firm profitability – fund performance. However, there may be unintended consequences. Since carried interest ("carry") is fund-based and firms are motivated to close out funds within a given timeframe to generate target returns, decisions to sell a portfolio company could be influenced by personal motivations and fund raising strategies, at the expense of the long-term value of the company.

The institution building PE firms also offer carry, but emphasize bonuses based on performance across a wide range of skill sets. They want their people to spend as much time coming up with investment ideas and helping portfolio companies achieve their value creation plans as they do structuring deals. To ensure alignment around firm goals, a portion of the bonus is based on firm level, geographic or industry sector performance, in addition to the individual's transaction performance. To calibrate an individual's performance, they seek a range of perspectives, including conducting 360 reviews of senior partners and reaching out to portfolio company CEOs for their feedback.

In many PE firms, the top few leaders, often the founders, hold the lion's share of the carried interest ("carry"). In contrast, several PE investors offered the following: "Everybody comes into carry within the first year or so. Everybody becomes a stakeholder. We try to live the 'partnership' mentality, give people a real crack at the economics at a much earlier stage than other firms."; "There's a philosophy of inclusion in the investment decision-making process and around how the economics are shared. Less stratification, spreading the carry deep into the firm."; and "We spread the carry very broadly. A lot of people don't talk about carry, but that's the hidden subject almost everywhere. We talk about it openly because no one in our firm has ten points or more of carry. No one. As a result, we're able to compensate our middle and young people very, very fairly at the high end of our peer range."

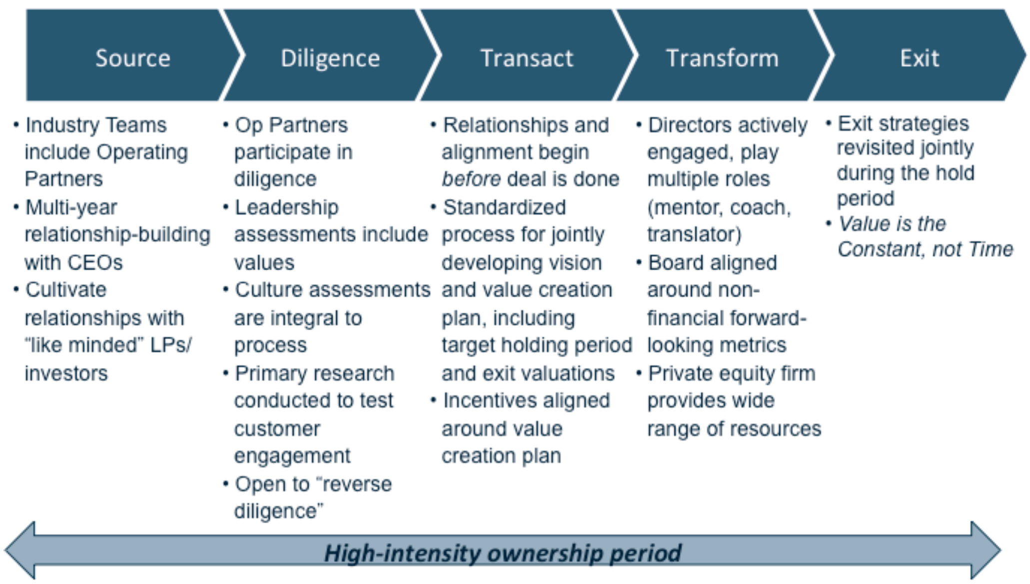
Alignment
Early on in the relationship, these PE firms foster alignment as they jointly build the value creation plan with the portfolio company. They reinforce alignment through executive incentive plans in which equity components ensure alignment on exit value and the bonuses drive nearer-term performance. A PE leader framed it this way, "We want incented, motivated and empowered 'A' managers running our companies. If we start telling them what to do, we're going get a Pavlovian response." Another described, "The plan starts with management before we close the deal because of the way we, and a lot of other PE firms, structure the economic alignment with the senior management team. It forces a discussion about the plan. 'What's the company going to be worth? Where's the value going to come from and how are we going to get there?' It then gets formalized immediately after closing, with a plan formulated with management. It's not imposed, it's a collaborative effort."

Relationships
These firms cultivate trust based relationships with key stakeholders. They connect with CEOs who they think would be a good fit for future investments and they spend time with "like minded" investors. One PE firm described their philosophy: "Our objective is to spend years and years building relationships, thinking about segments, trying to meet everybody." Another highlighted the importance of nurturing other ecosystem relationships, "We work hard to maintain relationships with legacy shareholders which helps us avoid auctions."

Similarly, they maintain contact with high performing CEOs after exiting an investment to keep them in their network. "Finding the right CEOs and having that network is very important. We have full-time, dedicated folks internally that are focused just on that. You try to keep the CEOs feeling positively about their experience, whether it's joining a Board or being involved in a future opportunity. You look for things to do together and make sure they feel appreciated and appropriately rewarded for the value they create." This pays off for the PE firms, "It's very much a partnership. If you look at who are our best references, particularly when you get to the fundraising process, it's our past CEOs."

Capabilities
These firms bring in a broad set of skills (e.g., human capital, IT and procurement experts, strategy consultants). Operating Partners work with teams to assess industry attractiveness and shape investment theses. They help assess the strategy and leadership teams of target companies. "Each sector team is run by an investment partner and an operating partner. They're peers. So all decision-making has the influence of both investment and operating perspectives because that's how you make the best decisions. We need one person to captain the process, so pre-close – we use a symphony analogy – the investment partner is First Chair and the operating partner is Second Chair. They're both involved and coordinated. They have their roles. The operating partner is supposed to call into question when the investment model just has a simple 5% growth scenario. Post-close, the operating partner becomes First Chair, and the investment partner becomes Second Chair."

Figure 6: Consistently Applied Values – Sourcing to Exit



Aligning the Broader PE Ecosystem

Our research initially focused on the relationship between the PE firm and the portfolio company. However, the reality is that PE firms don't exist in a vacuum. Their strategies, in large part, are governed by the expectations of the debt holders and the LPs. When asked about what is important to limited partners, a quote from one of the interviewees captured a common sentiment, "LPs, in the end, are all returns-based." However this conjures up a simple, one-dimensional view of what is actually a highly varied set of investors. LPs need to earn a return and many are passive investors, but the investment objectives, risk tolerance, and view of what makes a successful PE firm, differ not only across investor segments, but also across firms within any given segment. This highlights the importance of ensuring clear alignment between PE firms and their investors in terms expectations of financial returns and "softer" expectations.

While they don't use the language of "higher ambition", there are LPs who want to put their money to work by PE firms committed to building and growing healthy, enduring companies and who believe in the powerful duality of generating both economic and social value. A large institutional investor shared her firm's perspective, "In terms of mission, our funds that tend to be very disciplined, have a mission about them that they truly live by it. Often, these funds carry that through into their [portfolio] companies. So when I think about our top funds and our top portfolio companies, that's a very consistent theme throughout. Creating that vision, strategy and growth trajectory can expand everyone's sense of purpose."

A leader of a fund-to-fund framed it this way, "As finance people, it's easiest for people to think in binary terms about the nuts and bolts of what you're doing. 'We raise PE funds and our mission is to get top quartile performance.' Is that a mission? We hear 'Our strategy is to raise a billion dollars.' That's not a strategy. That's a result. It leaves people confused because what are you doing it for? We know the purpose is to raise money and get returns on the money and fees on the money and everything else, but it's not inspiring anybody. Bring it to something that you're achieving - that you're making the world a better place."

Because our initial sample of LP interviewees is small, at this point, it's not apparent how large a segment this represents. However, we've identified a few "flash point" areas, such as the culture and the strength of the values of the PE firm, compensation approach, and breadth of capabilities.

These investors look carefully at the behaviors of the senior team. "We spend a lot of time understanding the team dynamics because we believe it all starts with the team...making sure that folks with dissenting opinions are heard, making sure that there is a devil's advocate in the room, really pushing to make sure the best decision is made or optimized, and trying to understand how these teams work with [portfolio company] management teams to grow their businesses."

These investors examine how values are reflected in the PE firm's compensation model, specifically, how deep within the organization carried interest is spread. "It shouldn't be equal, but it should be spread across the professionals." One of the PE leaders shared his experience, "The level of inquiry and the kind of documentation that they want to see on the GP [general partner/PE firm], how it works, how it manages itself, is much higher than it was ten years ago when they just put the money into the fund. They bought into the investment strategy, they bought into the track record and it was done. But there's a lot more scrutiny now."

Capability depth and breadth is also a key focus area. These LPs value the role of independent Board members. One investor observed, "The operating execs usually add a lot of value. It's not always shown at the Board meeting, but it is shown often off-line, in one-on-one conversations with the management team." "The firms that are collaborative and are trying to find the best ideas to grow the business, usually end up putting more independent Directors on the boards. They're usually pretty savvy at trying to find the right people to assist the businesses. When we're directly investing in a company we love to see a couple of the independent Board members, because I think it provides a level of insight and depth and they typically provide a good sounding board for the management team."

As with the PE investors, these firms are not being altruistic. They have target returns, just as the PE firms have. In the words of a PE firm leader, "You know, this isn't paradise either. You have to be realistic because at some point, LPs want their money back. But this is, at least I think, is probably the most understanding asset class for long-term investors."