

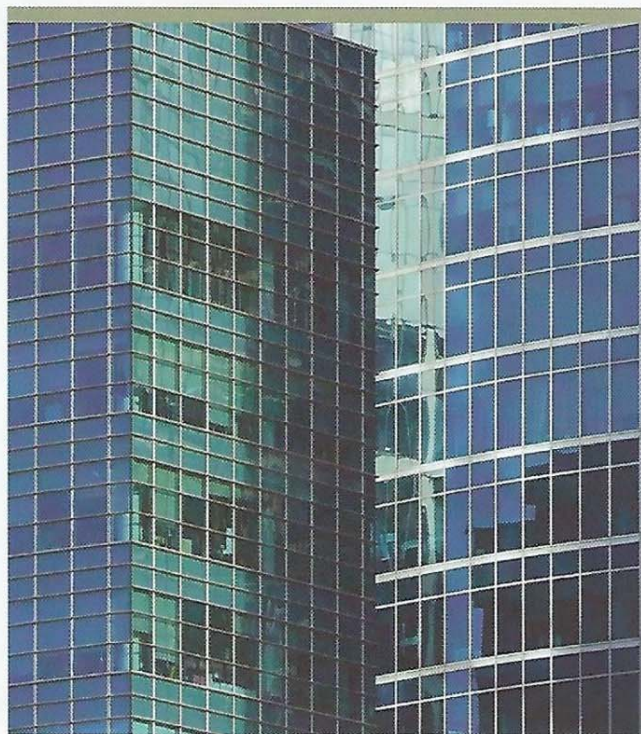
THE JOURNAL OF PRIVATE EQUITY

JPE.IPRJOURNALS.COM | VOL. 22, NO. 1 | WINTER 2018



“US Venture Capital and Private Equity momentum remains relatively strong with growing uncertainty about the economy and financial volatility risks.”

F. John Mathis, Editor



Why Hire Outside Directors When Private Companies Don't Have To? *Change! Break the Status Quo. Rejuvenate.*

John M. Collard

You need these guys — to increase cash flow and provide valuable guidance, contacts, growth, and credibility.

Outside directors are generally hired based on their experience, effectiveness, connections, and access to capital, which can be very beneficial to a company. Companies that are committed to going through significant business change (turnaround, transition into new markets, increased cash flow and corporate growth, generational ownership transfer), are anticipating a major liquidity event, or have shareholders who are not active or business savvy need guidance. An outside director is a member of the board of directors or advisors who is not part of the executive management team. These professionals are sometimes referred to as *independent* or *non-executive directors*. They are not employees of the company and are differentiated from inside directors, who do serve as executive managers and/or corporate officers.

Outside directors are advantageous because they are experienced experts who rarely have conflict of interest and they often see the big picture differently than insiders. Although corporate governance standards of public companies require a certain number or percentage of outside directors because they are more likely to provide unbiased opinions, private companies are normally left alone — but I highly recommend their unbiased advice.

In today's business environment, smart organizations frequently seek outside expertise. Traditionally, companies invited friendly advisors to join their board of directors. Now, however, there is more risk to these directors as a result of legislation (Sarbanes-Oxley). Whereas there is formality (shareholder reporting, responsibility, risk), liability, and more expense (e.g. directors and officers insurance) to a board of directors, there is a budget-friendly alternative in the form of a “board of advisors” that is beholden only to management. The main difference is in where the fiduciary duty lies: to the shareholders or to management. Regardless of the vehicle used, there is great value to be obtained by hiring an outside director.

An important consideration for private family businesses is that adding an outside director can lead them to secrecy where they want to maintain control. These businesses do not like to expose dirty laundry to outsiders. Get over it! Trusted outside directors can provide guidance for the business to produce value — for the business.

WHY ADD OUTSIDERS TO YOUR BOARD OF DIRECTORS OR ADVISORS?

1. Outside directors often increase cash flow and business growth. According to a recent Forbes/Lodestone Global survey; 97% of companies reporting increased revenues and 95% increased earnings before interest, taxes, depreciation, and amortization, with average increases of 56% since adding a board with outside directors.
2. Outside directors can be a low-risk, low-cost, but very valuable resource. They bring a new set of skills and ideas that will produce benefits for your company, while you maintain control.
3. Outside directors provide an external source of accountability, which is key for privately owned businesses to move forward.
4. Outside directors are on the side of owners, shareholders, and managers. Unlike other outsiders to whom even a private company must answer (e.g. banks and insurance companies, the Internal Revenue Service, the Occupational Safety and Health Administration, Environmental Protection Agency), these advisors answer only to you.
5. Outside directors add credibility. When it comes time for a liquidity-seeking event, such as new financing, selling the company, or an initial public offering, outside directors send the message that your company is a professional and serious organization with leadership and guidance.

With a board of directors, your company immediately gains legitimacy and a panel with expertise that you probably do not have in house. Selecting board members from business community can also bring greater awareness of your company. Although role of board members is to direct management accountability, develop strategy, protect assets, and oversee implementation, they are often adept at guiding major decisions, locating and serving as a resource, and being a confidant to the CEO.

WHO SHOULD CONSIDER HIRING OUTSIDE DIRECTORS?

One motivating factor in bringing anyone new into your company is for him or her to provide a service that you do not currently have inside the company. You hire a lawyer to advise you about legal issues. You hire a Certified Public Accountant to advise you about tax, accounting, and management control issues. You should hire a professional with an array of skills that you do not have when the company is going through substantial change, and outside directors fit this requirement nicely. Candidate companies can include the following:

1. Companies that are committed to going through significant business change need guidance. This can include a turnaround of a troubled company (stop the bleeding and return to positive cash flow), a transition into new markets (new focus), growing from small to mid-size (more structure for control), changing industry factors (deal with new outside influences), diversification through acquisition (corporate growth), or generational ownership transfer (new sibling ownership with or without qualifications, or professional management).
2. Companies that are committed to increasing cashflow and growth need guidance. Often, outside directors can be a catalyst to 3x to 5x multiple increases, depending on the starting point. Whether you want to increase shareholder value to impress future buyers or just increase distributions to shareholders, the goal is the same: Grow the cash flow.
3. Companies that are anticipating a major liquidity event need guidance. Whether you want new debt (lender) or equity financing (investor) the goals are similar: Prepare

for the complex process, find interested parties, and negotiate favorable terms.

4. Companies whose shareholders are not active or business savvy need guidance and validation. This situation is common in family-owned companies in which siblings are owners. Outside directors can serve to oversee that all shareholders are treated equally.

Managing leadership transition and succession is important in companies, particularly those that are family owned. According to the Family Business Institute, only 30% of family businesses last into the second generation, and just 12% last into the third. It is important to bring outside leadership to guide the planning for the future of these events.

Benjamin Zander, the conductor of the Boston Philharmonic Orchestra, once suddenly discovered at age 45 that he was the only person on stage that didn't make a sound. He realized that his job was to create great things out of the individual talents of the musicians in front of him. This is very much like the role of an outside director: to bring out the very best in the company's inside talent, to guide the company to meet its goals. The CEO and management make decisions and maintain control, based on guidance and information.

Outside directors bring an independent perspective, develop strategic thinking and planning, use their experience and objectivity, provide their Rolodex of contacts, find capital to finance the company, and guide transaction activity (Exhibit 1). Many, if not all, of these benefits are absent in most companies, so the outside influence should be used to your benefit. After all, you have nothing to lose and everything to gain by considering their advice when you make decisions that will influence your company. Remember, the key is for the CEO and management team to listen to the advice given and factor these inputs into their thinking, then make decisions.

EXHIBIT 1 Benefits of Outside Directors

Action/Skill	Benefit
Independent perspective Unbiased advice	Challenge management Sounding board for CEO Objective Mediate conflicts
Strategic thinking and planning	New directions Transitions Incentive-based compensation
Experience and objectivity New knowledge	Been there, done that Oversee performance and risk Accountability Credibility
Contacts Networks	Investors Lenders Resources Partners Customers Suppliers
Capital infusion	Raise Money Restructure Guide offering process Find capital
Transactions	Prepare company for sale Locate interested parties Negotiate a deal

Create a culture and structure that will withstand third-party accountability to add value to your business. Start thinking as a serious, growing company and prepare for a potential future life as a public company or for increased scrutiny of investors.

INDEPENDENT PERSPECTIVE

The day-to-day events in a business often distract the CEO's time and energy. It is easy to get wrapped up in the ways and means of running the operation and lose track of the bigger picture. The sounding board provided by an outside advisor can certainly help ground the CEO in real leadership duties. Typically, board members will focus on protecting the unique value of the company, but they often add much more.

The CEO needs unbiased advice and diversity of opinions from outside directors who care about the company's success, but who can view things from a distance and a different perspective. CEOs will be well served by adding board members who can challenge them and the decisions that they are about to make. This advice can often keep you from making mistakes that add significant costs. When the CEO only listens to "yes people," the CEO is essentially on his or her own, and new ideas do not enter the decision process. You want strong board members who are not afraid to offer advice, guidance, feedback, and argument on issues. Employee board members may be in fear of losing their job if they speak up. The CEO in a privately held business or family-owned company is often a lonely position. Outside directors offer the benefit of sharing ideas and perspectives. The CEO makes the decisions, but it is very helpful when they are based on sound advice.

Create the opportunity for people to disagree with you and confront your thinking. This is a must if you want to grow. Honest debate from knowledgeable people, who are on your side, will produce results on which you can rely. If you fear this approach, what are you hiding? Smart people learn from advisors who don't threaten their position — hence the need for outside independent thinkers. Remember, you make the decisions, and you keep the control.

In family-held companies all sorts of problems can arise when the senior executive decides to step down, or is forced out of his or her position for health or other reasons. Succession can be anything but smooth, with divergent and competing interests of shareholders and family stakeholders. An outside director can often be an independent party to mediate dispute resolution. Unresolved conflicts can only hurt the value of the company and thereby the value to all stakeholders.

STRATEGIC THINKING & PLANNING

Outside directors should constructively challenge and contribute to strategy development, implementation, and infrastructure. The board is the perfect way to help set aside your tactical perspective and force you to work on the strategic business issues. Planning requires fresh thinking and business analysis, even if the result in some areas is to continue business as usual. The value is in the process, which requires all participants to think through and understand the strategy. Put in place contingency plans for those events that we hope will never occur, but somehow always do happen.

Outside directors can be particularly adept at guiding the company into new markets or changing direction when trouble occurs. Because these outsiders have experienced these situations and guided other companies through the pitfalls, they can certainly guide you to success with less trepidation.

Once your strategy is set, you have defined where you want to go. Now communicate that message for all stakeholders to see and understand by using a mission statement. Make certain to answer several questions in this statement. What do you

do or provide? How will you deliver your services? How much will you do? Which customer needs will, and will not, be satisfied? What are the generic customer needs, and why will they buy? To whom will you sell, and where? What are your distinct competencies, and why will they buy from you? Differentiate yourself from your competition. Define and focus on those innovations and capabilities that give you an edge over your competitors.

There is nothing quite so effective as designing compensation and incentive plans that are paid out when goals are met but do not pay for nonperformance. Incentive-based management is extremely effective, but take care to set the right goals; if you have not, employees will take you in unplanned directions. Consider an incentive plan based 50% tied to what the employee can directly control (such as sales gross margin above plan), 30% tied to what the employee can influence (such as timing of sales through the production facility), and 20% tied to how the company performs as a whole.

EXPERIENCE & OBJECTIVITY

The very nature of growth implies that a company is going where it has not been before. It is refreshing to make that journey to new opportunities with the help of an advisor who has been there, and has done that, before. His or her objectivity can help you through the obstacles.

When independent observers scrutinize the performance of management in meeting goals and objectives and monitor results compared to long-term valuation goals, there is real value in their participation. Outside directors should satisfy themselves that financial information is accurate, that financial controls are in place, that internal reporting is at the right levels and prepared often, and that risk-management systems are in place. Make sure that the company complies with laws and regulations. This protects you.

Although most companies follow a well-understood life cycle, it is extremely helpful to distinguish between crises that are normal based upon their stage in that life cycle, versus crises that are troublesome because they are unexpected. Look for business advice from experts who have experience in these situations.

When transitioning into new markets, it helps to have someone on your team that has both gone through transitions before and understands the idiosyncrasies of the new market. For instance, doing business with the federal government is quite different from doing business in commercial and international markets. If you want to enter into new markets, have team members with diverse experience to help guide the way. Sell products and services to customers in the way that they want to be sold to. For example, if a U.S. auto manufacturer wants to sell cars in the United Kingdom or some Asian countries, it should make a model with the steering wheel on the right side of the car because residents of these countries drive on the left side of the road.

When a company finds itself in trouble, perhaps sliding toward bankruptcy, the fiduciary roles of directors change. Outside expertise in these situations to turn things around is critical to company value and survival and personal liability.

CONTACTS

Your contact book does not include everyone. Every company needs help when it wants to grow, prosper, or turn around. Outside directors can extend the company's reach by using their own contact network, including colleagues that can get involved to provide guidance and resources. Some outside directors have more quality contacts than others. Rely on these contact introductions to bring in new capital. New customers will drive sales revenue. New suppliers can favorably affect

cost cutting of materials, which drive a better bottom line. Strive for strategic teaming relationships to promote growth.

Contacts can be influential in bringing resources not previously available. They can attract new talent into the company at all levels and provide a new set of eyes and ears during the interview process. Locate other independent directors. Improve the management team. Grow the sales force and distribution channels. Introduce and improve marketing, penetration, and Internet presence strategies. Entice operational experts to produce product and services. Lure innovative people who can embellish research and development.

CAPITAL INFUSION

Outside directors often have a database of contacts who can supply capital, both in the form of equity (investors) and debt (lenders). Some have more extensive and higher quality databases than others. This means that you can get in front of many financing resources quickly once an expression of interest or offering package is ready. The key is to document the plan describing where you want to go and why you will succeed, put that in summary and detail form, describe assumptions and risks, and present rate-of-return projections. In other words, present your opportunity in terms the investor or lender wants to see. Your company is the product. Investors are in this for returns on their investment.

You will need a financial history of operations and projections of future plans to satisfy the stringent criteria of financing sources. Begin this process early so that you are prepared when the time comes. Consider a 2-page (executive introduction), 10-page (presentation of the deal opportunity), list of due diligence (details) available, and operating plan approach to walk potential interested parties through the process. Send the introduction to hundreds or thousands of potential investors. Finders often have such a Rolodex.

Build credibility by having a board with outside directors to demonstrate that you are ready for the scrutiny of investors. This independent presence serves to show that the company is ready for the next stage.

If a turnaround is in process, the task is more complex. Although an overabundance of capital is available, you will have to demonstrate that you have indeed made changes at the company. Changes in management, control systems, strategy, and so on are a must. A board of directors demonstrates that you are up to the task of reporting to an outside financing entity.

The process of raising money is complex and time consuming. The Securities and Exchange Commission has rules governing how finders and broker/dealers can operate and what each can or cannot do. Working with a broker is very expensive for small and mid-size companies, and you lose some control. Working with a finder is much less expensive; you maintain control and prepare the documents. An outside director, as part of the company, can be a finder to introduce you to investors or lenders; you then negotiate a deal that you can live with. When an outside director has a large database to utilize during this introduction process, measured in thousands of contacts, you can be in front of many investors. The key is to prioritize the flow of introductions and manage the diligence process. There is money available; just be the good deal.

TRANSACTIONS

As with raising capital, outside directors often have a database of private equity and investor contacts who both have deals for acquisition and who are looking for opportunities to buy. This means that you can get in front of mergers and acquisitions dealmakers quickly once an offering package is ready. Use a similar approach as described in "Capital Infusion" section.

Prepare for that future liquidity event. The best time to

sell a company is when a buyer wants to buy and has cash, which could come when you least expect it. Be prepared and work toward ultimate valuation throughout the process of growth. Privately held and family-owned companies should demonstrate that they can be run independently, without the owner, to maximize their valuation. Buyers do not pay for past sins, and they do not pay much for companies that are heavily reliant on the owner. There is much more value in the company when the management team (without the owner), processes, and procedures control the company to produce results.

Do not be surprised when you come to the realization that the company is not attractive to investors or lenders. This means that you have the opportunity to rebuild the company, or parts of it, so that it can be considered a good deal. Build a company in which investors want to invest.

WHAT BUYERS AND INVESTORS LOOK FOR

- *Businesses that create value:* Consistency from period to period.
- *High probability of future cash flows:* History of performance and improvement, or the promise of cash. Troubled entities must be on the mend and making progress.
- *Market-oriented management team:* Focus on producing revenue. Cost cutting is only a temporary fix; you must generate revenue to make growth viable.
- *Ability to sell and compete; develop, produce, and distribute products; and thrive and grow:* Track record or demonstrated changes in the right direction. Make certain that any problems are fixed.
- *Fair entry valuation:* Realistic return potential is a must to attract investors.
- *Exit options:* Lenders want their interest and the repayment of principal. Investors want return on investment multiples.

Outside directors are often adept at introductions or negotiating deals. They then elevate you (management and the board) to the decision-making role.

Hire that outside director. They bring about change.

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John M. Collard

is chairman of Annapolis, Md-based Strategic Management Partners, Inc. a turnaround management firm specializing in investing in and rebuilding underperforming companies, asset and investment recovery, outside director governance, and raising capital. He is a Certified Turnaround Professional, Certified International Turnaround Manager, past chairman of Turnaround Management Association, past chairman of Association of Interim Executives, senior fellow at Turnaround Management Society, and serves on public and private boards of directors. He is an adviser to company owners, investors, and private equity investors, and has participated in over 45 transactions worth \$1.2B. He has been inducted into the Turnaround Management, Restructuring, Distressed Investing Industry Hall of Fame. He received the Interim Management Lifetime Achievement Award from the Association of Interim Executives, SmartCEO Distinguished Leadership Award, Prince Georges Business Leader of the Year, and Most Admired CEO Award from the Maryland Daily Record. He can be reached at (410) 263-9100 or www.StrategicMgtPartners.com

