

THE UNIVERSITY OF TEXAS AT DALLAS

THE VALUE OF GOOD
GOVERNANCE FOR PRIVATE
COMPANIES¹

INSTITUTE FOR EXCELLENCE
IN CORPORATE GOVERNANCE

Faculty

Rebecca Files (Associate Research Director), Suresh Radhakrishnan (Research Director)

&

Private Company Governance Committee Members

Dennis Cagan, Joe Dwyer, Michael Grant, Chuck May, Brad Oates, Mark Sinclair (Chair), Don Springer

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The Value of Good Governance for Private Companies

Institute for Excellence in Corporate Governance (IECG), Private Company Survey Report
Rebecca Files (Associate Research Director), Suresh Radhakrishnan (Research Director)

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Is good governance valuable in private enterprises? Traditionally, the objective of corporate governance has been to enable arms-length owners/investors to “monitor” the controlling-owners or owner-managers. While most stakeholder groups – employees, customers, suppliers and debtholders – have specific contracts with the company detailing the quid pro quo, the owners/investors are residual risk takers that do not have a contractual agreement from the company to provide positive returns. Monitoring the managers is therefore needed to ensure that the interests of the arms-length owners/investors are protected. However, if private companies do not have arms-length owners/investors, then there should be no need for governance.

The Institute’s Private Company Governance Committee adopt a broader view of governance. Specifically, “Governance is an environment where the company has the people, processes, resources, and culture to enable a thoughtful and proactive focus on strategy, customers, operations, and risk so as to maximize the opportunity for successful results for all stakeholders.” This broader definition emphasizes the importance of balancing the resources at the company’s disposal in an optimum fashion so as to benefit all stakeholder groups. It also embraces both the monitoring/fiduciary role and the advisory role of the board of directors.

This perspective on governance is based on the fundamental premise of an enterprise, which is similar among both public and private firms: to use capital efficiently and obtain superior results/outcomes. To do so, companies strive to have an effective leadership team with the right tone at the top, stay abreast of emerging trends, and engage in activities that improve operating performance and expand their product offerings. While gathering data on any of these key performance metrics is challenging for private companies, a survey of private company governance practices conducted by IECG provides an interesting lens through which we can examine the value that private companies place on corporate governance (if any). The survey focuses on whether private companies have boards of directors and, if so, whether the roles that they play dovetail into the key performance metrics.

The results show that more than 80% of the private companies surveyed have a fiduciary board, an advisory board, or both – that is, less than 20% of private companies do not have any board. Companies with advisory boards are most likely to have members with expertise in the following areas: financial expertise, industry operations expertise, and expertise on industry customers. Companies that have a fiduciary board, an advisory board, or both consistently emphasize the value that boards add for strategy, as a sounding board for CEOs, and industry expertise. As such, boards help companies with strategy and operations – two of the pillars embedded in the IECG’s broader view of governance.

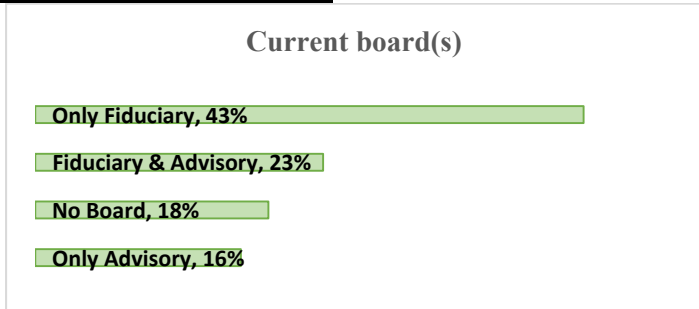
In spite of the general consensus that boards add value, 18% of the private companies surveyed do not have any board. The three main reasons cited are: loss of control, financial cost, and time-related cost. More than three-quarters of the companies without any board perceive a potential value in adding an advisory board, and roughly half of the companies without any board perceive a potential value in adding a fiduciary board. Operational and legal/compliance are the areas of expertise that respondents perceive will add the most value to their firm. As a result of this survey, these companies can also see that their peers find one of the biggest benefits of a board is its role as a sounding board for the CEO and other executives. This is an important benefit that may balance the potential loss of control. While the direct and indirect costs are a valid concern, it seems that the possible benefits will outweigh these costs. In addition to the benefits cited by the survey respondents, research on public companies show that effective governance practices also enhances the value of the company.

Interestingly, in today’s dynamic global business environment, very few companies with an advisory board have a member with expertise on future trends and/or risk. These two factors may go hand-in-hand, as risks cannot be assessed effectively unless future trends are also identified, especially with respect to cybersecurity.

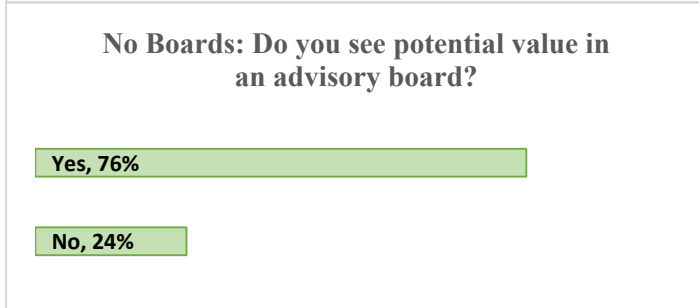
In summary, the value of good governance is acknowledged broadly by private companies mainly in terms of strategy and operations; the element of assessing and mitigating risk appears to be less crucial. As such, private companies may do well to consider adding expertise to assess future trends, for example in information technology, so as to effectively mitigate risk.

HIGHLIGHTS OF THE SURVEY

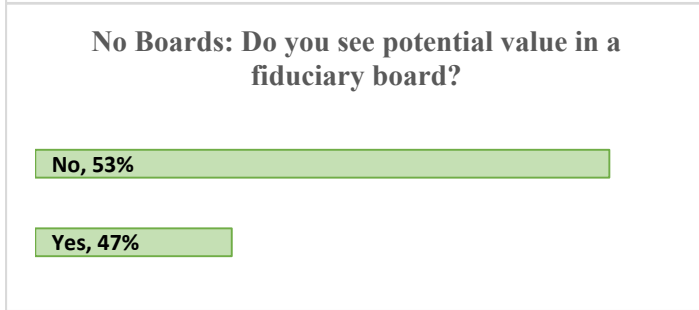
Roughly 66% of the private companies have a fiduciary/traditional board and only 18% do not a board: this suggests that private companies perceive the importance of boards.



Of the 18% who do not have boards, 76% see potential value in an advisory board;



and 47% of them see potential value in fiduciary boards.

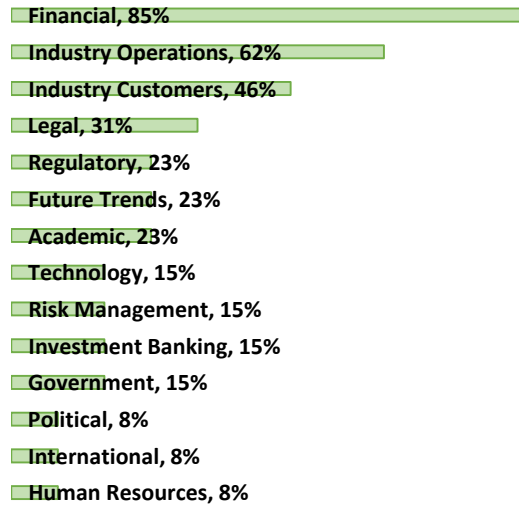


The top-5 areas of expertise that boards can add value include legal and regulatory compliance (65%), growth (65%), marketing (59%), technology (47%), industry connections (47%) and financial expertise (35%). Thus, operational expertise appears to be high on the list of value-added by boards. Interestingly, financial expertise related expertise do not appear to be as important as operational.

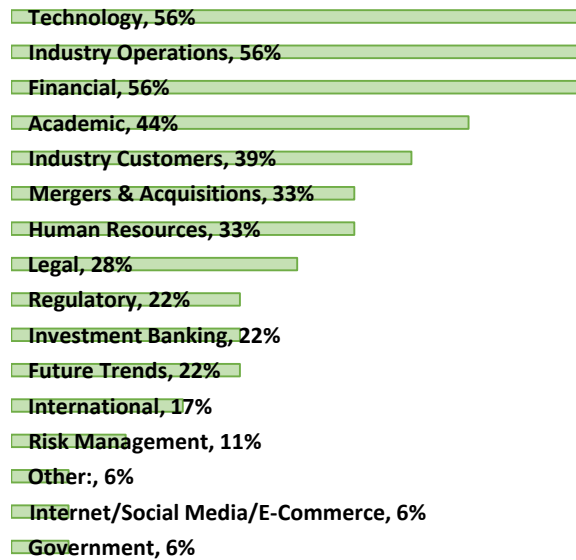


Financial, Industry Operations, and Industry Customers are among the top-5 areas of expertise represented in advisory boards in companies with only advisory board and both boards.

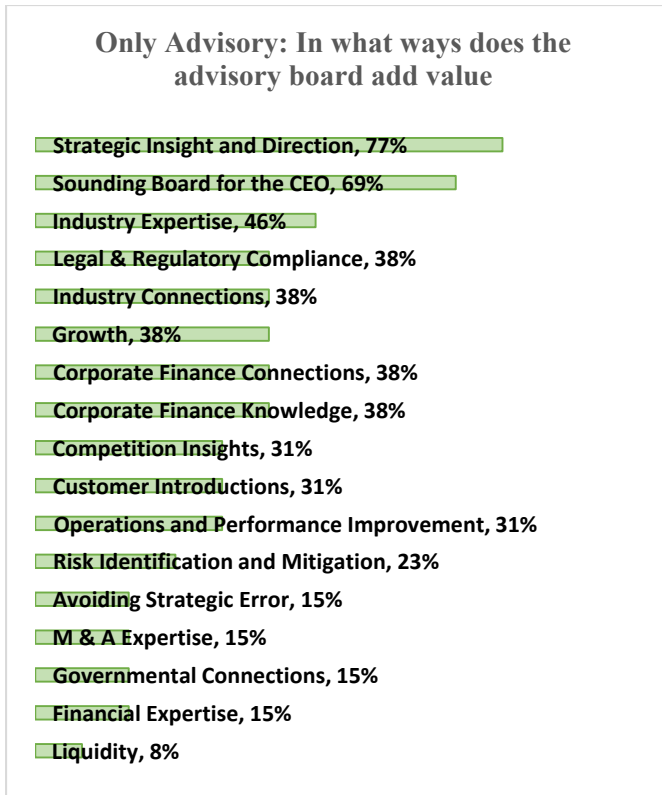
Only Advisory: Areas of expertise on the advisory board



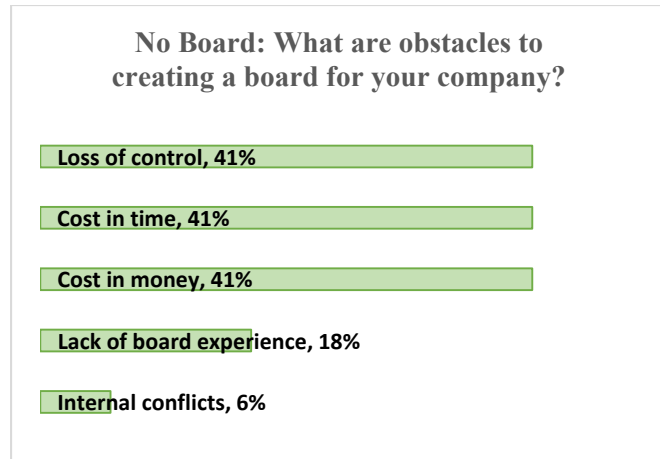
Both Boards: What areas of expertise are represented on the advisory board



Strategic Insight and Direction, Sounding Board for CEO, and Industry Expertise are the top three ways in which the advisory boards add value in companies with only advisory board and both boards.



The primary impediments to creating a board are the financial cost (41%), time commitment (41%) and loss of control (41%).



About the Research

- The report is based on a survey conducted by IECG. The survey was completed by 188 private company stakeholders in Fall 2016.

Respondents' Profile

- Sole Owner (15%), Majority Owner (30%), Minority Owner (30%), CEO (61%), Board Member (43%), Board Chairman (25%)
- 9 years average tenure at the company, and 5.5 years average prior tenure in similar positions

Company Profile:

- Type: Family (32%), Non-family (68%)
- Generational Ownership: 1st Generation (67%), 2nd and Later Generation (33%)
- Potential for IPO: Unlikely in the next 7 years (81%), Likely in the next 7 years (19%)
- Assets:
 - <\$5M (47%), \$5M-\$49M (32%), \$50-\$500M (13%), >\$500M (8%)
- Life-cycle Stage:
 - Start-up/Early Stage (18%), High Growth Stage (29%), Mature Stage (44%), Distressed/Turnaround Stage (9%)
- Industry:
 - Energy (9%), Financial Services (5%), Healthcare (8%), Manufacturing & Distribution (16%), Professional Services (18%), Retail, Restaurants and Entertainment (4%), Real Estate & Construction (11%), Technology (16%), Others (13%)