Middle Market Methods™ 2020: 1st Quarter

The Role of a Board of Directors for Lower Middle Market Portfolio Companies

By

John A. Lanier, DSL

Introduction

The lower middle market portfolio company population includes founding entrepreneurs who may not be familiar with many institutionalized best practices that comprise private equity governance. A subset of that governance is a proactive board of directors who meet quarterly. Before the advent of the equity sponsor, the composition of the board of directors may be few in number and devoid of independent "outsiders." Moreover, they may have met infrequently, as companies are only legally required in most states to meet annually and to memorialize the event with minutes. These board meeting minutes may be Spartan and perfunctory. In smaller owner-operated companies, annual board meeting minutes may have suffered benign neglect. Consequently, a potential seller may have to scramble to update minutes in time for diligence.

Strategy and leadership should dominant board agendas

The most important objective of the board of directors' is fiduciary stewardship. According to Steven N. Kaplan of the University of Chicago's Booth School of Business, the board of directors' stewardship shortlist includes compelling strategy and effective leadership. Surveys from prominent organizations like McKinsey & Company indicate that there is ample room for improvement. Private equity has responded to this constructive criticism in the perpetual quest for differentiation. Whereas a board seat may have been a status symbol in former times, board representation has appropriately evolved to include subject matter expertise aligned with the business model's investment thesis.

Board anomalies requiring remediation remain, including the machinations of the meetings. "Tales from the crypt" include massive pitch decks whose compilations take an inordinate amount of time to prepare (to the detriment of arguably more productive endeavors). Insult to injury for these tomes are their distribution the night before the board meeting to recipients who lack sufficient time to adequately digest their content before the meeting is called to order. The trifecta of dysfunction entails marathon twoday sessions that include tangents and accomplish little to guide the company toward improved enterprise value.

This quarterly value-creation installment will review board meeting best practices and challenge bad habits in an endeavor to transform the board experience into a value-add from the portfolio company's perspective. What is covered and how it is covered matter.

Alignment

Everyone has a boss. The official boss for the CEO is the board of directors. The controlling interest CEO in the company may become a minority interest shareholder upon the recapitalization of the company. The before and after contrast can be a culture shock. One of the sacrosanct priorities between the CEO's team and the board of directors is alignment. This should not be the result of directives or groupthink, but rather vigorous debate focused on competitive differentiation within the ecosystem in which the business model operates. The rationale for this necessity is rooted in the highest and best use of limited resources. This is the essence of strategy.

The best strategy limits initiatives to a vital few. Atop the leadership team's day jobs, initiatives must reconcile importance with available bandwidth. It is more productive to accomplish a few things well than many poorly (if at all). Where do these initiatives come from? A strategic planning session between the leadership team and deal team is the probable answer. Such planning makes the private equity investment thesis actionable. One non-board best practice—yet an input to board governance—is a post-close strategic planning deliverable. Therein lies the nature of the most important board functions: guide and monitor the strategic planning deliverables.

Strategic importance should not be a casualty of tactical urgency

Unfortunately, too many lower middle market board meetings are consumed with tactical items. Moreover, they tend to repeat numbers already exhaustively and dynamically reviewed between the portfolio company leadership team and the private equity deal team. Beyond this, dynamic interaction is supplemented by the weekly dashboard metrics, plus the monthly discussion and analysis reports.

At this point, we have a classic conflict between the urgent and the important, although it may be hiding in plain sight. The "urgent" regards the daily necessities of managing the enterprise, which coincidentally are correlated with the value-creation that attracted outside investors. Why are these regarded as urgent? The short answer is that these processes created the cash flow that supported the leveraged capital structure of the recapitalization. The posture for robust scalability requires balanced, timely metrics which enable leaders of the company to safely divert a portion of their attention to the "important" questions—the "vital few" strategic initiatives. More specifically, these initiatives have singularly "responsible" parties who answer to both the CEO and board of directors on their progress.

The Agenda

The first question that should be asked about the board of directors' agenda is whether it corresponds to the investment thesis. The second question is the balance between strategy and tactics—with an emphasis on strategy. An effective board meeting should take no longer than a half day. This infers a tight agenda with crisp preparation. Pitch decks should be distributed sufficiently in advance to safely presume attendee study. The minimum should be three business days. Moreover, the chairman of the board should guard against tangents. Whereas rigid formality is rarely necessary, the chairman should lean on Roberts Rules of Order when necessary to regain discipline relative to the agenda.

Board agenda discipline is a virtue

CEO Overview

The CEO should set the tone of the meeting with an overview that commences with the framework of the competitive ecosystem. The Porter Five Forces model is an excellent tool for this purpose. (See Figure 1.) Brevity may be accomplished by what has changed since the last quarter. Whereas the overview may reference financials to substantiate execution relative to plan, the intent is to explain what the financials mean instead of what they are. Financial details should be in the appendix as corroborating evidence instead of talking points. Remember, the leadership team and the deal team are already very familiar with the financial detail.

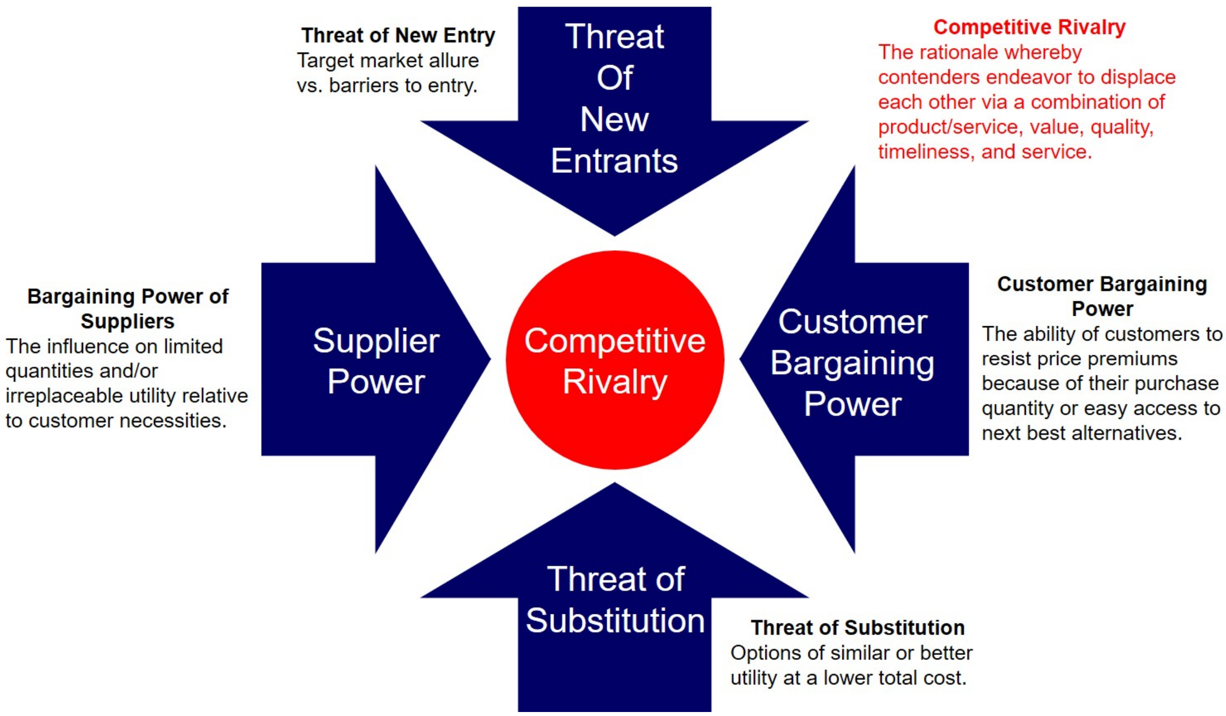


Figure 1: Porter Five Forces Model

The CEO overview should also review strategic initiatives. A four-blocker tool using the stoplight methodology is adequate. Four-blockers entail a simpler quarterly update depiction (and subset) of a likely more complex and detailed project plan. Alternatively, the CEO may elect to have the responsible leaders of the strategic initiatives review the four-blockers. (See Figure 2.) The four-blocks are:

- Green for accomplishments.
- Red for setbacks and resolutions.
  - The presenter objective is to cite root cause for delays and when the corrective action is projected to deliver the necessary results.
- Amber for issues.
  - This is a heads-up for what could happen but has not yet occurred.
  - The owner should indicate preplanned responses if the issue manifests into a real problem.
- Goals for the next quarter.

Since initiatives are time consuming, another recommendation is a timeline for point of reference. A high-level Gantt chart works well for this purpose. (See Figure 3.) A higher degree of detail to reveal significant milestones is fine; however, this decision should be tempered by the reality that individual project plans for a strategic initiative, e.g., acquisition integration, can be several hundred rows of tasks. Obviously, task detail "trees" may obscure the message of the initiative "forest."

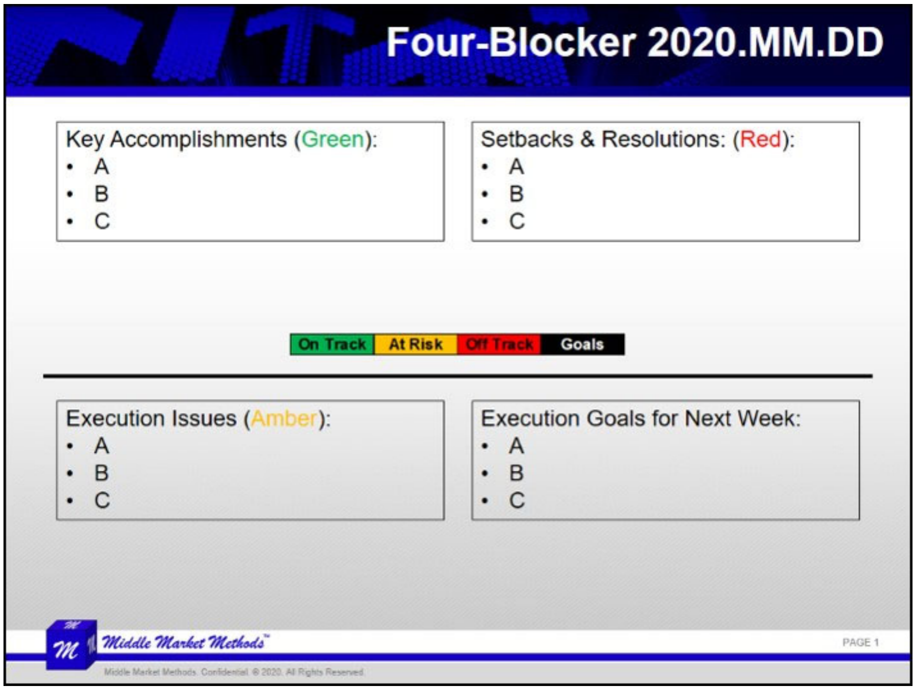
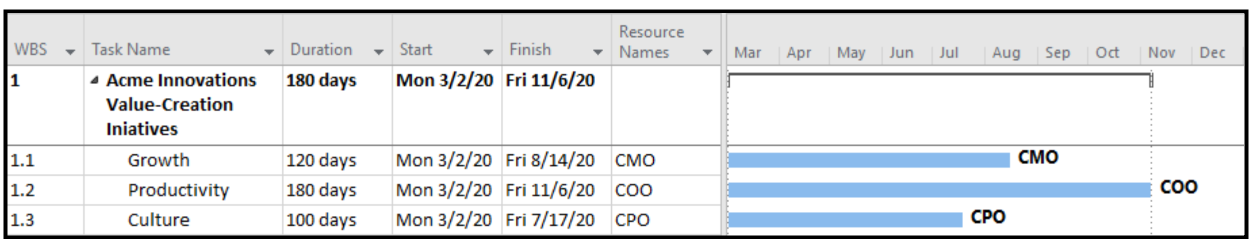


Figure 2: Strategic Initiative Four-Blocker update tool.



WBS	Task Name	Duration	Start	Finish	Resource Names
1	**Acme Innovations Value-Creation Iniatives**	**180 days**	**Mon 3/2/20**	**Fri 11/6/20**	
1.1	Growth	120 days	Mon 3/2/20	Fri 8/14/20	CMO
1.2	Productivity	180 days	Mon 3/2/20	Fri 11/6/20	COO
1.3	Culture	100 days	Mon 3/2/20	Fri 7/17/20	CPO

Figure 3: High-level Gantt chart depicting a progress timeline

Functional Review

The agenda should also cover function areas. In contrast to the CEO's overview, the functional leaders should be the presenters. This serves multiple purposes: visibility, leadership development, and skip-level access. Skip-level contact facilitates direct access by the board to a functional leader whose descriptors and insights may be otherwise (and perhaps unintentionally) filtered by the CEO.

The functional review outline should be consistent. The functional presenter should emphasize supervisory objectives and key results against them. Additionally, the functional leaders should convey how they are instilling the corporate values within their teams. Marcus Buckingham and Ashley Goodall impart in their book, *Nine Lies About Work*, that strong team culture is a more potent contributor to productivity, fulfillment, and retention than corporate culture. Whereas espoused values may be universal for the company, the cohesion of the team provides the acculturated pragmatic meaning of the values, i.e., how the values are lived within the team.

The four-blocker remains a handy communications tool. However, instead of describing a strategic initiative, the tool would be used to describe the functional environment. In complement, the functional leaders may supplement content that is easily digestible for substantiating a point. Graphs are particularly well suited for this purpose. Functional leaders may recognize exemplary performance within their teams—including inviting the employees to the meeting to receive kudos from the board.

Functional presentations are an excellent leadership development opportunity

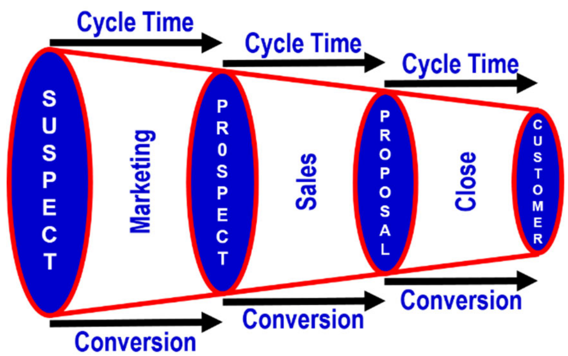
The functional presenter should entertain questions, with the board chairman proctoring the alignment of those questions with the agenda objectives. Action items are a common byproduct of these presentations. Even so, action items require clarification for whether they are something that should be reported in the next board meeting.

Functional topics should fall in three value chain categories: (i) inputs, (ii) processes, and (iii) outputs. In all cases, the points should be made with the metrics that are beneficial to (i) leaders for managing the business model and (ii) the deal team for tracking their progress.

Inputs

Inputs entail what feeds the business model with revenue. Accordingly, the functions may include product development, marketing, sales, and acquisitions. These growth contributors manifest in new goods and services, new markets, existing market penetration, and increasing customer share of wallet.

Pipeline metrics are particularly useful for communicating the progress of the story. For long cycle business models, solicitation stage conversion rates and cycle times lend integrity to the backlog's contribution to forecasting integrity. Moreover, the pipeline prop may convey satisfactory results ahead of revenue for long cycle models (See Figure 4.)



Cycle Times				
Segment	Suspect	Prospect	Proposal	Customer
Quantity	1000	300	30	10
Stage to stage cycle means (days)		32	91	27
Cumulative cycle means (days)			123	150

Conversion Rates				
Segment	Suspect	Prospect	Proposal	Customer
Quantity	1000	300	30	10
Stage to Stage Conversion		30%	10%	33%
Cumulative conversion (suspect)		30%	3%	1%
Cumulative conversion (prospect)			10%	3%

Figure 4: Pipeline

As revealed in Figure 4, conversion rates and cycle times may be confusing. For example, a stage-to-stage typically looks significantly better than end-to-end.

Process

Process covers how the business model digests the inputs and scales to keep up with growth. These functions may include procurement, operations, and logistics.

Productivity metrics are appropriate to indicate how well the company is managing expenses and/or creating value. For example, operations may include a graph depicting the productivity improvement of a Lean initiative, e.g., first quality units of production per fully burdened labor hour. In conjunction with pipeline metrics, productivity metrics may telescope necessary hiring activity.

Outputs

Outputs are predominantly financial in nature: revenue, gross margin, operating margin, and EBITDA. Interestingly—and especially for long cycle business models, good input and process metrics are leading indicators such that the outputs may be predetermined with confidence.

Beyond the inputs, process, and output functions, there are typically enabling and supporting functions that should have speaking parts.

Human Assets

The business model needs to attract and retain the labor necessary to grow. Status updates on the aspiration of “employer of choice” is advisable. Since turnover is an expensive and chronic challenge—and exacerbated by a full employment economy, onboarding has become a crucial barometer for cultural assimilation. The cohesion of a team trumps the corporate pronouncements. Accordingly, a rolling 90-day computation of the percentage of lost new hires is an important metric and belies the legacy turnover calculation. A graph may be the quickest way to communicate sustained improvement.

The talent pipeline should be a standing agenda priority

Systems

Technology is a large contributor to productivity. The status of software enablement is advisable. Advancements in technological support should correspond to operational productivity. Additionally, cybersecurity updates are wise.

Compliance, Quality, and Safety

Depending on the business model, these topics may be managed collectively or separately. In a healthcare model, for example, the compliance function reports directly to a compliance committee of the board of directors.

Committee Reports

The board of directors has common standing committees. Their content may be reviewed in executive session (sans non-board members and perhaps without the CEO). The reasons include sensitivity of content and/or regulatory fiat. These committees include (i) audit for financial matters, (ii) compensation, and (iii) compliance for regulatory matters.

Summary

This value-creation article installment is deliberately shorter than the M3 norm. Practical value may be created with fewer words and less time. Such is the case with prudent board of directors' governance. Focusing on strategic content, eschewing redundancy, and utilizing concision are key principles.

Let's adjourn and get back to creating value. Do I have a second? All in favor say "aye."

Until next time . . . .

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Middle Market Methods™ offers a value-creation toolbox of growth, productivity, and cultural solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother investment hold period, resulting in higher exit multiples. Additionally, deal team time is liberated from operational surprises to invest in new transactions.