GROWTH-ORIENTED MID-MARKET COMPANIES NEED INDEPENDENT DIRECTORS

BY GARY KUNKLE PH.D. & MARK ROSENMAN

ABOUT THE AUTHORS

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As the recovery picks up speed, hundreds of thousands of America's middle market companies appear poised for a new era of opportunity and growth. Gone are the days when declines in revenues and margins, excess capacity, anxious employees and restless investors were the general rule. Capital for expansion is on the rise. Credit is flowing again to private equity firms, armed with nearly $1 trillion to invest in growth companies, sufficient to fuel three and one-half years of deal activity.

Meanwhile a host of innovations like cloud computing and the virtual back office are enabling new variable cost-based business models that are flexible and adaptive to unexpected market changes. New social media channels and viral techniques like mobile promotions can help upstart companies get their products and services attention.

Yet the same market dynamism that spells opportunity also means intensified competition—from rivals across town or around the world. Copycat competitors threaten even the most successful product or strategy. Facing a complex regulatory environment, low cost offshore rivals and the increasing need for equity to fund growth—among other challenges—entrepreneurs are eager for any edge they can find.

GETTING ACTIONABLE ADVICE

A growing body of evidence points to a key frontier for growth-oriented middle market companies: their ability to reach beyond the borders of their own firm to tap the best available strategic and operational advice. As entrepreneurial companies track competitors, plan product strategy, raise capital and eye their long-term exit strategy, they need to look beyond day-to-day operational firefighting. They need the timeliest, savviest, most reliable counsel about markets, trends and companies. For example, counsel about changing market dynamics; how to keep the business ahead of industry shifts; how well yesterday's assumptions fit tomorrow's realities.

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The romantic image of the lonely entrepreneur trusting in intuition is out of date Entrepreneurs need as many compasses as possible to chart a course to success across an ocean of information.

Of course in today's hyper-connected world there's no shortage of advice, expert and otherwise. Blogs and Web sites offer free advice on all kinds of specialized business topics. Entrepreneurs can use CEO networks and forums to pick the brains of their peers. Albeit for a high price, expert network companies offer access to what they claim are tens if not hundreds of thousands of experts on call. Many entrepreneurs rely on occasional, informal advice from business people they know, typically through their social networks. But much of this ad hoc intelligence can be hard to integrate meaningfully into a company's operations. How can the CEO be certain that the advice is a good fit for the company's particular situation or that the advisor is competent enough to heed?

It's one thing for a CEO to pick up advice or market intelligence over drinks or a round of golf—it's another to figure out how to adapt it to an organization's unique market positioning, structure, culture and constraints.

ADVISORS WHO KNOW THE COMPANY

The idea of adding independent members to the board of a closely held company might seem surprising at first. Why would entrepreneurs, even those who haven't yet attracted external investors, want to give independent directors a say in their business? Sure, corporate boards often exist to represent minority shareholders and other stakeholders. But a board of directors should serve an even more important role: enlisting experts who invest time to understand the company through a regular process of review and analysis, offering seasoned advice to strengthen the firm's growth prospects and long-term value.

MAKING THE COMPANY MORE ATTRACTIVE TO OUTSIDERS

Another benefit of a board with independent directors is its impact on the audience of investors, lenders, venture partners, acquirers and acquirees that all growing companies play to. The presence of independent directors says that the company's mission and value proposition are compelling enough to have attracted accomplished business people to its side. The fact that the CEO entrepreneur has given outsiders a say in the business makes a statement that the leadership is confident enough to expose the company to broader perspectives and work collegially with other strong businesspeople to make decisions.

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This helps makes the company more credible and drives external interest.

WHAT BOARDS SHOULD AND SHOULDN'T DO

In considering the role of a board with independent directors, it is important to be explicit about what it should not do. Independent directors should not try to function as quasi-managers or get in the way of the company's ability to make and carry out decisions crisply.

Independent directors should help the CFO monitor discrepancies between planned outcomes and actual results. They should help management think through the company's toughest issues, such as: what gives the company higher intrinsic margins than its competitors; how can it improve cycle times and lower the breakeven point to ensure profitability under the worst case scenario; how can the company retain more margin for each dollar of growth, maximize cash flow from operations, and turn over the balance sheet faster.

BOARD ROLE SHOULD CHANGE OVER TIME

The role, composition, and operating style of the board need to evolve throughout the firm's development. Too many boards are slow to match their size and composition to the company's changing needs as it develops. According to one leading group of scholars in this field: "Boards carry with them the vestiges of their history and traditions and as a result, board composition is relatively persistent despite the changing needs for boards as firms move through the life cycle from adolescence to maturity" (Lynall, Golden and Hillman 2003). A board is better suited to deal with a growth company's challenges if its role and composition are adapted to the firm's changing circumstances.

EARLY STAGES

To be sure, many private companies will never have boards. When small family-owned businesses decide to incorporate, a board may be only the means to fulfill the obligations of incorporation law and rubberstamp the CEO's decisions. (Hermalin and Weisbach, 2003).

But more ambitious entrepreneurs tend to see early on the opportunity to widen their circle, awarding or selling stock in the company to senior executives with complementary skills and putting them on the board. These internal directors understand the business because they run it. Their livelihoods are at stake. But savvy entrepreneurs go further. They begin adding external directors to their boards to balance the myopic decision-making to which nearly all closely held companies are prone.

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Family-owned businesses, where personal relationships tend to dominate, can often benefit from having at least one neutral outside director. They secure the attention and advice of these outside directors with a fee or equity.

In the early stages of a firm's growth, a key role of independent board members is to encourage the entrepreneur to develop a stronger, more professional management team. At this stage the CEO tends to be consumed with producing new products and services. Decision-making is often real-time, opportunistic or reactive. Independent directors can help plan how the company should expand its capacity to scale production and sales while managing cash flow imbalances. They can oversee the creation of financial and operational controls, sharpening of the value proposition to customers and development of more systematic operating processes. Outside directors can help the CEO understand the underlying economics of the business and stand up internal functions like product development, production, marketing, finance and human resources.

Looking further down the road, boards can be particularly helpful in the creation of capital plans to provide liquidity for growth through external debt or equity financing.

Does having active independent directors mean that the board will ultimately overrule the CEO's decisions? No. CEOs still tend to lead their boards, considering the advice of all the directors and selectively pursuing that which fits best with the CEO's understanding of the firm and its marketplace dynamics.

INTERMEDIATE PHASE

The pivotal stage in a company's life cycle typically comes when it needs liquidity to finance growth—whether organically, via debt financing, M&A or IPO. An external funding transaction is often the trigger for further board expansion. Outside board members are needed for their expertise in positioning the firm to raise new capital for expansion; performing or undergoing due diligence; negotiating, completing and implementing M&A transactions when appropriate. They bring to the company an understanding of capital markets and contacts with capital providers. They can help the firm define its strategic goals and plans, develop and communicate its business case and financial projections, and understand the ramifications of financing alternatives, such as the aggressive exit strategy that private equity typically requires.

After external funding has been consummated, outside directors are typically added to the board to represent external financiers, depending on the amount of ownership and control ceded to them.

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MORE ACCESS

Independent board members facilitate access to a wider set of contacts than the CEO has, such as venture capitalists, private equity firms and experts of all kinds.

A private equity firm that places independent members on the boards of companies it invests in will tend to offer them stock so that they have skin in the game.

Board members at this stage also provide a kind of insurance policy in case key members of the management team falter. For example, a financially savvy director can step in to become interim CFO in order to consummate a transaction. Outside directors furthermore play a critical role in crafting an exit strategy such as going public or selling to a public company. If the exit strategy is to take the firm public, board members must be in place to oversee SEC financial reporting requirements and speak to the company's governance practices. A public company is likely to discount a private company or not bid on it at all if the acquiree has not implemented Sarbanes-Oxley financial and operational controls or hasn't had a strong Audit Committee with an outside director as Chair.

WHAT KIND OF BOARD MEMBERS?

How should companies go about figuring out what kind of outside directors they need? They should start by mapping their needs to four categories of board expertise.

- Compliance: For companies in regulated industries, expert advice on compliance may be the most pressing need, even at the company's earliest stages. The informal operating style that is often a private company's strength can also work against building a controls mentality. Independent directors can serve as mentors and a sounding board on compliance issues and encourage an appropriate "tone at the top" toward compliance issues.
- Monitoring: Board focus on strategy execution; identifying and correcting deviations from expectations; assessing performance targets and reviewing trend analysis.
- Strategic/Growth Advisory: Focus on creating a strategic framework, such as for expansion, scaling operations, making acquisitions and securing external resources.
- Resource Access: Facilitate access to a wider set of contacts than the CEO has, such as venture capitalists, private equity firms and experts of all kinds.
- A mix of expertise—continuously re-calibrated throughout the firm's growth—has the best chance of providing the expertise the firm needs.

WHAT ARE PUBLIC BOARD TRENDS?

Private companies considering establishing or enhancing their boards might want to look at current trends in the emphasis of public company boards. Current demand for new outside public company directors appears to be increasingly favoring directors with strategic skills to help the company understand complex markets.

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There is a sense that the emphasis on risk monitoring that started with the passage of Sarbanes Oxley legislation in 2002 has run its course—especially since attention to compliance was often at the expense of focus on strategy and driving better company performance (Pricewaterhouse Coopers 2010). Recent analysis shows that public companies tend to seek directors that can provide forward-looking strategic expertise, along with knowledge of new technologies and an understanding of how to expand globally (Hendry, Kiel and Nicholson 2010). Private companies should consider doing likewise.

NEXT STEPS

How should a mid-size fast-growth company take best advantage of the opportunity to build a board with strong, independent members? First, they should assess the sources of advice and guidance in their business and personal eco-system. Which strategic and operating challenges would benefit most from outside expertise? Target the specific areas—operating dilemmas or opportunities the company wants to capitalize on—that require rigorous, objective advice. Start with an Advisory Board that meets regularly, prepares for its sessions in advance, and makes substantive recommendations on key problems. Begin to add outside directors who match the growth needs of the firm. Compensate directors with fees or a small portion of equity to gain their full attention and participation. Share information with the board and develop a process for evaluating and testing their advice. Gather their ideas about the full range of possible paths to attract liquidity for growth.

There is a great deal for an entrepreneur to gain by developing trust in and collaborating closely with independent directors. An active board made up of expert outsiders will require a good deal of time and attention. But it can also transform a company's capabilities and profile in the eyes of outside funders and partners. Growing mid-sized companies are particularly well-positioned to take full advantage of this important opportunity.

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