A private equity approach to building a strong board

Based on our experience in working with hundreds of management teams, here are six key strategies for fast-growing companies to create the optimal board. By Tom Roberts

Independent boards can help companies at nearly every stage of development, as they provide a broader perspective, additional expertise, and critical fiduciary oversight. These boards are particularly important for companies in fast-changing industries, where there is a need to quickly understand and capitalize on opportunities.

An independent board can also help raise governance practices to the standards required for a company to complete a successful initial public offering or to be acquired by a larger public company. And yet, building an independent board can be stressful for founders and company owners, since it involves giving up a portion of control to outside independent directors.

The board's main functions are twofold: to debate and set company strategy, and to support and monitor the chief executive officer. All other functions — including audit and compensation reviews, strategic advice, and guidance during periods of crisis — flow from those two primary functions. While having a board can be invaluable, company managers must carefully consider what kind of directors can effectively fulfill these two critical functions.

Starting from scratch… or from an existing board

Not every company begins the process of building a board from zero, but relatively few private companies have truly independent boards. In some cases, a company may have no board at all, while in other situations, the company may have an ad hoc management committee that meets informally to discuss business strategy. These individuals are usually long-term employees who are familiar with the company's strategy and history, but who sometimes have a limited perspective on other industries or geographies.

Many companies have boards that are composed of spouses, children, relatives, and friends. Because of their close relationship to the CEO or founder, these capable people may find it difficult to speak with absolute candor.

In over two decades, Summit Partners has assisted more than 290 growing companies build boards, helping them to successfully transition from small, closely held companies to more substantial firms ready for an IPO or a strategic acquisition. Here are six key strategies we use to help fast-growing companies create the optimal board.

1. Make sure your board evolves to reflect your company's growth

When making the transition to a more sophisticated board, the challenge is to preserve your company's culture and history while adding fresh expertise and insight. As your business grows, your longest-tenured advisers may not have the expertise to guide you; if you keep them on while adding outsiders, your board may grow to be unmanageable.

The ideal size for a growing company's board ranges from five to nine directors — large enough to access the additional experience and perspective you need, while small enough to stay mobile and focused. We also recommend that you establish, as early as possible, board terms of approximately three years. That way, there is a natural point at which to discuss every board member's tenure and the possibility of extending it.

2. Use investor-directors as a resource

One catalyst for change in a board comes when an outsider, such as a private equity firm, makes an investment in your company. If the investment firm is purchasing a majority of your company, its management will ask for majority representation on the board. Even if the investor is purchasing a minority stake, the firm will usually expect one or two board seats. These investor-directors will often be the first outside directors — and in many cases, after they join, the board begins to function more formally, with increasingly structured meetings and professional reporting.

Bringing in outside independent directors can be difficult for some company owners, but these new board members should be viewed as a resource rather than an impediment. Private equity board representatives, for instance, will typically be partners at their firms who may have guided dozens of other companies through similar growth stages. Their perspective on events and trends outside the company can be invaluable. In addition, these professionals may have expertise in financial disciplines such as management information and forecasting or in acquisition strategies. As a result, they can help company owners upgrade their financial reporting infrastructure, identify likely merger and acquisition targets, and broaden their network in the investment banking and lending communities.

3. Fill the gaps in your company's skill sets

Investors will work with your company's management to further broaden the board, identifying areas where your firm could use additional expertise. They will pose questions such as: What is your company's strategy? What skill sets will be required to achieve its goals? From here, they will begin to build profiles of ideal board members, identifying what expertise they should bring — audit, international sales, research and development, or marketing, for instance. Then they will start to look for people who fit those profiles.

Often, companies target CEOs as they search for board members. We have found, however, that a tremendous number of qualified candidates are one step removed from the CEO. That is why we often urge companies to consider senior vice presidents at larger companies, particularly in areas such as sales, research and development, marketing, or finance. Many of these executives have valuable expertise and are eager to serve on boards.

In addition to identifying people with the right skills, you should consider intangibles. Look for a group of people who can work well together and who can commit the necessary amount of time and effort to your board. Think about what drives each member of your board and how you can use this insight to keep everyone engaged.

4. Find a director who can help you address Sarbanes-Oxley

Companies that plan to go public — or that simply want to comply with public company standards to be more attractive acquisition candidates — must consider the Sarbanes-Oxley Act as they construct their boards. This doesn't mean that these companies must meet all Sarbanes-Oxley requirements immediately; rather, they should start making conscious decisions about what changes they are willing to make now and which to address closer to an IPO.

The main issue here is meeting the law's requirements for an experienced person to head your audit committee. In order to be Sarbanes-Oxley-compliant, your company needs a board director who has served as a chief financial officer, a chief accounting officer, a controller, a public accountant, or an auditor — or has supervised someone in one of those roles. This person should also be able to help your company meet other Sarbanes-Oxley requirements for establishing internal controls and creating information systems for reporting your company's financial results. Since these requirements are quite detailed and technical, having a board member who can help you navigate through the maze of regulations is critical.

Not surprisingly, Sarbanes-Oxley has increased the demand for directors who have this particular expertise. Given the extraordinary shortage of people who qualify as audit committee financial experts, this will likely be a difficult board spot for you to fill.

Creating an effective board: A checklist

- ☑ Recruit board members to fill gaps in your company's skill sets
- ☑ Do not fill your board with "yes men," family members, or friends
- ☑ Keep board size reasonable at five to nine people, and consider term limits
- ☑ Set up committees — audit, compensation, and others as your business requires
- ☑ Plan meetings well ahead of time and ensure board members have materials with adequate time to prepare
- ☑ Have board members commit to reading materials beforehand and to attending all meetings in person

5. Keep your focus on the big picture — assign committees to handle key concerns

Effective boards provide strategic guidance on the larger issues that a company faces — without getting involved in the operating details. Most boards focus on these key areas:

• **Audit:** The board ensures that all financial reports are accurate and unbiased.

• **Acquisitions:** The board will sign off on transactions. For firms pursuing an active M&A strategy, the board will form an acquisitions committee with authority over acquisitions up to a certain threshold size; for acquisitions over that threshold, the entire board will become involved.

• **Compensation:** The board acts for the shareholders in an advisory role to evaluate the CEO's performance and to determine a fair level of compensation. In most cases, this extends to the CEO's top management team, as well.

• **Strategy:** Although the board approves and, in some cases, directs a company's overall strategy, in most cases it should not be involved in the day-to-day operational decisions.

• **Special projects:** Boards also can become involved in one-time issues or projects, such as labor issues, international expansion, or strategic partnerships with other firms.

Many of these functions are handled by committees, which should be formed soon after the board is established. The audit and compensation committees are probably the most critical ones; however, companies with active M&A programs should early on establish an acquisitions committee.

6. Plan board meetings well in advance

Even the best board works more effectively when it is used efficiently. You cannot underestimate the importance of scheduling board meetings well in advance; one very strong board on which I sit sets dates one year in advance to ensure that directors can attend.

Once committed to a meeting date, the company works backward from that date to produce materials. For a meaningful discussion of company issues, board members should have in hand all written presentations prior to the meeting, preferably by several days, to allow for review and preparation. In exchange, you must demand that your board members commit to reading all materials in advance and to attending meetings in person.

Make your board a strategic asset

A good board can help your company to identify industry trends, scrutinize its strengths and weaknesses, and provide complementary knowledge and perspective to your management team. Then you must use this resource effectively to draw on those skills, listen to dissent, and incorporate your board's broader perspective into your company's strategic plan. Rather than giving up control, building an independent board empowers you to equip your company for its next stage of growth. ■

Reprinted from Directors & Boards® Third Quarter 2007