GOVERNANCE

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Challenges for Remuneration Committees

'It is clear that outcomes for 2020, when reported in 2021, will be scrutinised in the context of Government support, dividend policy, employee experience, share price movement and underlying business performance. A focus on clear communication within remuneration reports is essential.'

Sean O'Hare

Risk and reward in private equity

'By providing guidance on what risks, actions and behaviours are expected through reward solutions – as well as which should be avoided – we can improve the alignment of capital providers, investment professionals and company executives to achieve higher quality and levels of Internal Rate of Return.'

Hans-Kristian Bryn and Carl Sjostrom

Content

We would like to take this opportunity to thank all our readers for their support and to wish you all a restful and relaxing holiday season and a very happy, healthy and peaceful 2021.

Feature

Risk and reward in private equity

Hans-Kristian Bryn and **Carl Sjostrom** explore the roles of risk-return and reward in evolving the existing private equity logic.

Introduction

The private equity (PE) sector keeps growing as an engine of value creation and its success has led to a very different perception of the attractiveness of private ownership. However, when PE firms are seeking to exit an investment, it is becoming increasingly clear that there is, in many cases, a shortage of effective risk management, reward and governance. In this article, we make the case that both owners and managers of PE businesses can achieve a higher quality of earnings and make shorter holding periods possible if attention to risk, actions and behaviours form an integral part of the value creation and protection journey, through risk management, reward and governance.

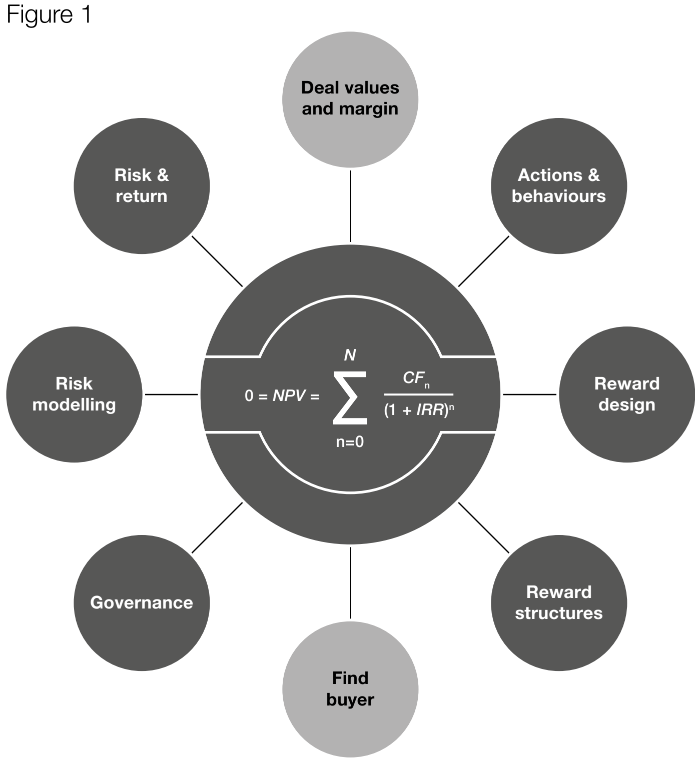
PE and Internal Rate of Return

PE is characterised by a relatively focused approach to performance: it is essentially all about the Internal Rate of Return (IRR) achieved when exiting an investment (exit price less investment plus/minus the cash flows with time value of money taken into account). One of the consequences of having such a clear goal has been for many firms to standardise structuring and analyses of risk and reward, typically with limited tailoring to specific business, market or human capital considerations. Reward, for example, often misses out on nuances that can lead to ineffective or over-compensating awards[1] and risk management is mostly limited to financial inputs and outputs.

For those PE firms and portfolio companies that haven't embraced 'best-in-class approaches' to risk, reward and governance, the upside of implementing these more sophisticated solutions is that they will deepen the understanding of the investment and its characteristics. As the simple illustration in Figure 1 describes, it is still clear that the basic variables of cash flow and time that determine the IRR are impacted by factors beyond deal and margin focus. Many PE firms may therefore be able to improve the realised IRR by enhancing the ability to value a potential investment, determine the likelihood of future growth and assess the timing of exiting an investment. From a future buyer of a portfolio company's perspective, it will also provide better insight, which is likely to attract a premium and in turn potentially improved rates of return, as timing can be better managed and uncertainty reduced.

The success of PE has not encouraged much reflection on its typical approaches, however, we have recently reached an inflection point for the whole investment industry where ESG considerations have been pushed to the top of the agenda. This has made investment managers, capital owners and companies debate whether 'stakeholder capitalism' has conquered 'shareholder capitalism'. We argue that the interests of equity owners will always be the key determinant of the purpose of an organisation, but we are now at a stage of business evolution where stakeholders' impact on the longevity of a commercial enterprise can no longer be ignored and a broader value approach is needed. There is therefore a need to recognise that value is not only a function of input and output but also of how these inputs and outputs come about.

Figure 1



Risk management in PE investment firms and their portfolio companies

PE firms will argue strongly that risk management is at the heart of their investment decisions and how they generate value from the investments they make. However, historically PE firms, and management in their portfolio companies, have tended not to consider explicitly how risk management can add value to the investment objectives of the firm or its funds beyond financial risks and capital structures. Equally, many PE firms have not set a minimum standard for risk management in their portfolio companies and, hence, they are not benefitting from consistent approaches, methodologies, risk management processes or risk-based reporting.

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It should be recognised that PE firms vary significantly in the approach they take to making risk-return based investment decisions and how they run their investments from risk management, governance, operations and reward perspectives. We have seen a broad range of approaches incorporating both extensive (and very detailed) modelling and less formal quantitative investment processes. However, even in the firms where there is extensive modelling, with some notable exceptions, this tends to focus on the financial risks and the impact of different capital structures and leverage. There is less emphasis on the external, strategic, and disruptive risks facing the companies in which the PE firm and its funds are looking to invest. Nor have we seen many examples of comprehensive risk models that incorporate multi-risk perspectives covering the full distribution of risks facing the potential investments (such as @Risk models like 'IRR@Risk' and 'Exit multiple@Risk'). We believe that @Risk models that show a range of outcomes rather than single point estimates with simple sensitivity analysis can support better decision-making and provide more robust input to the governance and oversight process once the investment has been made.

> 'The success of any strategy, whether investment, business or exit strategy, depends on the actions and behaviours that deliver it.'

Equally, our experience is that many PE owned companies don't focus on investing in risk management and governance processes as part of their restructuring and growth decisions, despite the fact that these practices could support both value protection and value enhancement and hence underpin their personal reward (see below), until such time that the prospect of an IPO or a trade sale becomes more imminent. This often becomes a very costly and time compressed process, to make the business look more attractive and marketable to potential buyers that have expectations of risk management and governance practices in line with the requirements of governance codes and listings requirements[2].

Actions, behaviours and reward

Reward for PE fund managers and many executives in portfolio companies aligns with the PE value creation's focus on IRR. The classic model is that a firm will charge its investors a management fee that is a fixed percentage of the capital invested or committed and a 'carried interest' that pays a percentage of a fund's growth over and above a hurdle rate of return. A senior PE fund manager will earn a salary and a bonus that come out of the fees the firm charge its investors and portfolio companies, plus a share of the carried interest, the latter providing the most significant earnings opportunity by far. Although the carried interest reduces investors' profits, it is a generally accepted practice as it focuses on returns above a level that makes it attractive in comparison to listed alternatives whilst addressing a principal-agent dilemma by incentivising people with insight into a relatively opaque investment to maximise value. Management in portfolio companies similarly receive leveraged equity incentives that are aligned with the IRR pattern of carried interest.

Remuneration arrangements can seem technically complex in the PE space but, as our high-level summary shows, the common goal is to enhance the value of the portfolio company to allow a profitable exit from the investment and the fund. Since the dominant performance hurdle is the IRR achieved, what follows is that the sooner the value can be realised the better, which in turn depends on whether that value can be significantly improved on or not. Hence, the predictability of the cashflows that underpin the valuation is key and this is a function of the ability to anticipate and model risks, as well as the actions and behaviours of portfolio managers and company executives.

The success of any strategy, whether investment, business or exit strategy, depends on the actions and behaviours that deliver it[3]. Those actions and behaviours will be informed by a range of factors, including the strategy's formulation, managerial direction, the context of the business and the assumed risk position – and can therefore be misinterpreted. Some examples we have come across include: impact on regulatory licences due to lack of governance in the acquired company; risks of fines and reputation loss by units that have ignored legal requirements; overexposure to risky assets; failure to capture business opportunities due to misunderstanding of risk appetite; and over-payment of reward for mediocre performance in growth sectors.

What reward does is to clarify the expectations for those executing the strategy. If the reward simply signals that performance equals IRR then individuals will pursue this to the best of their abilities and within their spheres of control and influence, which may not match the insights and intentions of investors. This is why when leaders are evaluated on a broader set of variables, such as track records of ESG and quality of earnings, the execution path chosen may not have been as optimal as first thought. By providing guidance on what risks, actions and behaviours are expected through reward solutions – as well as which should be avoided – we can improve the alignment of capital providers, investment professionals and company executives to achieve higher quality and levels of IRR. Examples of such signalling are short-term incentives with risk-adjusted return targets, ESG-based performance targets and equity award hurdles that reflect the quality of earnings.

Feature

Risk-return and reward in the deal cycle

In our previous articles, we have made the case for:

- Better linkage between risk, return and reward;
- The importance of making ESG an integral part of strategic planning and decision-making[4]; and
- The value of better governance in decision-making and oversight of risk-return and reward[5].

In Figure 2, we summarise key risk-return and reward areas that can impact a potential investment over the 'deal cycle':

As set out in the diagram, risk-return and reward considerations, such as ESG, can beneficially form an integral part of how PE firms evaluate, buy, operate and exit portfolio companies.

ESG as a driver of change in risk management and reward practices

PE investments make for an interesting case study with regard to ESG since performance tends to be so focused on IRR. Following our model of risk and reward planning[6], we can as a result focus on how different organisations can address ESG issues in relations to risk, actions and behaviours in order to determine and deliver the strategy that will maximise the rate of return and reward for those who have invested in the PE fund and for those employed to invest in or manage the portfolio companies.

First, a company that manages its risk-return position can shorten the investment period by providing future buyers with more transparent and predictable acquisition targets. Secondly, if the company builds ESG considerations into the modelling

Figure 2

	Risk-Return	Reward
Deal Evaluation	**Commercial evaluation of value of business uncertainty** • External, strategic, operational and disruptive as well as financial risk impact on future returns • Risks and opportunities from environmental practices, other stakeholder relationships and governance, e.g. relationships with regulators, structural weaknesses, agility, information access • Risk analysis inform required performance improvement, investments and growth	**Assess current reward for existing direction of travel** • Performance evaluation of current strategic focus and effectiveness of reward approach • Cost of retaining existing management, risks in reward design and precedent for new recruitment analysed • Guidance as to cultural and competence strengths and weaknesses • Remuneration governance as an indicator of strength of board supervision, governance and processes
Investment	**Financial and business volatility impact on financial returns** • Improved confidence in delivering IRR or other performance criteria • Improved understanding of levers for value protection and enhancement during growth stage • Value of ESG and other stakeholder aspects incorporated into strategy and business plans • Risk appetite defined and standards set for management, expectations clarified for investors • Risk-return analysis to evaluate cost/ investment / growth / restructuring opportunities	**Alignment of reward systems with actions, behaviours and desired risk-return profile to achieve objectives** • Using equity for more than alignment of interest and targeting incentives • Review franchise strength of management team vs. that of company to assess need to reward intellectual and management capital • Reward strategy to drive risk taking, actions and behaviours required to deliver the performance and IRR required with maximum predictability • Balancing different reward elements to maximise impact according to sector, business and individual's situation
Growth	**Managing the principal risks of the business** • Focus management attention and reward on managing out unwanted volatility • Identify areas where increased risk taking could generate value and evaluate required investments • Embed value and risk drivers into the performance management system • Business and investment case process incorporating risk and return • Risk appetite based decision-making and evaluation criteria	**Focus reward on minimising volatility and maximising quality of earnings** • Governance of performance, risk and reward – clear to all stakeholders • Incentives that signal key actions and behaviours required to deliver risk-return profile, supported by active performance management • Build governance, ESG and reputational record for the exit, learning to live with disclosure, reporting requirements and link this to reward • Reward and recognise long-term value enhancing actions and behaviours and penalise negative ones
Exit	**Risk management and governance meeting external benchmarks** • Risk disclosures including risk appetite and longer term viability • Clear delineation between the roles of Shareholders, Board, Audit and Risk Committee and management • Embedded and auditable processes supporting exit valuation	**Remuneration and governance meeting external requirements** • Reward potential exciting but fair to recipient and investors alike • Build reward story for future investors, regulators and recruitment • Transparent and compliant reward that signals strong governance of the company and clarifies expectations for existing and future managers • Clear delineation between the roles of Shareholders, Board, Remuneration Committee and management • Meet increased external transparency and disclosure expectations

Feature

of the risk, actions and behaviours for each deal phase this will provide insight on the potential ESG premium or discount for an investment. Thirdly, by rewarding both the management of portfolio companies and PE fund managers not only for returns on investments but also for return enhancing actions and behaviours within a set risk appetite, the enterprise value can be improved further by reducing unwanted volatility.

It should be recognised that it is often challenging to fit additional analysis into the deal evaluation and investment stages given the short time window and multiple interdependencies. However, a clearer recognition of the impact of potential value erosion from incomplete risk evaluation and modelling (eg ESG, reputational impact and disruption) and poor reward practices should support the case for integrating this into the investment case and price negotiations.

In our experience, the volatility of IRR arising from poor risk management, actions, behaviours will crystallise most clearly as the potential buyers see the results of how the business is being run and governed. Issues like ESG take time to address and must therefore be committed to throughout the growth phase of an investment in order to be able to provide a value-adding track record and positioning. This also gives new owners further insight into how unwanted volatility can be managed and ESG incorporated to facilitate a quicker and more successful exit.

‘There is therefore a need to recognise that value is not only a function of input and output but also of how these inputs and outputs come about.’

In an ESG context, commitment and track record are hence key, the exit valuation can easily attract a discount due to lack of, for example, compliance with governance standards or environmental track record. Simply rewarding IRR may not optimise it and firms should probe how executives and investment managers are delivering the eventual returns. Equally, a robust (cost effective and proportionate) governance process built around ESG with clear metrics and track record, gives a potential buyer a degree of confidence and could attract a premium.

Conclusions

Though there are clearly significant differences in risk management, reward and governance practices there is a compelling case for change for many PE firms and the companies they invest in. Putting long-term value creation at the heart of the equation, it becomes clear that risk-return, reward and considerations like ESG need to become more central across all stages of the deal cycle both in terms of protecting and enhancing value.

ESG provides a timely example, however, this is not about ESG but that it is critical that the analysis of such stakeholder aspects has considered and evaluated which risks, actions and behaviours will maximise performance given a more holistic view of the world. The risk, performance and reward equation can then take many forms but without including variables that have significant impact on IRR, the likelihood is that the wrong risks will be accepted, opportunities will be lost and energy will be directed to actions and behaviours that no one wants to pay for.

Carl Sjostrom is an independent senior adviser to company boards and management, working across Europe and with most industries and forms of ownership. With a focus on reward and performance, Carl is a frequent speaker and commentator on topics of strategy, executive pay and corporate governance issues from an international perspective.

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1. This is not a new point, see for example O. Smiddy, Equity remains top incentive, Financial News, 27 March 2006.

2 H-K. Bryn and C. Sjostrom, ‘A new governance framework’, Governance, issue 290, October 2018, p. 10.

3 C. Sjostrom and H-K. Bryn, ‘Risk, actions and behaviours’ (parts 1 & 2), Governance, issue 308, April 2020, p. 10; and issue 309, May 2020, p. 10.

4. H-K. Bryn and C. Sjostrom, ‘Risk & Reward: embedding ESG for strategic success, LinkedIn, 9 June 2020, https://www.linkedin.com/pulse/risk-reward-embedding-esg-strategic-success-hans-kristian-bryn.

5. C. Sjostrom and H-K. Bryn, ‘Symbiotic board committees’, Governance, issue 268, October 2016, p. 9.

6. H-K. Bryn and C. Sjostrom, ‘Linking risk and reward’, Governance, issue 267, September 2016, p. 10.

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