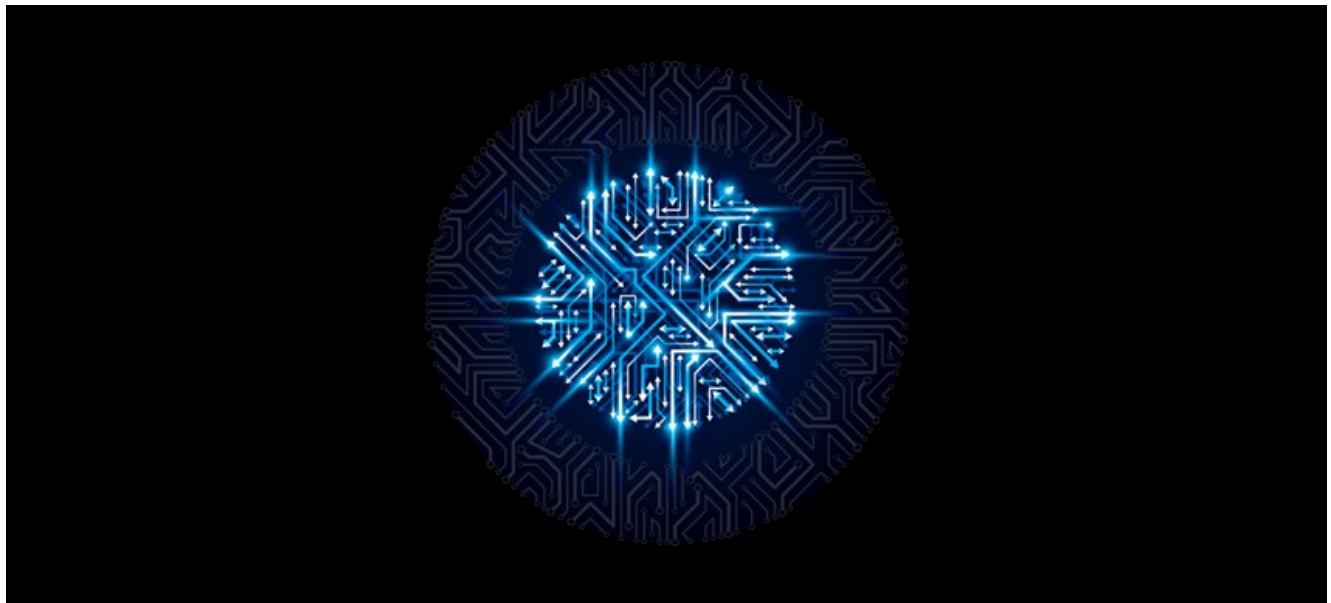




Board Leadership Forum

May 2019 | Meeting overview

The rise of the private markets and implications for public companies with Jim Millstein and Eric Talley

Professor Eric Talley and Jim Millstein shared findings from the Millstein Center's research and its recent white paper, *Private Ownership at a Public Crossroads: Studying the Rapidly Evolving World of Corporate Ownership*. The data show that capital formation in the U.S. is undergoing a significant transition: the role of the private markets is becoming increasingly important, while the number of publicly traded companies has been steadily decreasing.

Specifically, Eric and Jim highlighted the following significant statistics and trends:

- The **decline in the number of public companies has been particularly pronounced in the U.S.** By the end of 2017, the number of domestically-listed public companies had dwindled to roughly half its size at its peak in the late 1990s.
- **IPOs have regained some buoyancy** since they slowed to barely a trickle subsequent to the dot-com bust of the early 2000s, **but have not caught up with the steady wave of business**

About Jim Millstein



Jim Millstein is the Co-Chairman of Guggenheim Securities, the investment banking and capital markets business of Guggenheim Partners, and a member of the Millstein Center Advisory Board. He

has previously held several other distinguished roles, including as the Founder and Chief Executive Officer at Millstein & Co. and the Chief Restructuring Officer at the U.S. Department of the Treasury.

consolidations and going private transactions

which have reduced the number of publicly traded companies over the last twenty years.

- Private equity investments have grown significantly since the beginning of the financial crisis—**the number of private equity deals being consummated annually has tripled and the aggregate annual investment value of such deals has quadrupled.** Although some of these investments were made in public companies, the vast majority were made in companies operating outside of the public securities markets.
- **Companies that have remained public have grown larger.** Even as the total number of public companies has dwindled, there has been significant growth in the market capitalization of public companies (in part due to mergers). Measured as a percentage of GDP, the market value of public companies has returned to the same level as in the early 2000s.

About Eric Talley



Eric Talley is the Isidor and Seville Sulzbacher Professor of Law at Columbia Law School and Co-Director of the Millstein Center. He is an expert in the intersection of corporate law,

governance, and finance, and he teaches/researches in areas that include corporate law and finance, mergers and acquisitions, quantitative methods, machine learning, contract and commercial law, game theory, and economic analysis of law.

The Millstein Center is pursuing several areas of further research related to these trends, including analyzing the size and structure of the private markets, tracing ownership chains, evaluating access to and collection of data on the private markets, and exploring factors driving companies' decisions about whether to become or remain private versus public.

What could be motivating so many companies to become or remain private?

Participants shared a wide range of views about the pros and cons of the public versus private form and the experience of serving on a public company board compared to a private one. One public company director expressed a preference for the public form. She appreciated the accountability, increased scrutiny, and public availability of metrics and competitor comparisons, and the expectation for the modern public director to be actively involved in overseeing every aspect of the company's business. On the other extreme, a private company director commented that being private is the company's single largest competitive advantage, since it allows them to do things differently and think longer-term, rather than overly focusing on meeting their shorter-term performance metrics. Another participant noted that there are several beneficial features of private equity investments specifically: funds can attract top notch talent (due in part to the lack of say-on-pay scrutiny), move very quickly (typically with a 3- to 5-year time horizon), a laser-focused investment thesis, with more frequent interaction between the board and management (all of which are more difficult to accomplish in the public context).

Another potential explanation raised by one participant is that private companies could create greater value on average than public companies. Eric and Jim explained that the lack of robust data on the private markets means we do not have clear evidence that this is the case—at least not yet. On the other hand, the fact that investors are willing to pay private equity fees indicates that they see the upsides as justifying the cost.

Jim also pointed out that there is a growing secondary market in private equity limited partner interests, which provides greater private market liquidity. As a result, IPOs are no longer the sole exit option or liquidity event for private equity investments.

At this stage, the main drivers of the shift towards private capital have not been clearly identified by the research, but it is likely that many or all of these factors are influencing the change. The Millstein Center plans to continue its research into this area and develop deeper insights.



Public and Private Board Governance and the Board of the Future

The Millstein Center is also investigating another significant difference between public and private companies: their differing governance structures, and whether private company governance features can be adapted to improve on the public company board model.

While public boards are heavily regulated, and by some estimations their directors might spend 50-60% of their time deep in the minutia of compliance issues, private equity boards can dedicate much more time focusing on the company's strategy and operations as they more often have resources to support them.

Jim and Eric identified several differences between the way public company and private equity portfolio company boards operate. Specifically, they noted that private equity boards often have the following features¹:

- **small boards** with rarely more than 6 directors;
- 1-2 **"executive partners" who focus on overseeing management's strategy** and resource allocation;
- **more frequent (and more informal) meetings**—sometimes as often as weekly;

¹ See Gilson, Ronald J. and Gordon, Jeffrey N., Board 3.0 -- An Introduction (February 10, 2019). The Business Lawyer, Vol. 74, Spring 2019; Columbia Law and Economics Working Paper No. 602; Stanford Law and Economics Olin Working Paper No. 531. Available at SSRN: <https://ssrn.com/abstract=3332735>.

- directors **deeply invested in maximizing the value of the investment** in the company, including as a result of individual directors having substantial personal financial gain or loss at stake; and
- directors have the **power to marshal the full analytic capability of the private equity firm** to assess strategic and operational questions.

Although not all of these features are readily adaptable to public company boards, Jim and Eric identified a few proposals from recent academic research through which the public company “board of the future” could blend the current model and the private equity model:

- Add board **directors who are specifically charged with monitoring the strategy and operational performance** of management.
- Provide those directors with **robust resources to help them monitor strategy, including outside consultants if needed.**
- Provide these directors with strong personal incentives to maximize the company’s value through **long-term stock-based compensation.**²

These private equity-inspired features are just a few possibilities that Jim, Eric and other academics are seeing as a “third way” between public and private ownership.

Group discussion: culture, leadership structure, and activism in the boardroom

Participants separated into breakout groups to discuss some of the most common issues directors are facing in the boardroom today: the role of the independent lead director, overseeing culture, and trends in activism. The groups came away with several helpful insights.

What are the features of an effective lead director?

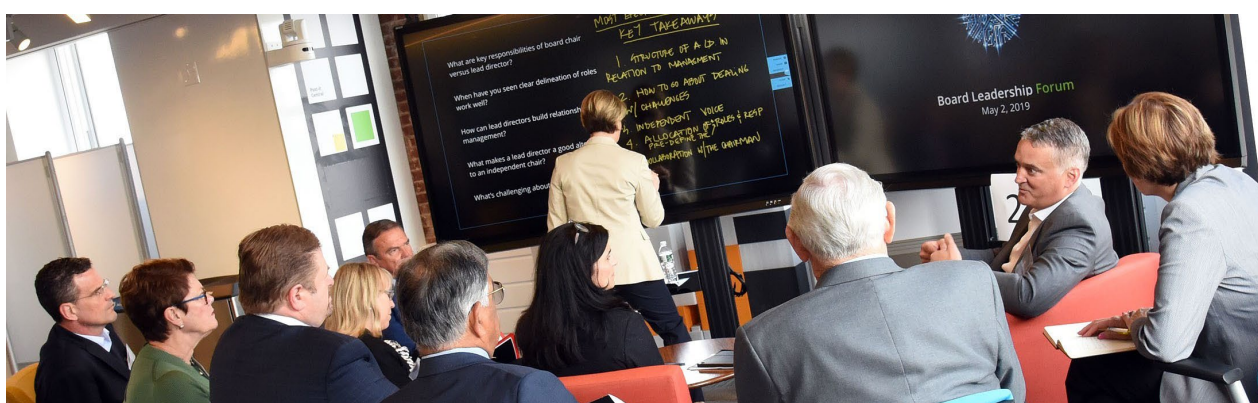
The role of the lead director can be complex, especially when it comes to clearly defining and separating the responsibilities of the lead director and the board chair to enable successful joint leadership of the board.

Although participants agreed that there is no “one-size-fits-all” approach, they identified several key features of successful lead directors:

- **Succession:** They play a key role in the CEO succession planning process and help to create board consensus. Participants agreed that succession planning is crucial to the success of any organization.
- **Relationship with management:** They have a close relationship with management maintained through informal discussions, but still maintain their independence.

² *Id.*

- **Setting the agenda:** They take an active role in working with management and the other board members to set meeting agendas, making sure that the right topics are covered in the right committees and that there is robust discussion of strategy.
- **Understanding of what makes the company unique:** They know the key drivers of the company's success and what sets it apart, and they bring that knowledge to the leadership of the board.
- **Drive effective board operations:** They take a lead role on important elements of board operation, such as orientation of new members, overseeing committee activities, and recruiting new talent.
- **Cool under pressure and high E.Q.:** They are able to respond well to stress and lead through times of pressure, and they have high emotional intelligence (which helps them navigate how and when to ask tough questions of management).



How can boards oversee culture?

There was broad consensus that overseeing culture is one of the most complex issues directors face. Participants identified some strategies and themes based on their experiences:

- **Compensation is an important driver of culture.** Make sure that the structure incentivizes the culture the company is trying to cultivate.
- Culture is **not a soft topic** — it can and should be measured and drive decision-making. Find ways to clearly define the company's culture, make it tangible, and ensure that management reports to the board on culture. What this means will vary from company to company.
- Reporting from management should not be the only way that the board assesses culture. There should be **engagement between the board and the broader organization**, including soliciting feedback directly from employees.
- **Culture at the board level sets the example for the company as a whole.** Boards should strive to foster a culture of openness where directors feel comfortable asking the tough questions and respectfully voicing their disagreements with management.

- Boards should pay **especially close attention to culture during times of transition**, like a merger or acquisition, where culture is especially vulnerable to change.



What are some of the latest trends in activism?

Participants learned insights about trends in activism by matching a group of figures to the relevant statistics.³



Some key takeaways and surprises were:

- The **overall level of activism, both in the U.S. and globally, remains high**, with both a high number of companies being targeted by activist demands and a high number of investors making public demands of companies.

³ Sources: Activist Insight and Schulte Roth & Zabel, "The Activist Investing Annual Review 2019"; Activist Insight, "Shareholder Activism in Q1 2019" (April 2019).

- However, although the number of investors engaging in activism is high, only 7% of these are funds or individuals whose primary focus is activism. Most of them (36%) only occasionally adopt activist stances.
- **Many board seats were gained** by activist nominees in 2018 and most were won via settlements rather than proxy votes.
- However, **statistics for Q1 2019 may signal the potential for slowdown:**
 - 189 U.S.-based companies faced public activist demands in Q1 2019, compared to what was a record high of 227 in Q1 2018.
 - 295 companies were publicly subjected to activist demands globally in Q1 2019, representing the quietest opening quarter on this metric since 2015. For example, there were 368 in Q1 2018, 309 in 2017, and 361 in 2016.
 - 53 board seats were gained by activists at U.S.-based companies in Q1 2019, compared to 88 in Q1 2018, 86 in Q1 2017, and 99 in Q1 2016.
 - 155 companies publicly faced impactful activist campaigns globally in Q1 2019, the lowest number since 2014. For example, there were 209 in 2018, 181 in 2017, and 222 in 2016.
- The **percent of U.S.-based basic materials companies facing public activist demands approximately doubled in Q1 2019** compared to previous years. It was 14% in Q1 2019 compared to just 7% in Q1 2018 and 8% in both Q1 2017 and 2016.

Nelson Peltz's Advice for Directors and How to "Think Like an Activist"

A fireside chat with Theresa Whitmarsh

Nelson Peltz joined Forum participants for a fireside chat with Theresa Whitmarsh on how to "think like an activist." He offered advice for directors from his perspective as a fellow director and as a "highly engaged shareholder."

Theresa opened the conversation by asking Nelson about Trian's approach of focusing on "great companies that have lost their way": what are the markers of a company that has gone down the wrong path? Nelson explained that frequently, companies underperform because their boards lack an ownership mentality. He added that board members sometimes view their positions as an honorarium rather than a responsibility to actively oversee the management of the company, and this can sometimes result in poor performance. Nelson contrasted this with the private equity governance model, where the boardroom is filled with owners

About Nelson Peltz



Nelson Peltz is Chief Executive Officer and a founding partner of Trian Fund Management, L.P., which invests in underperforming and undervalued public companies and works

constructively with the management and Boards of Directors of those companies to create shareholder value.

who are deeply invested in the success of the company. In addition, he noted that private equity boards and engaged shareholders can often leverage robust resources in their oversight of the company. For example, where an independent director is often required to read thousands of pages of a board book before a meeting, an engaged shareholder or private equity board member can share the reading and digesting of this material with their teams. Nelson also identified matrix organizations with multiple lines of reporting to different managers as potential targets due to the lack of accountability. There must be, he says, someone accountable for everything from sales to EBIT.

About Theresa Whitmarsh



Theresa Whitmarsh is Executive Director of the Washington State Investment Board, one of the United States' leading institutional investors, managing nearly \$116.5 billion of state pension, insurance, and other assets. She is a member of the Millstein Center's Advisory Board, and the former Chair of the Council of Institutional Investors.



So how can directors “think like an activist” and help their companies stay on the right path?

As the conversation continued, Nelson shared several pieces of advice for directors:

- **Be highly engaged and willing to ask the tough questions of management.** This means getting deep into the details. Particularly important examples include:
 - Are overhead costs too high? If so, who is responsible?
 - Is the firm maximizing its capital allocation? And, is it hitting its financial targets?
 - How is management being compensated? Is compensation tied to the company's strategic plan's financial targets? Are management's interests appropriately aligned with the creation of long term shareholder value?

- Try to **settle issues with management outside the boardroom**. Many issues can be resolved through informal engagement.
- **Take advantage of the executive session**. It is crucial to closely evaluate management and use the opportunity to candidly discuss their performance.
- **Be deeply involved in the strategy of the company**. Develop an opinion and get to know the industry. Don't allow management to ask for a simple yay or nay vote on their proposals.
- **Encourage and incentivize management and the company to be best in class**. One specific way to do this is to ask for monthly performance metrics. These don't need to be formal and can come in either the form of a phone call with a Q&A or written numbers with an explanatory cover letter from management. This will become especially important if there is a shift to a 6-month rather than quarterly financial reporting regime.
- **Ask for and review quarterly, annual, and three-year comps** to understand how the company stacks up to competition.
- Closely **examine management compensation** and ensure that it is aligned with shareholders' interest. Nelson recommends tying it to, among other metrics, total shareholder return over a 2- to 3-year timeframe.
- **Acknowledge the power of your "nay" vote**, even as a single director. Boards often strive for unanimity, so one vote can have an influence. Each director has the right to say no or ask for more information, even when everyone else is saying "yes."
- **Keep in mind that culture is the hardest thing to change in an organization**. The most effective (and perhaps only) way to guide culture, according to Nelson, is through structural changes.

Key Takeaways

- Capital formation in the U.S. is undergoing a significant transition. More companies are electing to become or remain private and fewer companies are undergoing IPOs or remaining public. At the same time, the size of public companies has been growing, and public companies still represent a very large market capitalization.
- There are several elements of this transition which merit further research, including whether elements of private company governance can be adapted for public company boards. One potential idea is to expand the use of board level strategy committees which task specific board members with overseeing strategy and provide them with robust resources to help them do so.
- Key features of a successful lead director identified by participants include:
 - playing a key role in the CEO succession planning process;
 - maintaining a close relationship with management through informal discussions while remaining independent;
 - understanding what makes a company unique and knowing the key drivers of the company's success;

- taking a lead role on important elements of board operations, such as orientation of new members, overseeing committee activities, and recruiting new talent;
 - responding well to stress, leading effectively through times of pressure, and possessing high emotional intelligence; and
 - taking an active role in working with management and the other board members to set meeting agendas, including to ensure that strategy is included.
- Boards can effectively oversee culture by:
 - ensuring that compensation structure incentivizes the desired culture;
 - clearly defining culture and making it tangible, and ensuring it is reported to the board;
 - engaging with the broader organization, including soliciting employee feedback directly;
 - setting the example through culture at the board level; and
 - paying especially close attention to culture during times of transition.
 - Nelson shared some specific pieces of advice for fellow board members on how to help their companies stay on the right path, based on his experience:
 - Be highly engaged and ask the tough questions of management.
 - Try to settle issues with management outside the boardroom.
 - Take advantage of the executive session.
 - Be deeply involved in the strategy of the company.
 - Encourage and incentivize management and the company to be best in class, including by asking for monthly performance metrics.
 - Ask for and review quarterly, annual, and three-year comps to understand how the company stacks up to the competition.
 - Closely examine management compensation and ensure that it is aligned with shareholders' interest.
 - Acknowledge the power of your "nay" vote.
 - Keep in mind that culture is the hardest thing to change in an organization. Do so through structural changes.

Next Meeting

Please join us for the next meeting of the Board Leadership Forum on Friday, November 8 from 8:00 a.m. to 12 p.m. at Deloitte's US headquarters, 30 Rockefeller Plaza, New York.

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