

CEO Tenure and the Effect of Private Equity

Will publicly quoted companies begin to resemble those in Private Equity ownership?

Summary

- *Contrary to popular opinion CEO tenure is increasing. And forces are at play which will continue this trend.*
- *Although a record 22 FTSE 100 CEOs will have left their roles in 06/07, it is possible that this is a high water mark of CEO 'churn'. The causes of short tenure are much discussed. Terminations of CEOs are so context specific that the underlying commonalities in these situations can be underappreciated. Undoubtedly the board's perception as to whether or not shareholder interests are being best served is the most common reported cause.*
- *Current data shows that FTSE 100 CEO tenure is stabilizing at around 4.9 years in the 2 years to June 2007. The low point was in 2003/04 when it was 3.5 years. However, if the trend towards more leveraged situations continues, we believe that even in quoted companies, a consequence will be that CEO tenure will further increase. We also believe that the role of the Chairman will tend to concentrate around the management of the relationship between the CEO and the key shareholder(s). Central to these changes will be an increasing trend by institutional shareholders to behave like private equity investors, holding larger stakes and operating more like owners than they have to date.*
- *In this article, we argue that the pressures under which CEOs in large quoted companies may change and, in some respects, lessen. In the recent past, the emergence of the private equity industry-driven public-private transaction has been a defining feature of the corporate landscape. Over the next period, it is possible that the defining feature of the publicly quoted landscape is likely to be increased shareholder involvement and that this involvement will bring with it many of the characteristics of private equity ownership. A chief characteristic will be much greater clarity between investors and managers on strategy and shared involvement in its creation. One of the outcomes of this is likely to be that, in the medium to long term, CEO tenure will increase.*
- *Our experience advising senior executives is that one of the major reasons for heightened CEO turn-over is a divergence of alignment with other senior Board members, notably the Chairman, and the major shareholders. Where the shareholders' will is not clear, as it frequently appears to be in the diversified shareholder model, divisions open which lead to senior departures.*
- *A further convergence of the public and private model may be in the more widespread adoption of private equity-style incentives woven into traditional corporate financial remuneration structures 'à la Cable and Wireless'.*

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It goes without saying that 'going private' alters the roles of members of the Executive Board. What has not been looked at is how changes in the shareholder register will increasingly affect those companies still in public ownership. We also should probably be considering the two corporate states, listed and private, as points on a financial ownership spectrum rather than as polar opposites or binary states.

The background – and the emergence of the 'Celebrity CEO'

Given the historic dynamism of capitalism, there is nothing to suggest that 'Private Equity' is the end of the development of listed shareholder capitalism as we know it. We are undoubtedly going through an unusual stage in the evolution of the Investor/Manager relationship. Being on the cusp of such a change is exciting and it is important for present and future CEOs to be aware of where the changes are originating and how to best manage this particular dynamic.

Family capitalism gave way to the institutional variety in an evolutionary response to taxes, mortality and the loss of interest or splintered stakes of subsequent generations. This set the scene for the high performance corporate manager responsible for operations and strategy on behalf of owners who were increasingly absent and aloof, representing an even more passive group, pension policy holders. This passivity of shareholders contributed to the development and emergence of the 'Celebrity CEO' of the 90's.

Examples of such are Stuart Rose and Archie Norman. Other less glorious examples would be Messrs Lay, Kozlowski, Ebbers, and Black. With the company's owners effectively one step removed from the business, and increasingly worried about the quarterly performance of their highly diversified portfolios, a control vacuum came into being. Andrew Carnegie said: *"Put all your eggs in one basket and watch them like a hawk"*. Institutional investors often represented the antithesis of the Carnegie approach.

Our hypothesis is that CEOs of large quoted companies are going to be increasingly watched over and, in fact, be 'partnered' by their institutional investors. This relationship need not be adversarial. Quite the reverse, it could be that fund managers, shareholder representatives and corporate management increasingly share their understanding of corporate strategy and market conditions. Successful CEOs and their Chairmen already work intensely hard on these relationships. Our suggestion is that this intensity will increase.

In the traditional (passively) institutionally owned model, it would appear that so great can be the power vacuum or absence of a focus of strategic intention at the heart of corporate control, even in the presence of the Celebrity CEO, that boards had no great clarity as to which of the potentially conflicting interest groups/goals they should pay most attention. For example, short term profit maximization and the building of long term market share often conflict. On top of this, CEOs have been expected to be governance, diversity, environmentally and politically aware. Although Boards have expanded to deal with the greater complexity of the stakeholder base and context in which the corporation is acting, the distraction has been considerable.

Enter the Private Equity model - three possible outcomes

Stepping in, as though as a counterweight, in recent years have been the Private Equity funds in “going-private” transactions or MBOs. This could be seen as no more than the repurchase of control of the corporation by new owners. Since the repurchase of the shareholders’ economic interest has generally involved the assumption of large amounts of debt, the reduction of this level of debt has usually become the number one corporate objective for CEOs and their Chairmen. As far as decision making is involved in these situations, there is little dispute as to who is really in charge. A clear link between ownership and management decisions becomes re-established - if you are owned by KKR or Blackstone, there is absolutely no doubt.

These public-to-private transactions usually involve

- (a) leadership change;
- (b) general cost reduction/downsizing, and;
- (c) a follow-on transaction.

However, it is at this point that we have to reflect on the future and consider whether or not this level of executive instability is likely to continue over the long term. And if Private Equity is not the end of corporate history, what lies next?

To answer this question, it could help to imagine oneself, 5 years hence reflecting on the changes in the intervening years in the UK corporate landscape. The period 2002 - 2007 has already seen MBOs at Boots, Debenhams, and perhaps Sainsbury’s, just in the retail sector. The credit markets are contracting at the time of writing. This latter event may even increase the rate of change. 5 years on from now, any of 3 scenarios may unfold:

1. The highly leveraged/private model proves outstandingly successful and is widely adopted by many major quoted companies. Listed stock exchanges could go out of business.
2. Alternatively, the consequence of large scale debt funding handicaps the private equity owned sector. Many such firms have to be recapitalised and may even face bankruptcy. Or,
3. As pension funds continue to move more into bonds, there is a commensurate shrinking of equity bases and a concentration of the share register as investors are forced to dilute or concentrate their shareholdings. With larger stakes, even a traditional institutional fund manager is likely to get much closer to management. They are likely to consider risk together with management to a greater degree, and to limit what might have been once the more ‘intuitive’ acquisition activities of the CEO, particularly a Celebrity CEO. The boards of Vodafone or Marconi may not have been allowed to make as many acquisitions or fundamental changes in strategy if they had had fewer investors with more at risk who held more sway with the board.

Combining the “traditional” model with the dynamism of Private Equity

It is clear that the first two scenarios are winner-take-all outcomes in which either traditional listed equity structures triumph over private equity or vice versa. The third scenario is the most likely as it enables society to combine the benefits of more conservative financial structures with the dynamism of private

equity. Richard Laphorne at Cable and Wireless may come to be seen as an early-adopter of this "third-way" with private equity-style incentives woven into traditional corporate financial structures.

Whichever of these scenarios or variety of them emerge over the next period, it would be safe to say that, compared with recent history, the defining feature of the changing corporate landscape will be increasing shareholder involvement. This will lead to a narrowing of focus rather than the broadening that has characterized recent years. CEOs and their close colleagues will increasingly be able to concentrate on issues which are the key determinants of long or short term value as agreed with the major shareholder(s). To the benefit of all, this narrower focus will make it easier to meet the goals and aspirations of everyone concerned.

The Role of the Chairman

The impact of this scenario on the role of the quoted company Chairman is that, instead of providing the CEO with air cover against a myriad of stakeholder interests, the Chairman will act more as the key link between management and the dominant shareholder(s). Before we reach that stage, however, there is probably still a transition phase. Companies, their CEOs and Chairmen face a remarkable opportunity today. They can influence the type of firm they wish to be in the future to a much greater degree than has been possible for previous post-war generations of management. For example, companies which wish to have only longer term shareholders (who will support patient long term strategies) could start now by aggressively pursuing a strategy of buying back their shares.

Conclusion

As Advisors to Executive Directors of publicly quoted companies on career matters, we frequently hear that they are highly attracted to the private equity model and are 'done with' the quoted sector. Financial reasons are not paramount in their motivation in this. Their primary dilemma is the difficulty in focusing on their major task of delivering performance when spending so much time on stakeholder management is crucial to continued tenure and success.

Our belief is that the pressures discussed will drive convergence between the publicly quoted and private equity owned contexts and that one of the chief beneficiaries, in addition hopefully to shareholders, will be the CEO in a reduction in the number of people to be kept on side with a given strategy.

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