

Preparing your private company for an exit: A board's role

Strengthening fundamentals enhances
your value



“Inflation, rising interest rates, and a looming recession are creating a new reality for many leaders of private companies. This confluence of uncertainties really presents an opportunity for board members to ask the important questions and provide strategic oversight as their companies evaluate the ‘when’ and the ‘how’ of a future exit plan. The good news is that there’s money on the sidelines in various forms. By encouraging longer-term value creation strategies that focus on weathering the storm and preparing for the deal process, directors can help position their companies for a higher valuation.”



Nichole Jordan
National Managing Partner,
Geography, Grant Thornton

After a record-setting year in 2021, a multitude of factors led to tempered mergers and acquisitions (M&A) in 2022. Inflation has contributed to escalating operational costs that were already increasing due to supply chain challenges and human capital spending. Rising interest rates are making it more difficult to finance deals, affecting what investors will spend on an acquisition. The ongoing war between Russia and Ukraine, an anticipated recession and potential stagflation mean uncertainty is not going away anytime soon. So it is understandable that the investor community has taken a step back in this particularly turbulent environment and tough market. Portfolio values are significantly lower, and investors don’t want to realize those losses.

We recently discussed these issues with corporate directors who have deep experience in M&A to get their thoughts on how private companies that are contemplating an exit can prepare for a successful outcome by focusing on value creation.



Playing a longer game

Leading up to this year, the market saw record increases, and private equity (PE), special purpose acquisition companies (SPACs), and family offices grew tremendously. With low interest rates and low inflation, the rising tide lifted all boats.

“Broadly speaking, multiple expansion has been by far the biggest factor in generating returns for PE deals over the last decade,” said Sheila Hooda, an independent board director; audit, risk and nom gov committees chair, and strategic advisor who currently serves on the boards of Enact Holdings, SciON Tech Growth, and Mutual of Omaha. She previously served on two other public company boards. “Only about 5% came from performance differentiation like margin improvement, high-quality management, and innovation.

“But buyers and sellers are in new territory now, with new headwinds and risks. Performance differentiation will be a key driver of value creation,” Hooda added. “It’s time for a reset of expectations in terms of the valuation,” noted Albert McLelland, who sits on the board of Breeze Holdings Acquisition Corp. He has served as an independent director and audit chair for five public companies. “With IPOs [initial public offerings] and SPACs on the decline, now is an opportunity for companies to concentrate on bolstering their profitability and raising their profiles so that when the markets do rebound, they will be well positioned to capitalize on potential liquidity events. It’s a ‘long game’ approach.”



There are a few steps companies can take.

Know the industry. Board members who view the market through an industry lens can help their companies set realistic expectations. Markets change, sector attractiveness evolves, and in-depth industry knowledge helps identify the optimal exit time frames. Boards should be asking management how macroeconomic shifts are impacting the industry, and whether the industry is thriving despite the turbulence or if it is facing significant challenges over the long term and short term that are likely to affect valuation.

Directors should require management to drill down on the implications for their industry and consider supplementing their perspectives on this topic with those of external experts and resources.

Identify sources for capital. “Undoubtedly, the cost of debt is going to increase, and without the appropriate investments, financial relationships, and partners, it’s going to be very difficult for a lot of smaller, earlier-stage companies to remain competitive,” said McLelland.

“In this context, the bigger PE firms will weather this period with little or no negative impact. With plenty of capital, they have staying power. Smaller or less established firms will be more hard-hit. They may struggle to reach their funding targets. You could expect to see some consolidation in the PE landscape and perhaps some wind-downs,” noted Hooda.

In a rising interest rate environment, investments tend to take a different shape in terms of what targets are attractive. Boards can help their companies by advising them to look at growth with a well-thought-out funding strategy and helping them establish the relationships they will need for growth and competitiveness for a future exit.

Elevate the importance of a human capital strategy.

“Over the last five years, human capital has risen on the board agenda,” said Hooda. “There’s stronger acknowledgment that human capital is a strategic asset of the company and a competitive differentiator.” This plays into the exit strategy of a company as well.

“What’s the plan on how you’ll use the money to create value? Expanding your workforce, increasing sales, cutting costs, or whatever it may be, make sure there’s an understanding that the liquidity event is the beginning of the process, not the end. Deals don’t fail because people can’t come to an agreement on numbers. They fail because of the soft issues.”



Albert McLelland
Independent Director,
Breeze Holdings Acquisition Corp.



Despite some indications that companies may scale back hiring, competition for talent remains strong, making it critical for companies to retain key employees as they plan an exit. Directors can ensure a focus on talent retention by requiring information about culture and employee engagement from across the company, not just from the top down. They should have the ability to engage and participate in a formal board process across the human capital spectrum that ensures appropriate understanding of employee needs, turnover trends, diversity at every level, and the strengths and weaknesses of the total rewards program. Although the board isn't necessarily responsible for total rewards decisions below the executive level, there should be a process by which the board can satisfy its fiduciary obligations to minimize risk and optimize alignment between the executive compensation program and the broader-based total rewards program, including performance reviews, incentives, pay equity, and short- and long-term compensation.

When considering retention packages associated with a transaction or an IPO, boards will also want to prepare themselves to approve retention bonuses. These may seem expensive for the bottom line, but companies need key people to stay on to provide continuity and help ensure deal success. This is a period during which compensation must match the market to avoid losing critical talent. This cost may be covered entirely by the seller or buyer, or it may be shared, but it is an important deal cost to be factored into the exit plans.

Talent acquisition is equally critical, and the establishment of a strong diversity, equity, and inclusion (DE&I) program via the company's environmental, social, and governance strategy, as well as a strong culture is important during the exit-planning stage. In Grant Thornton's 2022 State of Work in America Report, 21% of respondents said that they turned down a job because the company's values did not align with their personal beliefs. People want to know if the company's culture is real or just "on paper."

Remember that all strategic choices have tax implications. More than in the past, boards need insight into management’s understanding of the increasingly complex tax landscape. Globally, within the United States and in each state and local jurisdiction, choices about customers, employees and the way services are offered can have dramatic tax implications that in turn affect the bottom line. Moving a warehouse from one state to another, selling to a new customer in a state where the company does not have a nexus, allowing employees to work remotely, and even altering what the company’s cookies look like are just a few examples of actions that affect the company’s tax situation and may limit exit options. Management must have a well-informed tax strategy that takes into account all these variables. Further, the tax strategy should consider the exit strategy desired by the shareholders. The exit strategy must be considered from the onset, or the company risks significant tax costs in switching to the appropriate exit structure.

Focus on value creation. In the M&A game, timing is always everything, but never more so than in these historically volatile times. Let’s look at two key components of value creation: the operational side and organic and inorganic growth.

From an operational perspective, “When you go public depends on a number of factors and a lot of things that are outside of your control,” said McLelland. “Unless there is a strong strategic reason to execute now, use this time to focus on value creation and getting the house in order.”

Taking the “noses in, fingers out” approach, boards can focus on value creation by asking tough questions about their company’s readiness to operate as a public company. This includes asking whether the company’s financial, risk, governance, compliance, and communications operations can handle the scrutiny of the public eye, and whether the company as a whole can adhere to all the public company rules and regulations.

Other questions to ask include the following:

- Why do we want to exit, and what will be done with the funds to continue to the next stage of value creation?
- Have we conducted robust scenario-planning to understand and prepare for this value creation?
- Are our accounting and financials audited for the required time periods, and are they in order?
- Do we have a strong risk and controls framework in place?
- Do we have a human capital plan, and how will we retain key talent?
- Is there a governance structure and process in place to operate as a public company?
- Does the leadership have the necessary levels of expertise and experience for when the company starts operating as a public company? How prepared are the CEO, CFO, and general counsel to operate in the public spotlight?
- How will investor relations and other external stakeholder relations be handled?

Looking at the organic and inorganic growth side of value creation, boards can direct the management team to take advantage of the downturn to strengthen valuation. For example, when considering organic value creation, factoring in the following may be helpful for management to deepen and expand the business and enhance value:

- Ecosystem strategy
- New products
- New partnerships
- New geographies
- New segments or target audience/s
- Paths for differentiation and creating value for clients



Sheila Hooda

Board member, Enact Holdings,
SciON Tech Growth, and
Mutual of Omaha

The three D's: Due diligence, documentation and disclosure

In addition to building performance improvement discipline and enhancing risk management, companies readying for an exit need to prepare for life as a public company. There are three “D’s” that boards should insist upon:

- **Due diligence.** Rigorous examination, beyond financials, of governance, the quality of management, the product, the market, human capital and the strategic plan.
- **Documentation.** Private companies generally haven’t needed to function in a way that requires heavy documentation. When documentation is available and robust, there is increased confidence in the public markets that the company is well managed.
- **Disclosure.** Meeting a public-company level of disclosure may be a challenge. Private companies are less focused on providing transparency to shareholders, external stakeholders, and regulators; when they become public, they have to be prepared to meet this requirement and the scrutiny that comes with it.

Then looking at the company’s potential M&A strategy, boards can ask management to consider the following:

- Bolt-ons
- Picking up key players or teams
- Consolidating smaller players



Focus on preparedness

In the current environment, performance differentiation becomes more critical and more challenging to achieve. Therefore, performance improvement needs to become a required discipline. The board's focus will be on continually monitoring performance and requiring management to identify improvement opportunities to enhance valuation.

But at private companies, performance improvement is not always a core competency. Boards can encourage a performance improvement mind-set by ensuring that incentives across the organization are aligned to business value-creation goals, considering the following:

- What programs and structures are in place to embed continuous improvement?
- Who is accountable for performance improvement?
- How are we preparing to withstand a future downturn and remain competitive?
- Are we hiring with an eye toward candidates who exhibit a mentality of ongoing performance improvement and significant analytical skill?

Directors may also want to discuss the board's approach to performance improvement and strengthen their commitment to being a continual improvement mechanism for their stakeholders.

“The board is an ecosystem, not a returns system. There is definitely more involvement than there used to be”



Albert McLelland
Independent Director,
Breeze Holdings Acquisition Corp.

In addition, companies eyeing an exit need to manage risk. While it is necessary to implement the types of internal controls that were mandated by the Sarbanes-Oxley Act, there are always opportunities to assess and improve risk resiliency, including by evaluating enterprise risks with an eye toward risk management readiness. This may include careful consideration of redundancies and backups, business continuity planning and disaster recovery.

Further considerations include leveraging automation and embedding improved analytics and reporting to enable a better line of sight into what risks might be on the horizon. For example, a company might encounter risks it didn't foresee a few years ago, such as commodity unavailability due to supply chain constraints, the loss of key skills due to the Great Resignation or the emergence of new technologies and competitors.

And don't overlook integration issues with internal controls and technology. “I've seen transactions where nobody thought to look at the technology and figure out if systems could talk to each other,” said McLelland.



The changing role of the board

The expectations of a board member have changed significantly over the past few years. “The old rule of thumb that board members committed about 240 hours a year for quarterly meetings and other responsibilities is deeply outdated,” said Hooda. “It requires significantly more time to be a well-informed, well prepared and forward-thinking board member. It is not unusual to have more frequent meetings to deal with urgent issues come up. For example, if a social or political issue hits the news, we want to meet pretty quickly to be sure we have an aligned point of view and that we are following a robust process if we decide to take a position and don’t alienate employees or customers.”

The level of engagement today is higher and deeper than before, so the increased cadence and ready engagement are generally positive for boards. But for management, it requires a great deal more preparation and planning. This is where good analytics and reporting are helpful to companies so that data is more readily available. This level of sophistication may also enhance valuation because it shows the company has the infrastructure for timely and accurate financial and operation analyses.

Directors are also adjusting to changing committee charters, particularly that of the compensation committee. Their focus is, at some companies, much broader to reflect the importance of human capital, DE&I, culture, and longer-term planning.

When a company goes public, the roles and responsibilities of the board change significantly. The change comes when there is professional investment in the company and outside money is accepted. “The board is a fiduciary and a steward of their capital,” said Hooda. “The role of the stewardship and oversight on a public company board requires a completely different mind-set and a different skill set.”

In this time of turbulence and trepidation, companies eyeing an exit should focus on building internal efficiencies to get maximum valuations when the timing is right. Human capital has risen to a much higher level of importance. It is critical to invest in a comprehensive human capital strategy that identifies strategic needs and compensation, retention, incentive and succession strategies as well as DE&I plans. It’s always been imperative that the board understand the financial health of the company, including the risk control framework. The increasingly complex and dynamic nature of international, federal, state and local taxes means that the board also must be informed on the tax implications of business decisions. Finally, board membership has evolved to a higher level of involvement and time commitment. Be prepared to devote more time and become more engaged with helping your company succeed.

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