Closing the gaps in portfolio company board effectiveness

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Venture capital investors, private equity firms, and family offices may have different expectations of their portfolio companies, but these investors' ability to assess strategy and operations—and monitor the progress of their investments—is in large measure dependent upon the effectiveness of their portfolio company boards.

To better understand the challenges facing portfolio company boards today—what works, what doesn't, and opportunities for improvement—the KPMG Board Leadership Center surveyed more than 250 portfolio company directors who fall into three categories: portfolio company executives,[1] investment professionals, and outside directors.[2] We asked the directors to supplement their survey responses with write-in comments to expand on their views.

Taken together, the survey responses and write-in comments provide meaningful insights into the state of portfolio company board governance. Key takeaways include the following:

— **Agenda setting.** Given the complexity of the business and risk environment, it comes as no surprise that a critical challenge for portfolio company boards is to devote adequate agenda time to strategy, risk, and long-term value creation. *In fact, 72 percent of directors surveyed said that building forward-looking board agendas was one of the areas needing the most improvement—more than for any other category*. "Alignment of controlling shareholders, company management, and independent directors on strategic direction and value creation is critical, and a continuing challenge."

— **Composition.** A related challenge is portfolio company board composition—particularly linking board composition with company strategy, both for the short term and the long term. *Portfolio company executives give their boards significantly lower scores on "aligning board composition with the company's future needs" than investment professionals and outside directors.*

— **Communication.** In many aspects of portfolio company governance, those surveyed said the board-management relationship is generally good, but *nearly half of outside directors and company executives surveyed see a need for portfolio company shareholders to be more transparent in their communications with the board and management.* Conversely, in their write-in comments, investment professionals emphasized the need for management to be more transparent and provide important information on a more timely basis—and between board meetings. "Management teams don't like to deliver bad news and are afraid of the consequences."

— **Independent leadership.** Lastly, portfolio company directors surveyed have differing views regarding independent board leadership. *Nearly three-quarters of outside directors and a majority of company executives see the role of lead independent director/non-executive chair as "highly important," compared to only 40 percent of investment professionals.* "Passive representatives of shareholders are dangerous to the survival of a company. Most investors only have a couple of 'A Team' board members whom they carefully deploy."

While there is no secret formula for board effectiveness and improvement—particularly for boards of privately held companies with different ownership structures and in different stages of maturity—we believe that these survey findings can be used to help boards assess their own performance and identify opportunities for advancement.

[1] Portfolio company executives include executives and founders who sit on the board, as well as general counsel and senior legal advisors for portfolio companies.

[2] Outside directors include unaffiliated independent directors as well as operating advisors or management affiliates of an investment firm who serve as portfolio company directors.

Areas for greatest improvement

Company executives, investment professionals, and outside directors overwhelmingly said that building forward-looking board agendas focused on strategy was the top area for board improvement. The need for a greater focus on strategy and the board's impact on strategy was evident throughout the survey and written responses, with many directors saying that their boards need a better understanding of portfolio company strategy, operations, and risks, in order to be effective. Only 46 percent of portfolio company executives said their boards excel in "building agendas and managing board meetings," in contrast to 63 percent of both investment professionals and outside directors. (See Question 2a in the Appendix.)

"Look beyond the spreadsheets," warned one private equity portfolio company executive. A private equity investment professional added that board meetings should focus on "setting strategic priorities, not just updating directors."

"For venture-funded companies, the board risks becoming overly focused on near-term accomplishments rather than on strategy," said an independent director for a venture-backed portfolio company.

Survey respondents identified "understanding the company's risk appetite" as the second area most in need of improvement. "If risk is understood and managed within the context of the company and its industry, the downsides of risk are reduced and the board is more likely to have creative and robust discussions about strategic alternatives," said an independent private-equity portfolio company director. Directors should be "students of the company" and "understand the company's competitive position, its strategy, and the risks to the strategy," as one venture capital investment professional said.

With many portfolio company boards lacking formal structure and processes, it is not surprising that directors ranked the "the transparency of communications with the board and management by controlling and non-controlling shareholders," as the third area most in need of improvement. Several portfolio company executives said that they had additional challenges managing the demands and expectations of multiple shareholders, particularly the "agendas and incentives" of financial versus strategic investors. "It's very difficult to navigate, particularly within the board dynamic."

Figure 1: In which of the following areas do portfolio company boards need the most improvement?

Board agendas that are forward looking and focused on strategy with adequate time for discussion of these issues

Understanding of the company's risk appetite, including relative to the sectors/industries in which the company operates

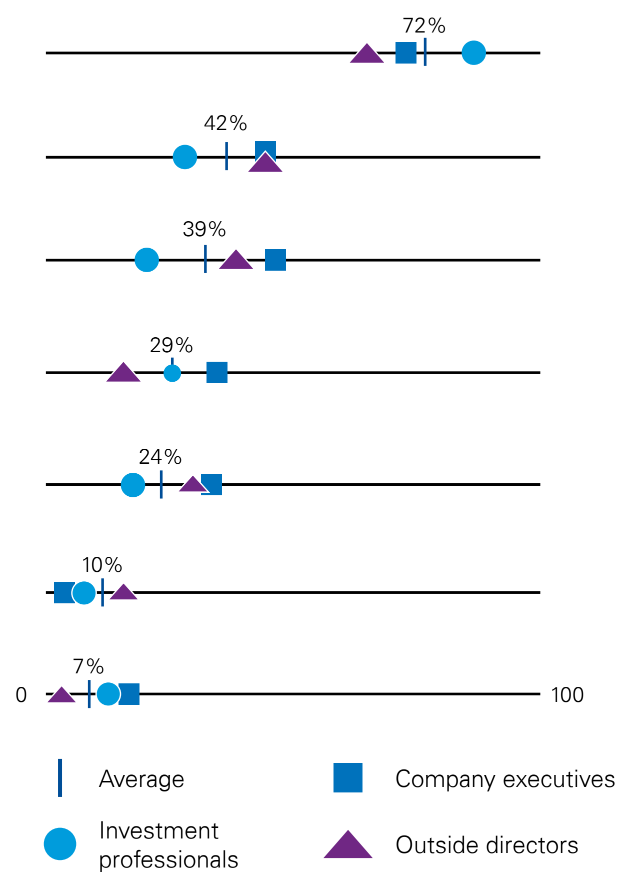
The transparency of communications with the board and management by controlling and non-controlling shareholders

Directors coming to board meetings prepared and having familiarized themselves with the pre-reads

Clarifying the duties and responsibilities of board members

Clarifying the duties and responsibilities of board committees

Board meeting minutes that are clear and concise



Multiple responses allowed. Percentages shown are averages including all respondent types. *For full results, see Question 1 in the Appendix.*

Board composition

While three-quarters of investment professionals and outside directors said that the board was meeting or exceeding expectations in "aligning board composition with the company's future needs," 42 percent of company executives said that the board was falling short. (See Question 2b in the Appendix.)

In their write-in comments, directors emphasized that, given the demands of the business and risk environment, boards should be increasingly focused on aligning board composition with the company's strategy, both today and longer term. Addressing competitive threats and business model disruption, technological and digital innovation, cyber risk, and global volatility requires a proactive approach to board-building and board diversity—of skills, experience, and viewpoints. And one private equity operating advisor cautioned that the composition of portfolio company boards needs to change over the course of an investment: "Often, sector expertise weighs in heavy at the beginning, but over time that perspective can lack strategic insight and can be very difficult to change."

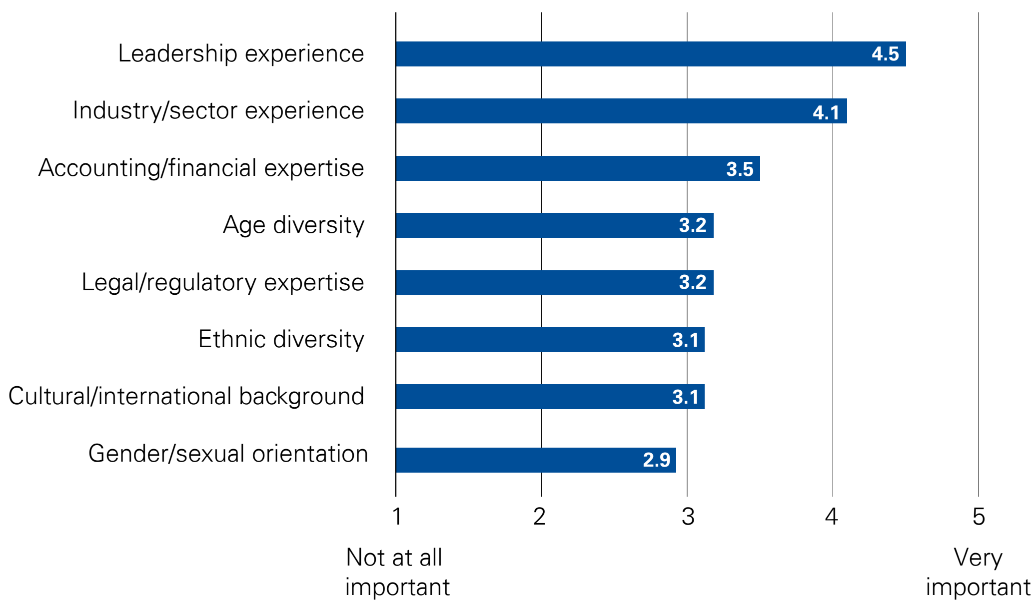
Portfolio company board composition is often dependent upon the expectations of the controlling shareholder(s)—and not necessarily guided by leading practices for public companies regarding board composition, independence, and leadership. "Independent directors can help bring expertise to the board and manage the agenda," said a private equity investment professional. Others stressed that independent directors are critical in "ensuring that management is heard," while also proving vital by "serving as a sounding board" for the CEO and "preparing the CEO for meetings." Another director emphasized that, given the rapidly expanding private company market, overboarding is a growing challenge for directors—particularly investment professionals. "Overboarding is problem #1, #2, and #3."

Figure 2: How would you rate the effectiveness of your board(s) in aligning board composition with the company's future needs?

1 – Needs improvement	11%
2	19%
3 – Meeting expectations	38%
4	26%
5 – Excelling	6%

For full results, see Question 2b in the Appendix.

Figure 3: How important are the following attributes to building an effective board?



Leadership and industry experience are viewed as the most important director attributes and essential to building an effective board. In addition, "the board needs to include directors who can provide functional expertise to management in the context of company strategy. We had too many shareholders with expertise in one area and needed more expertise in other areas." Moreover, directors who are experienced executives and industry leaders can work with the CEO to "improve his or her effectiveness as an executive and drive corporate performance."

Many of the current board composition pressure points for public company directors—age, gender, and ethnic diversity—were viewed by survey respondents as less important. Yet, as noted in write-ins, institutional investor emphasis on these issues appears to have caused some investment firms and family offices to focus more intently on diversifying portfolio company boards, particularly for gender.

Often, governance professionals recommend that boards consider a clean-sheet approach to board composition. Begin with a skills matrix without reference to who is currently on the board, outlining the skills, experience, geographical backgrounds, decision-making styles, mix of tenures, and demographic backgrounds that would best support the company's strategy. If the current board does not match this ideal matrix, develop a plan to move toward it. This exercise is especially critical during periods of change, such as after a crisis, in conjunction with a significant M&A transaction, or after a shift in strategy.

"Board effectiveness starts with having the right people in the room—nothing else really matters if board members don't understand the company's business."

– Portfolio company executive

Board-management relationship

Views on the board-management relationship were generally good, with directors rating various aspects of the relationship from 3.3 to 3.7 on average (on a scale of 1 to 5). The ratings assigned by the three categories of directors—investment professionals, outside directors, and portfolio company executives—were usually aligned. However, portfolio company executives scored the overall board-management relationship somewhat lower than other directors, and investment professionals and independent directors scored "management's communication of critical issues to the board in a timely manner" somewhat lower than directors who were executives of the portfolio company. (See Question 5 in the Appendix.)

Transparency and communication clearly merit more attention, as evidenced both by the survey findings and by the write-in comments. As we noted at the outset, nearly half of outside directors and company executives surveyed see a need for portfolio company shareholders to be more transparent in their communications with the board and management. Conversely, in their written responses, investment professionals emphasized the need for management to be more transparent and provide important information on a more timely basis—and between board meetings. Also of note, survey respondents generally gave their boards lower relative ratings for having "clear guidelines for communication between directors and management between board meetings."

Figure 4: How would you rate the following with respect to portfolio company board interaction with management?

Responses range from 1 (Needs improvement) to 5 (Excelling).

Conflicts of interest are disclosed appropriately and handled effectively	3.7
Critical issues are communicated to the board by management in a timely manner	3.7
Board-management relationship is constructive, candid, and promotes rigorous decision-making	3.6
Board effectively oversees the company's ethical behavior and reviews (allegations of) violations	3.6
Management's materials are timely, concise, and tailored to the board's needs	3.4
Clear guidelines for communication between directors and management between board meetings	3.3
Adequate time spent at board meetings discussing strategy and long-term value creation	3.3

Results shown are average means for all in sample. For full results, see Question 5 in the Appendix.

In many ways, the board-management relationship for portfolio companies is impacted by the operating model of the controlling shareholder(s). Many large, professional investment firms have portfolio operations groups that consult to their companies on financial reporting, information technology and cybersecurity resourcing, and supply chain management, as well as human resources, legal, and corporate finance. In many instances, these investment firm employees communicate directly with portfolio company personnel in the C-suite and below. While these communications are helpful to portfolio company management, some board members may not be privy to those communications, leaving some directors in the dark.

Similarly, early stage venture capital–backed companies may not have as many investment firm resources available to them, and instead may depend on the networks and affiliations of key shareholders to enhance the discussion with management. "Timely board packs lead to better focus of strategy and use of resources. Start-ups and fast-moving tech struggle with this," said one investment professional.

Portfolio company executives see the communications challenge a bit differently and urge directors to "talk to more executives and managers, not just the CEO, in order to get different perspectives."

"This would help ensure that management provides information to directors between board meetings and [would] help identify key topics—such as conflict/risk mitigation and plans for future growth—for deeper dives during board meetings," said a venture capital portfolio company senior legal advisor.

"Management needs to be transparent and provide important information on a timely basis. The problem is twofold: 1) The company may not have effective key performance indicators that are predictive of problems and reporting is delayed; 2) Management teams don't like to deliver bad news and are afraid of the consequences. Delayed reporting of a problem limits the board's ability to proactively respond."

Board leadership

While survey respondents rated "leadership experience" as the most important director attribute in building an effective board, they had different views regarding the importance of independent board leadership, which is viewed by many governance experts as critical to board effectiveness for both public and private companies. Nearly three-quarters of outside directors surveyed viewed independent leadership as "highly important," compared to 52 percent of company executives and just 40 percent of investment professionals.

Yet, in many write-in responses, company executives and investment professionals voiced concern about the lack of independent board leadership. "Independent board leadership helps the board focus on what's important, brings discipline to governance process, and can act as a counter-voice to controlling shareholders." "A strong, independent board leader sets the standard for directors, and professionalizes the board."

"Private boards are too casual—not really getting the value they could or should from their board members," said an independent director for a family office portfolio company. "While a loose structure may suffice in the early stage of an investment, as the investment matures and strategic discussions become more complex and nuanced, strong board leadership and an effective board are critical."

Eighty percent of survey respondents indicated that their boards were "organized and effective," but more than half of those respondents said that board leadership was "biased toward the views of the controlling shareholder(s)."(See Question 7 in the Appendix.)

"The chair or some other director needs to the take a lead role in describing, defining, and implementing effective board discipline so that members know their responsibilities and live up to them," said one executive. "Committee appointments should be well thought out," said one venture capital investment professional. According to another venture capital investment professional, "A strong board leader is essential. Passive representatives of shareholders are dangerous to the survival of a company."

Figure 5: How important is the role of lead independent director/non-executive chair for a portfolio company board?

	Company executives	Investment professionals	Outside directors
Highly important	52%	40%	74%
Somewhat important	37%	44%	17%
Not important	3%	10%	6%
Unsure	7%	6%	2%

For full results, see Question 6 in the Appendix.

Final thoughts

Portfolio company boards have different needs and expectations depending on size, stage, and ownership interest, but they all rely on three types of directors (company executives, investment professionals, and outside directors) to work in sync and drive value. Indeed, for many companies, investment professionals and outside directors utilize their board seats to help advance the strategy and monitor execution.

Yet, it's clear from the gaps in portfolio company board effectiveness identified by the survey respondents—particularly board processes, leadership and structure, and communication—that portfolio company boards have significant opportunities to raise their game and deliver even greater value.

Appendix

Closing the gaps in portfolio company board effectiveness is based on 255 responses to the KPMG Board Leadership Center's U.S. portfolio company board effectiveness survey, fielded from March to August 2019.

1. In which of the following areas do portfolio company boards need the most improvement?

	Average	Company executives	Investment professionals	Outside directors
Board agendas that are forward looking and focused on strategy with adequate time for discussion of these issues	72%	70%	83%	63%
Understanding of the company's risk appetite, including relative to the sectors/industries in which the company operates	42%	46%	35%	46%
The transparency of communications with the board and management by controlling and non-controlling shareholders	39%	48%	27%	43%
Directors coming to board meetings prepared and having familiarized themselves with the pre-reads	29%	37%	29%	23%
Clarifying the duties and responsibilities of board members	24%	30%	13%	29%
Clarifying the duties and responsibilities of board committees	10%	7%	8%	15%
Board meeting minutes that are clear and concise	7%	9%	8%	5%

Up to three responses allowed.

2. Please rate the effectiveness of your board(s) in the following areas:

a. Building agendas and managing board meetings	Average	Company executives	Investment professionals	Outside directors
1 – Needs improvement	3%	7%	1%	1%
2	9%	13%	5%	10%
3 – Meeting expectations	30%	35%	30%	26%
4	44%	32%	58%	41%
5 – Excelling	14%	14%	5%	22%
Mean	3.6	3.3	3.6	3.7

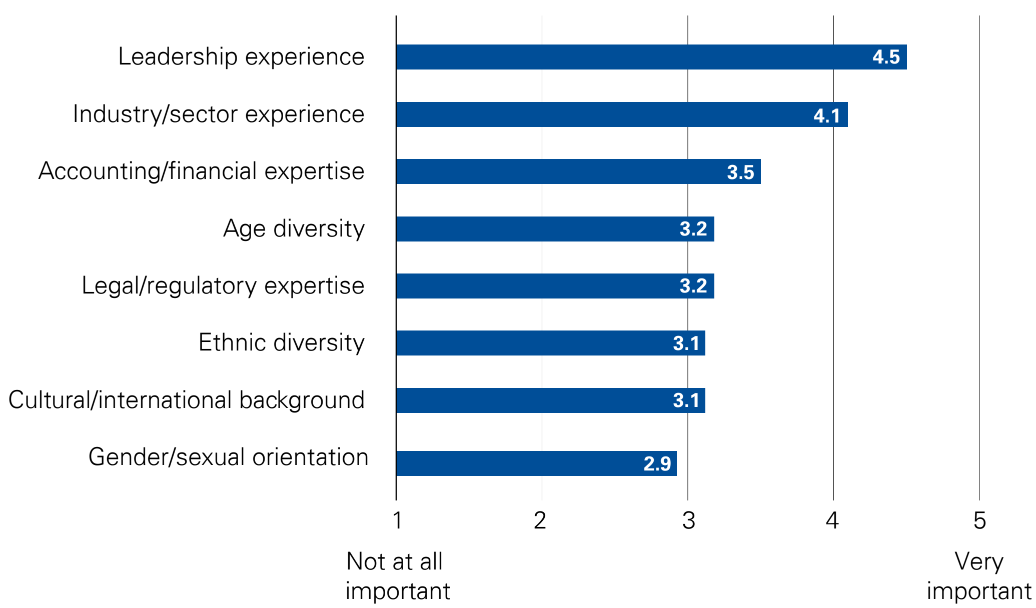
b. Aligning board composition with the company's future needs	Average	Company executives	Investment professionals	Outside directors
1 – Needs improvement	11%	19%	7%	7%
2	19%	23%	18%	16%
3 – Meeting expectations	38%	30%	47%	39%
4	26%	22%	25%	30%
5 – Excelling	6%	7%	4%	7%
Mean	3.0	2.7	3.0	3.1

c. The use of executive and third-party updates on emerging business trends	Average	Company executives	Investment professionals	Outside directors
1 – Needs improvement	11%	16%	10%	6%
2	29%	30%	29%	29%
3 – Meeting expectations	32%	33%	32%	32%
4	20%	16%	22%	23%
5 – Excelling	7%	6%	7%	10%
Mean	2.8	2.7	2.9	3.0

d. Onboarding process for new directors	Average	Company executives	Investment professionals	Outside directors
1 – Needs improvement	10%	13%	6%	12%
2	23%	24%	30%	16%
3 – Meeting expectations	45%	38%	49%	47%
4	17%	19%	11%	21%
5 – Excelling	5%	7%	4%	4%
Mean	2.8	2.8	2.8	2.9

e. Investing in and encouraging continuing director education	Average	Company executives	Investment professionals	Outside directors
1 – Needs improvement	19%	25%	18%	13%
2	37%	34%	40%	35%
3 – Meeting expectations	31%	28%	32%	34%
4	9%	9%	10%	9%
5 – Excelling	4%	3%	0%	9%
Mean	2.4	2.3	2.3	2.6

3. How important are the following attributes to building an effective board?



4. A diverse board is most helpful for enhancing a company's view on:

	Average	Company executives	Investment professionals	Outside directors
Long-term value creation and strategy	52%	59%	49%	48%
Customers and other stakeholders	42%	40%	38%	46%
A diverse and inclusive workforce	38%	33%	41%	39%
Innovation and disruption	33%	32%	34%	32%
Risk mitigation	18%	17%	20%	15%
Board diversity has no impact	4%	3%	3%	5%

Up to two responses allowed.

5. How would you rate the following with respect to portfolio company board interaction with management?

a. Conflicts of interests are disclosed appropriately and handled effectively	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	3%	5%	3%	2%
2	7%	6%	10%	5%
3 – Meeting expectations	26%	26%	29%	25%
4	37%	34%	40%	38%
5 – Exceeding expectations	26%	29%	18%	30%
Mean	3.7	3.7	3.6	3.9

b. Critical issues are communicated to the board by management in a timely manner	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	2%	1%	1%	5%
2	9%	9%	14%	5%
3 – Meeting expectations	25%	22%	25%	29%
4	43%	38%	51%	39%
5 – Exceeding expectations	20%	30%	9%	23%
Mean	3.7	3.9	3.5	3.7

c. Board-management relationship is constructive, candid, and promotes rigorous decision-making	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	3%	5%	1%	4%
2	9%	15%	5%	7%
3 – Meeting expectations	27%	33%	31%	18%
4	40%	28%	44%	49%
5 – Exceeding expectations	20%	19%	18%	23%
Mean	3.6	3.4	3.7	3.8

d. Board effectively oversees the company's ethical behaviors and reviews (allegations of) violations	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	4%	9%	1%	2%
2	9%	12%	9%	7%
3 – Meeting expectations	28%	22%	34%	27%
4	37%	33%	42%	36%
5 – Exceeding expectations	22%	24%	14%	27%
Mean	3.6	3.5	3.6	3.8

e. Management's materials are timely, concise, and tailored to the board's needs	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	4%	4%	4%	4%
2	13%	7%	18%	13%
3 – Meeting expectations	35%	36%	39%	31%
4	36%	36%	29%	44%
5 – Exceeding expectations	12%	16%	10%	8%
Mean	3.4	3.5	3.2	3.4

f. Clear guidelines for communication between directors and management between board meetings	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	3%	5%	4%	1%
2	15%	18%	9%	18%
3 – Meeting expectations	38%	37%	39%	37%
4	35%	31%	42%	33%
5 – Exceeding expectations	9%	9%	6%	11%
Mean	3.3	3.2	3.4	3.3

g. Adequate time spent at board meetings discussing strategy and long-term value creation	Average	Company executives	Investment professionals	Outside directors
1 – Not meeting expectations	7%	13%	3%	5%
2	14%	18%	16%	7%
3 – Meeting expectations	29%	30%	31%	26%
4	40%	31%	42%	48%
5 – Exceeding expectations	11%	9%	9%	14%
Mean	3.3	3.0	3.4	3.6

6. How important is the role of lead independent director/non-executive chair for a portfolio company board?

	Average	Company executives	Investment professionals	Outside directors
Highly important	56%	52%	40%	74%
Somewhat important	33%	37%	44%	17%
Not important	6%	3%	10%	6%
Unsure	5%	7%	6%	2%

7. Which statement would you say best describes the leadership of your board(s)?

	Average	Company executives	Investment professionals	Outside directors
Organized and effective, but biased toward views of the controlling shareholder(s)	46%	41%	52%	46%
Organized and effective, communicating consistently with all directors	34%	31%	27%	43%
Ad hoc, with chair/committee roles undefined	13%	15%	16%	7%
Ad hoc, often acting unilaterally	7%	13%	4%	4%

8. A focus on board effectiveness is most significantly impacted by:

	Average	Company executives	Investment professionals	Outside directors
The controlling investor(s)	75%	74%	83%	68%
The company CEO/founder	70%	70%	75%	66%
The expected holding period	7%	6%	4%	10%
Regulatory requirements	7%	7%	4%	9%
Debt covenants	4%	7%	4%	0%
Other	6%	3%	3%	11%

Up to two responses allowed.

Survey demographics

n = 255

Executive/ founder

81

General counsel/senior legal advisor

13

Investment professional

77

Operating advisor/ management affiliate

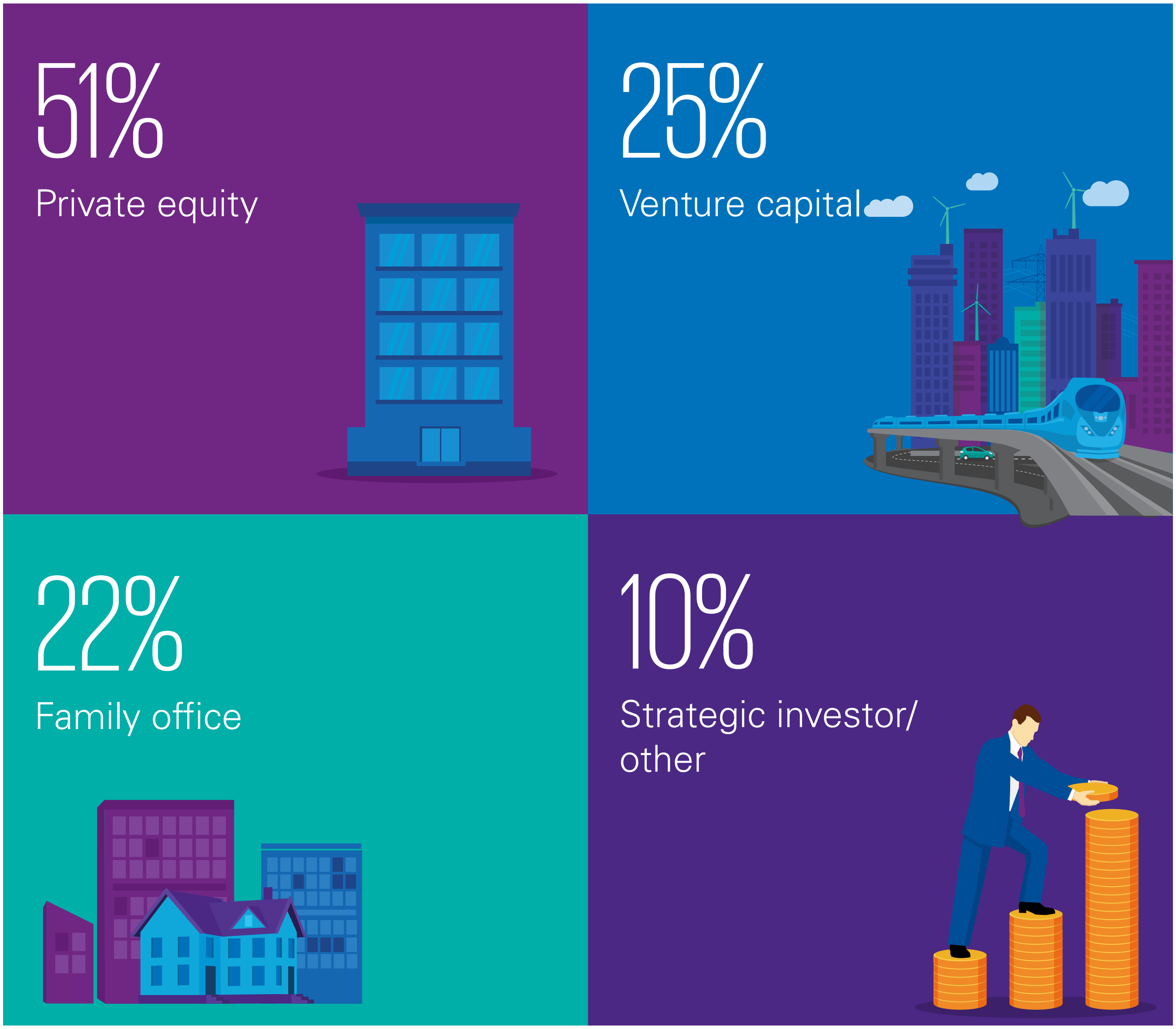
24

Independent/ unaffiliated director

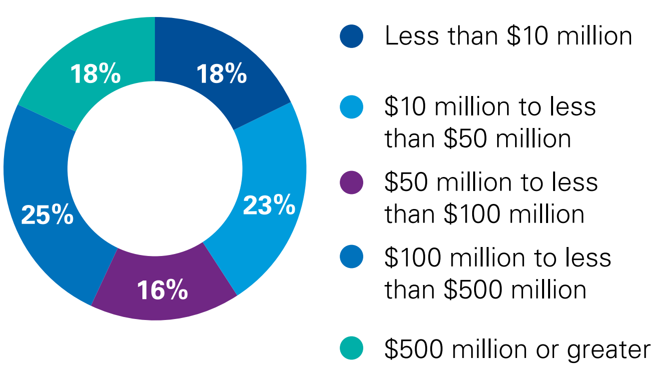
60

Primary owner of portfolio companies represented

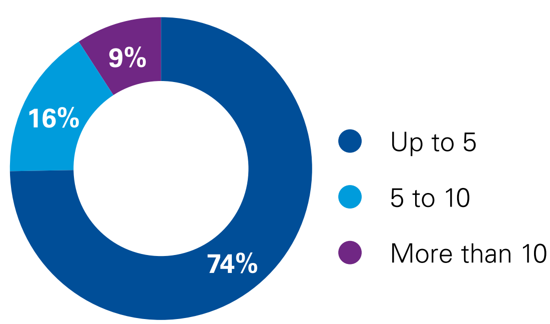
Multiple responses allowed.



Largest portfolio company by revenue as served by each director respondent



Number of portfolio company boards served by director respondents (current/prior)



Does not equal 100% due to rounding

KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at kpmg.com/us/blc.

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