Corporate Governance, the Great Opportunity for Private Equity

Kingsley Gate

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Introduction

By this point, almost everyone (if not all of us) is aware of the relevance that sustainability criteria (ESG) have in the long-term value creation of a company. However, we detect that there is still progress to be made in the implementation of these policies, especially after a challenging year like 2023, where the macroeconomic environment has hindered access to financing, and company valuations have taken time to adjust, extending into the second half of the year. Consequently, the value creation strategy in portfolio companies becomes more crucial to maximize returns to Limited Partners (LPs).

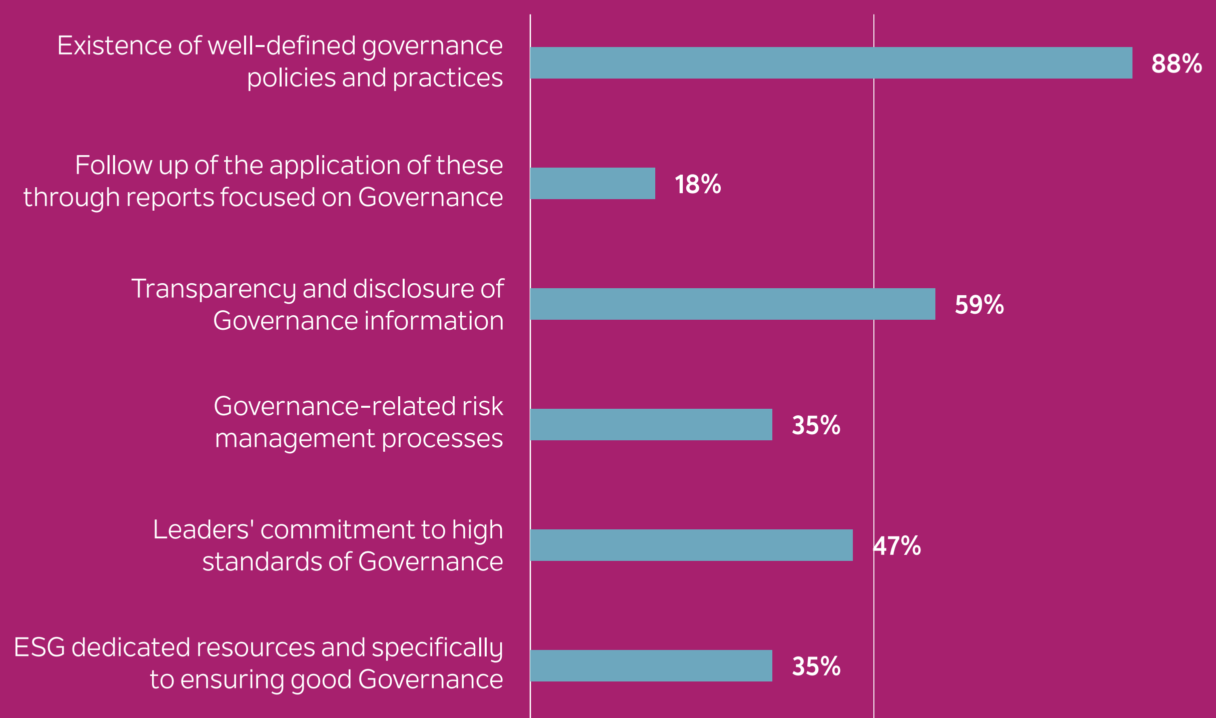
At Kingsley Gate, we have engaged in discussions over the past few months with Partners, Operating Partners, and ESG Directors from leading national and international PE Firms operating in Spain. The objective is to provide data that allows the design of a framework of reference with those best practices that are taking place in the Private Capital environment related to sustainability and ESG criteria, with a special focus on Governance. Additionally, we have also surveyed 20 firms with a proven commitment in relation to ESG in order to gather different perspectives from investors, the asset manager themselves, and their portfolio companies.

Having a Well-Defined Plan

Undoubtedly, over the past three years, there has been a progressive increase in pressure and intensity from institutional investors regarding sustainability issues. What was once a trend is now a reality that directly impacts the value creation of companies. While these criteria are often challenging to measure, the majority of firms (88%) have a formal plan that includes detailed processes and indicators to position themselves as ESG players in the market. They agree that "having a well-defined plan for ESG policies does not always add value, but not having one definitely penalizes you."

At the same time, there are no clear priorities when assessing the importance of each of the ESG criteria: managers say that LPs are looking for well-defined governance practices where there is transparency of information and a high commitment from leaders to develop quality governance policies. However, environmental and social impact prevail as priority practices for fund managers over corporate governance.

Actions implemented to ensure excellence in portfolio company governance (% of implementation in surveyed companies)



**There is a strong focus on policy definition and transparency, and less emphasis on implementation, resources and monitoring.*

Invest in specialised resources for sustainability

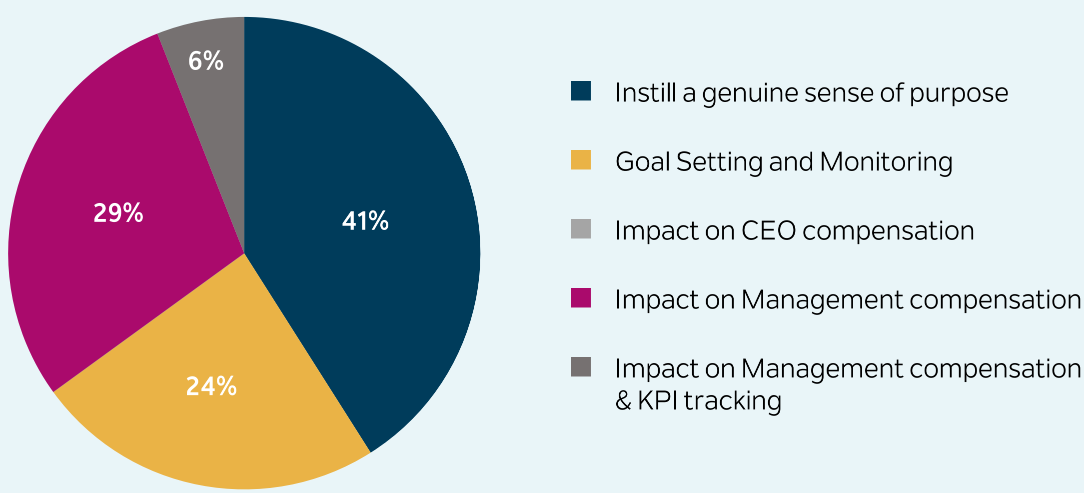
More than 75% of PE Firms claim to have teams dedicated to the control, measurement and development of ESG policies both in the management company itself and in invested companies. This gives us an interesting insight into the importance of assessing these criteria and extracting tangible data that allow us to make decisions that lead companies to be recognised as sustainable in the market. However, these resources are not always dedicated exclusively to tasks related to sustainability management (56.3%), but divide their time with the operation of investees or even with their own investment tasks, reporting in most cases (60%) directly to the Partners or MDs.

As the emphasis on sustainability grows, the prevalence of roles with sustainability as their primary mission expands according to positions where sustainability is merely an additional responsibility.

While having dedicated resources is important to advance the implementation of sustainability practices, we believe it is even more important to have "grounded processes" e.g. compensation policies that are linked to the achievement of ESG objectives at both management and investee company level. This is still a pending area of development to accelerate sustainability engagement, as although there is a growing trend compared to previous years, still more than half (64%) of portfolio companies do not have remuneration packages associated with the sustainability performance of their executive team, especially in the case of CEOs.

We are convinced that the moment a single leader is appointed to firmly lead the evolution towards sustainability, with clear, measurable and impactful remuneration objectives and a genuine sense of purpose, a "snowball effect" will take hold, which will carry the rest of the management team along with it.

Practices most used by management companies to align their executives with ESG policies (% implementation of companies surveyed)

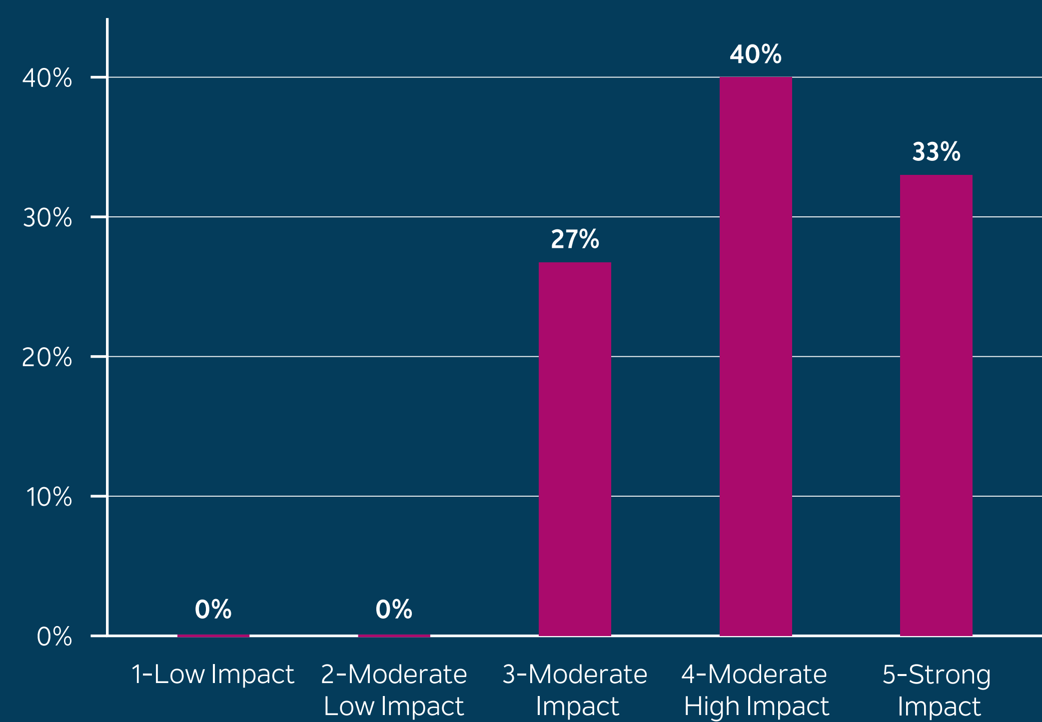


**Note the almost non-existent implementation of specific ESG-related remuneration practices for CEOs*

No G, no E, no S

Corporate governance is not simply a set of rules and regulations; it is a strategic framework that determines how a company makes decisions, regulates itself and relates to its stakeholders. In the Private Equity environment, while there is a tendency to "focus" on environmental and social issues, there is a growing awareness of the importance of governance, especially when looking at exit or divestment processes, so we have no doubt about the **growing commitment of managers and invested companies to developing robust governance** to increase investor confidence, strengthen market reputation, drive operational efficiency and contribute to long-term value creation.

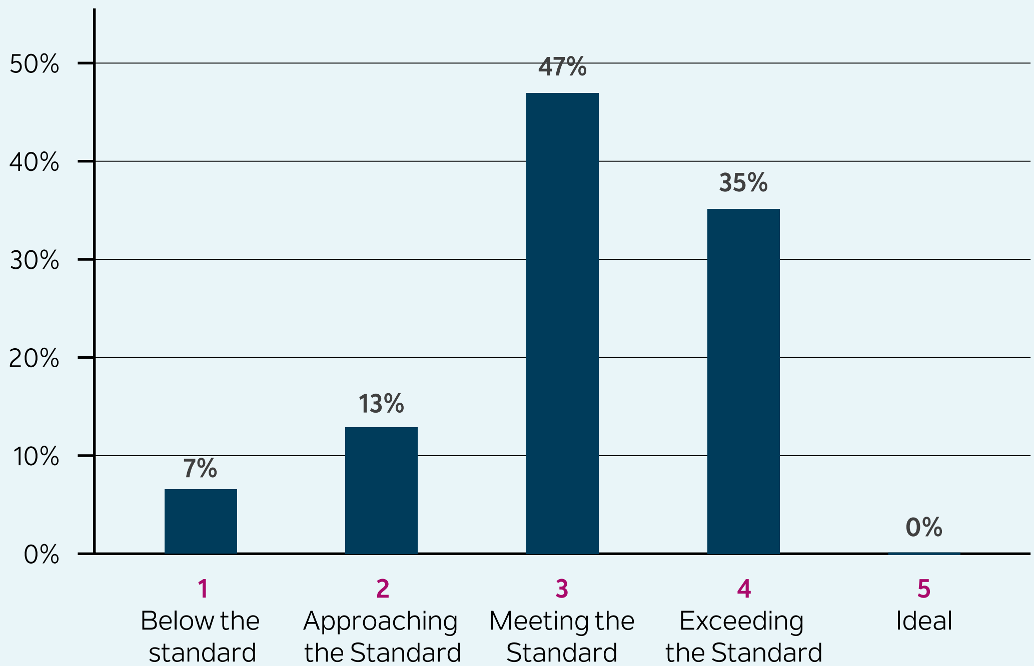
Perception of Governance's impact on value creation in portfolio companies (% of respondents' answers)



**73% of the managers surveyed believe that the impact of implementing good corporate governance in their portfolio companies is high.*

Throughout our conversations we found that the vast majority (82.4% of cases) consider that they have designed adequate governance policies, where the board is committed to such a wide range of issues as sustainability, diversity, the regulatory framework, transparency and ethics, risk management or the separation of roles between the executive team and the board to avoid conflict of interest. However, beyond the more formal aspects of governance, there are different levels of satisfaction regarding the actual impact boards have on defining and driving value creation strategies.

Degree of compliance with good governance practices at Board level in portfolio companies (% of respondents' answers, at different levels of compliance).



While the responses demonstrate a healthy ambition to meet or exceed "formal" standards, we note areas for improvement:

1. On the one hand, in terms of the actual monitoring of these good governance policies, as only one third of the indicators defined are audited and included in the Corporate Social Responsibility report, and on the other hand, in terms of the actual monitoring of the good governance policies, as only one third of the indicators defined are audited and included in the Corporate Social Responsibility report.
2. On the other hand, regarding the contribution of Independent Directors to the creation of value in portfolio companies. Undoubtedly, this is one of the most recurrent issues throughout the conversations we have had and which highlights the growing concern for having Directors who, in addition to increasing knowledge of the target industry, really promote the contribution of the rest of the Board through their independence, good judgement and commitment to the definition and implementation of strategies to create value for the business.

Of course, if the selection of directors is based on a fiduciary culture, based on trust in the individual, and in most cases is done through acquaintances and personal networking, and **only one out of seven directors** is recruited through a specialised advisory process, the result in terms of value contribution is significantly below the expectations of managers and investors.

It is very difficult to find Advisors who are truly committed and at the same time bring real value in decision making. In my 20-year career in PE I have seen very few who are truly different.

In general, the Independent Directors are not sufficiently aligned with our vision and expectations in terms of value creation. We feel that they do not have the real independence required for this type of role.

We are considering separating expert roles (industry-specific or specific functions) and forming an 'advisory board,' while maintaining a smaller Board of Directors composed of individuals who actively contribute to defining and implementing business strategies.

In a Nutshell

In Spain's complex private equity investment environment, corporate governance is proving to be a critical component of value generation and sustainable business success. For mid-sized funds, implementing effective governance practices is not only a regulatory obligation, but a smart strategy to ensure viability and prosperity in the volatile corporate landscape.

We believe that, although progress is being made and awareness of good corporate governance is growing, there is still a long way to go to design, but above all to implement, more robust sustainability plans that, stemming from the managers and together with the ambition and support of institutional investors, accompany the corporate strategy to create both economic value and long-term growth. Today the focus is on formal compliance with market-defined standards, i.e. what "must be done", but the value of implementing and applying good governance practices is not being maximised. When this happens, there will begin to be a genuine sense of purpose, and a real appreciation of the value of good governance.

Likewise, executive remuneration models associated with the achievement of ESG objectives should be clearly incorporated in order to attract talent that really constitutes a key differential in decision-making, both from the governing bodies and from the executives.

Finally, we are convinced that the contribution of independent directors will increase exponentially when selection practices based on two current paradigms are abandoned: knowledge of the specific industry and personal trust. A commitment to attracting and incorporating talent for its strategic agility, experience in transformation and capacity for sound decision-making, bringing together a complementary and cohesive team, will be the great instrument for generating value, which managers will not be able - nor will they want - to do without.

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