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Enterprise Risk Management for Private Equity

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Introduction: The Value of Enterprise Risk Management for Private Equity Firms

Imagine you are the CEO of a Private Equity firm and you are faced with the following scenario:

> *ACME Equity Partners is optimistic about the crown jewel in their portfolio, Global Interconnect, a global widget manufacturer with facilities in San Francisco, Hong Kong, and Singapore. The company has been extremely profitable and has been a significant contributor to ACME's investment performance. But then, unexpectedly, Riff Rocket, the President of Global Interconnect, telephones Tadd Smith, ACME's President, with some unwelcome news. News reports that facilities for Global Interconnect have unsafe working conditions are circulating in the Hong Kong press. To make matters worse, there are allegations that these unsafe conditions have been concealed through bribing of local inspectors in the widget factory.*

Maybe all of this is bad luck. But these types of scenarios could be detected or avoided through the implementation of an effective Enterprise Risk Management (ERM) Program.

ERM is a business process for effectively managing risk within your organization. It applies to any organization and is invaluable in identifying and avoiding unforeseen risks, which is particularly helpful given the increasing regulatory pressure for certain organizations to implement such programs. While ERM existed before the Great Recession, the world of Risk Management changed considerably after the financial collapse, because of the widespread view that risk controls failed at large financial institutions, threatening the global economy. This perception led to increased oversight by Congress, and extensive measures that were codified in Dodd-Frank. As discussed below, many financial institutions and certain operating companies have been subject to increased regulatory expectations in this area.

ERM Programs are important for Private Equity firms in two ways: (1) they develop a framework of internal controls to mitigate risks associated with the companies in which the PE firm invests, and (2) they develop internal controls for the PE firm itself. PE stakeholders include the management and employees of the Private Equity firm, the limited partners and/or investors in the fund, and the stakeholders in the underlying companies. Avoiding surprises like those in our Global Interconnect example is the objective and value of a robust ERM Program. While the Securities and Exchange Commission (SEC) and other regulators have placed increasing pressure on PE firms and investment advisers to develop more robust compliance programs, ERM Programs can provide a 360-degree approach to managing business risk at PE firms, which many firms consider a prudent business practice in the current market and regulatory environment.

ERM Programs for Operating Companies within the PE Portfolio

In a general sense, Private Equity firms make investments in operating companies, focus on maximizing their value for investors and/or limited partners, and, at some point, seek to exit those investments in a profitable manner. At the appropriate time, PE firms will seek buyers for operating companies within their portfolio, the characteristics of which vary. Buyers typically evaluate many factors in determining whether to purchase a company, including the type of business, management, profitability, and cultural and business fit. In this regard, risk management recently has received more attention, particularly with respect to litigation, regulatory, and reputation risk. To avoid surprises, potential buyers are demanding greater transparency of how a potential target company manages risk. Accordingly, portfolio companies failing to consider ERM potentially diminish the pool of available buyers, which, in turn, may jeopardize the likelihood of a successful exit for PE firms. In addition, limited partners invested in PE funds are increasingly demanding of controls at the portfolio company level and within the PE firm itself.[1]

ERM supports the general partner's interest in maximizing portfolio value for limited partners. A primitive or nonexistent ERM program often adversely affects a company's value. Therefore, many PE firms are expecting that their portfolio companies develop and implement significant ERM programs, covering all aspects of their business.

The general partner's interest in maximizing value coincides with the demands of regulators to identify, understand, communicate, and address risk. For example, "large banks" (with assets greater than $50 billion) are required to have extensive enterprise risk management programs that are reviewed annually.[2] Smaller financial institutions, such as banks below $50 billion, investment advisers, and mutual funds, are subject to increasing regulatory scrutiny when it comes to risk management. Other regulators in areas such as energy,[3] consumer, and environmental are further emphasizing risk management.

In a similar fashion, public companies have been trending toward programs designed to capture the basics of an effective ERM program: 1) risk identification; 2) risk evaluation; 3) contingency planning; and 4) crisis management. More recently, public companies have been utilizing risk management in their strategic planning and goal-setting processes.[4] Given this emphasis on risk management by public companies, PE firms seeking a public exit for their portfolio companies would be wise to review such company's ERM program or practices.

Preparing Operating Companies for the Next Step

Regardless of the type of exit, an effective ERM program should be relevant to the business, structured in a practical manner, and implemented efficiently. Effective ERM programs share certain common elements: (i) risk identification; (ii) risk rating, (iii) identification of risk mitigation and adjusted risk, and (iv) presentation of key risks to senior management and the board. In connection with these elements, "risk owners" typically are designated to identify risk, the risk team ranks each identified risk (e.g., high, medium, or low), risk level adjustments occur (taking into consideration countervailing controls), and critical risks and recommendations are presented to senior management and the board for appropriate action.

In addition, the following important characteristics should also be part of any ERM program:

The ERM Program Should Be Tailored to the Requirements of the Business: The ERM program should be tailored to manage risk related to essential business purposes of the company. For example, although there may be common elements or characteristics, an ERM program for a hotel chain would differ significantly from an ERM program for a small alternative energy company.

The ERM Program Should Be Strategic in Nature: According to the Association for Financial Professionals,[5] successful ERM programs have a "strategic lens." For PE firms, the "hold" for each investment informs the strategy for exit and, therefore, risk identification and management.

The ERM Program Should Have the Input and Support of Senior Management and the Board of Directors: An ERM program that is closely linked to the strategic vision of senior management and the board will improve the operations of the company and could have a positive impact on profitability and exit value.

Independence and Support of the Chief Risk Officer (CRO): The CRO will need the full support of management to carry out his or her responsibilities. A CRO's independence is crucial to an effective ERM program. CROs must be sufficiently empowered, among other things, to ensure cooperation from other stakeholders, and the collection of complete and reliable information.

The ERM Program Should Create a Culture of "Risk Ownership": A culture of "risk ownership" throughout the organization is critical to an effective ERM program. Each stakeholder (whether senior leadership, middle management or staff) needs to understand his or her role in identifying and managing risk and should be accountable for successfully fulfilling such role. Failure at any level jeopardizes a successful outcome. Operational heads should be identified as "risk owners" throughout the organization and have significant input into the risk identification and mitigation process.

ERM Programs for Private Equity Firms

It is equally important for PE Firms to apply ERM Programs to themselves. In fact, there are generally three levels of risk for PE firms: (i) firm-level risk, (ii) fund-level risk, and (iii) operating company or portfolio risk. Each of these levels may be impacted by litigation risk, regulatory risk, and reputation. Similar to operating companies, PE firms should appoint a person with responsibility for guiding the ERM program at the firm level. This individual requires a similar level of independence and support to ensure that the effort is appropriately managed and effective.

A. Firm Level Risk

At the PE firm level, regulatory risk and investment risk become paramount concerns. In terms of regulatory risk, recent examinations and enforcement actions have focused on conflicts of interest that are not disclosed to limited partners, especially in the area of fees in connection with limited partnership agreements.[6] Moreover, because many private equity firms recently registered as investment advisers, such firms face many of the same traditional compliance issues as more mature investment advisers (e.g., annual certifications of control processes, compliance manuals and related testing, and routine SEC examinations). In connection with SEC reviews, regulators will also be reviewing marketing materials to ensure that performance information is accurate and valuation methodology is consistent with the methodology disclosed to investors.

PE firms also manage investment risk, which is impacted by their due diligence of potential target companies. PE firms typically undertake significant operational due diligence on companies targeted for investment. This essentially means that operating company risk also represents firm-level risk. In terms of ERM, PE firms should develop a strong internal operational due diligence (ODD) team that can evaluate key business risks associated with each target company, including core business strategy and operations, cybersecurity, valuation, corporate governance, and related compliance challenges. Because investment decisions of the PE firm depend heavily on the quality of the work of the ODD teams, oversight of ODD practices, controls, and evaluation standards is an importation part of the ERM program.

B. Fund Level Risk

At the Fund level, clear and adequate disclosure to investors is paramount. Among other things, fees, potential conflicts of interest, valuation methodology, third party relationships, and monitoring arrangements must be fully and completely disclosed. On an on-going basis, material changes to such disclosure needs to be updated and disclosed to limited partners. In many cases, limited partners also may require substantial information on the firm's ODD reviews of the firm's portfolio companies, including a review of such operating companies' ERM programs, compliance and governance practices, cybersecurity issues, potential pressure on margins and profitability, and other material facts.

C. Operating Company Risk

A strong ERM program, such as that identified above at the portfolio company level, provides tangible benefits. First, assessing operational risk at the firm and fund levels becomes more manageable for the ODD team and all who are involved in making investment decisions. In our initial example, an ERM program by ACME would easily have determined whether Riff Rocket and the Global Interconnect team had to make safety improvements to their facilities and potentially avoided any related bribery concerns. In addition, an ERM Program would reduce the time, expense, and risk associated with ODD reviews and ongoing monitoring by the firm. The ODD team would have a better opportunity to evaluate more complete and critical information. Finally, an ERM program at the operating company level potentially increases exit value for the general partner and limited partners of the investments within the portfolio. In other words, the time and effort spend on an ERM program would not only greatly reduce the risk within the portfolio, but could greatly enhance investor returns.

Conclusion

In sum, an ERM program benefits the PE firm, the fund in which the limited partners invest, and its portfolio companies. Effective ERM programs help firms manage risk from a 360-degree perspective, including investment risk, regulatory risk, and reputation risk. From a diligence perspective, ERM programs facilitate a sharper focus on the value of the assets under consideration and reduce the time and expense inherent in a meaningful ODD review. Perhaps most importantly, an effective ERM program at the operating company level provides important strategic information that informs critical elements of the investment decision (e.g., the appropriate length of time to hold the asset and the likely exit). For PE firms, ERM programs can provide meaningful benefits to all stakeholders and are becoming more important throughout the investing life cycle, particularly in the context of increased regulatory oversight, as well as increased opportunity to enhance investor value.

[1] The Institutional Limited Partners Association (ILPA) has developed a substantive voice in the industry since first forming as a networking organization in 1990. ILPA has been outspoken about various diligence and regulatory matters, calling for increased diligence on behalf of PE firms, greater transparency with limited partnership agreements, and more layered and intensive due diligence by PE firms. Adoption of and/or more robust ERM programs align with such greater demands by ILPA and limited partners in general. *See 7 Ways the Private Equity Industry Will Change in 2016*, Jen Choi, Director of Industry Affairs, January 2016.

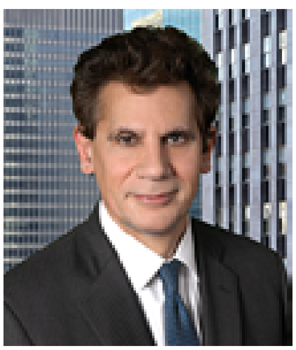
[2] The Office of the Comptroller of the Currency (OCC) requires that a large Bank Holding Company must maintain an enterprise-wide risk committee of the board of directors that periodically reviews risk management policies and oversees the operation of an extensive global risk management framework. There are somewhat similar requirements for Mid-Sized Bank Holding Companies. *See* 12 CFR, Parts 30 and 170.

[3] Energy is regulated by the Federal Energy Regulatory Commission (FERC).

[4] In its Treasury Risk Survey of 327 public companies in North America and Europe (dated 2013), 92% of all public companies in North America and 86% of all companies in Europe responded that they had active risk management programs. In the United States, 26% of responders indicated that they approached risk "in an integrated manner across functions, business lines and classes."

[5] *See* CTC Guide to Enterprise Risk Management, Nilly Essiades, *Enterprise Risk Management Beyond Theory: Practitioner Perspectives on ERM*, p. 4 (2013, Association for Financial Professionals).

[6] The SEC has focused on "monitoring fees," undisclosed administrative fees, fees exceeding the limits set out in partnership agreements, and value provided by third-party service providers. *See Spreading Sunshine in Private Equity*, Andrew Borden, Private Equity Private Fund Compliance Forum, May 6, 2014, SEC Speeches.



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