WHITE PAPER • JULY 2013

Public or Private? Challenges Facing the Board Room in a Changing Marketplace

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Executive Summary

Directors, non-executive chairman, and chief executives face increasingly significant challenges in governing a business for short-term success and accretive shareholder value. The accelerating issue of operating the business for success versus the weight of public reporting, governance and stakeholder management responsibilities has become more visible in the past year through highly publicized ownership model changes.

The potential conflicts of interest are substantial in value creation decisions that involve the choice to remain public or take a company private at a share price premium. Maximizing long-term value creation for all stakeholders without creating potential conflicts between shareholders, board members and executive leadership is an emerging and continuing issue in the marketplace and the board room.

In Q4 2012 and Q1 2013, this issue has become visible on an almost daily basis. The initial public offering of Facebook, cash release pressure on Apple, potential privatization of Dell, the return to private ownership at American Greetings, and the acquisition of Heinz by Berkshire Hathaway and 3G Capital all provide insight into the challenges facing boards and senior executives as they chart a course for future economic success. Underlying these more conspicuous public announcements and press speculation about them is a groundswell of valuation and business model review across the full spectrum of industries, from consumer products to technology and industrial product companies.

As boards and executives review these difficult choices, they must consider the implications for the business and shareholders in an almost dispassionate way, as the shareholder's interests may in fact collide with the continued service and individual financial remuneration of board members and senior executives. Directors and executives across industries must be able to negotiate the advantages and disadvantages of public and private operation.

The Cost and Risk of Remaining Public

While the perils of remaining public vary from sector to sector, five key criteria should be reviewed from an independent perspective:

1. The escalating cost and risk of financial reporting requirements
2. Tax consequences of capital gains treatment for dividends in a public company
3. General and administrative costs that produce no potential economic value or increased profitability for the business
4. Time and energy boards and management spend on messaging in the public domain
5. The inability to move at the speed of the marketplace in the 24 hour business cycle

The shareholder's perspective and rights make these considerations far more complex than they appear on the surface.

Immediate Value Creation for Shareholders

Will the immediate financial gain of privatization be of significant value for the shareholder in comparison to long-term future potential returns? This dilemma underlies all the challenges of today's business environment. Coupled with this issue is the alternative investment value of the released cash to shareholders. Individual shareholders can always buy or sell based on their own view of potential value, and in reality, they can seek higher returns elsewhere independently of any large scale change in control or ownership.

Directors and executives must carefully weigh the premium paid against the future potential value for the shareholder given the severing of shareholder rights to future potential gains after privatization.

Is There a Conflict of Interest?

Yes, there is a potential conflict inherent in the decision to create "one-time" optimal shareholder value through privatization. When struggling with this conflict, directors and executives should be mindful that individual and institutional shareholders have significant remedies available to them through the U.S. legal system and other potential jurisdictions based on the incorporation and domiciled status of the legal entity. Directors and executives need to carefully review these potential derailments of efforts well in advance of any discussions with potential suitors or private investors.

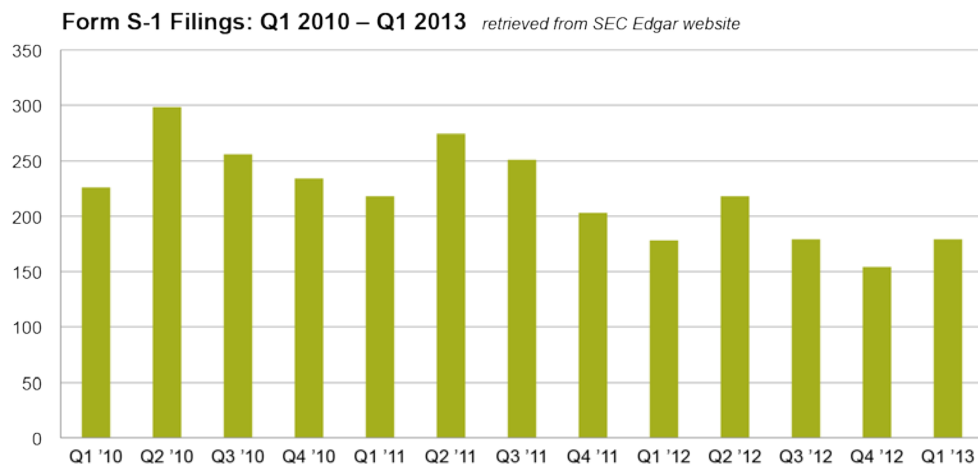
Board members and senior executives also face the visceral risk of losing their governance or leadership post following privatization efforts. In addition to immediate financial impact that could be perceived as either very positive or negative at an individual level, directors and executives are potentially working themselves out of a future governance or leadership role in the new entity.

Given this potential collision of interests, directors and executives must remain focused on their specific charter to seek the best results for shareholders and the enterprise as they obey the precept "do no harm."

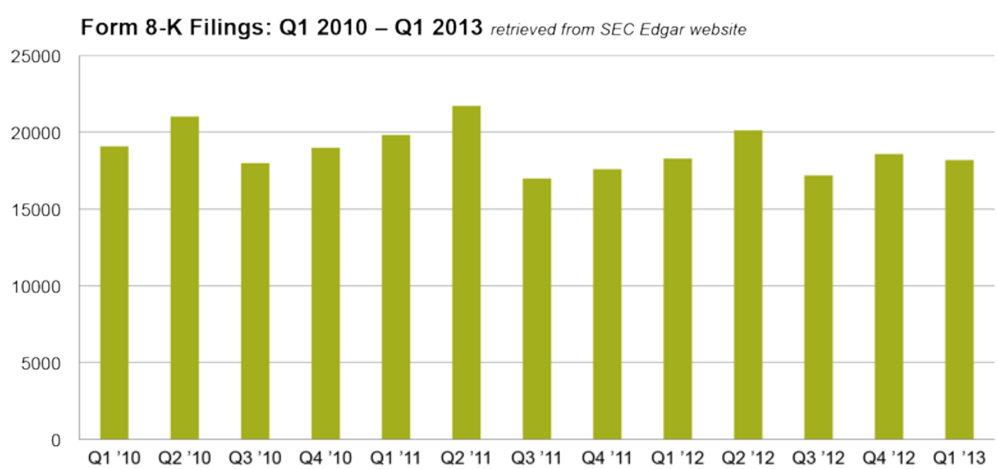
The Privatization Trend in the Markets

The trend of privatization has shown its face through a variety of forms, including dramatic changes in exchange listings, SEC filings, IPOs and M&A activity:

1. According to Forbes, the number of listed companies on US exchanges dropped from 8,823 in 1997 to under 5,000 by Q1 2012.
2. Since the capital-rich Q2 2010, S-1 filings have trended downwards, indicating a reluctance among public companies to issue further stock and hesitancy among private companies to go public.



3. 8-K filings, however, have held steady, indicating that closed-door corporate activity has increased among a shrinking assembly of public companies. This inverse relation is yet another indication that executives and leadership have shied away from the public domain.



4. Research from Ernst & Young has highlighted the dramatic plunge in both the volume and value of IPOs, from a high of 64 deals at $24.7 billion in Q4 2010, to 34 deals at a value of $7.8 billion in Q1 2013.

The Privatization Trend in the Markets, continued

5. IPOs and S-1 filings have also been squelched by a rising volume of aggressive M&A activity. Thomson Reuters Q1 Mergers & Acquisitions Review indicates that 2012 M&A activity was up 2 percent compared to 2011 levels while Q1 2013 activity is up 10 percent over comparable 2012 activity. However, the worldwide volume of M&A deals declined 16% relative to Q1 2012 in step with an overwhelming concentration of $5 billion M&A deals in the hands of a small cross section of companies.

For directors and executives, the challenges of operating a public company have exacted a clear toll, as multiple market trends speak to the growth and speed of privatization.

CEOs Face Higher Turnover

The acceleration of privatization has been bolstered by a second and equally alarming trend: the decrease in average tenure for CEOs. No longer do CEOs serve public companies for as long as they once did.

At the world's top 2,500 public companies, CEO turnover is up from 11.6 percent in 2010 and 14.2 percent in 2011 to 15 percent in 2012 — the highest level since 2005, says Booz & Co. The rate of planned succession climbed from 7.7 percent in 2010 to 10.8 percent in 2012, and among companies in the lowest performing quartile, forced turnovers have climbed to 39 percent (excluding M&A activity). According to the Conference Board, the tenure of Fortune 500 CEOs was just 4.6 years in 2011.

In a less tumultuous economy, top public companies finally feel stable enough to show underperforming CEOs the door. In turn, this pressures CEOs to favor fast growth solutions over those that may cater to the long-term value and stability of their organization. This Catch-22 pressures CEOs to either exasperate shareholders or prioritize immediate growth over sustainability. Consequently, executives have recognized the advantages of operating in a private sphere, where a long-term strategy does not carry short-term consequences.

Case Studies of Privatization

To better understand the pressures of privatization, it is instructive to compare and contrast three very different public companies that transitioned to private entities.

Georgia-Pacific LLC	Interline Brands, Inc.	H.J. Heinz Company
■ Closed December 23, 2005	■ Closed September 7, 2012	■ Closed April 30, 2013
■ Pulp and paper manufacturer	■ Non-industrial maintenance, repair, and operation (MRO) supplies	■ Food processing
■ Acquired for $13.2B by Koch Industries	■ Acquired by Goldman Sachs PE and P2 Capital Partners for $1.1B	■ Acquired by Berkshire Hathaway and 3G Capital for $23B
■ Shareholders received $48 per share, a 39% premium over last closing price	■ Shareholders received $25.50 per share, a 42% premium over last closing pricing	■ Shareholders received $72.50 per share, a 20% premium over the last closing price
■ Chairman and CEO A.D. "Pete" Correll retained as Chairman of the Board to assist with the transition. Currently Chairman emeritus.	■ Chairman and CEO Michael J. Grebe has retained his role through the present	■ Chairman, President, and CEO William R. Johnson currently retains his role

In each case, the companies certainly expected a known set of benefits:

1. Lower expenses
2. Re-focus on long-term goals
3. Greater confidentiality
4. More flexibility in corporate affairs
5. Protection against securities litigation
6. Recaptured shareholder value
7. Avoidance of double taxation

However, there are significant differences in the context for each case of privatization.

The Georgia-Pacific buyout occurred specifically when rising energy costs were exacting a heavy toll on hydrocarbon-intensive industries like paper and pulp manufacturing. Furthermore, asbestos-related legal settlements had generated significant debt, forcing the company to sell off paper and lumber mills. The low-cost and accessible financing of 2005 also fueled a wave of privatizations. From a strategic perspective, the buyout allowed Georgia-Pacific to make more aggressive investments, even into the present. In April 2013, for instance, Georgia-Pacific spent $1.5 billion to acquire Buckeye Technologies, a producer of specialty fibers used in diapers, car filters and toilet paper.

Case Studies of Privatization, continued

Unlike Georgia-Pacific, a public company from 1949 to 2005, Interline Brands was only public from 1996 to 2000 and then returned to the NYSE in 2004. In contrast to Georgia-Pacific, which felt the acquisition was necessary to make competitive investments, Interline appeared to be making a modest recovery from the recession. Indeed, industrial space growth has been robust coming out of the recession. Interline brands certainly did not face the macroeconomic challenges presented to Georgia-Pacific. Rather, the decision comes across as internally motivated and future transitions may make the decision appear cyclical.

Finally, the privatization of Heinz after a 67-year run in the NYSE was one of the biggest acquisitions in food industry history. Compared to the Georgia-Pacific buyout and Interline Brands acquisition, details on the Heinz deal are scarce. 3G Capital refused to comment on their plans for the company, though a drive in emerging markets, a shakeup in management and cost cutting is expected. Perhaps to an even greater extent than the Georgia-Pacific or Interline Brands deals, Heinz's new stakeholders intend to take full advantage of operating privately. Nevertheless, shareholders made a strong show of support for the deal: 95 percent of casted shares voted in favor of the deal and 60 percent of the 321 million outstanding shares were voted. The shift may unchain the company to shift resources towards foreign growth markets on a scale that would have been impermissible as a public company, due in part to potential layoffs and public backlash at home. Although three shareholder lawsuits followed the initial announcement in February, all three were dismissed in federal court.

The Interline and Heinz deals demonstrate that access to capital, a core reason to be public, is also available to private companies in an era of global quantitative easing and generally cheap money. Not to mention, US companies alone sit on over $2 trillion in cash reserves — much to the ire of demanding shareholders. For today's public companies, the burden and restriction of public operation are powering the transition to private operation.

Implications for Directors and Executive

Publicly traded companies will need to carefully evaluate the pros and cons of privatization before making the decision to resist or carry out the transition. So long as the pressure to privatize exists, executives and board members who understand this dilemma and can navigate it will be of utmost value.

It is up to board members to protect shareholder's assets and ensure that they receive a decent return on their investment. Therefore, directors who can meet this responsibility while supporting long-term value creation and forging unity between divided shareholders and executives will be particularly valuable.

So how do directors carry out this task?

1. **The creation of a special committee:** Removed from the conflicts of day to day governance, the special committee can not only evaluate existing offers but also insure alternative options are proactively pursued to insure maximum pricing for any buyout.
2. **Study the landscape frequently:** Directors must watch emerging trends and review adjacent market activity in privatization efforts.
3. **Review cost of capital and debt proactively:** A semi-annual "checkup" on debt structure, debt service costs, and refinancing of credit lines, revolving and long term debt will inform critical decisions.
4. **Manage CEO and CFO succession and morale:** Directors must take a pulse check of these leaders at a personal level frequently and outside the confines of the board room. They are in the crucible daily, and if they are underperforming on a short term basis or managing a crisis, they need counsel to return to optimal performance. With CEOs facing the chopping block quicker than ever before, boards will do well to select executives who can exceed the dismal 4.6 year tenure. Companies and shareholders cannot expect long-term value creation with short-term rotations in leadership. Sustainable strategies demand sustained leadership throughout implementation. CEOs that can face the public will stand a better chance of surviving shareholder pressure.

The marketplace continues to evolve and Adam Smith's concept of "The Invisible Hand," so eloquently conceived in The Wealth of Nations, has been validated once again through the struggle between public and private models of operation and ownership. In some cases, companies can better execute their responsibilities as private entities. Some CEOs and directors will resist such a transition in order to protect their role. As the Heinz acquisition has made clear, both executives and directors risk becoming obsolete when an outside investor takes control. The privatization trend, however, shows no signs of abating, and directors and executives must brace themselves for the monumental choices, schisms, and backlash that may follow. Remain vigilant, protect the owners of the business, and ultimately "do no harm" while evaluating these challenging decisions on the road ahead.

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