DO YOU HAVE THE RIGHT LEADERS TO DELIVER ABOVE MARKET RETURNS?

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Private Equity Leadership Series

If your investment horizon is three to five years, you have six months (and certainly no longer than a year) to get top leadership right at your platform companies or they will under-perform compared to investment expectations.

Gone are the days when above-market investment returns could be achieved through financial engineering alone. The financial expertise of a private equity partner can fuel the next-stage growth of a company, but today's investors are aware that operational expertise is also critical to growth and profitability.

Key to delivering above-market returns, and one operational area where a private equity firm can excel and make a critical impact in the performance, is in the area of talent management.

Leadership Under Private Equity Ownership is Different

Effective leadership in this space is very different from other types of ownership platforms. The acquisition of a company by a private equity firm is a seismic change for its leaders and employees. Yet private equity firms "place their bet" on the strength of a leadership team that has succeeded in the past.

Effective leadership is situational and there is no single effective leadership profile. ***A great leader in one company and under one ownership, market or financial situation can fail miserably in another, and it can happen quickly.***

Leadership skills that successfully propelled a company in the early stages of growth may not be effective when that same company matures with more scope, scale and complexity. Correspondingly, a leader who has been effective in a turnaround may not be effective when the turnaround is complete and the focus is on growth.

The Wrong Leadership Destroys Enterprise Value

Great leadership can significantly enhance stakeholder value, just as quickly as bad leadership can destroy value. But if great leadership is situational and hard to profile, the same can be said of wrong leadership until in becomes a serious problem and has drained resources and profitability from the platform company.

An example of this situation occurred when a client expressed concern that one of their portfolio companies, a medical device company with $75 million in revenue, was not performing up to expectation. They suspected the legacy leadership was impacting results. An audit revealed that not only was the CEO producing poor results, but he was also engaging in behavior that opened the company up to liability. The solution consisted of exiting the leader and finding his replacement within the existing ranks of the company. With the right leadership in place, the company saw an immediate improvement in financial results.

Without the appropriate fiduciary oversight, it can be difficult for private equity firms to spot when a leader is the wrong match for their platform companies. In a worst case scenario, private equity firms are surprised to find out that a CEO has carefully managed the Board by controlling both the information flow and their insights into what is really going on in the organization. This can be prevented by a proactive leadership wellness program.

Six Principles to Ensure an Effective Leadership Wellness Program

1. Make Talent Management a Top Priority

For bigger private equity firms operating in the large-cap company space, this likely means hiring a Chief Human Resources Officer, perhaps with a small staff to do recruiting, consulting, etc. For mid-size firms operating in the mid-cap to small-cap company space, this likely involves partnering with an outside resource to assist in the development and execution of talent management initiatives.

2. Perform Pre-Acquisition Leadership Due Diligence

As part of the due diligence process, it is a best practice to invest in leadership assessments. Skillful leadership assessment can be a critical strategic tool, sending a positive message to the leaders of the company being acquired.

The outcome of pre-acquisition due diligence is the baseline understanding of leadership strengths, bench strength, and areas of possible concern or need for development.

3. Immediately Clarify Private Equity/CEO Relationship

Invest in bringing clarity to the relationship between the CEO and the private equity firm. If this is not done, the CEO will continue to operate as they always had and all parties will waste time and energy trying to figure out how to work together. Although PE firms have different visions for what this governance needs to look like, we recommend a formal Board of Directors approach. The Board's role needs to be made clear in terms of both performance monitoring and strategic oversight. Board meetings should be regular and operate with a formal agenda. The CEO should be coached on how to work collaboratively with the Board.

4. Conduct an Early Leadership Effectiveness Audit

At the three to six month mark, the honeymoon is over and there is a greater awareness of how well the leadership/private equity ownership team is doing. This is the critical tipping point where great leadership will propel the organization toward top tier private equity investment returns and less effective or bad leadership will underperform. A well designed and consistently applied leadership assessment and development process will make good teams great.

5. Own the Executive Recruiting Process

As the private equity owner, don't abdicate responsibility for finding the new executive who is the right fit. Think about the recruitment process strategically and not as a transaction. Without a clear vision, you may get an "echo" of the executive you decided to move out.

The executive employment markets are so transparent that it's easy to find executive level candidates who have industry, function or product/market experience. What is more important and elusive is the leader who will bring the right new leadership behaviors into the organization. Organizational and cultural transformation starts at the top and if left solely to the discretion of the platform company, they will be more likely to hire in their own image.

6. Effectively Manage Executive Transitions

Don't underestimate the importance of effective executive transition management, especially when it involves a previous owner. Even if they feel they are ready to move on to a new life stage, some career/life transition support is a good investment. It sends a positive signal to all stakeholders, including owners of future company acquisition candidates.

An example of this situation is when a $150 million energy company brought our firm in to coach an executive who was succeeding the former owner. Through careful planning, an effective transition plan was put in place that recognized the contributions of the exiting leader, reassured the 1,000 employees in the workplace and successfully positioned the new leader to navigate the role. Supported with targeted reorganization and role alignment, within three months the company's financial results were strong and the prospects for the future were bright.

Leadership Makes the Difference

Look at any business success story from start-up to turn-around - the prime factor in realizing ROI is leadership. Effective leaders inspire employees, make bold decisions and propel good companies to greatness. Conversely, average or poor leadership puts downward pressure on results. If you're looking to optimize your return on investment, you can't start too early to make this assessment. Ideally, it should occur during due diligence, but if not, start now. The alternative is leaving money on the table.