AlixPartners

Private Equity & Investors
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INVESTMENT SUCCESS ISN'T JUST ABOUT THE NUMBERS. IT'S ABOUT THE PEOPLE:

Specifically, the PE–CEO–CFO relationship

ALIXPARTNERS' FOURTH ANNUAL PRIVATE EQUITY LEADERSHIP SURVEY

Last year, our private equity (PE) leadership survey—conducted jointly with Vardis—dug deeper into a key aspect of the owner–CEO relationship: misalignment between the two sides on a wide range of critical matters.

In this year's survey (our fourth annual), we take a closer look at the ongoing disconnection between respondents' beliefs and behaviors and between their views on certain topics—most notably, the role of addressing talent needs to drive growth at portfolio companies (portcos).

Respondents this year included portco chief financial officers (CFOs), thereby adding richness to the insights to be gained from our survey findings.

Also new this year, we've organized our findings and analysis into two reports. The report you're reading now is part 1 of two parts. In part 1, we focus on three main themes:

1. Proactive management of the triangular relationship between PE sponsors and portco CEOs and CFOs.
2. Early understanding of major misalignments related to the role of human capital in PE firms' investment theses.
3. Disconnections between beliefs and behaviors with regard to predeal assessment of prospective portcos.

In part 2, we shift focus to the keys to success in the first 100 days after a deal is inked and the management of performance evaluation, turnover, and replacement of portco executives.

MANAGING THE PE–CEO–CFO RELATIONSHIP TRIANGLE: NO EASY FEAT

As noted in our **recent post on the PE Hub Network,** the relationships between a PE sponsor, a portco's CEO, and the portco's CFO count among the most critical a PE firm will ever have to manage.

Trouble in any of the three legs of the relationship triangle—such as jealousy, mistrust, and poor communication—can torpedo the success of an entire investment by preventing key members of the management team from executing the investment thesis, thereby ultimately sabotaging returns.

To safeguard an investment's success, PE owners have to proactively manage each dimension of the triangle, including identifying and swiftly mitigating risks.

"Almost 50% of investors agree that assessing the CEO/CFO relationship is vital—but few actually do it."

We think PE firms should pay closer attention to that imperative. Consider that only about 50% of the investors in this year's survey said they view the assessment of CEO–CFO relationship dynamics—including collaboration between them—as "extremely important" or "very important". However, just 43% of those who hold that view said they actually conduct an independent assessment of a target portco's management team in the predeal phase.

PE investor, CEO, and CFO respondents each shared perspectives on how to determine whether the CEO–CFO relationship is problematic.

THE TOP THREE SIGNS OF TROUBLE CITED WITHIN THE RELATIONSHIP BY RESPONDENT GROUP:

PE INVESTORS	CEOs	CFOs
60% "An **uncollaborative relationship**"	**55%** "**Misalignment on strategy**"	**66%** "An **uncollaborative relationship**"
60% "**Misalignment** [between the CEO and CFO] **on strategy** execution"	**52%** "Infrequent communication"	**58%** "Infrequent communication"
54% "Differing perspectives on the company's financial performance"	**48%** "An **uncollaborative relationship**" with the CFO	**35%** "**Misalignment** [with the CEO] **on strategy** execution"

The need for collaboration, communication, and alignment on strategy and execution underscore the complementary nature of the roles. These views suggest the need for careful assessment of the relationship—not only in the due diligence phase but also at key junctures throughout the investment hold period—to make sure the relationship dynamics remain healthy and alignment remains intact.

The common theme of lack of collaboration across the three groups in our study indicates that both CEOs and CFOs view their relationship with each other as one based on teamwork—with each person depending on the other for successful execution of accountabilities.

MUTUAL UNDERSTANDING: A KEY TO BUILDING TRUST AND FOSTERING CANDID COMMUNICATION

KEYS TO THE RELATIONSHIP: TRUST AND COMMUNICATION

Proactively building trust and engaging in open communication between PE sponsors and portco top executives about such matters as accountability and expectations are key to managing the relationship triangle. PE respondents identified factors they deemed critical to maintaining a constructive relationship with their portco CEOs:

- **96%** "trust"
- **94%** "open communication"
- **93%** "an understanding of the CEO's drivers and motivations"
- The lowest-ranked response was "realistic strategic execution"

IN THEIR OWN WORDS: PE SPONSORS

We asked the PE respondents, "This year, what has been the one thing that portfolio company CEOs need to understand better about their PE investors?"

Key theme: urgency

For example, they wanted their portco CEOs to understand:

"Our insistence that we act quickly on value-creation priorities."

"The need for speed."

"[That] the pressure to deliver performance and returns has only increased."

"The importance of the investment timeline."

"[The importance of] positioning for exit."

IN THEIR OWN WORDS: PORTCO CEOs

We asked "This year, what has been the one thing that PE firms need to understand better about their portco CEOs?"

Key themes: alignment and execution

"Trust the executive team with execution, and give them space to deliver."

"Let the CEO run the company; micromanagement"

Another key theme: uncertainty

"[It's] never been a tougher time to be a CEO; so many obstacles outside our control."

IN THEIR OWN WORDS: PORTCO CFOs

We asked: "This year, what has been the one thing that PE firms need to understand better about their portco CFOs?"

Key themes: alignment and execution

"We have to balance the company's best interests and the PE firm's objectives."

"Understand our company's inner workings to put information in perspective."

Another key theme: competency

"We are operations CFOs—not financing gurus."

"CFOs are actually running the business too."

"Great CFOs are critical to the value-creation process."

ACHIEVING ALIGNMENT

We believe that investors and portco executives can set the stage for success by conducting an independently facilitated alignment workshop soon after the close of a deal between a PE sponsor and a portco management team. The workshop should be devoted specifically to reaching agreement on and committing to shared expectations. In our view, such a workshop—a standard practice during that crucial, first-100-days period—is a form of insurance for getting off to a productive start in the postdeal phase.

DEFINING AN INVESTMENT THESIS: MISALIGNMENT ON THE IMPORTANCE OF HUMAN CAPITAL

When deciding where to channel their investment dollars and crafting an investment thesis for new assets, PE firms must consider multiple factors.

NEAR-TERM PRIORITIES FOR PORTCOs: HUMAN CAPITAL COMES IN SECOND ONLY TO GROWTH . . .

When we asked our PE and portco respondents what they considered the most pressing near-term issues their portfolio companies face, we saw a stark contrast in their responses. Although "growth"—especially in revenues and margins—topped the lists of both of the groups, 63% of the PE firm respondents cited “human capital” as their number two concern versus just 42% of portco respondents (figure 1).

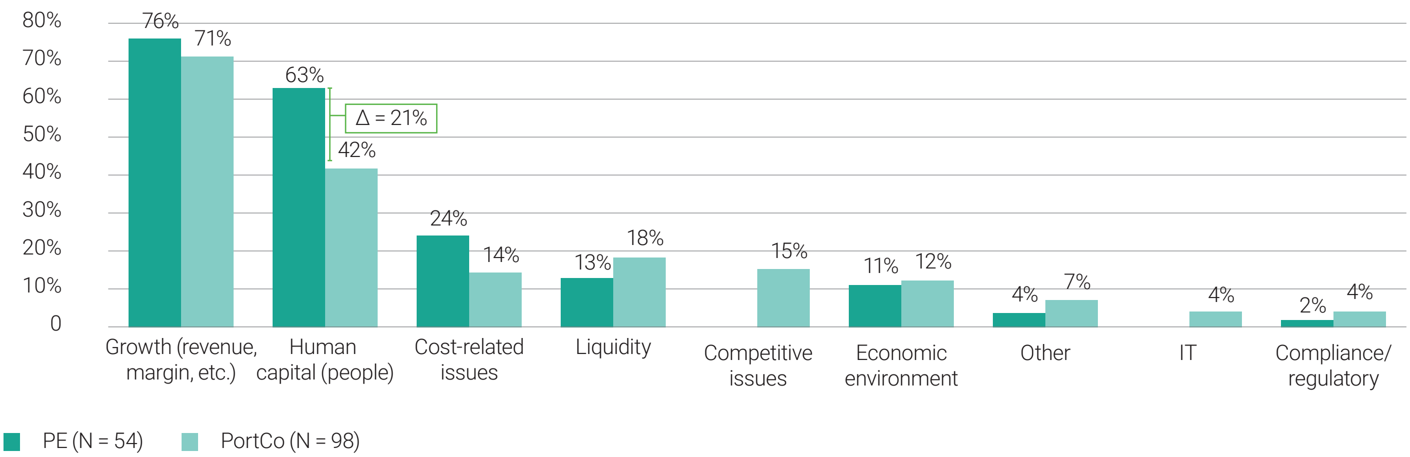
What explains the 21% delta between PE and portco responses? Perhaps PE firms are looking more to talent as a mechanism for accelerating growth in their portcos—and portco executives may be complacent about their current talent benches.

We see additional signs that PE firms are increasingly recognizing that investment success isn’t just about the numbers; it’s also about the people. Among PE respondents who indicated that they install or upgrade portco management teams, 40% said they wait more than one year to replace the CEO. As much as 72% of those who retain portcos’ existing management teams still end up replacing the CEO after one year. However, last year’s participating PE investors cited "assessing portco management teams" and "establishing senior team alignment" as top priorities during the first 100 days postinvestment.

40% of PE respondents said they wait more than one year to replace the CEO.

FIGURE 1: PE FIRMS PUT MUCH MORE EMPHASIS ON HUMAN CAPITAL AS A NEAR-TERM CONCERN ABOUT THEIR PORTFOLIO COMPANIES

Q: What are the most pressing near-term issues facing your portfolio of companies?



Note: respondents were asked to select up to two applicable responses
Portco respondents ‘Other’: M&A (2), Tariffs (1), Production (1)

. . . BUT ACTUAL BEHAVIORS SUGGEST OTHERWISE

Nevertheless, when deciding where to invest, PE firms in this year's study emphasized targets' financial performance and operational efficiency over the quality of the targets' current leadership teams and organizational cultures. We found that surprising given that investors had named human capital as a major concern regarding their portcos.

Despite longer hold times and stiffer competition for talent, a weighted average of roughly 50% of the investors in our respondent pool said they're not doing much to change their talent-management strategies—including in the area of CEO and CFO succession planning. In fact, the response "No change" to the question about whether hold times had caused owners to rethink their approaches to CEO succession was up from 38% in last year's survey results.

"Human capital is a top concern, but surprisingly not cited as a key factor when deciding to invest."

What explains this misalignment? Investors see the importance of onboarding and retaining top talent to achieve successful sales—but still have work to do in this area.

VALUE-CREATION LEVERS

Sponsors emphasize operational efficiency more than portcos do

We also saw misalignment on what most drives value creation in portcos. PE and portco respondents see organic and inorganic growth as key drivers—but 52% of investors also named operational efficiency, versus just 30% of portco executives.

The delta may indicate that sponsors focus more on operational efficiency because it delivers cost savings that go straight to the bottom line. Moreover, cost savings can translate into head count reductions, and CEOs may be feeling protective of their in-house talent.

ASSESSING PORTCO EXECUTIVES AND CULTURE: MUCH TALK, LITTLE ACTION

When it comes to assessing portco executives' leadership skills and companies' organizational cultures during the predeal phase, we saw additional misalignment—on multiple fronts.

"WE'RE GOOD AT EXECUTIVE ASSESSMENT—BUT WE SELDOM DO IT."

Perhaps most telling, 59% of representatives of PE firms in this year's study gave themselves high grades ("very strong" or "above average") for their ability to take stock of their portcos' leadership teams. And they agree that such assessment is vital, yet only half of them said they "always" or "often" formally assess CEOs' and CFOs' leadership competencies. Moreover, as much as 67% said independent assessments of targets' incumbent CEOs would be useful to them during the predeal due diligence phase of the investment cycle.

“WE ASSESS CEOs AND CFOs DIFFERENTLY.”

In assessments of incumbent CEOs, PE investors cited "ability to drive value creation" as the top factor they consider, followed by "ability to build, motivate, and work on a strong team." That’s clearly a nod to the importance of managing talent effectively. But other key interpersonal competencies—such as "self-awareness" and "communication skills"—fell closer to the bottom of the list (figure 2).

With regard to assessments of CEO candidates, both investors and portco executives identified "drive and work ethic" along with "people leadership skills" as vital. Portco CEOs also noted "personal compatibility with the board/ investors" as an important ingredient for high performance.

When we widened the lens to include assessments of CFO candidates for portcos, another form of misalignment came to light: more than 89% of PE-firm respondents cited "technical and financial skills," "prior CFO experience," and "drive and work ethic" as "very critical" or "extremely critical."

CFOs cited the top three most-important skills as:

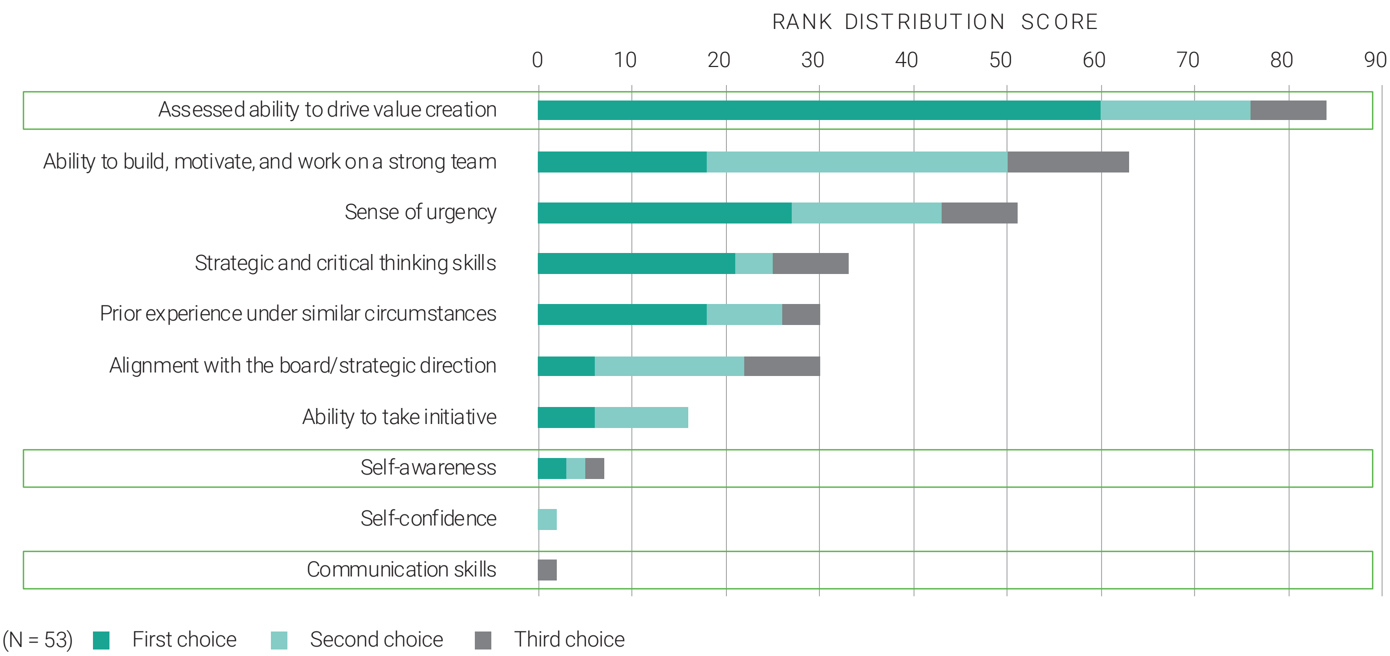
COMMUNICATION SKILLS

STRATEGIC THINKING

DRIVE AND WORK ETHIC

FIGURE 2: ABILITY TO DRIVE VALUE CREATION IS CRUCIAL FOR INCUMBENT CEOs

Q: In rank order, and excluding financial performance, how critical are the following factors to your evaluation of the incumbent CEO?



Note: respondents were asked to rank top three answers; Chart based on ranked distribution of weighted responses

CULTURE ASSESSMENT

Does it matter more to portcos than to investors?

As much as 86% of the portco executives said they see culture assessment as important when a PE firm adds a new asset to its portfolio. But just 28% of them said their PE investors "always" or "often" conduct such assessments.

11% of represented PE firms said they do not perform diagnoses of portco culture.

For PE firms this year that do carry out such assessments, conducting individual interviews is their method of choice—far ahead of other methods such as:

- Reviewing a company's reputation in its industry
- Conducting employee surveys
- Evaluating a company's identity on social media
- Performing psychometric assessments

We view PE firms' heavy reliance on speaking directly to individuals in a portco as risky. The reason? In itself, that approach may not be structured enough to paint a comprehensive and accurate picture of a portco's organizational culture.

Clearly, there's room for improvement there—given that 34% of the PE firms rated their ability to assess a portco's culture as "average," and 11% gave themselves a grade of "below average" on that ability.

NEXT STEPS FOR PE FIRMS AND PORTFOLIO COMPANIES

As this year's survey findings make clear, misalignment between PE investors' and portco executives' perceptions and expectations has persisted—on multiple fronts. Proactive effort can help all of the parties involved identify the most-problematic sources of such misalignment. Equally important, such effort can help them address those issues—before the issues can pose serious threats to each party's goals.

With all of that in mind, we offer the following suggestions to PE firms and portfolio companies seeking to lay a foundation for success early in the investment cycle:

DUE DILIGENCE

Rigorously assess prospective portcos' organizational effectiveness and talent in this phase. Evaluations can help uncover possible sources of misalignment and capability deficits—as well as potential growth levers in an asset under consideration. The sooner those things get recognized, the sooner they can be addressed—whether it involves clearing up conflicting expectations, crafting plans to close capability gaps, or taking maximum advantage of growth levers.

CULTURE ASSESSMENT

Make sure that assessments of prospective portcos' organizational cultures are informed by strategic considerations and the business context. Ask, "Does the culture support the strategy and investment thesis?" If it doesn't, identify aspects of the portco's culture that have to change—and how feasible making those changes would be.

DEPTH OF ASSESSMENT

Before inking an investment deal, sponsors typically aren't in a position to do deep-dive assessments on portcos' levels of organizational effectiveness, cultures, and so forth. But investors want to know as much as possible about what they'll get if they acquire a particular asset. Prospective portcos naturally want to put their foot forward and be acquired. But assessments at this stage can uncover only higher-level issues involving a prospective asset's talent and its executives' understanding of and alignment with the PE firm's strategy.

So, although sponsors don't have full access to a prospective asset during due diligence, they should strive to conduct the deepest investigation possible under the circumstances—including seeking signs of a healthy relationship between the CEO and CFO and other members of the senior leadership team during early interviews with those execs. And they should plan to repeat the effort in a more focused way during the postdeal period. Armed with that fuller picture, they can more effectively determine how to maximize value creation in their new portco.

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ABOUT OUR 2019 SURVEY

This year's survey was administered online from October through December 2018. Respondents comprised 54 managing directors and operating partners from PE firms and 98 senior executives (primarily CEOs and CFOs) from portfolio companies. Roughly three-quarters of the survey participants hailed from locations in North America, with much of the remaining ones from locations in Europe. The largest share of portco respondents were with companies with annual revenues of $100 million to $500 million. The majority of PE firm respondents reported assets under management of less than $20 billion.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.