AlixPartners

Private Equity

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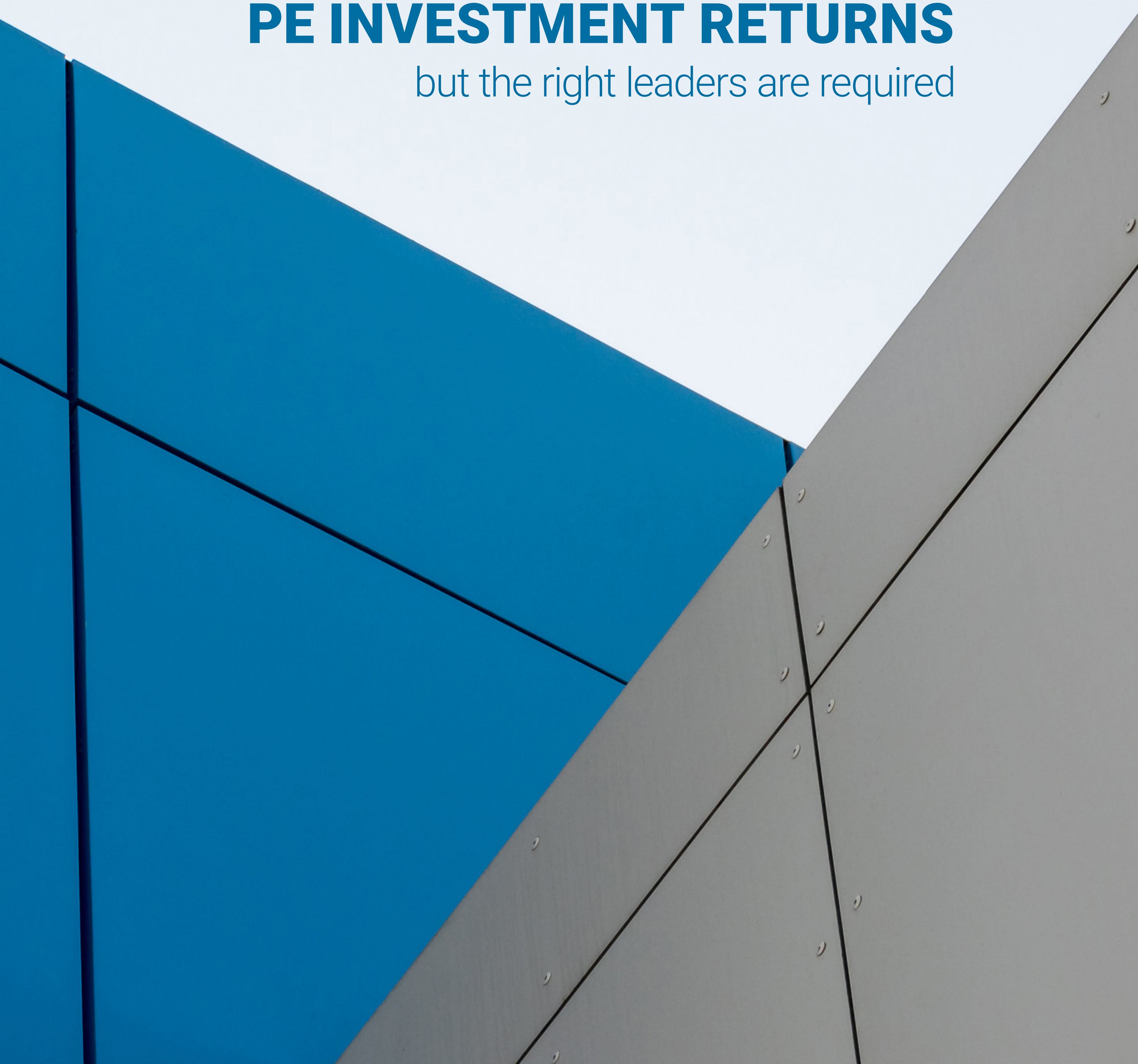
FIFTH ANNUAL PRIVATE EQUITY LEADERSHIP SURVEY

CORPORATE CULTURE CAN MAKE—OR—BREAK PE INVESTMENT RETURNS

but the right leaders are required



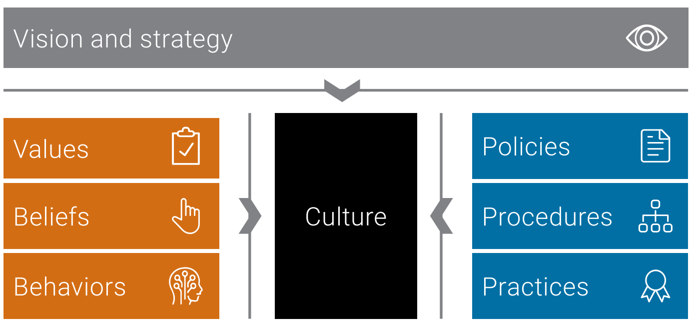
An ubertheme clearly emerged in last year's findings: Smart management of human capital is vital for generating top-decile internal rates of return (IRRs).

Tracking any trend over the course of five years generates valuable insights. Developments in private equity (PE) leadership are no exception. With that in mind, we at AlixPartners are delighted to share findings from our fifth survey of leaders of PE firms and portfolio companies (portcos), conducted jointly with Vardis. (See About Our Fifth Annual PE Leadership Survey.)

This year we've built on that theme, asking participating investors and operators for their thoughts about the role of organizational culture in portco performance. After all, culture is all about human capital—in other words, leadership and talent.

SPOTLIGHT ON CULTURE

In any company, culture can be summed up as 'the way we do things here,' and it's powerfully influenced by what we call culture carriers—people in authority, who set the tone of a company by way of the behaviors, beliefs, and values that they demonstrate.



The right corporate culture at a portco is essential for generating the business results required by the company's PE sponsor. And a portco's culture depends to a great degree on who's at the helm.

Once a PE firm invests in a business, performance expectations intensify, as the sponsors usually seek to professionalize management of the company. To meet those expectations, the management team and the rest of the workforce may have to modify how they do things on several fronts, such as establishing new organizational structures, collaborating in unfamiliar ways, and delivering results more speedily. Those kinds of changes may call for a different corporate culture.

The notion that organizational culture is crucial for successful execution of business strategy has garnered increased attention in the PE industry and the general business press. We've all seen the headlines announcing household-name companies that paid a high price for allowing a toxic culture to take root and sabotage those companies' futures.

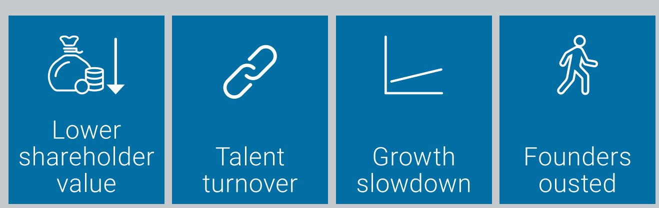
7% Annual increase in mentions of culture during earnings calls

Forces that transform the broader business landscape also powerfully influence how strongly a company's culture supports—or imperils—the strategic direction laid out by company leaders. For example:

- **Employment trends.** Because of low unemployment rates, PE owners face stiffer competition in the drive to recruit, hire, and retain the best talent for their portcos.
- **Born-digital businesses.** At portcos birthed as digital natives, corporate culture takes on even greater importance. AlixPartners' recent born-digital study revealed that cultures can clash if new leaders brought into a born-digital company hail from traditional businesses. Born-digital companies should help new leaders adjust to their culture while staying focused on their mission.
- **Digitalization.** Many work activities today can be performed by people located anywhere, at any time, with no manager on hand to command and control them. Getting the best from employees in a digital world requires a decidedly different organizational culture.

THE HIGH COST OF A TOXIC CORPORATE CULTURE

Businesses that allow a toxic culture to take root can pay a high price—in such forms as:



Source: CEB

KEY FINDINGS

Human capital was rated the top factor in predicting the success (or failure) of a PE investment.

EXECUTION SPEED AND TRANSFORMATIONAL LEADERS ARE ESSENTIAL FOR INVESTMENT SUCCESS

Our survey findings point to several imperatives that portcos and their PE sponsors must meet to maximize IRR. Those imperatives include the ability to quickly and effectively execute the strategy defined for a portco—which in turn hinges on leaders who possess unique blends of skills.

Our participants' responses clearly indicated that talent and human capital play a critical role in effective strategy execution. To illustrate, for our PE and portco participants alike, two factors—(1) alignment between key constituents and (2) portco leaders' speed in executing on strategy—took first and second places as key factors in successful strategy execution (figure 1). For PE respondents, the ability to attract, develop, and retain the best talent came in at third place; for portco participants, it was leaders' ability to inspire and motivate others.

What explains these responses? To be sure, the PE market is awash in financial capital—accumulated dry powder. But we can't say the same about human capital.

There's a scarcity of exceptional leadership out there precisely when companies need it most.

At an increasing number of portcos, the founders are retiring. A company's PE sponsors may not realize how important a departing leader has been as a carrier of the portco's culture through the beliefs, values, and behaviors that that leader has long demonstrated. Without such realization, the owners may not realize which elements of the company's culture should be sustained and which must change to support the investment thesis. Lack of awareness on that front could cause investors to unwittingly destroy a portco's culture—by bringing in a new leader who cannot disseminate and sustain the corporate culture that will prove essential for investment success.

FIGURE 1: ASSUMING CAPITAL AVAILABILITY, WHICH ARE THE PRIMARY FACILITATORS OF STRATEGY IMPLEMENTATION, EXECUTION, AND SUCCESS?

Top three answers

	PE investors	Portco executives
1	Alignment between key constituencies: board, management team, employee population	Alignment between key constituencies: board, management team, employee population
2	Leadership's speed of execution	Leadership's speed of execution
3	Attraction, development, retention of the best talent	Leadership's ability to inspire and motivate

The speed of change as well as the degrees of volatility, uncertainty, and complexity that characterize business today are increasingly calling for organizations to transform their cultures. To survive under those conditions, portcos need transformational leaders—people who can do far more than just excel at strategy execution. Such leaders also have to know how to:

- Motivate, inspire, and empathize with others
- Create a sense of urgency within the organization
- Communicate exceptionally well to build high-performing teams
- Help their businesses navigate the profound isruptions reshaping their industries

Among our survey respondents, for the first time, it was the PE leaders who most clearly recognized the challenge of this new reality.

FURTHER CONFIRMATION OF THE LEADERSHIP/TALENT–IRR LINK

Both cohorts in our survey:

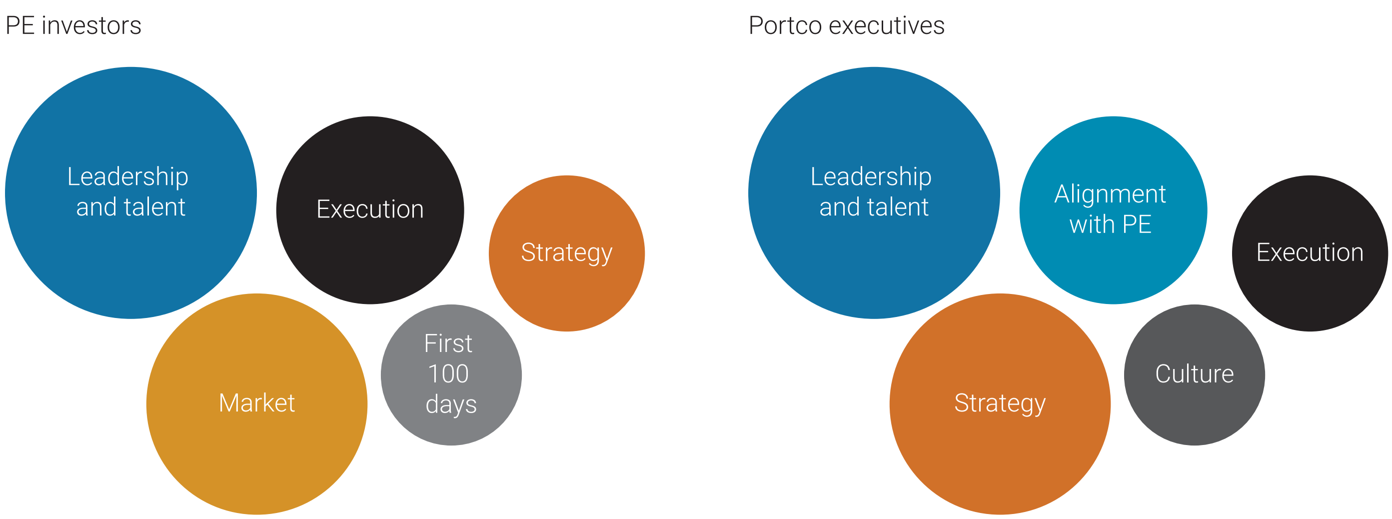
- Rated a world-class management team as the number-one predictor of a strong exit for a portfolio company.
- Identified leadership as the primary driver of successful organizational transformation.
- Included leadership and talent in their top factors for achieving financial-return targets.

Exploring the other side, we also posed the following open-ended question to respondents.

What factors have had the greatest impact on an investment that has not delivered the expected target returns?

We rigorously analyzed the many detailed textual responses to that question—for which participants were free to answer in any way they chose. Our analysis further echoed the message that PE leaders and portco executives see shortfalls in leadership and talent as the main culprits behind failed investments (figure 2). However, the two groups' responses differed in other respects. In particular, PE leaders identified the market as the second-most-important determinant of investment failure, whereas for portco leaders, strategy came in second. And although culture didn't appear in any of the PE leaders' answers, it cropped up in nearly 18% of our portco respondents' answers.

FIGURE 2: BOTH RESPONDENT GROUPS AGREE ON WHAT MOST ERODES IRR



CULTURE SEEMS TO BE OCCUPYING MORE REAL ESTATE IN CEOS' MINDS THAN IN PE SPONSORS' MINDS. A CULTURE WAKE-UP CALL FOR INVESTORS?

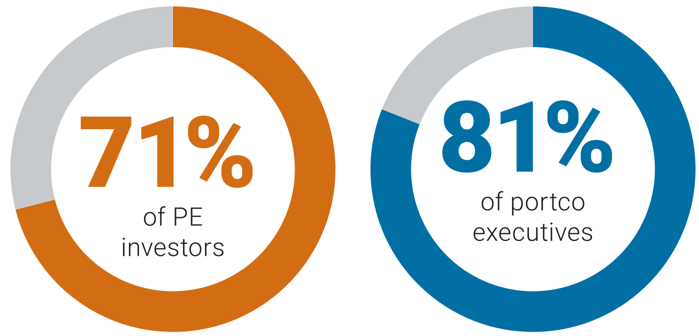
MUCH TALK ABOUT CULTURE—BUT LITTLE ACTION

This year's survey results revealed a misalignment between respondents' stated beliefs about culture and their actions. In answer to the question, When building a company strategy, how critical is it to consider organizational culture in its capacity to support the strategy? About 88% of PE leaders and 87% of portco executives said it's critical to align the culture with the strategy to generate strong results.

Similarly, 71% of PE respondents and 81% of portco participants said successful execution of strategy hinges on having a culture that enables and encourages people to help implement the strategy. Indeed, the PE leaders strongly endorsed assessment of portco culture as part of the due diligence process.

But despite their belief in the importance of culture assessment, only a minority of our study respondents said they take a formal approach to the evaluation of a portco's culture. We see that as risky because relying on informal culture evaluations can lead to subjective assessments that bear little resemblance to reality. Result? Leaders gain few insights into whether a portco's culture needs to change—and if so, how.

Culture evaluation:



SAID "COMPANY CULTURE IS CRITICAL TO THE SUCCESSFUL IMPLEMENTATION OF STRATEGY"

ON A WEIGHTED AVERAGE, NEARLY

30% of portco respondents said neither they nor their investors evaluate their company's culture despite its importance for driving positive IRR.

But perhaps both cohorts are more aware of the need to improve their culture-evaluation abilities.

In this year's survey, more PE leaders were rated average or below average on culture assessment—by themselves and by portco executives—than in last year's survey.

57% OF PE INVESTORS
(an increase from last year's 49%) indicate average-or-below ability to assess culture

If that means PE firms may soon start walking their talk about culture assessment, it won't be too soon: Only about half of this year's portco respondents said they saw their company's culture as fully aligned with their business strategy.

WHEN A PORTCO NEEDS A CULTURE MAKEOVER

The majority of our survey respondents concurred that CEOs who don't fit well with their company's culture are at risk of delivering poor performance. What's more, both respondent groups agreed that a portco's C-suite executives most strongly influence its culture and that when culture change is required, the CEO should be the formal sponsor of the effort.

On one level, that's good news: Because of their authority and gravitas, senior executives are best positioned to drive cultural transformation. Most important, they can model the behaviors, values, and beliefs required to shape and sustain the desired culture.

While some senior leaders have a natural talent or the right professional experience for leading cultural transformation, others do not. Senior leaders who need to enhance their culture-transformation abilities can benefit from broadening their view of who can help lead cultural change—including their portco's head of human resources and chief operating officer. Tellingly, only a few of our respondents identified such alternative roles as possible agents of cultural change. We believe they're missing out on a crucial opportunity to gain strategic partners for cultural transformation programs.

Replacing an existing CEO with someone who embodies the required corporate culture is another viable step for correcting a portco's culture.

As many as 68% of our PE respondents said they had hired a CEO specifically for that purpose—and 82% of those respondents said the effort had paid off. However, the majority of our survey participants also said they believe that a portco's culture can be transformed by promoting from within. Each approach has pros and cons, of course. For instance, outside CEOs bring proven track records based on the experience they've gained at other companies, but they lack deep knowledge of the portco; for leaders promoted from within, the opposite is true.

For PE sponsors seeking to onboard a new CEO after closing an investment deal, conducting a prehire assessment of candidates' personalities is crucial. In particular, candidates with disruptive or derailing personalities should be avoided.

The good news is that our PE and portco respondents concurred on the characteristics that correlate most closely with a positive corporate culture.

TOPPING THE LIST FOR BOTH GROUPS:

EMPLOYEE ENGAGEMENT AND SATISFACTION

EFFECTIVE LEADERSHIP

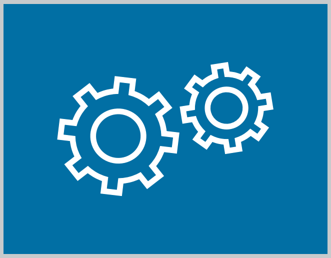
EFFECTIVE COMMUNICATION

Interestingly, compensation policy appeared much lower on the list. Those findings suggest that both groups know that companies can't pay their way out of an ill-suited culture. The findings further underscore the notion that human capital and talent matter much more than dollars do when it comes to building a successful business.

NEXT STEPS FOR PE FIRMS AND THEIR PORTCOS

As this year's survey findings make clear, investment success hinges on deep understanding—and deft management—of the complex interplay between leadership and talent, corporate culture, and investment strategy. Within that dynamic, leadership and talent play a central role: Leaders not only drive strategy execution; they also shape and sustain their company's culture, which in turn strongly determines how quickly and effectively a portco's strategy can be put into action to drive IRR.

With all of that in mind, we offer several suggestions:



BROADEN YOUR VIEW OF THE FORCES THAT ARE TRANSFORMING BUSINESS

Understand the trends most powerfully shaping your industry, such as employment-rate fluctuations and demographic shifts. Ask yourself whether the business must modify its culture to manage the ripple effects of those trends, such as the ability to attract and retain the right talent. For born-digital companies, decide how you'll recruit leaders who can be comfortable with the culture but who also bring skills the company will need to scale, such as operational expertise. Identify the kind of culture needed to get the best performance from managers and employees in a digital world.

CRACK THE STRATEGY-EXECUTION CODE

Assess how well portcos are set up to execute the strategy defined by their PE sponsors. In particular, diagnose degree of alignment between key constituents (portco board, management team, workforce); measure leaders' speed in executing on strategy; and assess leaders' abilities to attract, develop, and retain the best talent as well as to inspire and motivate others.

GET SMART ABOUT CULTURE ASSESSMENT

Consider taking more-formal approaches and using today's tools for assessing portco culture during the due diligence and postdeal periods. Formal approaches will generate more-useful insights into how a portco's culture needs to change—if at all. Ask yourself what beliefs, values, and behaviors senior leaders should embody. And carefully weigh the pros and cons of replacing a current CEO with an outsider versus promoting from within.

PARTNER UP TO LEAD CULTURE CHANGE

Yes, portco CEOs are well positioned to drive the culture changes needed to execute strategy. But they don't have to—and they shouldn't necessarily—go it alone. Leaders in other roles—such as in human resources or operations—can serve as powerful allies.

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ABOUT OUR FIFTH ANNUAL PE LEADERSHIP SURVEY

The survey was administered online from October through December 2019. Respondents consisted of 56 managing directors, operating partners, or founders from PE firms and 52 senior executives—primarily CEOs and CFOs—from portfolio companies. Sixty-eight percent of the respondents hailed from companies based in North America, with much of the remaining ones from locations in Europe. The largest share of portco respondents worked with companies registering annual revenues of $100 million to $500 million, whereas the majority of our PE firm respondents reported assets under management of less than $5 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.