AlixPartners

Private Equity & Investors

MARCH 2018

SURVEY

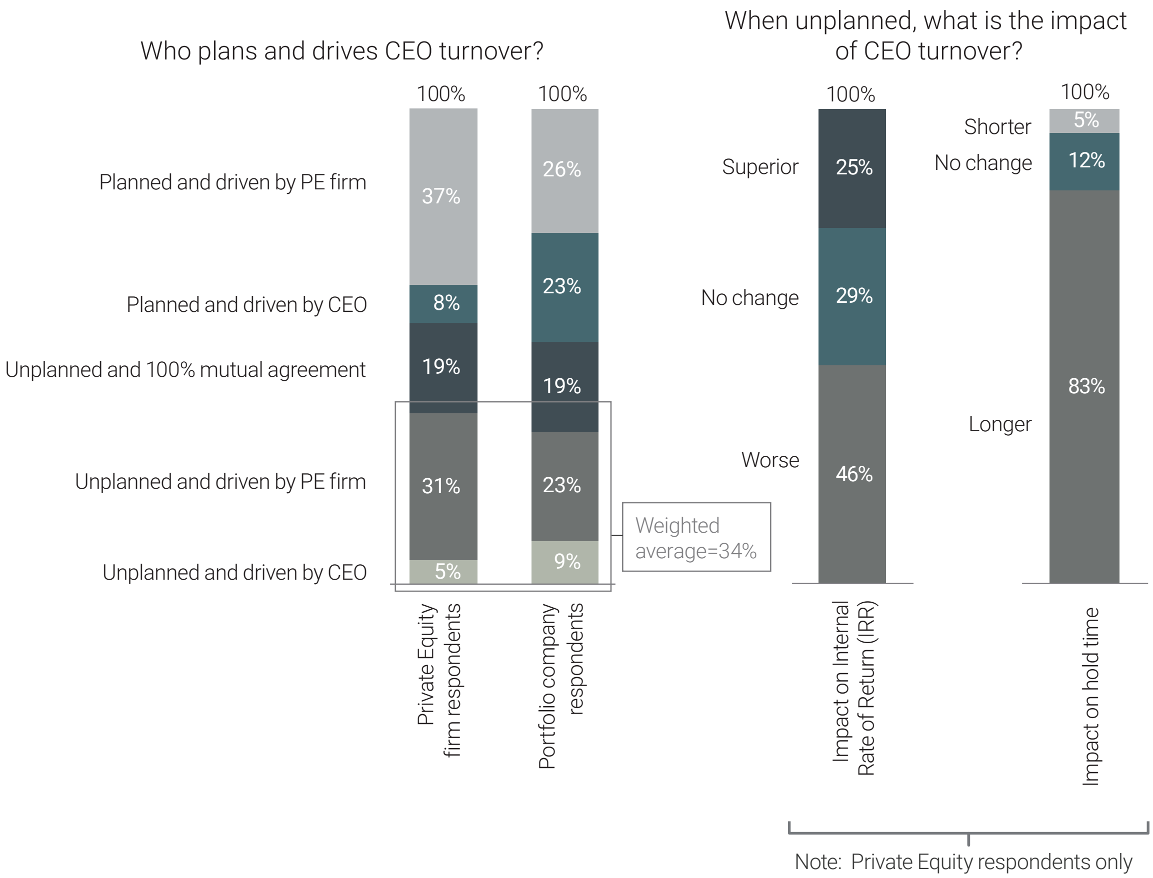
Misalignment between Private Equity investors, portfolio company CEOs triggering costly turnover

Last year, our Private Equity (PE) and CEO survey performed jointly with Vardis, focused on the relationships between PE owners and the CEOs running their portfolio companies, and generated insights into how those relationships might be strengthened. In this year's survey—our third annual—we delve more deeply into an especially significant aspect of owner/CEO relationships: misalignment between the two sides on a surprisingly wide range of critical matters.

For too many PE owners, misalignment is triggering unplanned turnover among their portfolio company CEOs. Indeed, for this year's survey respondents, CEO turnover was unplanned for 34% of investments. And everyone's paying the price (figure 1). Such turnover can disrupt entire companies, causing confusion and sparking fear among managers and employees about what the change in leadership will mean for them.
Result? Productivity and morale plummet. Equally worrisome, as much as 46% of the PE firms participating in our survey said that unplanned CEO turnover was eroding the internal rate of return (IRR) on their investments. And a whopping 83% said that such turnover was lengthening their investment hold times.

These numbers don't bode well for PE owners seeking to realize their investment theses—their theories about how prospective acquisitions will create value within a specific time period after an M&A deal is inked. But investors can turn the situation around—if they improve CEO assessment during investment due diligence, build a robust CEO succession plan, and support their portfolio company CEOs more effectively during the first 100 days following the investment.

FIGURE 1: UNPLANNED CEO TURNOVER LEADS TO SIGNIFICANTLY WORSE RETURNS AND SIGNIFICANTLY LONGER HOLD TIMES



ABOUT OUR 2018 SURVEY

This year's survey was administered online from October-December 2017. Respondents comprised 53 managing directors or operating partners from PE firms, and 63 portfolio company executives (the majority of them CEOs). Survey participants hailed primarily from North America and Europe. As with last year's survey, the largest share of portfolio company respondents worked for companies with annual revenues of $100 to $500 million, while the majority of our PE firm respondents reported assets under management of less than $20 billion.

MISALIGNMENT ON MULTIPLE FRONTS

When asked what they thought drives CEO turnover, most survey respondents cited CEOs' lack of ability to execute the new strategy the PE firm defined for the business and a lack of alignment on how to execute the strategy. We saw significant disagreement between the two respondent groups on other fronts, too.

For example, when asked, "What's the one thing portfolio company CEOs need to understand better about their PE owners?", the investors said:

- A sense of urgency and time: "The need for rapid execution and delivering required financial performance", "Timing to exit is very important, and every day, week, and month counts . . . share all bad news quickly", "PE owners have an investment thesis and a timeline, and CEOs need to work to accomplish these".
- A focus on value creation: "It's all about the equity value", "The importance of targets and a detailed value-creation plan", "What CEOs consider to be the key strategic drivers of value".
- Alignment and communication: "[CEOs] are on the same team as we are: cooperation, transparency, and collaboration work best", "We are here to help", "The need for transparency and open communication, accompanied by clear ownership and accountability".
- Financial targets: "Investment strategy versus expectations about returns", "Direct alignment with our financial interests and timing".

Meanwhile, when asked "What's the one thing that PE firms need to understand better about their portfolio company CEOs?," the executives said:

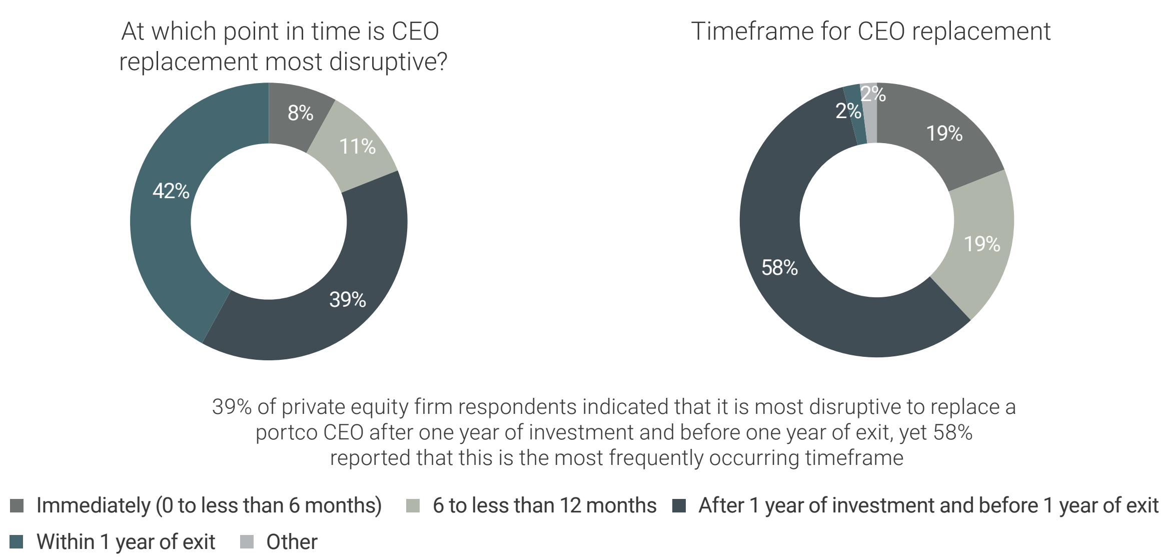
- Business drivers and CEO motivations: "The business-driver headwinds and tailwinds", "[We] CEOs live and breathe with the company [we're] running", "[PE owners] need to appreciate the power of passion and mission as the big drivers".
- Patience and communication: "Listen to the CEO about his concerns", "Pressure alone does not help", "Providing direction and feedback", "It's a hard job! Coach us before you fire us".
- Realism and balance: "Better assess the... realistic speed of execution", "The ups and downs of the business", "Operating is different from investing".
- Trust: "Willingness and ability to fully delegate", "Recognizing [PE owners'] power position but engendering mutual trust and respect", "[CEO] strengths and understanding how to leverage them".

With such sharp contrasts between the two groups' expectations of one another and what they consider most important, perhaps the high rates of unplanned CEO turnover in portfolio companies aren't so surprising. Nevertheless, when PE investors conclude that they must replace a CEO, the timing of such action can make matters even worse (figure 2).

Among our PE survey respondents, 39% said that replacing a portfolio company CEO after one year of investment and before one year of exit inflicts the most disruption on the organization. Yet they also indicated that as much as 58% of CEO replacements are made precisely within that timeframe. What's more, for PE investors who support portfolio company management teams as part of their investment thesis but ultimately are compelled to replace a CEO, 72% said they waited more than a year to carry out the replacement—well within the most disruptive time period.

Clearly, the disruption triggered by ill-timed CEO replacements does little to help drive the IRR that PE owners are looking for. Combine that disruption with the longer investment hold times that also come with unplanned CEO turnover, and it's obvious that PE investors need a better approach. However, improving CEOs assessment, succession planning, and CEO support can help.

FIGURE 2: IF PE INVESTORS ARE GOING TO REPLACE A CEO, THEY SHOULD DO IT EARLY IN THE INVESTMENT LIFECYCLE



CEO ASSESSMENT DURING DUE DILIGENCE

To avoid ill-timed CEO replacements, PE investors should factor CEO assessment and the possibility of replacements into the investment theses they develop for potential acquisitions.

THE VALUE OF INDEPENDENT ASSESSMENT

These findings point to the importance of alternative approaches to CEO assessment, including independent assessment, which many investors represented in this year's survey say they value. Provided by a neutral and objective third party, these activities typically combine interviews with results from behavioral and psychometric tests to gauge the degree to which a target company's CEO or entire leadership team can help realize the PE firm's investment thesis. As many as 61% of the PE investors in our survey said they "usually" or "always" seek independent assessments during pre-deal due diligence rather than rely on information from other sources (such as evaluations of a target company's reputation or perceptions provided by former executives, customers, or suppliers).

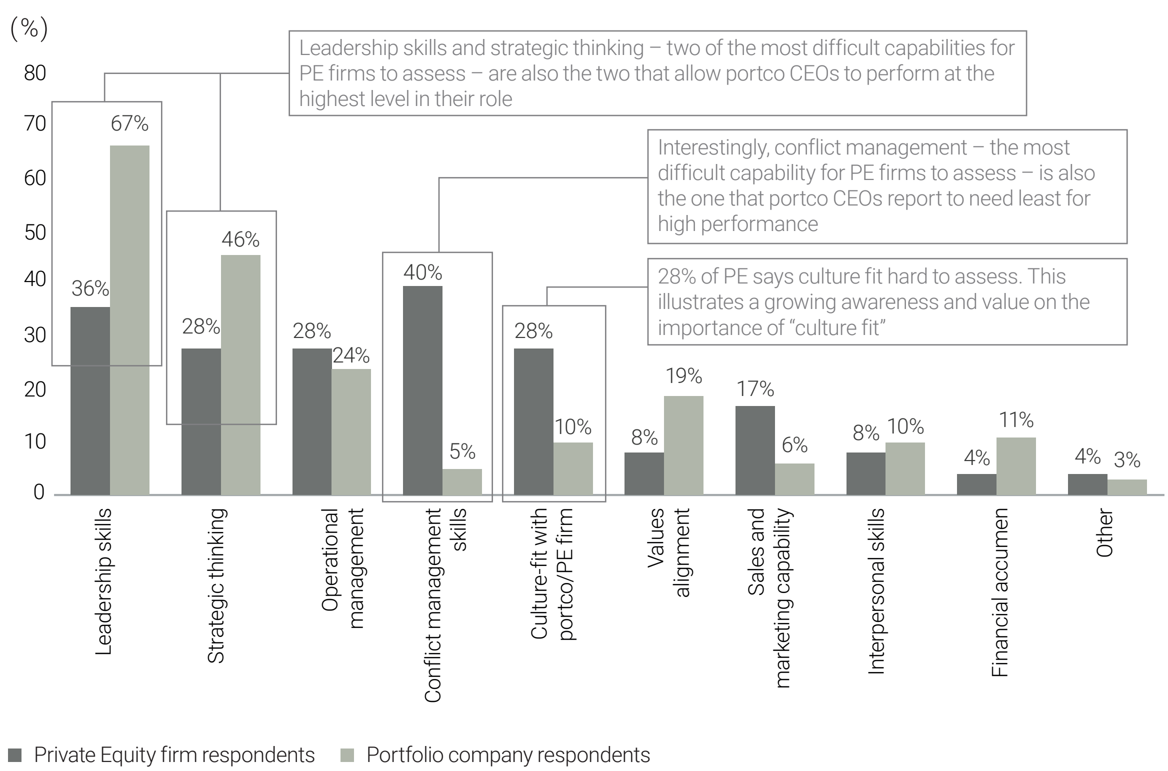
Conducting independent assessments during the pre-deal phase can prove challenging for investors who have limited access to target companies' management teams. But when possible, they can be invaluable in gauging management team alignment and capability.

CAPABILITIES COVERED IN CEO ASSESSMENTS

Are PE investors prioritizing the right capabilities in their pre- and post-close CEO assessments? In this year's survey, respondents from both groups cited "leadership skills" and "drive and work ethic" as "extremely critical" capabilities for portfolio company CEOs. Yet PE investors also identified conflict management and leadership skills as among the most difficult capabilities to evaluate (figure 3).

FIGURE 3: MISALIGNMENT: CEO CAPABILITIES THAT ARE MOST DIFFICULT FOR PE FIRMS TO ASSESS ARE ALSO THE MOST IMPORTANT FOR HIGH PERFORMANCE

Q PE firm respondents – What aspects of a CEO's capability do you find hardest to accurately assess?
Portco respondents – Which capabilities allow you to perform at the highest level in your role?



TOOLS USED FOR ASSESSMENT

When it comes to tools that PE investors use to assess current or prospective CEOs, reference checking (87%), meetings and interviews with PE executives (81%), and interviews with external consultants (77%) counted among the most-often cited by our survey respondents. More than half – 53% – reported using personality assessments in their CEO evaluations, and 23% reported using cognitive ability tests. These numbers closely resemble those we saw in last year's survey results.

The upshot? Investors tend to rely on sources that focus on CEOs' past performance and current (subjectively assessed) characteristics. These are relatively unhelpful for evaluating important dimensions of CEOs' ability to deliver high performance in the future, which will rely on the potential to learn and change – that is cognitive and emotional flexibility – and cultural fit. As a result, investors may be getting only part of the picture of a CEO's potential—one that doesn't highlight how effectively he or she will be able to execute new business strategies defined by the PE firm and lead the portfolio company in often unpredictable future environments.

CEO SUCCESSION PLANNING

Given the high rates of unplanned CEO turnover in portfolio companies, building a robust CEO succession plan makes good business sense for PE investors and CEOs alike. However, in our survey, only 39% of PE respondents indicated that they've sharpened their focus on modifying their approach to CEO succession to accommodate longer investment hold times, while 38% reported no change in their approach. And of the portfolio company executives taking part in the survey, as many as 63% said longer hold times haven't prompted them to alter their approach to succession planning. We see this as a very concerning blind spot on both sides.

Succession planning appears to be more of a growing priority for PE investors than for portfolio company CEOs. Still, on a weighted average, 64% of both PE and CEO respondents in our survey said they don't have suitable successors identified for the CEO role in their company, nor for the CFO and COO roles.

REDUCING UNPLANNED CEO TURNOVER

How can PE investors mitigate costly unplanned CEO turnover in their portfolio companies? We recommend action on the following three fronts.

CEO ASSESSMENT TOOLS

Formal, third-party executive assessment is the gold standard, but if this isn't feasible, for example, during pre-deal due diligence, PE firms can consider alternative methods. For example:

- Use structured interviews, aligned with the investment thesis, to explore how well a target company's CEO meets criteria essential for leading the portfolio company to success in the future. Check references thoroughly, including speaking with the CEO candidate's former colleagues and evaluating his or her track record.
- Benchmark findings against other potential CEO candidates.
- Use psychometric and behavioral assessment instruments whenever possible.
- Take stock of the company's and leadership team's reputation in the market, access social media and sites such as Glassdoor.com.
- Talk with market influencers (such as industry experts, consultants, and PE leaders), executives in the same industry as the target company, and former executives, as well as customers and suppliers of the company—to get their perceptions of the CEO's capabilities.

PE firms that use these methods in the pre-deal phase can then conduct a comprehensive CEO and senior team assessment in the post-deal phase, ideally during the first 100 days.

SUCCESSION PLANNING

We recommend that PE investors move succession planning to the top of their priority list. Why? Doing so will help them replace CEOs during less disruptive periods in the investment life cycle, limiting the destructive impact that a change in leadership can have on workforce productivity and morale, and on their primary driver – returns. Having a robust succession plan that is regularly refreshed creates a focus on development and career planning that has many other benefits, including retaining important, high potential executive leaders and attracting 'A-players'to the organization.

To build a robust succession plan, investors can work with CEOs and their teams to define:

- Clear and compelling career trajectories within the organization
- Developmental opportunities for individuals at all levels in the reporting hierarchy
- Opportunities for executives to strengthen their skills and to be groomed for the next level of leadership
- Multi-year development plans for high performers

CEO SUPPORT THROUGH CLEAR EXPECTATIONS

As noted earlier, PE firms can set the stage for successful delivery on their investment theses by clarifying expectations about goals, performance metrics, and content; cadences and channels for interactions and meetings with members of each portfolio company's leadership team. They need to communicate these expectations early and integrate performance goals and metrics into CEOs' compensation packages to foster alignment.

Finally, PE firms can ask CEOs who are working in a portfolio company for the first time to meet with chief executives at other companies in the investor's portfolio who have more experience in the C-suite and in portfolio companies. Through interactions with these more seasoned leaders, newcomers can gain vital insights into questions such as what role they'll be expected to fulfill in the company over the investment life cycle and how they can best build a mutually beneficial relationship with their PE investors.

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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.