AlixPartners

Private Equity & Investors
MAY 2017

ANNUAL PRIVATE EQUITY SURVEY

Replacing a portfolio company CEO comes at a high cost

Market conditions are forcing private equity (PE) firms to hold their investments longer than ever. Seeking new ways to create value, they are eyeing the clear links between a portfolio company's overall performance and its talent, culture, organizational design, and—in particular—its leadership team.

Our second annual private equity survey, performed jointly with Vardis, focuses on the relationships between PE owners and portfolio company CEOs. These relationships at the top can either promote stability or cause disruption, with significant consequences for the overall value of the asset as well as for the asset's executives and employees.

In an ideal world, PE investors and portfolio company CEOs would align on how they work together and lead the business long before a deal closes. In reality, our 2017 survey findings reveal that such an understanding is rarely the case. Instead, CEO turnover rates are alarmingly high, potentially disrupting strategic milestones and the owner's exit timeline.

What's more, we discovered that underlying that churn are issues that could have been detected much earlier—during due diligence. The survey findings (1) shed light on why PE–CEO relationships unravel so frequently and (2) underline the importance of moving early and quickly to shore up relationships between PE owners and portfolio company CEOs.

SURVEY OVERVIEW

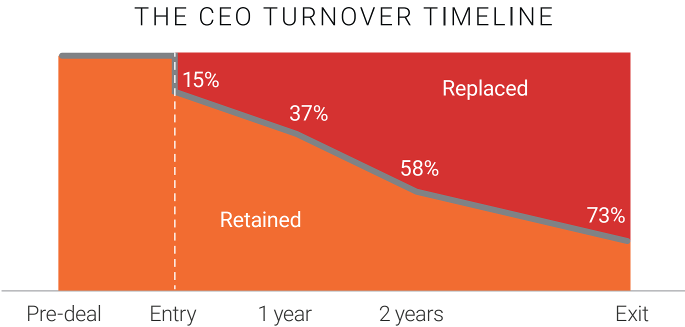
The 104 survey respondents from across the PE industry in the United States, Europe, the Middle East, and Africa were PE investors (38%) and PE-owned-portfoliocompany executives (62%). CEOs of portfolio companies made up the survey's largest respondent group (42%), and PE managing directors made up the largest investor group (24%).

**PE FIRMS PREFER TO REPLACE CEOS—
AND SOME DO IT FAST**

PE respondents reported a strong tendency to replace CEOs within the first two years of an acquisition, with an astonishing 73% of CEOs likely to be replaced during the investment life cycle. 58% of replacements occur within two years (figure 1).

FIGURE 1: FIRM PREFERENCES – RETAIN OR REPLACE CEOS OF NEW ACQUISITIONS

THE CEO TURNOVER TIMELINE



WHAT DRIVES PE OWNERS TO REPLACE CEOS?

According to investors, the most common reason for replacing a CEO is a lack of fit with the portfolio company's new strategic direction. This response highlights the critical importance of accurately assessing a CEO's suitability and fit for the future role. For example, does the incumbent CEO have the capabilities, motivation, and knowledge needed to implement the new strategy? Can those qualities be developed within a reasonable time frame?

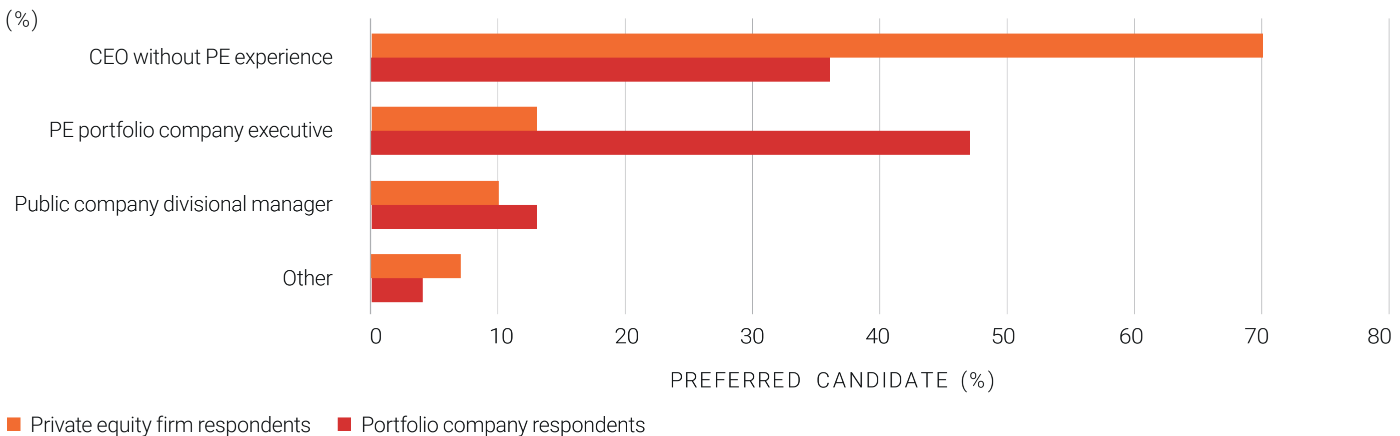
Investors also cited failure to deliver results in line with expectations, highlighting underperformance as a key reason for replacing CEOs. Taken together, these results suggest that thorough preliminary screening would reveal many if not most deficiencies well before a deal closes.

WHICH MATTERS MORE: GENERAL CEO EXPERIENCE OR FIRST-HAND UNDERSTANDING OF THE PE INDUSTRY?

PE respondents consider experience as a CEO in the PE environment a key success factor. From their point of view, PE experience enables their portfolio company leaders to get up to speed quickly. In the absence of an experienced PE CEO, we explored where PE firms turn. Are high-performing portfolio company executives with firsthand knowledge of the PE environment stronger bets than CEOs from public companies who will need time to adapt? The survey findings show that PE firms prioritize CEO experience above direct PE experience. Portfolio company executives, by contrast, championed the value of promoting high-potential individuals who have proven they can operate effectively within PE-owned companies (figure 2).

FIGURE 2: CEO SELECTION CRITERIA – IN THE ABSENCE OF AN EXPERIENCED PE CEO, WHO MAKES A BETTER CANDIDATE?

A candidate's record of success, experience with strategic challenges facing a portfolio company, and people leadership skills were identified as the top three most important selection criteria across both sets of respondents



WHAT PE FIRMS LOOK FOR?

According to PE executives, 73% agreed that they prioritize a CEO candidate's record of success above all. More than half (55%) also scrutinize whether a candidate has faced strategic challenges similar to those facing the portfolio company in question.

People-leadership skills was the third-most-important CEO characteristic required, with 48% of respondents agreeing on that point.

IT'S HARD TO MEASURE SOFT SKILLS

It can be a challenge to piece together a comprehensive portrait of the executives brought in to lead portfolio companies. Some qualities are more difficult than others to analyze and understand. Characteristics such as financial acumen are relatively easy to assess, with 90% of PE respondents feeling confident in their ability to gauge that skill. A similar percentage expressed confidence in their ability to assess sales and marketing skills.

On the other hand, 50% of PE investors said their greatest challenge was to assess an individual's fit into a portfolio company's culture, and 35% agreed it's difficult to evaluate a CEO's leadership skills. It's especially important to correct these shortcomings, because investors are eager to derive value from the human capital dimensions of their investments.

"An overwhelming 78% of PE investors named pace of change the most significant source of conflict between PE owners and portfolio company CEOs."

KEY AREAS OF DISAGREEMENT BETWEEN PE OWNERS AND PORTFOLIO COMPANY CEOS

Disagreement between investors and portfolio company CEOs can be avoided if both sides know what to look out for. An overwhelming 78% of PE investors named pace of change the most significant source of conflict between PE owners and portfolio company CEOs.

The subject of performance targets and metrics was the second-most-contentious issue, with which 50% of respondents struggled.

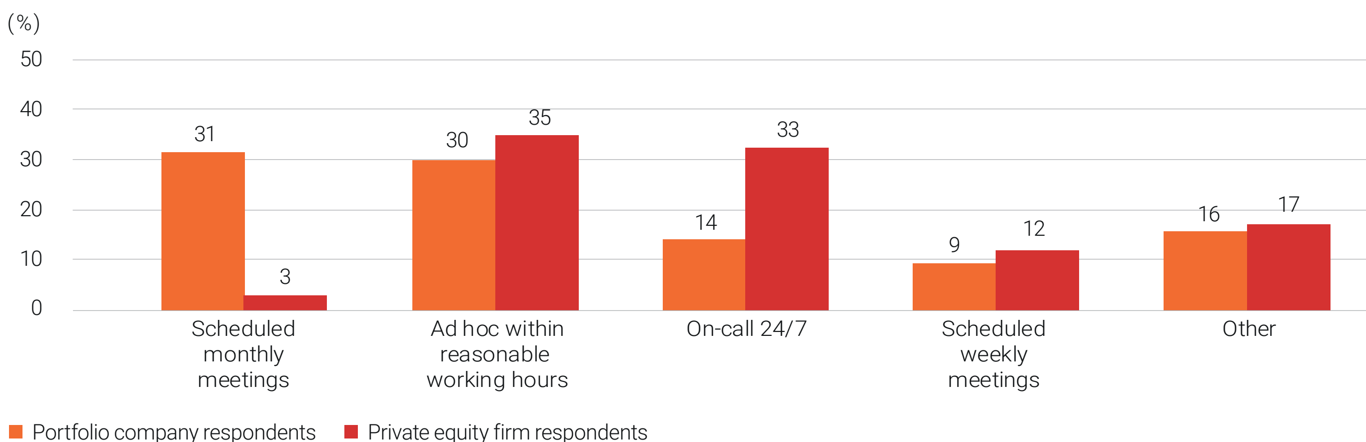
STARKLY DIFFERENT COMMUNICATION PREFERENCES

PE owners and portfolio company CEOs also appear far apart on the question of the frequency of contact and communication. When asked about their expectations regarding the availability of portfolio company CEOs, 3% of PE investors said they were happy relying on scheduled monthly meetings. By contrast, 31% of CEOs prefer planned monthly meetings with investors. When it came to being on call around the clock, 33% of PE investors held that expectation while only 14% of CEOs thought that was acceptable (figure 3).

Such stark differences indicate that it's critical to establish clarity and alignment around expected meeting cadence in the early days of the holding period. In fact, discussions about communication and meeting cadence expectations can reveal differing perspectives about the desired pace of change—and may therefore ease many of the tensions in PE investor–CEO relationships.

FIGURE 3: PREFERRED MEETING CADENCE – WHAT IS THE IDEAL FREQUENCY OF CONTACT BETWEEN THE PE FIRM AND PORTFOLIO COMPANY CEO?

PE firms are looking for higher levels of accessibility than most CEOs would like



AlixPartners

PREVENTING DISRUPTION

The survey results clearly revealed a disturbingly high rate of portfolio company CEO turnover in the PE industry, as well as key areas of chronic misalignment between CEOs and investors. Replacing a CEO is disruptive and comes at a cost. The cost to investors can be measured in lost time. Additional losses stem from the impact of disruption on the portfolio company's workforce, such as increased employee uncertainty and turnover which ultimately reduces employee productivity. The timing of CEO replacements is also worrying, because replacing a CEO post-acquisition can disrupt—or at least delay—the implementation of a new strategy.

Paying closer attention to the key drivers of CEO replacement can help investors make those decisions earlier. When replacing a CEO is imperative, the PE owner should act quickly. To select the right CEO, investors can use robust assessments to identify an executive whose strengths are closely aligned with investment thesis objectives. The larger issue that PE firms have to address involves the approach and the capability of their investors to size up CEOs and management teams during pre-diligence. This research creates an argument for better selection and development of investors to improve their skills in people judgment and relationship management. Such skills ensure that a CEO's fit with the strategic direction gets assessed early and misalignment is minimized.

When it comes to strengthening and stabilizing investor–CEO relationships, two critical topics to discuss in the early days of an investment are investors' expected pace of change and preferred oversight meeting cadence. Portfolio company CEOs should gain clarity on those expectations quickly—especially if PE investors have not explicitly outlined a preferred approach. To drive down disruptive turnover and bolster portfolio company performance, the topic of alignment should be on every investor's agenda.

FOR MORE INFORMATION CONTACT:

Ted Bililies, Ph.D.
Managing Director
+1 617 849 6004
tbililies@alixpartners.com

Keith Warren
Senior Vice President
+1 212 845 4049
kwarren@alixpartners.com

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.

The opinions expressed are those of the author and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective professionals or clients. This article regarding Annual private equity survey: replacing a portfolio company CEO comes at a high cost ("Article") was prepared by AlixPartners, LLP ("AlixPartners") for general information and distribution on a strictly confidential and non-reliance basis. No one in possession of this Article may rely on any portion of this Article. This Article may be based, in whole or in part, on projections or forecasts of future events. A forecast, by its nature, is speculative and includes estimates and assumptions which may prove to be wrong. Actual results may, and frequently do, differ from those projected or forecast. The information in this Article reflects conditions and our views as of this date, all of which are subject to change. We undertake no obligation to update or provide any revisions to the Article. This article is the property of AlixPartners, and neither the article nor any of its contents may be copied, used, or distributed to any third party without the prior written consent of AlixPartners.

©2018 AlixPartners, LLP