EXPERT COMMENTARY

Thoroughly assessing the CEO of a newly acquired portfolio company early and making necessary changes immediately is key to optimising value creation, says Shannon Gabriel of TBM Consulting Group

The four positions a CEO must be able to play

Last year saw nearly 3,000 mid-market PE deals, according to PitchBook, and many of the incumbent CEOs involved in those deals have already been shown the door. According to a 2018 private equity survey completed by AlixPartners, 58 percent of CEOs are likely to be replaced during the first year.

That survey shows that 72 percent of PE investors wait more than 12 months to make the switch. That can be a costly mistake. With shorter holding periods trending, companies must generate value in the first 12-18 months, or they put the deal thesis at risk. It's difficult, if not impossible, to make up for any value you fail to generate in the critical first few months.

So why waste precious time on an ineffective CEO who is ultimately on the way out? If a change at the top is in order, make it now. Indeed, research by Russell Reynolds Associates indicates that in less successful deals, the operating partners wait longer to replace the CEO. In our own research, we found that PE leaders believe subpar management can cost one to two multiples when a portfolio company is sold.

Ask yourself if that is value you're willing to give up.

The four hats every portfolio company CEO must wear well

To make changes at the top fast, PE firms need an effective means for sizing up the capabilities of an incumbent CEO during the pre-LOI phase of the deal. That starts with knowing exactly what to look for.

Some experts say CEO success hinges on past experience. Others argue that emotional IQ trumps track record. In our experience, it takes both. PE firms need a multidimensional leader who can fire on all cylinders, all the time.

It's a tall order, but so is the task of unleashing an acquisition's full potential in just 36-60 months. The CEOs who beat the odds – and who are most successful in their roles – are capable of playing four particular positions simultaneously.

MVP: A track record of past performance with impressive stats on meaningful measures

First, you need a CEO with a history of delivering growth and financial returns in the industry in which you operate. You want to see that the CEO has consistently hit performance targets. Under the CEO's leadership, key operating metrics must have either held steady or improved. The leader must demonstrate the ability to take strategic direction and show quantifiable progress towards specific metrics and goals.

If you are acquiring an organisation that is struggling or in which performance has been declining, you will need a strong reason to justify hanging on to the current CEO. But, if you are taking on a company that is already on a top line growth trajectory, then the incumbent CEO has some victories under his or her belt. But can that leader continue moving the business forward? To do so, he or she needs to show signs of perseverance and mental toughness.

The leader will be expected to head up intense growth for three or more years. Can the CEO handle the pressure for an extended period of time without burning out? It's a question that needs to be explored.

Quarterback: Alignment with the strategic direction set by the PE firm and the ability to put it into play

The most common reason for CEO replacement is lack of fit with the portfolio company's new direction, and it is easy to see why. The person leading the team down the field must be 100 percent aligned with the PE firm's game plan. Otherwise, he or she won't be able to execute per the playbook.

> *"PE firms need a multidimensional leader who can fire on all cylinders, all the time"*

Like an all-star quarterback, portfolio company CEOs must operate tactically and strategically at the same time. They need to grasp the big picture and be on board with the PE group's long-term goals and exit strategy, and they must be able to translate the end goals into short-term results. Consider the CEO's sense of urgency. Will he or she take immediate action in order to make progress in the critical first weeks and months of the deal?

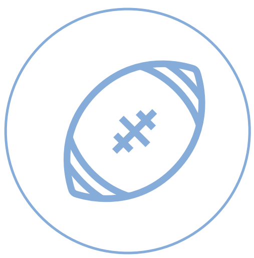
While some of this comes down to past experience, much of it has to do with the leader's beliefs on how the firm will succeed in both the short and long-term. These beliefs must align with the new owners', and there must be solid agreement on the specific actions needed to realise operational gains. If that alignment isn't there, or worse, if it isn't legitimate, you jeopardise your opportunity to realise critical gains out of the gate.

The four roles of an effective portfolio company CEO

MVP

Track record of past performance

- Consistently delivers financial returns
- Maintains or improves key operating metrics
- Shows quantifiable progress against strategic goals



QUARTERBACK

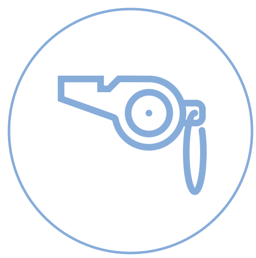
Knows the game plan and puts it into play

- Fully aligned with the PE firm's strategic direction
- Capable of acting both strategically and tactically at the same time
- Sense of urgency to put plans into action and generate value immediately

COACH

Develops and motivates the team

- Can align teams with strategy and break down long-term objectives into short-term goals
- Holds the respect of employees and is capable of creating momentum
- Develops key members of the team



REFEREE

Straightforward communicator capable of making tough calls

- The candour to articulate the facts – good and bad – in a clear and concise manner
- Comfortable communicating daily with the PE operating partners and leadership team
- Ability to quickly execute difficult decisions

Coach: Ability to build consensus, motivate the team and develop key players

It's one thing for the CEO to be aligned with your strategic direction for the portfolio company. It's another thing for him or her to drive the company there. No CEO lives or dies alone. Once you are sure that the leader shares your mindset and knows which plays to call, the next area to assess is his or her ability to get the team on board.

Driving performance comes down to three things, and the CEO must do all three well: align teams against strategy; set direction by breaking down goals into quarters, months and weeks, and; create momentum, keeping people motivated for extended periods of time.

Despite intense time pressure and the need to hit the numbers, the CEO must keep tabs on key players and work to build up individuals along with the organisation. By developing the capabilities of the team and turning out A-players along the way, the CEO helps to create incremental value for the portfolio company at exit.

All of this requires the CEO to possess an internal following. At a minimum, there must be a sense of respect and trust for the CEO across all levels of the organisation. The CEO may be asking people to work harder than they ever have before, to change the way things have historically been done and to embrace a new culture. Your leader will not succeed without existing support from the troops.

Referee: The candour to tell it like it is and the confidence to make the tough calls

Too often we see leaders unable or unwilling to share the difficult details of a business situation with the ownership team. We've even seen leaders purposely withhold information during the due diligence phase. This is not acceptable.

Your portfolio company needs a leader who can identify and accept problems. The person must be forthright enough to give you the facts, even when they aren't pretty, and must be good at articulating issues clearly. There isn't time for sugar coating when every minute counts towards value creation and the business has to achieve aggressive growth in short order.

In portfolio companies, open and honest communications with the owners and the leadership team are part of the everyday working relationship, not something that happens only once a quarter in a board meeting. Is your CEO going to be comfortable in this type of operating environment? Does he or she have the confidence to share feedback with the PE team, the leadership team and direct reports in a straightforward manner? Does the leader have the composure to accept that straight talk in return? And, if so, does he or she have the fortitude to swiftly act on the facts? CEOs must be able to make – and live with – the difficult decisions that are necessary to drive value in the business.

"There isn't time for sugar coating when every minute counts towards value creation and the business has to achieve aggressive growth in short order"

How to quickly assess your CEO

Knowing what makes an effective CEO is only half the battle. PE firms need a proven formula for determining if an incumbent CEO has the right capabilities to be an MVP, quarterback, coach and referee all at once.

While most of these attributes can't be measured with a balance sheet, income statement, or facility walk through alone, it is possible to gain insight in each area before the deal is done. Here's how:

1. **Start with a detailed capability profile customised to your PE firm and your deal thesis.** Track record, shared vision, leadership capabilities and candour are musts. But there will be other attributes specific to your firm and deal thesis that your CEO must possess. List them out and be sure all the boxes are checked.
2. **Review past performance and do a metric-based assessment.** Look at the hard data for clear signs of financial results and KPI improvement.
3. **Use behavioural assessments to gauge communication skills, teamwork aptitude and leadership style.** Get a sense of the CEO's personality, beliefs and attitudes and use the results to guide further hands-on assessment.
4. **Interview players from across the organisation for additional insight.** Embed yourself with the executive team, direct reports and people at all levels of the organisation to see which common denominators emerge around the CEO's working style, urgency, ability to handle stress and teamwork capabilities.
5. **Vet assessment results with in-field observation.** Validate what you've learned from the data, assessments and team interviews by watching the CEO at work and through one-on-one conversations.

If the CEO can't play all the right parts, don't wait to make a change

Spending some time during the due diligence phase to assess the CEO's capabilities in four critical areas is one of the most important steps you can take to ensure the success of your deal thesis. Research and experience show that waiting is costly. To achieve full value creation, you must hit the ground running with a leader who knows how to win, aligns with your objectives, is capable of rallying the troops, and will be upfront with you at every step.

The sooner you know if the incumbent leader falls short in any of these key areas, the sooner you can make a change. And the better positioned you'll be to make progress right out of the gate and sustain momentum throughout the investment lifecycle. ■

Shannon Gabriel is managing director of TBM's Leadership Solutions practice, helping clients identify and resolve weaknesses within their organisational structure and hiring process, build bench strength and engage interim leaders to facilitate growth and drive immediate performance improvements.