A joint research project by University College London and Mercuri Urval International

Managing private equity buyouts – Cracking the human element

"We are buying a life or a proud tradition, not buildings and machines.

Thus, our work cannot be reduced to numbers only."

(An anonymous senior private equity professional)

Introduction

"We spend too little time on people issues
compared to the amount of time we spend on numbers."
(An anonymous senior private equity professional)

Merger and Acquisition (M&A) activity has shot up in recent decades. Next to trade or industry buyers, an increasing share of M&As are conducted by private equity players. **Private equity players tend to outperform trade buyers in M&A activity. Why is this?**

Most research into private equity investment to date has focused on financial performance. Less is known about the management and human dynamics of the buyout process. In 2011–2012, Mercuri Urval and University College London joined forces to explore whether **buyout management and its human dynamics represent the private equity sector's 'magic bullet' or its Achilles heel.**

Our international research project concentrated on the human dynamics in mid-market private equity buyouts. From this analysis, our aim was to provide best practices and recommendations on how to optimise performance in private equity buyouts. To reach these aims, the research project encompassed eight countries – USA, United Kingdom, Germany, France, Sweden, Denmark, Norway and Finland. Together, Mercuri Urval and University College London adopted a qualitative research design[i], based on a multiple case study approach, using interviews, observations and publicly available information as our sources of data. This totalled a sample of 27 private equity houses, through 33 interviews with senior professionals (Table 1)[ii]. The research involved private equity firms representing a combination of local (29.6%), regional (40.7%), continental (7.4%) and global (22%) players. Most of these can be classified as top players in their respective country or strategic niche[iii].

Our findings lead us to conclude that the human element has potential to be a powerful tool for success for the private equity sector. More often than not, it is its 'Achilles heel'. On the following pages, we provide recommendations with respect to the best practices to adopt to manage the human element with more success.

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Key findings

"The Private Equity firm that solves the human puzzle in buyouts will be a front-runner."
(An anonymous senior private equity professional)

A. Research findings
1. The human element matters in private equity buyouts: Our analysis shows that the 'human element' in mid-market private equity buyouts is critical. Why is this?

The buyout business model is people-dependent, as investments are made in organisations that, de facto, consist of people. This explains why the human element:

(1) Is an underlying and critical success factor in buyouts
(2) Is the cause of the main mistakes in buyouts
(3) Affects the potential to create value and reach the performance targets sought
(4) Has the potential to be the future source of competitive advantage in the sector.

The significance of the human element in buyouts has increased over the past years. This stems from an uncertain and, in many cases, dire macroeconomic context, which poses a greater premium on management and ownership excellence. Also, financiers, investors and regulators are exerting pressure on private equity players to shift toward value-adding ownership. *In responding to this call, private equity houses recognise the need to pay attention to the human element in buyouts.*

2. Private equity firms lack focus or ability to prioritise the human element: Despite the importance of the human element, interviewees acknowledged that most private equity houses are not currently well-equipped to deal with this challenge. Human issues tend to be approached with 'a gut feeling' and 'intuition'.

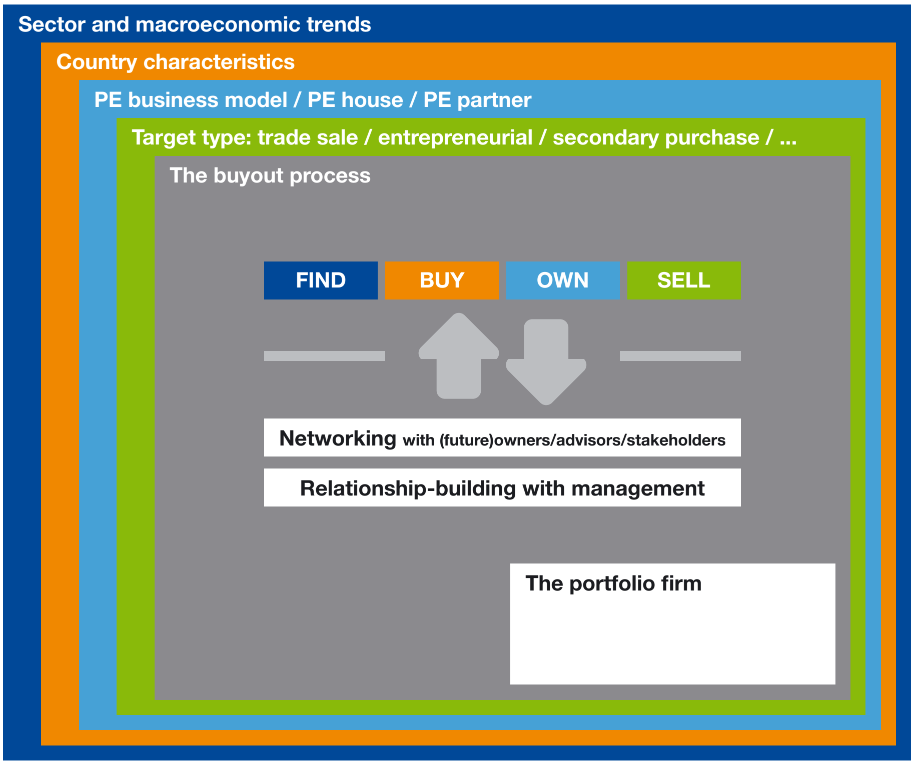
This stands in stark contrast with the sector's otherwise professional and disciplined approach to the buyout process, be it with regard to its financial, strategic or corporate governance dimensions. *Though the human element is identified as being critical, it is not approached in a 'disciplined' way.*

3. Understanding the human element in private equity buyouts requires an understanding both of the people involved and the context they are operating in: All players included in this study handle the human element in a commendable manner, but few, if any, seem to 'capture it all'. The main outcome of our research project has been the development of a phase-based buyout model that maps the human dynamics by phase. We found the human element of buyouts to be relevant across multiple contexts and processes, involving numerous people, and best when endowed with the right attributes (Fig. 1):

a. **Context:** The human element of buyouts is shaped by the macroenvironment, economics and the country in which the buyout takes place. Additionally, the context of the private equity house as well as the approach of the professionals involved all affect the execution and human dynamics in the buyout process and the management of the portfolio firm. Further, buyouts differ depending on the type of target company.

b. **Processes:** Within the buyout process, human elements shape its various phases, be it the sourcing of deals, the identification of targets for purchase, the ownership period or exit. In addition to these 'set' phases, the parallel processes of networking with stakeholders and relationship building with management shape the success of buyouts.
c. **People:** All people matter, whether they are on the side of the private equity organisation, the portfolio firm or the experts that are brought in as consultants, executives or Board members throughout the buyout process.
d. **Attributes:** Not only do people matter, certain human characteristics appear more significant than others. The individuals involved need to exhibit the required level of *talent* for the job; they need to *fit* their role and organisation; they need to be *motivated*; and, especially at the higher levels, the *chemistry, trust and relationship* between key persons need to match. At their best, organisations – either private equity or target companies – exhibit characteristics of 'world class' operations. The private equity sector seeks excellent individuals and organisations exhibiting drive and energy, passion, enthusiasm and engagement as well as the tenacity to face the labour-intensive and demanding years of private equity ownership.

Figure 1. Context affecting human dynamics in buyouts.



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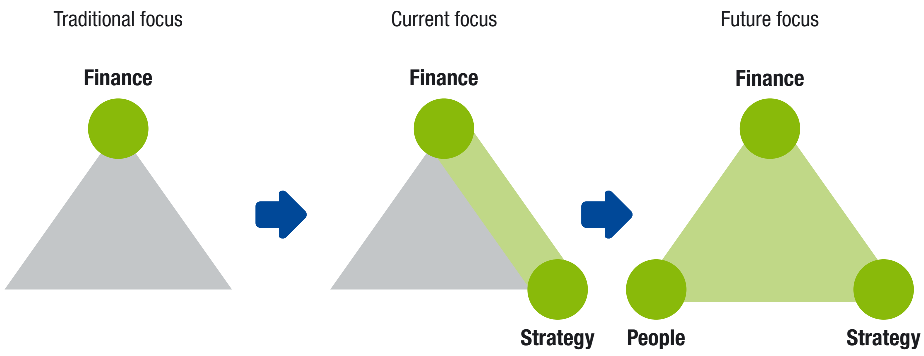
The sector has evolved from having a largely financial focus to encompassing strategic and ownership capabilities. Now the sector needs to pay more attention to the human element in buyouts (Fig. 2).

Figure 2. Evolving capabilities in the private equity sector.



B. The academic interpretation of our research findings and conclusion: The social sciences have been debating the significance of the human side of enterprise since the 19th century. It has been featured in early management theorising and models since the 1930s, and by the 1980s it was recognised as a success factor of the modern (industrial) organisation. In this respect, the private equity sector seems to have lagged behind to some extent. Here, the difference between the business models of private equity and industrial firms needs to be acknowledged. Nevertheless, in the early 21st century, where the 'human element' is increasingly seen as central to organisational success across sectors, it seems that the private equity sector is gradually catching up.

Mercuri Urval's perspective: In what ways do you want to differentiate yourself from your competition? Success in Private Equity Buyout is dependent on people. Their capabilities matter, and, what is more, the skills needed can be identified, measured and developed.

Trends affecting private equity players

"We are on our way towards understanding human factors in Private Equity deals. We have taken the first steps, but we are not there yet."

(An anonymous senior private equity professional)

A. Research findings

1. A young industry reaching maturity: Though private equity has always existed in some form[iv], its present origins can be traced to the post World War II era. The 1980s saw the modern birth of the sector, which has since spread globally. Despite different historical paths and degrees of maturity across countries, the sector is now well established. It is well understood by its immediate stakeholders, i.e. the sellers, investors and financiers.

Yet the sector suffers, in part, from a negative media and societal image. The image of *"leverage-based deals, where all the juices are squeezed out"* was deemed a poor fit with reality. As a young sector that has emerged, grown and matured in a short period of time, has it simply not had time to explain itself to the wider audience?

2. Excellent players are expected to stand out: Reputation is critical in an industry where stakes are high in terms of investments and expected returns. The economic bubble of the early 21st century drew interest, equity and new entrants into the sector. Many of these players face the risk of fading away in an increasingly competitive and transparent market, while those with a sound reputation and track record are expected to stand out.

3. A sector suffering in dire economic circumstances: The economic situation since 2008 has taken its toll on the private equity sector. This affects the buyout process in the following ways:

- The sourcing for new deals is more demanding and competitive
- The purchase of companies depends on financing that is more difficult to secure. There is also the question of how to find targets with business models that can resist economic downturns.
- Securing the desired returns on investment from portfolio firms is more challenging
- Exiting from buyouts has become difficult and prolonged

In terms of the human element, this means that the need for outstanding talent is increasing.

4. 'From Excel spreadsheets towards active ownership': A marked distinction between the pre-crisis – meaning the pre-Lehman Brothers – and the post-Lehman era is made. The private equity 'playing field' has become more regulated, demanding and transparent post-Lehman. This has long-term implications for private equity ownership. Previously, private equity companies focused on the purchase decision and a 'financially orientated', distant ownership approach. Now, there is a need for private equity funds to transform themselves into 'active owners':

"From numbers and Excel spreadsheets, we are transforming into a mode of active ownership and industry operatorship."
(An anonymous senior private equity professional)

Though best-in-class private equity houses are used to operating with an active ownership approach, the sector overall is caught in a 'metaphysical' quest to unveil the meaning of 'active ownership':

- What is (active) ownership?
- How can one learn about and develop into being an active owner?
- What are our 'ethos' and ethical guidelines as a sector?
- What is being industrial? And who *is* industrial?
- How transparent as an industry should we be?

5. The significance of 'best-in-class' private equity management: Faced with an increasingly demanding marketplace, the management of the private equity house becomes critical. The characteristics of successful private equity houses comprise:

- *Having created a 'playing space'* through a niche strategy or long-standing dominance
- Proven ways of defining and implementing the *formality and discipline* sought in the buyout process. Some private equity houses operate using clearly defined 'playbooks' that are constantly updated and provide a means of formalising the seniors' knowledge. Others are more informal in their approach.
- *Organisational excellence.* The significance of the private equity house's culture was stressed by professionals from funds that are 'aiming high' and are 'inspired by the best'. The cultures of the best-performing private equity houses combine focus, seriousness, positivity, equality and dynamism.

6. Private equity professionals' excellence: Founding partners and recruited professionals are each private equity fund's strength and differentiator:

"Though we come from an established house, ultimately winning the deal boils down to the individuals in the deal. A good brand opens the door, but it is the individuals that make or break the deal."
(An anonymous senior private equity professional)

The talent in the industry is of the highest calibre, with top houses boasting demanding recruitment conditions. Capabilities required in the sector are changing, though. In line with the trend toward active ownership, recruits are no longer drawn solely from the financial sector, but a broader variety of competences is being brought into the business:

"The game has shifted from a battle to save costs towards one of developing businesses."
(An anonymous senior private equity professional)

In support of active ownership, a private equity professional is a business developer. This role requires:

- Financial excellence
- Strategic acumen
- Intelligence, humour and sociability
- Analytical skills
- A structured, fact-based approach
- Excellence in project management and coordination rather than general management

In defining the characteristics of successful private equity professionals, people-related skills rose to the top. Successful professionals combine:

- Flexibility and the ability to take risks
- A hard-working nature
- A passion for the business
- Interaction, coaching and networking skills

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B. The academic partner's interpretation of the research findings and conclusion: The external and internal contexts in which buyouts take place are central to defining the human element in mid-market private equity buyouts. Thus, we note the increasing significance of people excellence, not only on the portfolio firm's side, but also on the private equity organisation's side. Private equity houses are professionally run service organisations with an exceptionally high calibre of talent that is hard-working, passionate and driven. Whereas many multinational corporations currently seem to lament the lack of 'employee engagement', private equity organisations seem to 'tick' with enthusiasm and drive. Now, what is it that organisations across sectors can learn from their private equity peers? And how can private equity companies further incorporate human elements into their own way of working?

Mercuri Urval's business perspective: Talent is at a premium–whilst company strategy and financing are critical, without the right talent in the right roles deals do not work.

Human dynamics in the buyout process

"It has been a costly process to find out the significance of the human side in private equity buyouts."

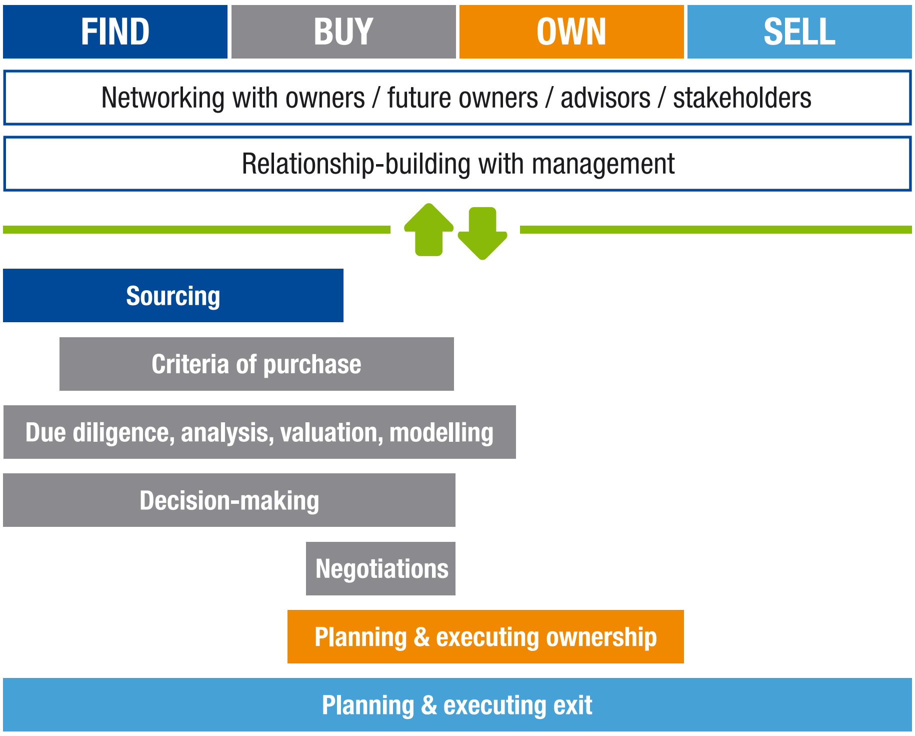
(An anonymous senior private equity professional)

A. Research findings

In summary, the buyout process consists of four intertwined stages, combined with ongoing networking and relationship-building (see Fig. 3):

- **Phase I (FIND):** Finding potential targets through sourcing and deal identification.
- **Phase II (BUY):** Having identified a potential target, proceeding to thorough analyses, discussions, valuation, modelling and negotiations in support of the final purchase decision.
- **Phase III (OWN):** Planning and executing ownership of the portfolio companies.
- **Phase IV (SELL):** Planning and executing the selling of the portfolio company to the next owner.
- **All phases (NETWORKING and RELATIONSHIP-BUILDING):** Relationship management on an ongoing basis to support present and future purchases.

Figure 3. Phase-based overview of the buyout process.



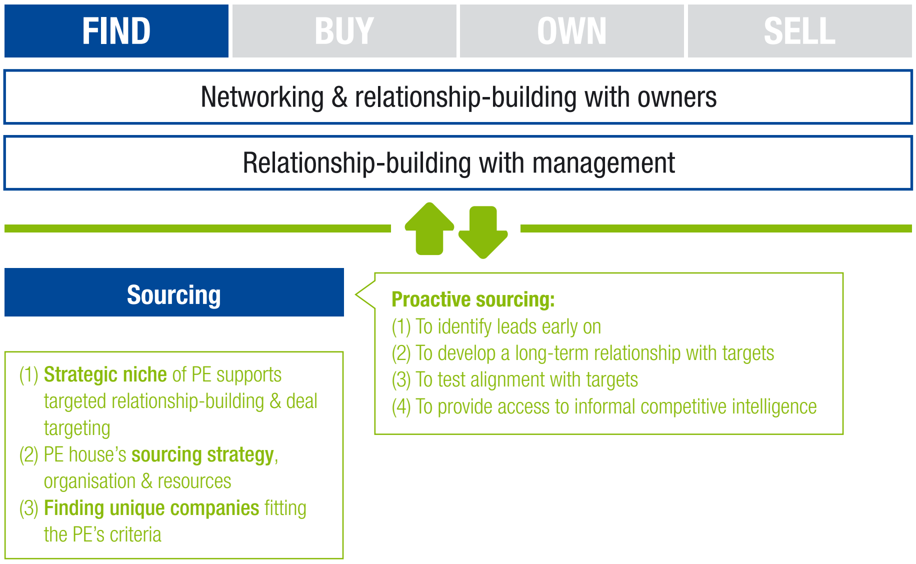
1. Active sourcing is at the heart of the 'find' phase:

Creating increased value through company purchases is at the heart of the private equity business model. To this end, buying 'right' is critical. Thus, the sourcing (phase I) and buying (phase II) phases need to be professionally executed (Fig. 4). The industry takes its time in this buyout 'front end': it can last from months to a decade.

The official investigation, or 'buy' phase, is preceded by years of relationship building with potential targets (Fig. 3). Private equity houses adopt a proactive approach to sourcing targets. This serves several purposes:

- Potential leads can be identified early on and, if possible, before the competition.
- A relationship with the selling side, be it with owners or management, can be established. This early relationship-building helps both sides decide whether the partnership has the potential to succeed. Relationship-building is a long-term endeavour: it takes years to develop a relationship based on trust. The stronger the relationship, the more likely it is that the private equity fund secures the deal and further, succeeds in the ownership phase.
- A good relationship provides access to competitive intelligence on the target's potential.

Figure 4. Human dynamics in the 'find' phase.



2. Analysis, decision-making and relationship-building at the heart of the 'buy' phase.

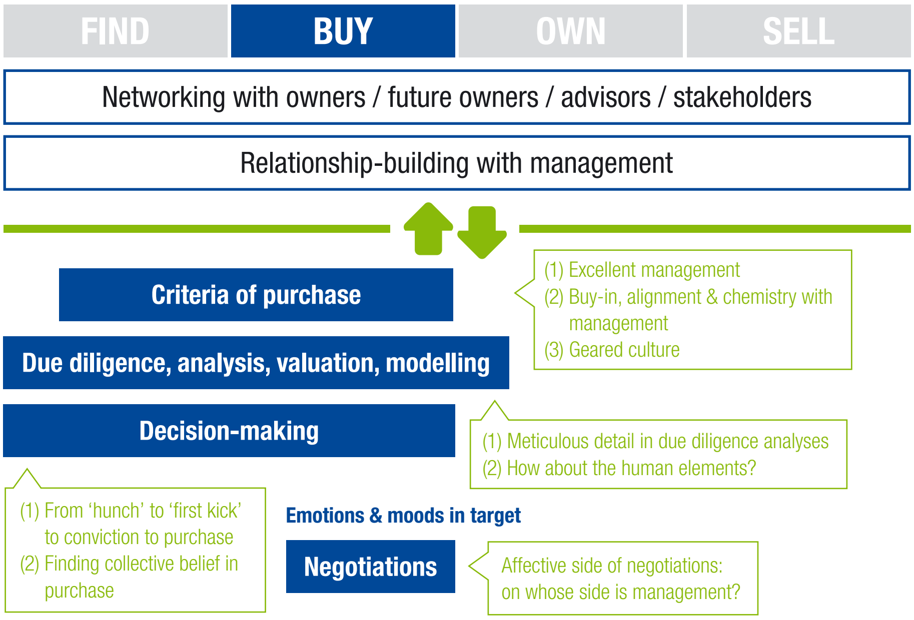
People-related purchase criteria: Though private equity houses analyse target companies in meticulous detail, the question is, Should exact purchase criteria be adhered to? While such criteria are published for the purposes of external communications and positioning, in practice, criteria shift from case to case and sector to sector. Moreover, each partner operates with different criteria in mind. Private equity professionals seek 'unique and excellent' companies.

Typical purchase criteria revolve around sector- and company-related opportunities as well as identifying the risks and the value added that the private equity house can provide. In addition to these strategic and financial considerations, people-related purchase criteria relate to

- Seeking high-quality management teams. These 'good' to 'great' management teams are ingrained with ambition, vision, drive and proactiveness. These characteristics are critical under private equity ownership, given the high ambition levels involved.
- The relationship between the target's management and the private equity house representatives needs to exhibit chemistry and good rapport, a high degree of trust and an alignment of interests and plans. This is critical, given that the ownership era is largely dependent on the relationship between the owner and management. The seeds of this relationship are ideally sown early in the pre-deal era.
- The significance of corporate culture depends on the type of purchase and strategy for the deal. For some private equity houses, great companies come out of great cultures; here, culture is a purchase criterion. Deals go astray or are not invested in if the target does not display the desired culture. Conversely, private equity companies see that companies lacking in cultural excellence can be good investments too. Bankrupt or distressed companies are an example, where a poor, sluggish and, in part, unethical culture might have prevailed prior to the purchase. Investments in traditional, slower and more hierarchical sectors might focus on companies with potential – though clearly less 'driven' cultures.

Minute attention to non-human due diligence: Once a private equity house has set its sights on a potential target, it conducts rounds of analysis culminating in official due diligence. There is a pronounced emphasis on due diligence in the sector, given the significance of the 'right' purchase to the success of the investment. Commercial, strategic, legal and environmental due diligence analysis is part of the industry standard. Much is financially invested in this pre-deal analysis. Whereas early analysis might be conducted in-house, official due diligence is outsourced to external consulting firms. Many have quasi-permanent relationships with these consulting suppliers. The focus is on the financial and strategic soundness of the deal, while the analysis of the management and organisation remains on shakier grounds.

Figure 5. Human dynamics in the 'buy' phase.



The affective side of negotiations: As the negotiations proceed and the closing of the deal becomes imminent, there is a shift in management's allegiance. They start to think about 'what's in it' for them. All the while, it is critical that management keeps its focus on the business. At this stage the incentive programme for management is finalised. This is an opportunity for both sides to gauge 'what's the money behind the talk?'

Intuitive hunches and collective belief drive decision-making: The process of deciding to make a purchase consists of a series of iterative rounds from identification through interest, discussions, analysis, formal due diligence, valuation, modelling and negotiations to deal closing.

From a human perspective, the investor's 'first hunch' or 'first kick' from a company is critical. The 'first hunch' occurs early on in the sourcing process, when skimming through numerous potential deals. The 'first kick' occurs when meeting management. Such socio-emotional and partly intuitive decision-making attests to any deal's non-rational, non-linear and non-financial sides. The involved professionals also need to 'click' with the potential target – that is, feel an emotional bond and attachment towards it, an intuitive sense of value-creation potential.

Further, as professional service organisations are often organised as partnerships, there is a need to find a 'collective belief' in the purchase among the owner–partners in the investment committee.

The strategic significance of relationship-building with management: The early meetings with management are a 'mutual matchmaking process', where both sides are making a decision about the other. It is in the private equity company's interest that good chemistry and strong bonds are developed upfront. The significance of personalities is highlighted – private equity funds consider carefully which professionals they allocate to each deal. Ideally, there is a fit between the partner involved and the selling side's owner and management. Early meetings are also characterised as a 'trust-building process'; there is a need to establish trust with management. The role of the first meetings is especially critical in auctions, where the two sides have few possibilities to meet. Private equity houses make an effort to present themselves as an attractive option. Further, the pre-deal meetings are an opportunity to establish terms of cooperation and to find alignment.

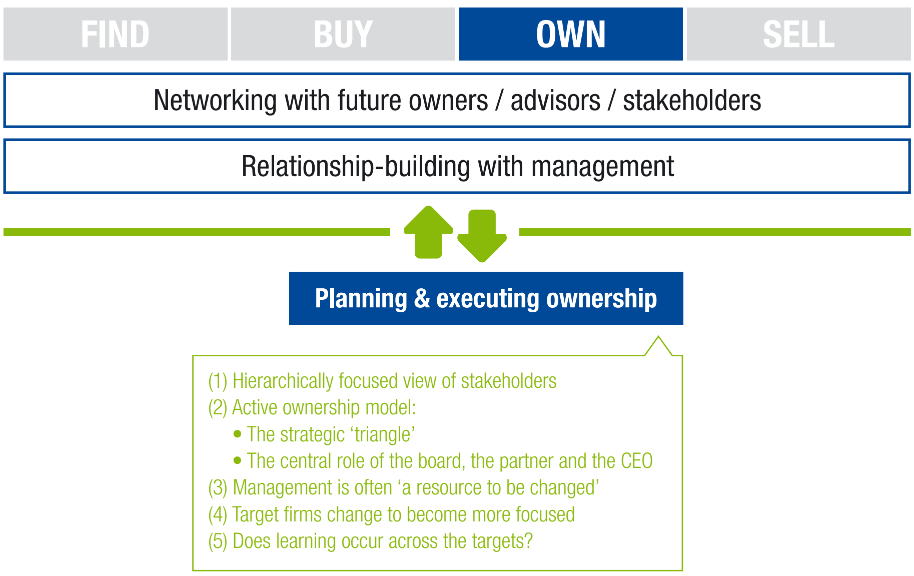
3. Human dynamics in the ownership phase:
It is difficult, if not impossible, to pinpoint the moment when the ownership phase starts.

The sector identifies its key stakeholders as:

- The portfolio firm's owner, CEO, CFO and possibly its management team
- The board, the chairman of the board and the owners of the target company
- The private equity house as the majority owner; this includes the partner and the deal and value creation teams
- External stakeholders who are mentioned relate to banks as the deal's financial backers, future owners, suppliers and customers, and the tax and regulatory environment

The term 'employee' did not surface in the interviews, apart from those in France and the U.S. The 'human element' in private equity buyouts at this phase appears thus to largely revolve around the owners and the CEO.

Figure 6. Human dynamics in the 'own' phase.



An active ownership approach: As the majority owner, the private equity firm's primary means of influencing the portfolio firm is through the Board of Directors. This is paralleled by a private equity partner engagement in support of the CEO. Thus, ownership rests on a 'triangle' (see Fig. 7), consisting of:

(a) The Board of Directors[1]
(b) The portfolio company's CEO, and possibly the CFO and management team
(c) The private equity house as the majority owner, i.e. the responsible partner and support teams

Strategic plans, goals and key initiatives are at the heart of the private equity company's ownership agenda.

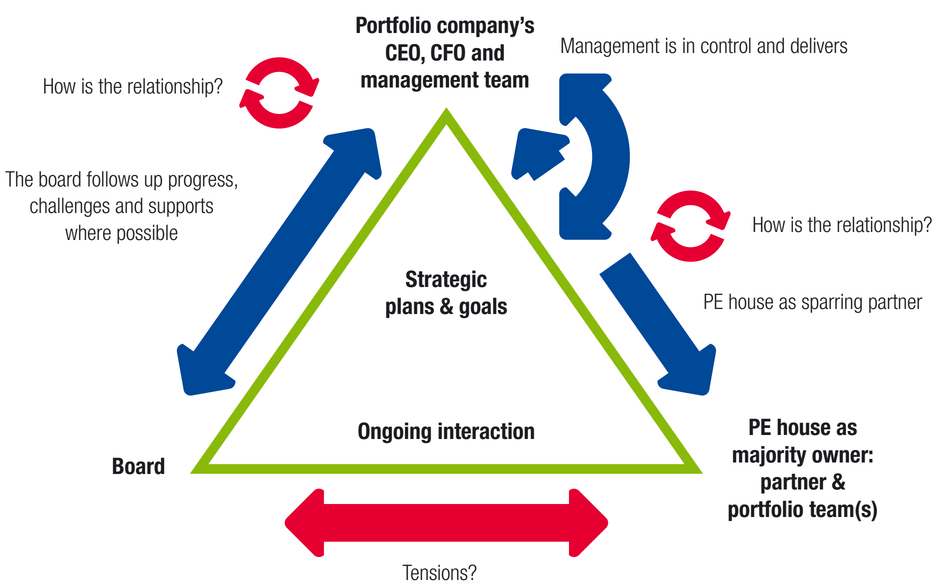
Human dynamics related to the Board of Directors: There is some debate as to whether an internal or external Chairman of the Board should be used. In both cases, the relationship between the Chairman and the CEO is critical. At its best, the board:

- Sets high expectations
- Challenges management
- Remains critical, albeit encouraging
- Is able to prioritise and see the big picture
- Provides ideas
- Involves all its members
- Is forward-looking rather than backward-looking

The role of external board members in adding sector-specific and function-specific expertise is emphasised. The question is: How to find external board members? Some private equity houses use elaborate processes, or board members might also be reused across cases. Yet, questions were raised:

- Do external board members have sufficient time allocated to board work?
- Are external members sufficiently listened to, or does the private equity house 'run the show'? Alternatively, are external board members too loud in their views?

Figure 7. Roles and interactions within the strategic ownership 'triangle'.



[1] By board, we refer to the Board of Directors.

Human dynamics related to the partner role: The partner in charge has a central role vis-à-vis the success of the buyout. The studied private equity companies allocate different amounts of time for senior partners to devote to portfolio firms; it depends on each partner's portfolio company workload. In the sample, the ratio ranged from 1–2 to 9–10 portfolio companies per partner. In the former, an active ownership model is implemented, whereas in the latter, the private equity operates mainly through the board, taking a more distant and passive stance to ownership.

When private equity houses are active owners, there is much interaction between them as the majority owner and the CEO. The relationship between the partner and the CEO is then ideally characterised by:

- Mutual trust
- Thinking alike
- An ongoing exchange of information
- Informality, openness and directness
- Avoiding politics or hiding information
- Moving fast

Given the CEO's solitary position, he or she might turn to the partner for sparring support. The relationship thus easily veers towards a 'buddy' relationship. This might deter the partner from making difficult decisions regarding the portfolio firm. For example, how easy is it then to change the CEO or management? Furthermore, the partner's emotional attachment to a target might deter him or her from exiting. The partner needs to tread a careful balance in this respect.

Human dynamics related to the CEO: The CEO of the portfolio company is perhaps in the most critical role to ensure that, operationally and managerially, the investment delivers.

The role of a CEO is in itself a challenging one. In the context of working for a private-equity-backed portfolio company, this challenge is coupled with having to meet the needs of a demanding owner. There is more pressure and a greater focus on reporting, as progress is closely monitored. The CEOs need to understand the private equity owner's agenda, i.e. that private equity companies need to realise the investment at high value. All the same, not all CEOs enjoy having an active owner who seeks close involvement.

What makes a successful CEO of a private-equity-backed firm? The best CEO combines (1) the ability to deal with the demanding private equity owner and (2) the ability to lead the portfolio firm through the set strategic agenda. With respect to the former, the best CEO:

- Is an open and transparent communicator; hidden agendas, politics or the protection of one's turf are alarming signs
- Knows the organisation and its performance inside out
- Is a flexible, solutions-oriented problem-solver
- Is strong-minded enough to be able to face the owner's demanding questions

Within the portfolio firm, the CEO is moreover:

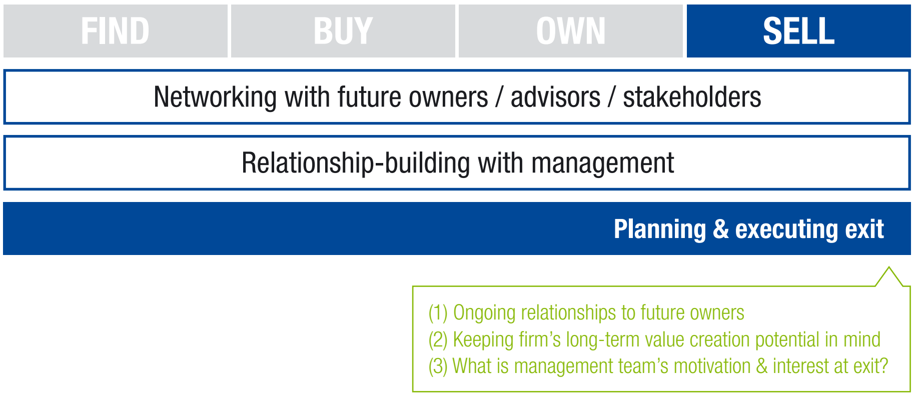
- A transformational leader
- Ambitious
- Able to be the spokesman in front of the owner and the board.

Notwithstanding this, the CEO's role in private-equity-backed firms is hard work. The CEO needs to be in good health and have a supportive work–life balance. Health or family issues might explain a deteriorating performance.

The need for a competent CFO: The CFO in private-equity-backed companies is 'instrumental'. For some respondents, the CFO is more important than the CEO. Financing banks require portfolio companies to have highly competent CFOs. This is the position that is most often replaced, or an additional CFO position is created to support the existing more accounting-geared finance role in smaller to medium-sized companies. Attracting a qualified CFO to a small-sized firm can prove difficult. Given the financial orientation of the private equity world, the CFO role in private-equity-backed firms is culturally different from a CFO role in other types of companies. CFOs in private-equity-backed firms need strength of character to be able to cooperate with the CEO.

Learning across portfolio firms: Private equity houses differ with respect to their attitudes to working across portfolio companies. The seemingly more advanced private equity houses have adopted a mature approach to learning across portfolio companies – services are jointly sourced and best practices from within and beyond the industry are shared across the portfolio companies.

Figure 8. Human dynamics in the 'sell' phase.



4. Human dynamics in the 'sell' phase – planning and executing exit: Exit is considered a key success factor in buy-outs: how to ensure the right exit value and timing, so that value is also secured for the next owner? Private equity professionals differ with regard to when exit is considered. For some, this is an ongoing concern; others consider good purchases to be 'sellable' at the right time.

From a human dynamics perspective, the issue revolves around the loyalty of management and the ability of the responsible partner to 'let go' of the portfolio firm (Fig. 8). In terms of management loyalty, the questions are: Whose side will management be on during the sales process? Will they stay on the seller's side or move onto the buyer's side? There is a risk if management has its own agenda and starts manipulating the sale. Having completed the exit, do private equity houses conduct post-investment learning sessions?

B. The academic partner's interpretation of the research findings and conclusion: The private equity owners' excellence resides in ownership that is temporary, high-ambition, corporate-governance-driven and active. The private equity companies' excellence at sourcing, relationship management and professionalism with regard to corporate governance and active ownership needs to be highlighted. Yet the lack of attention to the organisation at large, be that to non-financial metrics or members outside the management team, deserves mention. Many interviewees lamented the resulting *"lacking a clear view of the organisation"* they were investing in. While private equity owners are at their best excellent business strategists, the business model relies heavily on the upper part of the organisation, with all the risks that this choice entails.

Mercuri Urval's business perspective: How do you clarify the critical factors for success and failure for the CEO and CFO roles? More than track record and capability, understanding the likely dynamics between key leaders in a deal is critical to ensuring success.

How is management assessed?

"The quality of people is possibly the biggest determinant of value creation."

(An anonymous senior private equity professional)

The interviewees define the private equity buyout business as a 'people business'. They unequivocally recognise the significance of the human element, which they largely equate with the quality of the management team.

Despite the significance attached to management, we find that the practice of management assessments is at best patchy, though it is showing signs of improvement. We note a trend towards assessing the capability and dynamics of the whole management team, instead of just assessing the CEO.

We found that each of the private equity houses in the sample studied fell into one of the following four categories:

- **Category 1:** Management assessments are always conducted (33%)[v]
- **Category 2:** Management assessments are at times conducted (38%)
- **Category 3:** Management assessments are conducted informally (21%)
- **Category 4:** No practice of management assessment (8%)

Within these four categories, private equity firms differ with respect to:

- The significance attached to management assessments
- The impact that assessments bear on the purchase decision
- The consistency and formality of management assessments
- The attitude towards management assessments
- The breadth of internal and external involvement in this exercise
- The stance towards convincing target firm management
- The timing of assessments

Category 1: 33% of private equity houses recognise the significance of management assessments. This exercise is seen as a 'must-do' exercise. It is even raised as a 'differentiator' from their more financially orientated competitors.

The assessment affects the decision to invest. Private equity houses in this category mostly rely on an external consultant, some having worked with the same consultant for years. The assessment approach often relies on a method the private equity house has developed in-house or with the consultant. Target firm management has little choice other than to agree to being assessed. The private equity houses adopt a constructive stance; they explain the need for the assessment to the management teams.

Category 2: 38% are unsure whether *"to conduct or not to conduct management assessments"*. As there is no policy, the use of management assessments comes to depend on the partner and the purchase type. For example, in exclusive deals management assessments are more prevalent. A number of informal approaches to management assessment are in use. These range from:

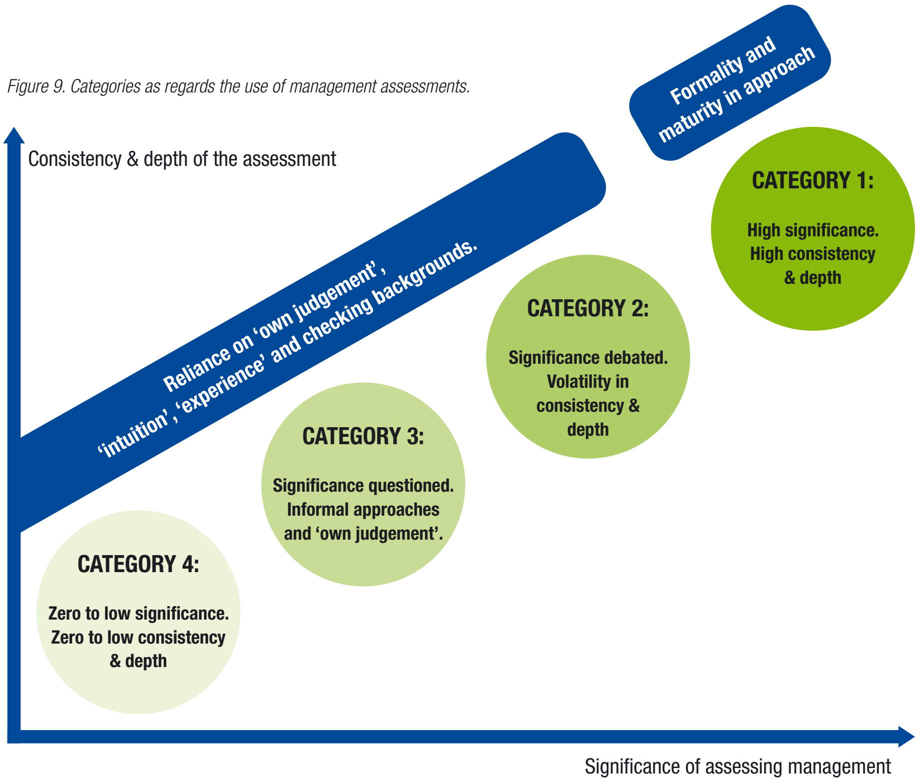
- Spending time with management pre-deal
- Checking the management's background and references
- Using an analysis approach developed in-house
- Several private equity representatives meeting target firm's management

The use of one's own judgement was emphasised:

"We use our judgement."
"We get a sense of them."
"We use our experience of seeing and working with management teams."
(Various anonymous senior private equity professionals)

All agreed, however, that there was a need to do more as regards management assessments.

Figure 9. Categories as regards the use of management assessments.



Category 3: 21% state that the significance and the need to conduct management assessments is debated. No conclusion has been reached. The conduct of assessments remains sporadic. Private equity houses in this category have reverted to their own in-house, informal approaches to assessment including:

- Checking references and backgrounds
- Socialising
- Using their own profiling tool
- Using their own judgement and impressions: *"we need a good feeling", "we set our first impression in the management presentation", "we trust our feelings"*
- Discussions at the investment committee
- Several representatives of the private equity house join the negotiations as observers
- The involved pre-deal strategy and finance consultants' views are heard

Thus, there are efforts to triangulate views. The interviewees agreed that they could do better, though.

Category 4: 8% do not recognise the significance of management assessment, but in addition, there is little formality or consistency in the approach. As a result, these organisations largely trust their own experience, intuition or networks and come to make their decisions:

"based on the little information available. We have little contact, we get a sense, impressions, and we check their reputation".
(An anonymous senior private equity professional)

Categories 2, 3 and 4 are similar; most management assessments are formed on the basis of one's own judgement and intuition along with background checks. This means that only a third (Category I with 33%) of the sector has, at best, reasoned its stance, attitude, strategy and approach to management assessments. *The majority (67%) of the industry is thus not making effective use of this strategy and is thus making decisions on management on a seemingly ad hoc basis.*

The academic partner's interpretation of the research findings and conclusion: While the private equity business model relies heavily on management, it appears that few private equity houses actually thoroughly analyse this talent. All the same, excellent management and driven cultures are part of the purchase criteria and are found to impact value creation. This paucity of attention is surprising in a sector that is otherwise disciplined, formal and professional. Scant attention to assessing managerial talent results in a potential talent and capability risk within the portfolio firm.

Mercuri Urval's business perspective: What is the right balance between objectivity and subjectivity to make the 'right call' on key appointments? What is the best possible approach to assessment in this situation?

Management as a 'resource to be changed'?

"Management teams make the difference between good and bad investments."

(An anonymous senior private equity professional)

We identified two schools of thought regarding whether management is to be replaced or not. 62% of private equity companies are keen to replace management, when and where required:

"Management is considered a resource to be replaced".

In this category, 30%–75% of the management team is changed: two-thirds of CFOs are changed, or a new CFO is added to the existing structure and between one-third and two-thirds of CEOs are changed in the first years. Nevertheless, it was acknowledged that:

"This is not an easy call to make".

Reasons for management changes relate to:

- Planned changes, as the owner retires
- Underperformance
- A lack of motivation and capability – *"it's too tough"*
- Changes in the firm's stage of development; it is rare to find the same management team steering the firm across subsequent stages in the firm's lifecycle.

Performance-wise, one change of CEO can have a positive effect on performance. However, when the CEO is changed more than once during a private equity house's ownership era, this tends to have negative performance effects, given the ruptures that the change causes across the organisation.

The mistake most commonly lamented was that of changing management too late and of not reacting to the first signs of discomfort. Private equity professionals require a ‘social intelligence’ and an ‘early warning’ mindset towards management behaviour. Early warning signs were identified as:

- Management lacking drive and energy
- Management not being in control and unable to make tough calls
- Management being stubborn, not listening and/or in an explanation mode
- Management team dynamics showing signs of suffering
- Management hiding information, e.g. few people are brought into board meetings and the owners’ access to the organisation is obstructed
- Trust between the owners and management is eroding

38% of professionals consider that:

> *“We prefer keeping management”.*

Sometimes management is not changed because private equity professionals struggle to identify the root cause of poor firm performance. Further, there are risks and costs involved:

- It creates noise in the organisation.
- It takes time for the new person to be in place and functioning effectively.
- It is costly – *“half a year is lost”*.
- There is the risk that the new management is no better
- The change in itself creates a cycle of fear in the firm (for example in France, where the workplace is an emotionally charged space)
- It is not easy
- In volatile macroeconomic times, management change creates additional confusion
- It is difficult for a new CEO to replace a founder

The academic partner’s interpretation of the research findings and conclusion: As the private equity business model relies heavily on management, it is management that bears much of the weight of buyout success. Has management become the scapegoat, if things are turning sour? Is it a ‘resource’ to be changed? What are the ripple effects across the organisation?

Mercuri Urval’s business perspective: How can you best anticipate, rather than react to, changes that will need to be made? How could your diagnostic and due diligence processes be improved? What tangible benefits could be achieved?

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Appendices

Table 1: Interview sample.

Location of interview	Number of PEs / origin	Number of interview(ee)s	Number of PEs interviewed	Organisation, e.g. PE (no. of interviews)
The US	4	1	1	1 (1)
The UK	2	6	5 (+1)	6 (1)
France	4	4	4	4 (1)
Germany	2	3	3	3 (1)
Sweden	6	4(+1)	4	3 (1) 1 (2)
Denmark	4	6 (+1)	5 (+1)	5 (1) 1 (2)
Norway	3	4	3 (+1)	4 (1)
Finland	1	4	2	1 (3) 1 (1)
Overseas	1			
Support interviews (Paris/London)		9 = (1) (3) (1) (1)	French VCA (1) UK Bank (3) UK Expert (1) UK Target (1)	1 (1) 1(2*3 = 6) 1 (1) 1 (1)
Total	**27**	**= 43 interviewees:** - 34 PE interviewees - 9 support interviewees	**= 31 organisations:** - 27 PEs (3 PEs met more than once) - 4 other organisations	**= 39 interviews:** - 33 interviews in PEs - 6 interviews in other organisations

[i] Qualitative research is well suited to the study of social phenomena unfolding over time, particularly when knowledge concerning the topic is scant (see e.g. Glaser & Strauss, 1967; Easterby-Smith et al., 2008; Eisenhardt, 1989; Yin, 2009).

[ii] As we targeted highly experienced professionals, interviewees occupied a range of senior positions including partner, founding partner, senior partner, chief executive officer, chief finance officer, regional head, head of buyouts or chairman of the board positions in the studied PE houses. In addition to this focal sample, we conducted a set of six 'support interviews' in the London area with senior representatives from the banking sector working in various roles with private equity firm buyouts, an executive manager involved in a professional role in buyouts, as well as a portfolio company manager. A senior representative of a national venture capital association was also interviewed. This brought the total interview sample to 39 interviews, with 43 interviewees, in a total of 31 organisations (Table 1).

[iii] For a full overview of the research method adopted, including research design, case studies, data collection, interviews and data analysis, please refer to the project's final report (2012). Given that the focus in this research project was on the private equity professionals' views, it is recommended that later research also encompasses the views of the sector more broadly, including the views of portfolio firms, investors and financiers.

[iv] See Demaria (2010).

[v] Note to the reader: These percentage results need to be treated with caution given that the studied sample only included few and selected players per country. The number does not represent an industry average, but rather, an indication of the behaviour of private equity firms in the studied sample. Given that this study focused on well-known private equity players, the actual practice of management assessments might be worse than is here portrayed.

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