LEADERSHIP DUE DILIGENCE:

The Elephant in the Private Equity Boardroom

EPSEN FULLERGROUP
GLOBAL TALENT SOLUTIONS

TABLE OF CONTENTS

02	Introduction
02	The Evidence
06	Whether Old or New, the Right Team Makes All the Difference
09	Confidence Comes From Insight, Pre- and Post-Closure
11	Customary Due Diligence – By the Books
12	The New Human Capital Due Diligence: Assessing the "Leadership Quotient"
	Overview of a Leadership Quotient evaluation
15	Some PE Firms Are Redefining Their Due Diligence Process
16	A Future of More Timely Exits?
17	About the Author
	Acknowledgments
19	Our Expertise

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

© All Rights Reserved. Epsen Fuller Group

"Delay is the deadliest form of denial." It turns out that these words, written by the British naval historian, C. Northcote Parkinson, who immortalized Parkinson's Law, provide a sage caveat for the private equity industry. PE firms spend hundreds of thousands of dollars on outside counsel (legal, financial and strategy consultants) as part of their due diligence, but are missing information that is as critical, or even more critical, than anything customary due diligence processes uncover: an understanding of the leadership quotient of the organization.

The absence of a rigorous human capital evaluation results in a prolonged investment holding period, suboptimal fund and deal IRRs (internal rate of return), and a lot of avoidable turmoil.

THE EVIDENCE

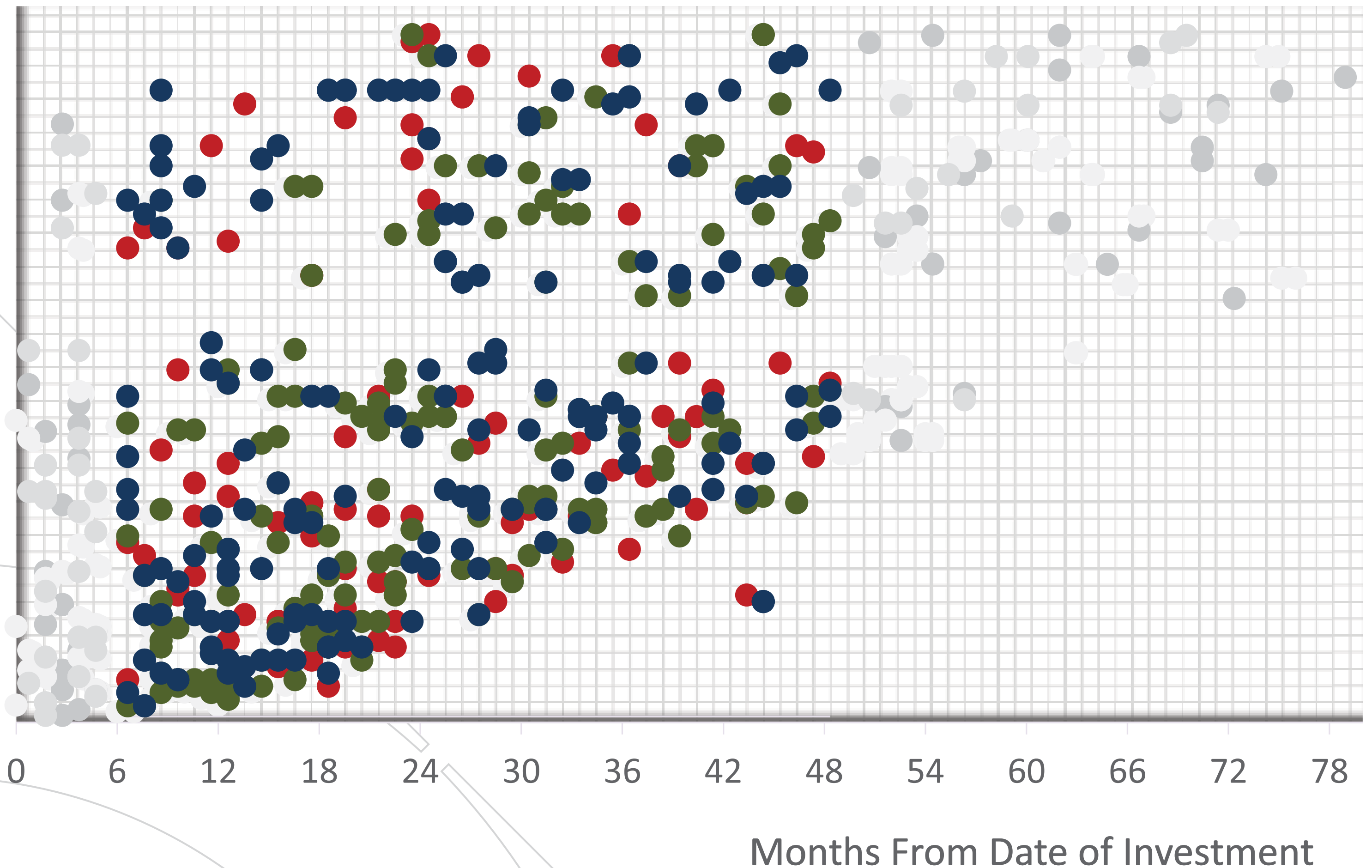
When private equity firms close a deal, they are betting their successful exit on outstanding leadership. Yet we have found many of those same PE firms making a decision some months or years later to switch out one or more members of the senior leadership team. Clearly, something wasn't working according to plan. As an advisor to PE firms, specifically in the area of leadership, talent and human capital due diligence, Epsen Fuller Group set out to discover if this type of "miss" on the leadership capacity of the teams in which they are investing is indeed a pervasive, and costly, trend.

Epsen Fuller analyzed current and recent deals made by 27 private equity firms, representing a broad cross-section of various sized funds and industry specializations, from large to boutique and niche investors. Among these firms' cumulative 323 portfolio companies, we found that the average deal resulted in two C-suite changes between the sixth and thirtieth month after deal closure. A full 69 percent of all the CEO and senior leadership changes occurred between six and 48 months post-acquisition.

© All Rights Reserved. Epsen Fuller Group

Figure 1: PE Leadership Changes – Too Many, Too Late

● CEO ● C-Other ● Senior Leaders



Scope:

- **27 PE Firms**
- **323 Portfolio Companies**
- **660 Leadership Changes Between 2006–2014**

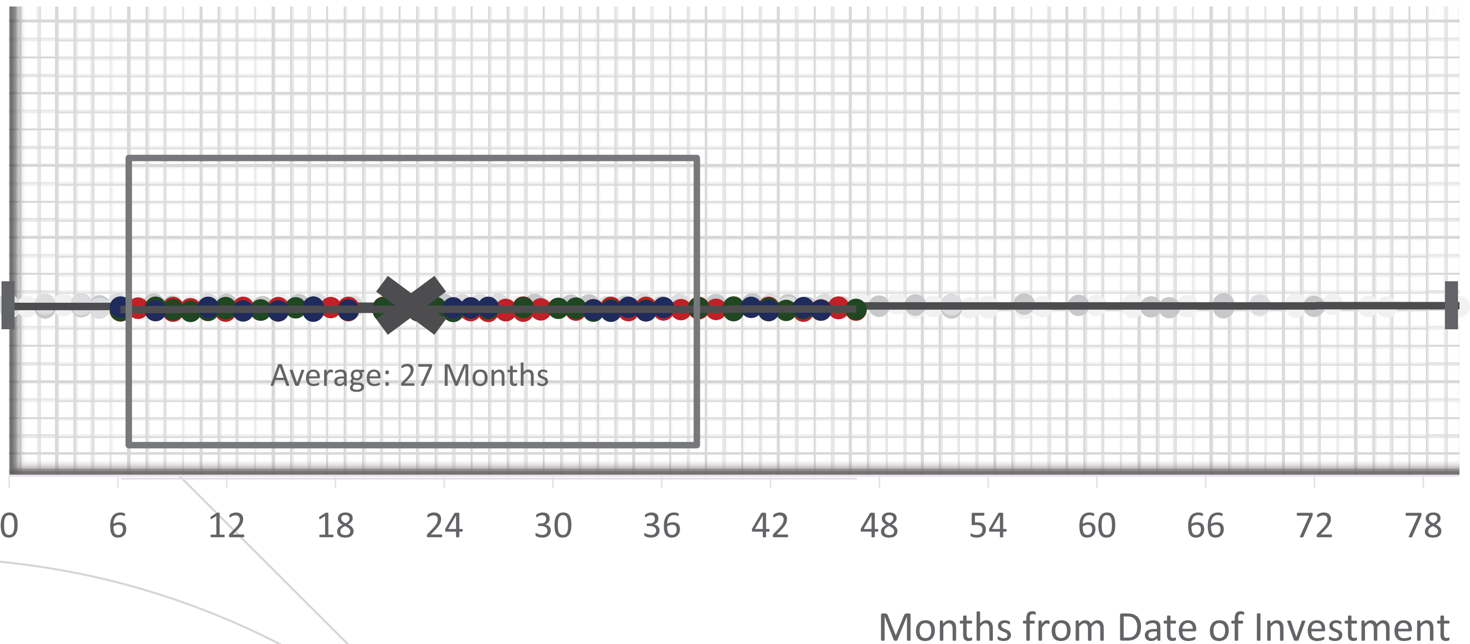
69% of all changes occurred between 6 and 48 months

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

Figure 2: PE Leadership Changes – Too Many, Too Late

The most dramatic, and telling, figure is the timing of the average leadership change – ***a full 27 months after acquisition.***



Average time before change: 2.3 years

"Leadership changes take us much too long!"

– Founder, Market Leading PE Firm

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

© All Rights Reserved. Epsen Fuller Group

These statistics should set off some alarms. After all, the holding period of portfolio companies has a significant impact on private equity fund performance and the firms' ability to raise future funds, as well as on the entire arc of each deal. Data from Preqin's Buyout Deals Analyst shows that the average holding period has increased substantially in recent years, with far fewer exits in the four-year target range. If, on average, a PE firm waits two or more years to make a change in the leadership team, this significantly handcuffs their ability to meet their target timeline for a successful exit.

Indeed, this disquieting finding of the considerable lag time between date of investment and key changes in leadership is private equity's metaphoric "elephant in the room."

Factors such as economic upheaval, increased adoption of flexible or long-term ownership strategies, and bloat in the IPO market, as well as disruptive innovation and difficult global political climates, obviously have an impact on the PE environment. But in spite of this and the unmistakable trend toward longer holding periods, in terms of sheer numbers, the exit environment is fervently alive.

Figure 3: Global Average Holding Period by Year of Exit, 2006 – 2015 YTD (As at 23 April 2015)

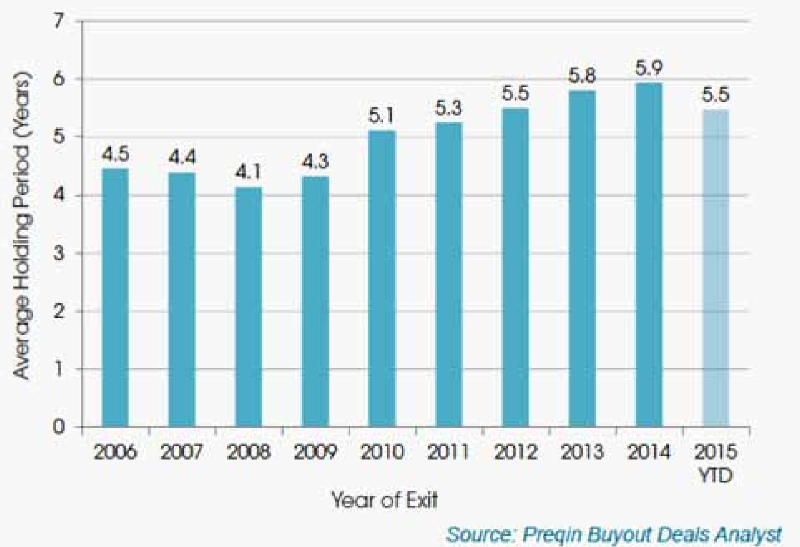


Figure 4: Breakdown of Holding Periods by Year of Exit, 2006 – 2015 YTD (As at 23 April 2015)

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

In fact, the number and total value of private equity-backed exits in 2014 reached their highest levels on record. It is the success rate of these deals that is not keeping up.

What causes the delay in establishing the right leadership team from the outset, and what is it costing these PE firms? What can these firms do to embark on the investment with deeper insight into the current management team and talent structure, as well as future leadership needs so they can achieve their desired holding period?

WHETHER OLD OR NEW, THE RIGHT TEAM MAKES ALL THE DIFFERENCE

Numerous studies of PE acquisitions over the past 10 years reveal a correlation that provides some insight for us. Rarely did PE firms that failed to meet their objectives integrate a thorough human capital evaluation into their due diligence process. But those deals in which due diligence did include a strong human capital element, and where any indicated leadership changes were made early in the process, produced an earlier exit and higher IRR.

Further, Ernst and Young's study of 439 PE exits between 2005 and 2013 offers strong evidence that whether the firm keeps or replaces leadership is not the pivotal factor, but getting that decision right from the start is!

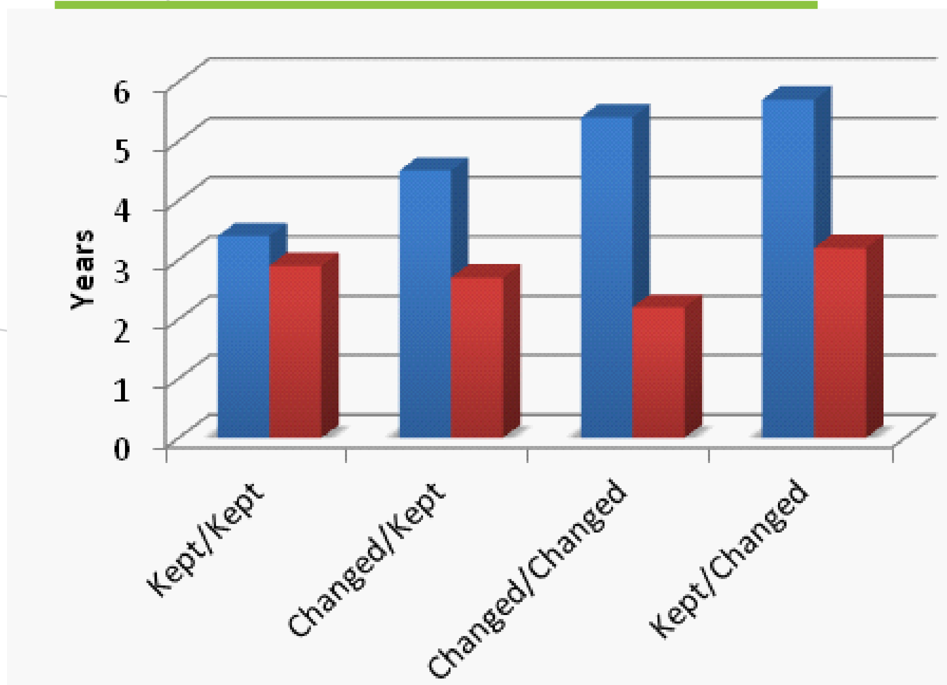
EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

In 41 percent of the deals EY reviewed, the CEO was retained, and these deals had the shortest holding period (3.4 years). In another 28 percent, the CEO was replaced at the start of the investment, and these firms saw a 4.5 year average holding period. Significantly, those firms that delayed making a change until they were well into the investment period (28 percent of the firms) had an average holding period of 5.7 years. The small number that changed out the CEO both at the outset and during the investment fared similarly, at 5.4 years.

Other studies of private equity deals in which CEOs were replaced revealed that a large number of CEO changes were made two to four years after the transaction date, due mostly to underperformance. These changes were unplanned at the time of deal closure. While these studies did not track the date the investments were sold, based on Epsen Fuller's research and the EY data, the disastrous impact these late changes made on holding periods is easily inferred.

Figure 5: EY Study of 439 PE deals (EV: $150m+)



Holding Period
Equity Multiple

CEO Retention at Start/During the Investment Period

 © All Rights Reserved. Epsen Fuller Group

"Our research shows that regardless of whether you keep the original team or change the team, it's best to do it at the outset of the deal - if you have to change the team midstream, it's associated with demonstrably inferior outcomes in terms of longer hold periods and lower IRRs."

– Pete Witte, Global Private Equity Research Leader, EY

There is statistically no overwhelming performance advantage between insiders and outsiders. But that doesn't mean the decision to go one way or the other doesn't matter. It was the talent engagement, leadership capability and organizational alignment at the time of transition that were the critical factors in determining whether an insider or an outsider was the best choice.

Throughout the studies we examined run the laments of those PE firm managers whose deals were less than successful, wishing they had been more aggressive in acquiring assets, more global in their marketing, pursued more outsourcing options, etc. Most vocal, though, are those who regret giving the leadership and human capital evaluation short shrift. Comments like "We should have changed management sooner once it became apparent they weren't up to the task" and "We had a chance to hire our first choice for management initially, but we passed. This led to a false start with the management team," abound in the summaries.

Clearly, having the right CEO and C-suite team in place at or near the start of the investment, whether they are incumbents or new recruits, has a significant impact on the holding period.

 © All Rights Reserved. Epsen Fuller Group

CONFIDENCE COMES FROM INSIGHT, PRE- AND POST-CLOSURE

The next question is what the most successful PE firms do to make sure they have the right leadership team in place from the outset. We turn to a McKinsey study for insight on this.

McKinsey looked at the self-reported successes and failures of 11 PE firms in over 60 deals. They found that a "boots-on-the-ground" approach both before and just after closure had a huge impact on ultimate results. The most successful PE partners devoted half their time to the acquisition over the three months following closure, meeting almost daily with top executives. In contrast, the less successful partners spent about 15 percent of their time on the acquired business.

This part may be intuitive: more time invested plus greater insight yields better results. Importantly, however, the aspect of this intensive on-site work that McKinsey highlights as most critical is the time devoted to assessing the leadership team. The study reports that "The senior executives must...get to know the team's strengths and weaknesses, identify who must be replaced and which new roles must be filled, and have enough knowledge to supplement the team with external support that plugs any remaining gaps." Only when the acquisition team follows the best practice of gaining real insight into the leadership and talent structure of the company – not just in terms of on-site meetings, discussions and walk-throughs, but through a thorough assessment process – can they discover whether this is a team that is fully ready and capable of delivering on the strategic plan.

 © All Rights Reserved. Epsen Fuller Group

The study concludes that the more successful deals "had active partners [who became] familiar with management, sometimes long in advance of a deal, and made any replacements quickly."

> "Too often dealmakers...gather reams of financial, commercial and operational data, but their attention to what we call human due diligence – understanding the culture of an organization and the roles, capabilities and attitudes of its people – is at best cursory and at worst nonexistent,"
>
> – Harding and Rouse

David Harding and Ted Rouse of Bain Capital echo this conclusion relating to the outcome of 40 mergers and acquisition deals they studied. They investigated why two-thirds of acquired companies lost market share in the first quarter following a merger, with that number rising to 90 percent by the third quarter. Their findings point to a lack of attention to the people and culture as a prime culprit, causing the high turnover and infighting that precipitated these market share losses.

Harding and Rouse's studies also bolster the argument that the timing of changes is a crucial factor in success. They found that among the acquiring firms who had executed successful deals, 90 percent had identified key employees and targeted them for retention during due diligence or within 30 days of acquisition. In contrast, this was the case in only 30 percent of the unsuccessful deals. Timing is, indeed, everything – or nearly so.

© All Rights Reserved. Epsen Fuller Group

CUSTOMARY DUE DILIGENCE – BY THE BOOKS

If the imperative of having the right leadership team in place at the outset is not only logical but is borne out in the research, why aren't we seeing all PE firms expand their attention accordingly? The answer may lie in the traditional role and bias of the due diligence process itself.

Human capital due diligence, as carried out by the large PE firms, generally takes the form of a cost analysis of human capital under various scenarios. Financial experts compute the costs of the benefits packages, severance packages, retention incentives and other expenses that may be generated once the deal takes place. In typical due diligence processes, the PE firm looks at:

- Corporate records
- Technical and intellectual property
- Material agreements
- Regulatory matters
- Taxes and financial statements
- Litigation and other disputes
- Rights and permits
- Personnel and employee benefits (policies, compensation and benefit plan costs, contracts, etc.)

Later in the process, a review of more intangible issues such as customer and vendor relationships, market potential, competitive landscape and brand strength may follow, but an in-depth leadership and talent assessment seems to fall by the wayside.

 © All Rights Reserved. Epsen Fuller Group

THE NEW HUMAN CAPITAL DUE DILIGENCE: ASSESSING THE "LEADERSHIP QUOTIENT"

It is the "leadership quotient" (LQ) that reveals the organization's talent structure, its human capital strengths and weaknesses, providing the requisite transparency for solid decisions to be made on the leadership team, the culture and the talent alignment with the overall strategy.

McKinsey's research revealed that in 83 percent of successful deals, partners sought out expertise from the board, management or a trusted external source to help secure insights and privileged information about the company before committing to the deal. Conversely, such expertise was sought less than half the time in the worst deals. A key benefit of this expertise is to provide the PE firm with the same clarity and transparency into the acquisition's leadership capital and overall talent structure as they have into its financial capital and marketing metrics.

Overview of a Leadership Quotient Evaluation

The typical PE firm's starting point in looking at human capital is to assemble the data: organizational charts, headcounts, job descriptions, compensation packages, etc. This process provides clues to imbalances that warrant an in-depth look. Rarely, though, is that next step taken. Cost accounting generally takes over at that point to find financial synergies – ergo, opportunities to trim costs. Most often, this is where human capital due diligence ends.

What creates visibility, and therefore value, lies far beyond. Successful LQ evaluation requires something private equity firms have not traditionally devoted resources to – discovering the different reality that always underlies the formal organizational structure.

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

A holistic assessment of the organization's leadership capabilities, the culture and engagement of the workforce, and the structural alignment of talent to the business strategy should be examined. Unearthing this view with clarity and transparency requires a level of diligence above and beyond the standard, which is often based on superficial references (e.g. "We've met with the CEO and CFO a number of times," and "People say really good things about them.").

Some of the key questions to explore include:

- Does the company mission and strategy resonate throughout the organization?
- Do employees at various levels and in various functions feel they have the resources to deliver on the company's mission?
- Who are the company heroes? What makes a "company hero"?
- How do they hire? Who do they hire? Who gets promoted and why?

With a deep-seated understanding that misalignments in any of these areas will hurt the future business performance, these questions are often best answered through a third party team that:

1. Conducts professional, market-proven culture surveys,

2. Performs a thorough assessment of the leadership team – their skills, behavioral competencies, learning agility and strategic thinking, and

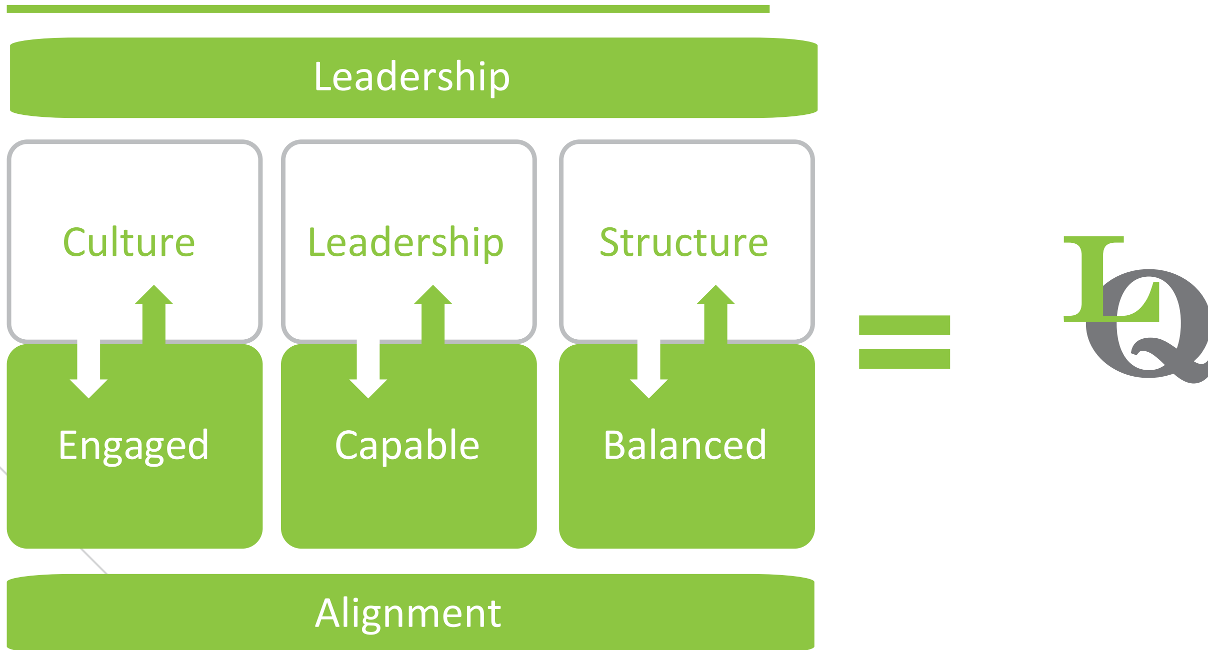
3. Delivers a thoughtfully executed talent inventory that maps structural alignment with stated corporate objectives.

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

© All Rights Reserved. Epsen Fuller Group

Doing so requires a disciplined approach to collecting and evaluating the necessary data, but will yield actionable insight into the LQ.

Figure 6: Actionable Insight into the Leadership Quotient



The OUTCOME: Actionable Insight to ensure the organization is engaged, capable and aligned, to deliver on the business strategy.

Coupling this evaluation with deep, robust referencing ensures significant reality checks throughout the process.

Results from this broad and deep sweep of the organization form a clear picture of the company's leadership and talent landscape. Only then may conclusions be drawn that lead to appropriate and timely action, i.e. actionable insight.
Using this approach to guide the "retain or replace" decision pertaining to C suite and other senior-level leadership can make a significant impact on reaching the desired exit multiple faster, and with less pain along the way.

Clearly, gaining insight into the LQ and the overall talent structure as part of the due diligence process, thereby determining the right leadership at or near the purchase date, is crucial to turning the tide toward earlier and more profitable exits.

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

SOME PE FIRMS ARE REDEFINING THEIR DUE DILIGENCE PROCESS

More PE firms are starting to embrace human capital evaluation as critical to due diligence. Brian Wilkerson, who served as global practice director for talent management at Watson Wyatt (Towers Watson), bemoans the fact that most large PE firms traditionally have not critically examined the top leadership team prior to closure. He says that, until recently, "only one or two of the 30 largest private equity firms had initiatives to ensure that their portfolio companies had the best possible senior management." Now, however, he says he sees more firms "looking at all the critical people – the key sales people, the key operations managers...the people who make things happen day-to-day."

BAIN AND COMPANY

Bain and Company's study of 40 acquisitions revealed that in the 15 deals classified as successful, nearly 90 percent of the acquirers had identified key employees and targeted them for retention during due diligence or within the first 30 days after the announcement. In only one-third of the unsuccessful deals had this been accomplished. Bain now applies a human capital due diligence model to PE acquisitions.

KKR

Peter Fasolo, former chief talent officer at KKR, described their progressive approach to human capital evaluation. Typically, KKR engaged an outside consulting firm that utilizes a combination of conversations (three-hour interviews with as many as 45 top people in the firm), written assessment tests and 360-degree assessments to produce critical information. "We look at management practices," Fasolo explained. "Do they do engagement surveys? Succession planning? Who do they hire? Who gets promoted?" The goal, he says, "is to get a sense of the rhythm of the management practices."

Longitudinal studies of how these approaches impact their holding periods vs. those of firms employing traditional due diligence will be instructive.

 © All Rights Reserved. Epsen Fuller Group

A FUTURE OF MORE TIMELY EXITS?

For a company to attract a private equity firm's interest, it is usually underperforming. This is because it:

1) lacks aggressive management,
2) is under-resourced or suboptimized, and
3) has some potential that isn't readily apparent.

In virtually all of these cases, the problem lies at least partially, if not completely, in inadequate leadership and their inability to move the needle forward by any significant measure. Whether the PE firm can guide the incumbent leadership or needs to change the leadership team to leverage the latent value of the company, is arguably the single most critical decision it makes, and one that should be made as early as possible.

The goal should always be to begin the investment with clarity and insight into the leadership quotient of the organization, make any needed changes early, and determine how to keep key people who have been identified for retention. This funnels the energy of the team into the singular purpose of creating a success story.

Companies that do this will reach their target exit date sooner. If more private equity firms employ truly deep human capital due diligence and act quickly to make needed leadership changes, we fully expect that future research will demonstrate earlier achievement of exit goals.

 © All Rights Reserved. Epsen Fuller Group

ABOUT THE AUTHOR

Tom Fuller
CEO & Managing Partner

An NACD Certified Board Governance Fellow and independent Board Director of Tingley Rubber Corporation, IMD International, and The Association of Executive Search Consultants, Tom has executed hundreds of senior executive and board director search projects for Fortune 500 as well as small to mid-cap, and privately-held companies.

ACKNOWLEDGMENTS

Rick Cannellos
CFO & Senior Partner, Financial Officer Practice

Calgary Branagan
Marketing & Creative

Jack Moffitt
Research

Margy Rockwood
Contributor

EPSEN FULLERGROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

If you liked **LEADERSHIP DUE DILIGENCE: THE ELEPHANT IN THE PRIVATE EQUITY BOARD ROOM**, you'll enjoy this too.

Download Now, Thank Us Later.

EPSEN FULLERGROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

OUR EXPERTISE

Epsen Fuller Group is a Top-20 executive search and leadership consulting firm headquartered in New York, and with offices in New Jersey and San Francisco, as well as major markets and business centers throughout the world, providing instant access to a world-class executive talent pool driving the global economy.

"Leadership, talent, people... these have the greatest impact on the success, or failure, of any organization."

EPSEN FULLERGROUP
GLOBAL TALENT SOLUTIONS

© All Rights Reserved. Epsen Fuller Group

[1]Preqin Quarterly update: Private Equity, Q1, 2015. Buyout Deals. Retrieved from https://www.preqin.com/item/buyout-deals-analyst/1/2464/?ps=1&rid=363&utm_source=Hedgeweek&utm_medium=Web&utm_campaign=BDA190515

[2]Ernst & Young. (2014). Returning to safer ground: How do private equity investors create value? A study of 2013 North American exits. Retrieved from http://www.ey.com/Publication/vwLUAssets/EY-returning-to-safer-ground/$FILE/EY-returning-to-safer-ground.pdf

[3]Heel, Joachim, Kehoe, Conor. (2005, November). Why some private equity firms do better than others. Retrieved from http://www.mckinsey.com/insights/corporate_finance/why_some_private_equity_firms_do_better_than_others

[4]Harding, David, Rouse, Ted. (2007, April). Human Due Diligence. Retrieved from: https://hbr.org/2007/04/human-due-diligence/ar/1

[5]Heel, Joachim, Kehoe, Conor. (2005, November). Why some private equity firms do better than others. Retrieved from http://www.mckinsey.com/insights/corporate_finance/why_some_private_equity_firms_do_better_than_others

[6]Flander, Scott. (2009, February). A New Helm for HR? Human Resource Executive Online. Retrieved from http://www.hreonline.com/HRE/view/story.jhtml?id=169615791

[7]Harding, David, Rouse, Ted. (2007, October). Human due diligence. Bain & Company Insights. Retrieved from http://www.bain.com/publications/articles/human-due-diligence-wall-street-journal.aspx

[8]Flander, Scott. (2009, February). A New Helm for HR? Human Resource Executive Online. Retrieved from http://www.hreonline.com/HRE/view/story.jhtml?id=169615791

EPSEN FULLER GROUP
GLOBAL TALENT SOLUTIONS

 © All Rights Reserved. Epsen Fuller Group

Americas
Europe
Middle East
Asia Pacific

New York • New Jersey • San Francisco
www.epsenfuller.com