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Private Equity Needs a New Talent Strategy

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Summary. Historically, the efforts of private equity firms to address leadership challenges have been limited primarily to replacing portfolio-company CEOs. Now, in an era of higher interest rates and more competition for limited acquisition targets, these firms are realizing that... **more**

Private equity firms have historically paid little attention to the art and science of leadership. Yes, PE investors recognize that they need strong executives overseeing the companies they acquire. They examine target-company leadership when considering an acquisition, and they often install new top-level leaders, particularly in the CEO and CFO roles. They give portfolio company leaders tough targets and rich financial incentives to align the interests of management and investors. But that's about it.

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And that has become a problem. In the past, PE firms could punt when it came to leadership—counting on a hard-nosed team to create value fast and leaving the patient work of building leadership capability to whoever acquired the company when the PE firm sold it. Those days are gone. Investors can no longer buy an underutilized asset, pile on debt, and turn up the pressure, because financial engineering by itself won't generate superior returns for investors. There are at least four reasons for this.

- Private equity firms worldwide are sitting on about $2 trillion worth of "dry powder"—assets they manage but have not yet invested—at a time when the number of attractive targets has declined. This drives prices up, weakening financial engineering's advantage.
- Rising interest rates have made debt capital more expensive; since most PE-owned companies are highly leveraged, this means they must improve their operating performance simply to do as well as they did in the recent past.
- Because few $100 million–$400 million companies remain to be bought as standalone acquisitions, more PE deals are now "platform" or "roll-up" plays, whereby several smaller companies are stitched together into a larger enterprise. In 2022, 70% of

deals were of this type, according to PitchBook's *Global M&A Report.* Melding companies demands exceptional leadership and management skills—and is made even harder by the fact that these smaller (and often younger) companies have less management bench strength and only rudimentary talent-management capabilities.

- Partly because PE firms are stitching smaller companies together, they are holding on to companies longer. They once aimed to exit an investment in five years or less; today seven years has become common, which means that both owners and management must deliver value through operating excellence over a sustained period.

For all those reasons, portfolio companies (or "portcos") will have to outperform their rivals, which means they must be motivated by superb leaders who are supported by able, execution-oriented managers.

The industry itself knows it has a problem. A study by the Institute for Private Capital has found that value creation through operations (revenue growth and margin improvement) has accounted for 47% of value creation since 2010, up from 18% in the 1980s, while the value created by financial engineering has fallen from 51% to 25%. Asked which levers are most important for creating value in their portfolio companies, PE executives cite leadership effectiveness more often than anything else—70% more often than they cite operational effectiveness, according to AlixPartners' eighth annual PE leadership survey, conducted in late 2022. We see this qualitatively as well as quantitatively. PE firms hire us to perform in-depth assessments of candidates for senior roles in portcos, and a review of our work over the past 10 years shows that they are looking for substantially more from leaders today. A decade ago hiring specs emphasized a cluster of capabilities and characteristics having to do with flexibility, adaptability, and change management. Now companies increasingly have to look for executives who are also adept at managing, motivating, and inspiring people, who are authentic and credible, and who possess high EQ and people skills.

Recognizing a problem, however, is not the same as knowing what to do about it. The high rate of executive turnover in portfolio companies is evidence of failure. About three out of four CEOs leave after a PE acquisition. Some leave immediately, when the PE firm brings in new leadership, and sometimes the PE firm initiates a change for performance or other reasons. But in more than half the cases—54%—the CEO turnover is unplanned and often takes place a year or two after the acquisition. Unplanned exits cause enormous disruption: Forty-six percent of PE firms say that unplanned CEO turnover erodes the rate of return on their investments, and 83% say it lengthens investment hold times. Turnover rates among other C-suite executives in portcos are similar, and almost certainly higher among CFOs.

Unique Challenges

The leadership challenges in a PE environment are unlike those in public companies or family businesses—two areas in which leadership has been studied extensively. Existing leadership frameworks or initiatives from those businesses don't work in a PE context. The differences come largely from the unique dynamics of the relationship between PE firms and their portcos. Among the issues are the following.

Heavy time pressure. Portcos aren't subject to the tyranny of quarterly results that can force public companies to manage for the short term, but they and their investors face time pressure that is in some ways more relentless. After the five-to-seven-year holding period, investors want to recoup their equity and gain a big profit through a sale to another company, an IPO, or some other recapitalization. The ticking clock puts two kinds of pressure on portco leaders. The first is psychological: Some otherwise excellent leaders balk at—or buckle under—the pace demanded by PE investors, leading to turnover or conflict. The second is a deadline-driven approach that results in underinvestment in leadership development and so-called soft skills, whose returns are hard to quantify. The HR teams at portcos emphasize transactional compensation (pay and benefits) and incentives (particularly for executives), but compared with public companies, they pay less attention to leadership bench strength or strategic human-capital investments (culture, training, and diversity and inclusion). Succession planning, too, is bypassed—ironically and unfortunately, given the high turnover.

Different views of what makes a great leader. Even when firms wish to invest in or develop talent, the various players may not agree on what talent looks like. PE firms are led by dealmakers, portcos are led by executives who focus on operations, and the two groups tend to define great leadership differently. Our survey of PE and portco executives shows that the former place a premium on "charismatic" leadership traits: They are 20% more likely than portco executives to value the ability to lead change, 50% more likely to admire agility and adaptability, and almost twice as likely to set store by resilience. Despite their reputation for urgency and cost cutting, when we actually talk to portco leaders, most describe leadership as a team sport. They are 40% more likely than their investor-owners to put a premium on the ability to inspire and motivate, 20% more likely to prize collaboration, and more than twice as likely to prioritize relationship building, talent development, and succession planning.

> **Asked which levers are most important for creating value in their portfolio companies, PE executives cite leadership effectiveness more**

often than anything else.

Because PE firms hold more power in this relationship, their view often wins out. They bring in portco CEOs who execute quickly, typically by cutting costs, and tend to give short shrift to the value of collaboration or building trust. When the retiring founder of a $50 million electronics manufacturer sold it to a PE firm, the new owners brought in a CEO with a terrific résumé and an all-guns-blazing mindset, who quickly sought to eliminate overhead, improve purchasing, and tighten up a sales process that had become too quick to offer discounts. His failure to connect with people, however, created problems. Over six months several key managers and technical specialists left, citing the coldness of the new boss and the changing culture. One major customer (representing 10% of revenues) defected. From the PE firm's perspective, it was a disaster: The firm was forced to delay the add-on acquisitions at the heart of the rationale for the deal. Stories like this are endemic within private equity, and differing ideas about the right kind of leadership are typically the root cause.

A lack of management infrastructure. When portcos are platforms or roll-ups, they often face the challenge of building a management infrastructure out of bits and bobs. A similar challenge comes with "carve-outs," depending on how much the newly formed company relied on its former parent for functions such as purchasing, legal, and HR. "We had absolutely zero infrastructure and about 150 employees on day one," one carve-out CFO told us. Tropicana—spun out from PepsiCo and sold to PAI Partners, one of the largest PE firms in Europe—had to build a management structure and team in a matter of months, replacing all kinds of capabilities that its former parent had provided, including HR, sales, and distribution. Portco leaders must pull off this feat while under pressure to cut costs, particularly overhead—and while many incumbent managers may be preparing a personal plan B in case staying at the new entity doesn't work out.

That's a leadership agenda starkly different from trying to energize and optimize an established, often entrenched, sometimes bloated bureaucracy—the task most public-company CEOs face.

Potential tension between PE owners and portco operators. PE fund managers, usually through their operating partners, can (and do) intervene in how portcos are managed far more than public shareholders can. Being owned by a PE firm is like having a board dominated by activist investors. Portco executives may be exhilarated by the challenge and the opportunity to work directly with boards and investors—something their public-company peers rarely get to do—but they are also usually quite unprepared for it. It is not always a positive relationship: Twenty-eight percent of portco leaders complain that their PE owners are too hands-on, while 33% of PE leaders believe that they are too hands-off. The relationship between owners and operators is often tense and variable; AlixPartners frequently leads discussions early on in the relationship to see where disagreements might emerge and how to manage them if they do.

A relentless focus on enterprise value. Of course, all management teams are supposed to increase shareholder value, whether the shareholder is the public, a PE firm, or a private owner. But PE firms obsess about it, largely because they explicitly intend to sell the company after a few years. In PE-owned companies, all decisions are evaluated first and foremost according to their immediate impact on value, with other considerations coming into play only if the value test has been met. And because cutting costs can drive value more quickly than fostering profitable growth can, and is easier to measure, PE firms tend to prioritize it—even as holding periods lengthen. Investing in talent development requires resources, so the focus on costs at portcos is an obvious constraint.

Taken together, these issues go a long way toward explaining why this famously can-do industry has struggled to address a leadership problem it knows it has.

What Should Be Done

For PE and portcos to close this leadership gap, both investors and management need to show and track how leadership can produce *accelerated value creation:* that is, can identify, protect, strengthen, and expand value. These actions can take place at three levels: at the PE firm, at the portcos, and in the context of a specific deal. What follows is a breakdown of the changes that should be made at each level, starting at the PE firms.

Hire and empower a human capital partner. A growing number of PE firms have responded to the need for better leadership by hiring someone to focus on the issue. Variously called “chief human capital officer,” “talent leader,” or “performance specialist,” these people can be found in perhaps half of large PE firms (those with more than $2 billion in assets under management) and are starting to appear in smaller, middle-market firms as well.

Some human capital partners’ roles are limited and transactional, however. They get involved in managing searches and interact primarily with search firms. Others are asked to participate in the due diligence process to evaluate the strength of a target company’s top leadership team; or they assess, or hire outside specialists to assess, the capabilities of prospective senior hires; or they coach key portco executives. More-advanced PE firms sometimes ask their human capital partners to provide expert support for operating partners and portco leaders during the holding period as well.

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This role should be expanded and become an industry standard—that is, every PE firm should appoint a human capital partner to advise operating partners and portco leaders. In most cases this person should be on the PE firm's senior leadership team and given a broad mandate (and sufficient budget) to upgrade talent at the firm and at portfolio companies. The best person for this role often has deep experience in hiring, executive team development, and coaching. For example, TPG, one of the 10 largest PE firms in the world, hired the former head of North

American leadership and talent at Spencer Stuart for the job. Among other objectives, that executive and TPG have worked to increase board diversity at the firm's portcos.

To use a baseball metaphor, historically the PE industry hasn't had a great farm system (minor-league teams) to develop talent for tomorrow, but it is highly skilled at navigating the free-agent market for established talent (to bring in new CEOs at portcos). An experienced and empowered human capital partner can play a vital role in helping PE firms learn how to build, not just buy, great leaders.

Develop a leadership playbook for the firm. One way to reduce complaints that PE firms are micromanaging or undermanaging portcos is to create a playbook of processes and systems to clarify expectations, timelines, and communication patterns. It should include resources, investments, and programs offered by the firm to empower and develop portco leaders, not hog-tie or hassle them. The playbook should address three talent-related areas.

- *Assessment and recruitment.* PE firms can help portfolio companies assess current talent and identify skill gaps. Ideally, they will bring in one provider to identify common issues and create common measurements across portcos. Firms can also provide expertise in recruitment and strategies to enhance diversity and inclusion. Some venture capital firms offer a model: They have well-developed capabilities in this area, since recruiting is so vital for start-ups.
- *Leadership development and succession planning.* More than 70% of middle-market companies—the most common targets of PE firms—say succession planning is important, but only about 45% say they do it well. Here, too, PE firms can both assist with better performance and insist on it. Good succession planning looks across the firm's human assets and identifies high-potential

leaders who might be right for openings at other companies in its portfolio.

- *Performance management and incentives.* Private equity firms can help portcos establish performance management systems and metrics aligned with the company's strategic objectives. They can provide guidance on setting goals, conducting reviews, and linking compensation and incentives to individual and team performance.

Beyond these formal processes, the playbook should include creating opportunities for peer-to-peer learning among portco executives. Some of the larger PE firms—Carlyle Group, for example—bring portco CEOs together to share ideas. Investcorp, a global alternative-investment company whose PE arm manages $50 billion in assets, regularly holds events to which portcos send their CEOs and CHROs; the agenda includes topics such as talent assessment, hiring processes, and understanding the career needs and wants of Gen Z employees. In addition to gatherings, PE firms can produce webinars and other learning events for companies they invest in. The Riverside Company, a global firm focused on the middle market, produces a regular series of programs, called Riverside University, on topics such as reputation management and sales leadership. These activities need not be limited to C-suite executives. Advent International has partnered with Harvard Business School in a custom leadership program for high-potential and diverse portco leaders. Advent also invites outside experts to brief portco leaders on urgent topics—for example, several of my AlixPartners colleagues presented a two-day workshop on recession readiness in the fall of 2022.

Programs like these can do more than create ways for PE firms to provide guidance for portcos. They can inspire an important attitudinal change by making portcos view their owners as a source of resources and support rather than a provider of intrusive and not always helpful oversight.

To increase the caliber and depth of portco talent:
Develop a leadership agenda. Although strong PE firms should provide support to portcos in recruiting and developing great talent, ultimate responsibility for their leadership lies with the portcos themselves. They must combine an unblinkered assessment of current leadership capabilities—the people on the bus, as the management expert Jim Collins puts it—along with a plan for when "the bus gets larger and goes faster [and] the seats get bigger and more difficult." Three principles should guide portco leadership strategy.

- *Begin with an end in mind.* Portcos should work backward from what they believe their business will look like when the holding period ends. That's not easy to do in a pedal-to-the-metal PE environment. But strategic talent management cannot be relegated to back-of-the-envelope "planning" or treated as an afterthought. It includes organizational design, rigorous role definition, and positions, of course; but it should also include measurable goals for less-tangible assets such as leadership and culture. For one portco AlixPartners worked with, those goals included achieving employee retention rates in the top quartile of the industry; a specific rise in employee engagement scores; a target for employee referrals that bring in new hires; 5% improvement in labor productivity, cross-training, and succession planning for every key role; and demonstrable improvement in outside ratings of the culture, as measured by Glassdoor and Great Place to Work.
- *Integrate leadership and human capital metrics into reports to the owners.* Part of the value of measurable goals is that they can be integral to financial reporting to PE investors. Portcos can also connect their reporting on human capital to other issues that

matter to PE firms. For example, seven out of 10 PE executives say that environmental, social, and governance concerns (which include diversity and other talent goals) are a lever for value creation. Documenting talent milestones alongside financial performance will help make the case for continuing investment.

- *Transform portco HR teams from transactional to strategic.* Many roll-ups and carve-outs begin life with HR departments that focus on low-level personnel tasks: pay, benefits, compliance, and the like. Carve-outs might be endowed with only a skeletal HR function, since high-value talent-strategy leaders often stay with the original enterprise. The same weakness may afflict other departments, such as finance and IT. PE owners are unlikely to want to fund big cost increases in any of those departments. Outsourcing transactional work is one way to transform many corporate-services functions without busting the budget and has the additional advantage of being a solution that can scale up as the business grows. But outsourcing low-value work is effective only if the funds freed up are used to do high-value work such as improving recruiting processes, succession planning, and leadership development.

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Portcos that use this playbook can drive significant increases in value. We worked with one such company, a supplier of equipment to restaurants and other food-services customers, that had an aggressive plan to double its sales (from $500 million to $1 billion) in five years, essentially by upgrading talent, starting with a new CEO and CHRO. During that period the company turned over a third of the workforce and replaced the people in virtually all the key value-creating roles, offering equity stakes and the excitement of a high-performing workplace to entice strong leaders to join the team. Eventually the company sold for four times the purchase price—and almost all the investment driving that increase was in talent. Few companies will have so aggressive a talent plan, but all should have a zero-based plan that starts with where value will be created and builds a team from that.

At the individual deal level, PE firms can take the following steps to increase the quality of leadership.

Embed leadership in the deal thesis and due diligence. Getting the leadership agenda right begins with the deal thesis—what the PE firm sees as problems it can fix (such as bloated costs) or opportunities it can seize (such as reviving a stalled brand or gaining scale through a roll-up). The often-overlooked key to a deal thesis is identifying the management capabilities needed to make the thesis work. A deal thesis that emphasizes control and professional management requires different kinds of executives—and asks different things of them—than does one predicated on aggressive growth. Entrepreneurial companies are often overled and undermanaged—light on planning, process, and control. Stale companies, by contrast, might be overmanaged and underled. Smart PE firms recognize what kind of talent they'll need to help acquisitions thrive.

For example, when one telecom giant carved out a major customer-facing division and set it up as an independent company, the deal thesis included finding ways to run the place more leanly, but it also included reimagining the spin-off's innovation processes and capabilities, which had fallen behind those of rivals as it competed for investment inside its former parent. Ultimately the first-year value creation from new revenue was two-and-a-half times the amount of cost savings, achieved not by throwing money at the problem but by more-effective leadership and management of the innovation process. That value might not have been realized had the leadership agenda focused only on costs, since cost cutters frequently try to put innovation on pause.

Due diligence should test and validate—or rebut—the deal thesis, including leadership. In our experience, due diligence is too often siloed: One team ticks and ties legal and governance loose ends, another looks at operations and costs, a third vets technology and cyber risk, and a fourth investigates commercial prospects. Management and leadership are essentially treated as nice-to-haves.

To protect value, due diligence should look for possible misalignment—square pegs in round holes—and identify must-keep people.

Instead the process should include rigorous assessments of organizational effectiveness and talent focused on the specific sources of value. To protect value, diligence should look for possible misalignment—square pegs in round holes—and, equally important, identify must-keep people who might not be in the top ranks. Given the high post-deal turnover rates, finding those people and making a plan to retain them is a critical part of due diligence. Get to know high-potential employees, understand what the target company has done to develop career paths for emerging leaders, and assess the company's culture to see whether it supports the strategy and the deal thesis. In addition, if possible, acquirers should look for data on employee engagement, turnover, and morale before the deal closes, to get a baseline, identify weaknesses, and begin to create a plan and targets for improvement. If those assessments cannot be done before closing, they should be undertaken as quickly as possible afterward.

Start off on the right foot. The first few months of new ownership are when the PE firm's operating partner and the portco's management team are determinedly trying to capture synergies fast. Speed is important, but quick wins will prove ephemeral if leadership issues are pushed aside in the rush.

Addressing those leadership issues picks up where due diligence left off. Define the key value-creating roles throughout the organization—not just at the top. Be as specific as possible about how those roles matter and how to track performance. Note that the roles will change as the organizational design evolves. Next identify vital leadership capabilities for the key roles. What activities and outcomes are most important? What skills will people need to thrive in those jobs? Be as specific as you can. Then assess the people in those roles. If you did this during due diligence for top leadership, go one level down, seeking to identify stars who must be retained and laggards who should be replaced. As you shape the roles to address the organization's new challenges, ensure that the compensation scheme reflects their importance and reinforces behaviors that are critical for success.

Moving beyond the early months, avoid the temptation to adopt a one-and-done approach to talent. Instead invest in ongoing assessment and development capabilities that will ensure A-player selection, promotion, and growth throughout the organization. Recognize that even if the portco manages talent well, some attrition is inevitable, so begin thinking about succession planning for key roles from day one.

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Accelerated value creation is the essence of private equity: working quickly to identify where and how value is created, protect those sources of value, strengthen and enhance them, and grow them. All that requires capable leaders who focus on retaining top talent, incentivizing, coaching, cross-training, planning for succession, diversifying talent, and analyzing how industry and technology changes will affect future leadership requirements.

These are all measurable activities—a fact that should be dear to the hearts of PE investors. But they are more than that. A PE firm that builds a quantifiable, systematic, and repeatable assessment of leadership into its acquisition, due diligence, and portco management processes can use the same method to prepare its companies for sale. The strengths and weaknesses of a company's human capital and leadership should become part of the pitch to prospective buyers. An asset that has exceptional value-creating leadership will fetch a better price than one where leadership is little more than an afterthought.

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