Grant Thornton

Handling Management Talent In Private Equity and Related Transactions:

Formal Due Diligence, Introductory Meetings and Interviewing Skills

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Preface

The previous report in this series looked in depth at just one issue – the ways in which private equity firms handle management due diligence.[1] This follow-on survey looks at four topics around that traditional core: (a) some measures of impact and value across all types of due diligence (financial, legal etc); (b) views of key management strengths and weaknesses; (c) the handling of MBI and non-executive candidates; (d) the people skills of investment teams.

It looks less at typical practice at firm level and gauges instead the perceptions of individual deal-doers. The method used to gather data (web survey) is more time-efficient for busy participants than telephone interviews but inevitably leaves less room for comments outside the scope of the questions and does not offer the same immediacy of other people's words. Some of the conclusions are necessarily my inferences rather than representing investor consensus.

As in the previous report, and to allow more detailed analysis, firms were categorised as one of the following types based on their typical transaction size (in terms of equity invested) – Upper Mid-Market (£20 to £100 million) – hereafter UMM; Lower Mid-Market (£5 to 20 million) - LMM; Early Stage (below £5 million) - ES. A couple of firms described in the old report as 'Top Bracket' (typically doing transactions of more than £100 million of equity) have been added into the UMM category. In addition representatives of some banks involved closely in private equity transactions (some offering just debt packages, others integrated finance) have been included.

[1] *Taking Management to the Next Level: Current Practice and Future Directions in the Assessment of Management Teams by Private Equity Firms*, Mike Hicks 2005 (If you have not seen this report then contact me to see how you can receive it at no cost)

Participants and their firms

64 individual investors from forty organisations completed the survey. Comments from early completers led to some minor changes being made to it half way through. However, this does not seem to have affected the way that answers were made. Data from eleven individuals from one UMM firm, who completed the survey as part of an internal benchmarking exercise, have been excluded where appropriate to avoid distorting certain comparative conclusions.

3i	HgCapital
Aberdeen Murray Johnstone	HSBC
ABN AMRO Private Equity	Interregnum
Advent International	JP Morgan Capital Partners
Albany Ventures	Lazard European Private Equity
Alchemy	Legal & General Ventures
Amadeus	Lloyds TSB
Bank of Scotland	NBGI
Barclays Bank	Nomura
Barclays Private Equity	NVM
Barclays Ventures	Piper
Bowmark	PPM Capital
Cabot Square	Promethean Investments
Doughty Hanson	Rutland
Duke Street	TDR
Dunedin	West Private Equity
ECI	WM Enterprise
Elderstreet	YFM
Granville Baird	Yorkshire Bank
Gresham	Zouk Ventures

1. The impact of management and other due diligence

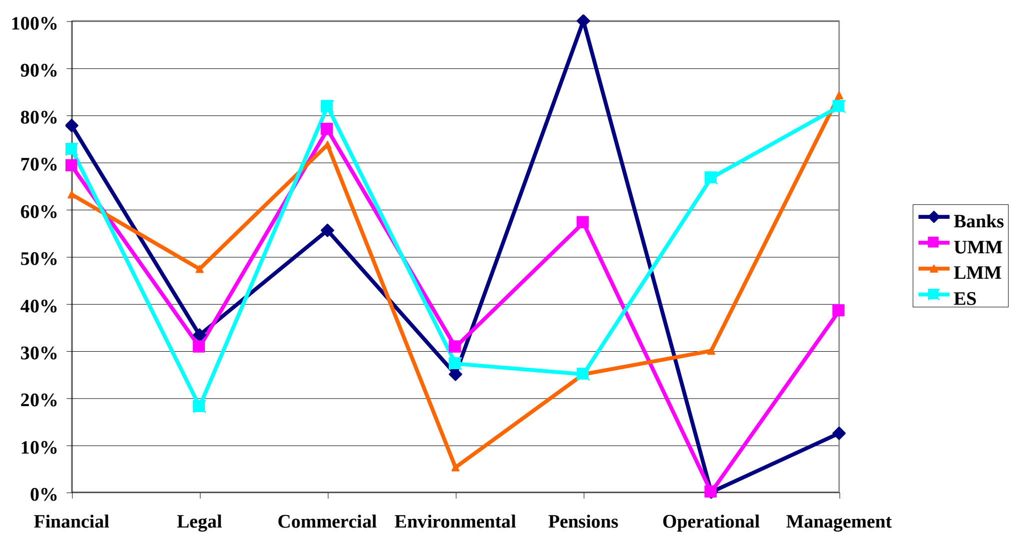
The range of pre-investment due diligence work has expanded considerably over the last ten years, and the range of advisers with it. Understanding the specific contribution of management DD - and future prospects for it - is best achieved within the broader context of all due diligence.

1.1 What does due diligence contribute to the deal?

There are a variety of ways in which diligence activities can impinge upon transactions. Figure 1 suggests that whereas most organisations reckon that financial due diligence (hereafter FDD) and commercial due diligence (CDD) have a fairly high chance of leading to deal aborts, views on management due diligence (MDD) are much more varied by type of investor. About 80% of LMM and early stage investors reckon that it can persuade them to kill a deal. Only about half that proportion of UMM investors see MDD as being so decisive while virtually no bankers are convinced of the same thing.

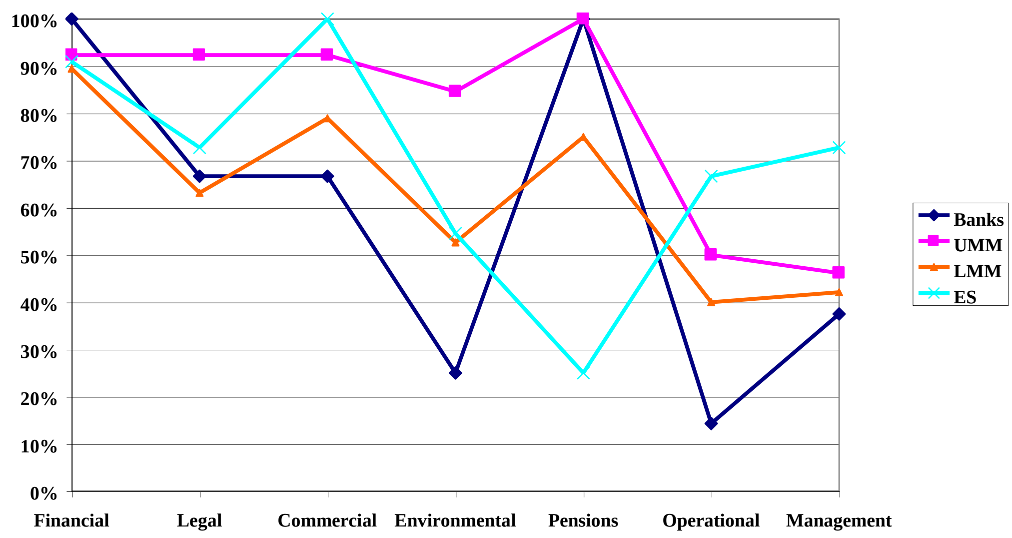
In the previous report one clear finding was that investors in smaller deals ascribe more importance to management quality generally and suffer more economically significant surprises from their management teams. In consequence LMM investors were the most likely to have experimented with third party consultants in this area and to have tried out different techniques. It is difficult to say, however, whether using more tools explains the greater likelihood of MDD leading to aborts, or whether the greater dependence on key management individuals means that more emphasis is placed on diligence as a way of handling this risk.

Figure 1: *How often do findings from the following types of due diligence lead to deals being aborted?(% ‘frequently’ or ‘sometimes’)*



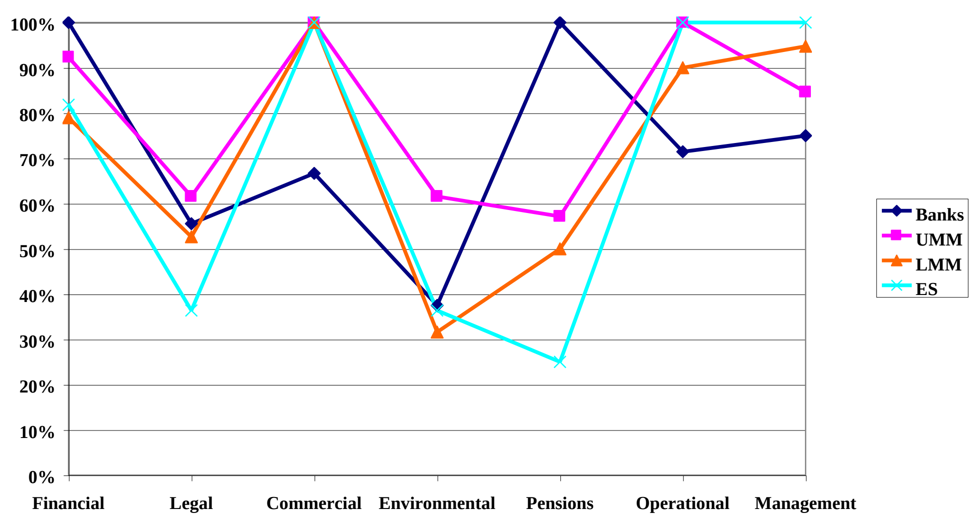
One contribution that diligence can make for investors is to provide ammunition for negotiation of terms. Here FDD stands out as the essential tool, with legal and commercial serious contenders too. MDD is generally seen as a secondary influence on such discussions by most investors.

Figure 2: *How often do the findings from these kinds of due diligence have an impact on deal negotiations/terms? (% 'frequently' or 'sometimes')*



Although due diligence has traditionally been seen as a means of kicking the tyres before purchase, respondents seem to expect more from their diligence expenditures now – they are apparently seen as an influence on the way that investees will be managed post-deal.

Figure 3: *To what extent does information from these types of due diligence affect the way that you set the agenda with the investee post-transaction? (% 'frequently' or 'sometimes')*



The question is how much this influence is created by supply of information that allows investors to set post-deal targets and how much it derives from explicit advice on performance improvement. To the extent that DD providers are helping target-setting, management may gain less advantage. Consequently comparing Figure 3 with Figure 4 suggests that FDD helps investors post-deal mostly by assisting target-setting. Operations information offers both target inputs and useful advice to management while commercial and management DD appear to assist management in generating performance.

Figure 4: *To what extent do managers of investee businesses typically perceive value in the outputs of due diligence?(% 'a lot' or 'some/depends')*

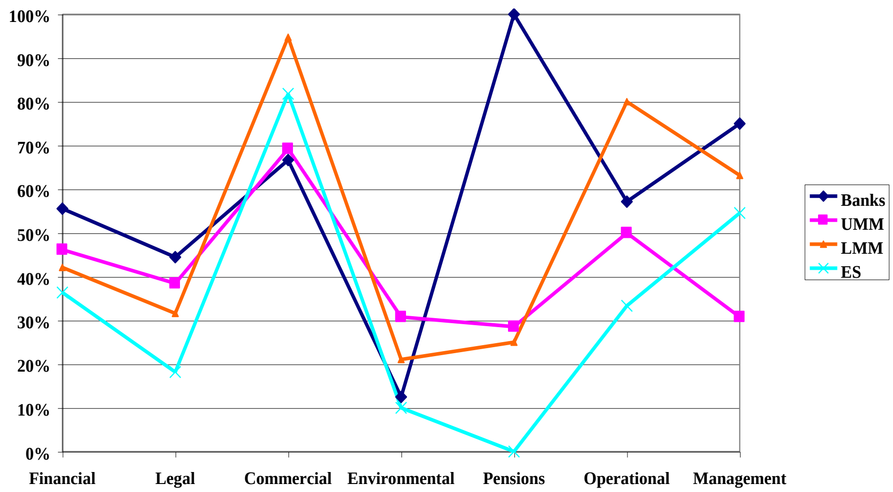
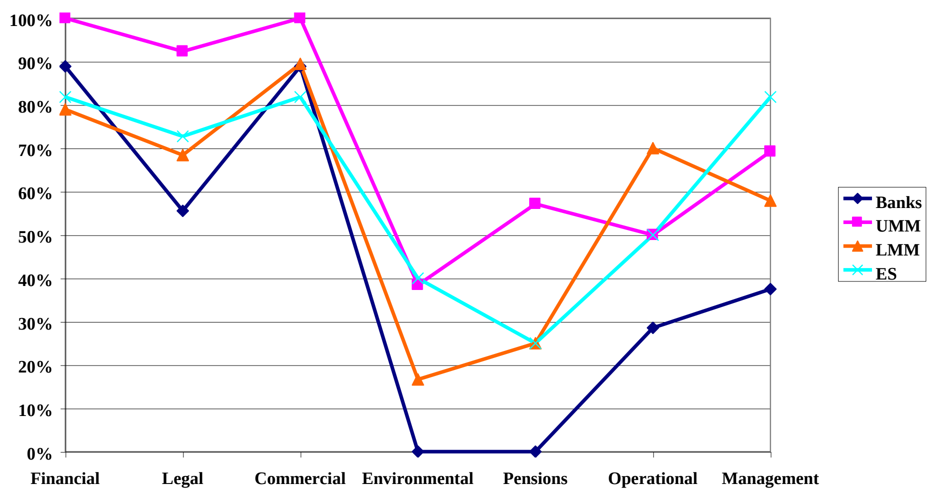


Figure 5 gauges the ability of DD providers to fit into the deal process and provide investor-friendly outputs. The longer established disciplines (financial, legal and commercial) score better than the newer ones (e.g. environmental and management) and organise their offering through dedicated transaction service teams. By contrast, the newer areas of DD are still evolving and establishing their user-friendliness.

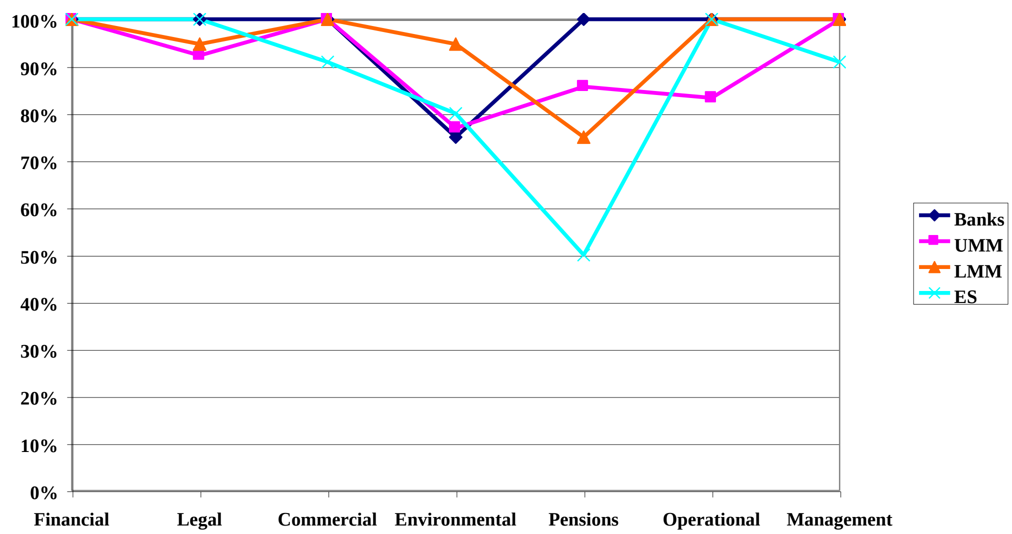
Figure 5: *How well do your business advisers in these areas typically understand the broader context of the investment decision?(% 'excellent' or 'good')*



1.2 How is value-for-money evolving?

In principle there are at least two ways of gauging whether DD work is a helpful exercise. Firstly, do investors actually take their time to plough through the vast masses of paper produced over several weeks? With the partial exceptions of environmental and pensions/insurance DD, investors claim to read pretty much everything that is sent to them by their advisers. This is more impressive in regard to the voluminous and often dense formats created in financial and legal DD than in the (hopefully) shorter and snappier reports produced by MDD advisers.

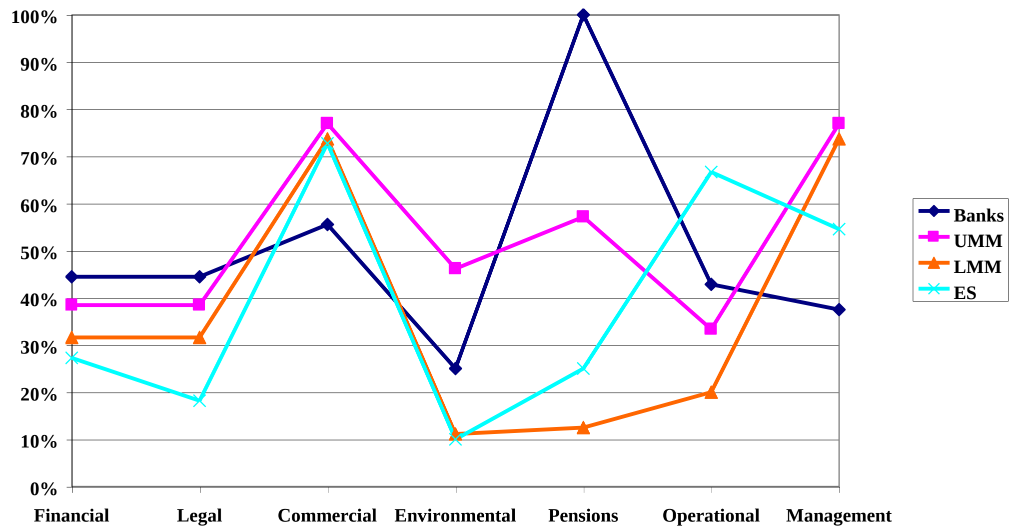
Figure 6: *How much of the written due diligence reports do you usually read during a fast-moving deal process?(% 'everything' or 'executive summary plus any problem areas')*



Secondly, do investors perceive that money spent on DD represent value for money? It would be a bit surprising if investors were to award full marks to their suppliers on this dimension, but it is interesting to see the relative scores. Broadly the more expensive types of DD in absolute terms (financial and legal) are marked down while the shorter and cheaper types such as commercial and management are scored higher. It is a shame more detailed questions were not asked here because in the case of financial DD this seems quite anomalous – it scores well on relevance to aborts, negotiations, post-deal, usefulness to management, amount read, and level of understanding but gets only a mediocre score for value for money. This riddle may partly be explained by reference to Pareto's law (a.k.a. the 80:20 rule) since FDD reports need to cover a lot of ground 'just-in-case' – but therefore risk spending too much time on issues of secondary interest. That belt and braces approach may explain why bankers in the survey scored FDD higher than private equity investors in almost all questions.

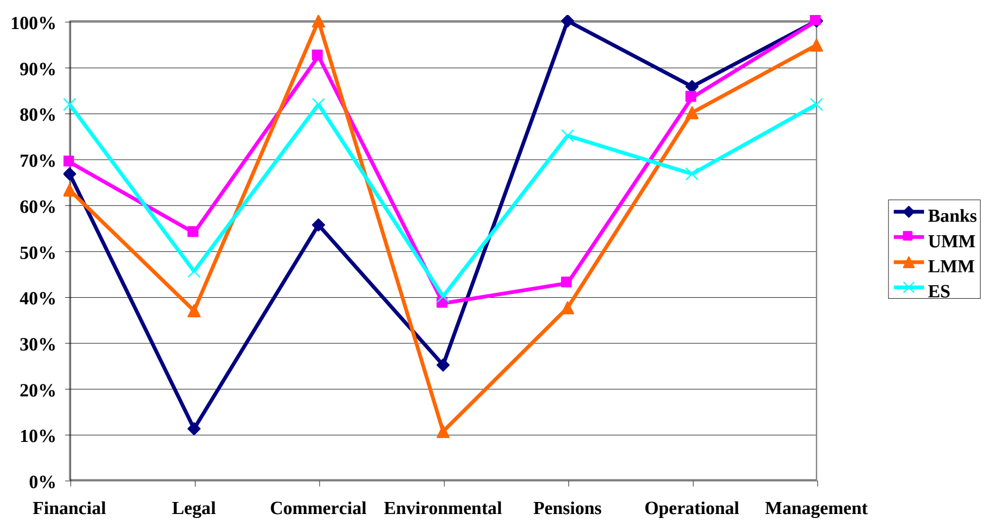
It is also worth noting that while MDD is given a high score here on value-for-money, in practice the use of MDD on all transactions is still a minority habit amongst investors. Although growing in profile it remains a nice-to-have rather than the must-have which legal and financial DD represent.

Figure 7: *How would you rate the overall value for money provided by this kind of diligence?(% 'very high' or 'high')*



A critical question for a relatively new discipline like MDD is buyer expectations of future evolution. Respondents to the survey apparently have high expectations of how the value-added MDD can grow in the next years. It is not unique in this regard – operational, commercial and, to a lesser extent, financial DD all seem to inspire optimism or hope from most investors.

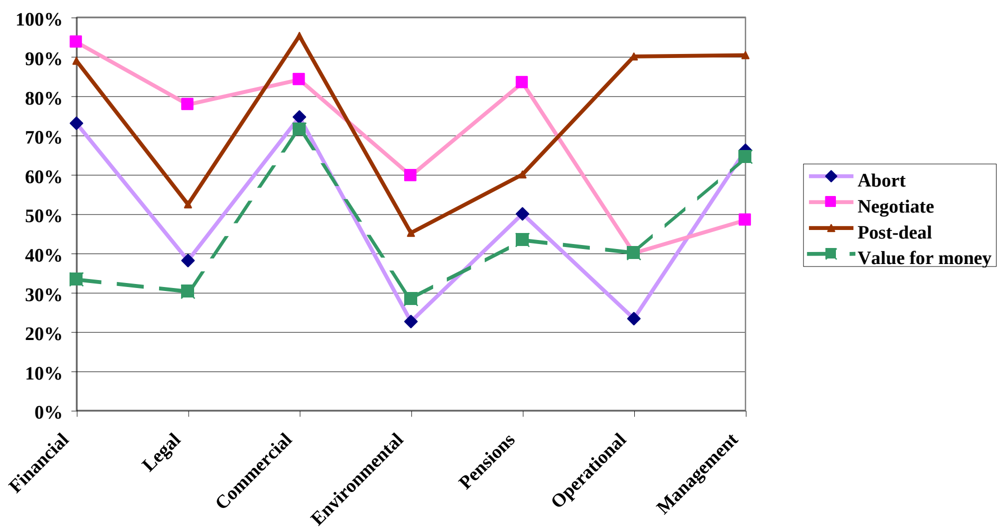
Figure 8: *Over the next 5 years, how much scope is there to make improvements and add additional value in this kind of diligence?(% 'plenty of headroom' or 'some possibilities')*



In the absence of detailed commentary the reason for these expectations are speculative. However, we may suspect that the agenda for the next years will be different depending on type of DD. FDD, for example, is probably grappling with the tension between the need to continue providing decent coverage of all key areas while pruning its output in order both to limit cost and also to focus on the questions highest up investors' worry lists. CDD, by contrast, scores handsomely on most dimensions and so its challenge is more one of incremental improvement. As relative newcomers, operational and management DD have primarily to demonstrate their ability to provide consistently substantive insight.

Figure 9 brings together the main dimensions of impact and value for money for the different types of due diligence. It suggests that whereas measures of impact correlate well with perceived value-for-money in the case of legal, commercial, environmental and pensions DD, this relationship is looser for financial and management DD. In the case of FDD perceived value is significantly lower than one might expect from examining effects on deals. In the case of management, perceived value is, if anything, higher than expected.

Figure 9: The Impact of Due Diligence Compared with its Perceived Value -Added (% 'frequently or 'sometimes', and 'very high or high')

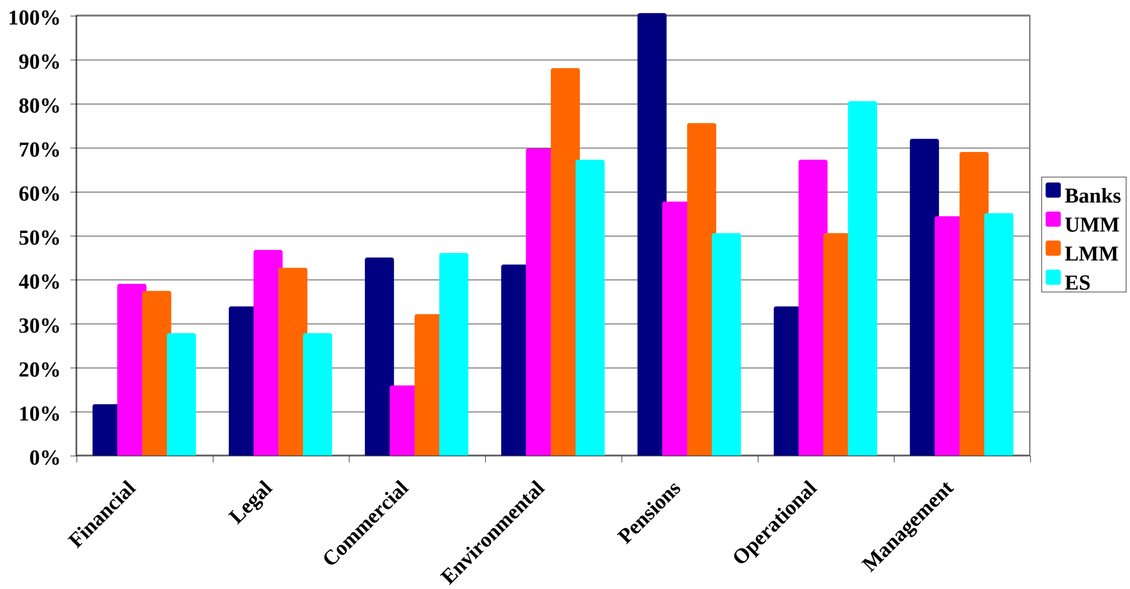


The implication of all this for management due diligence is that it now needs to find ways of adding to its delivered impact on deals to justify this apparent vote of confidence. This is the task which should occupy investors and providers of service in the next few years.

1.3 Due diligence buyer loyalty and timings

It is noticeable that in the case of the better established types of DD (FDD, LDD, CDD) investors seem happy on average to have spread their DD work widely – only about a third of investors claim to have used just one or two suppliers. We may speculate whether this represents a maturing of the respective markets such that quality standards are sufficiently universal and buyers relaxed about switching their business based on price and other deal-specific reasons. By contrast, investors seem less likely to have spread themselves so wide in the case of the newer, smaller types of DD. One possibility for this may also be that the newer types of DD are less likely to be delivered by crowds of juniors and so individual relationships and reputations may play a greater part in buyer decisions.

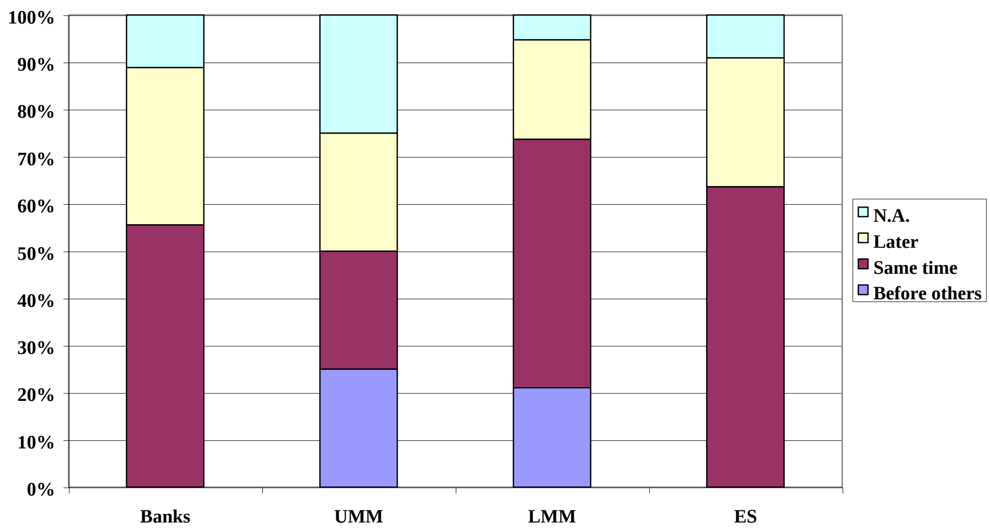
Figure 10: *% of firms who have used just 1 or 2 DD suppliers in last 3 years*



The increasing role of structured sales processes in the middle market means that the timing of any management due diligence is often hostage to vendor timetables and deliberately restricted access to management. Nonetheless, one might imagine that investors would have a preference to front-load this work as far as possible. It is typically lower in cost and shorter in duration than other forms, and addresses what most investors claim is the single biggest 'moving part' in determining risks and returns. Consequently I had expected that most respondents would say that they either front-loaded management DD or launched it in parallel with their overall diligence efforts. In the case of firms in the lower mid-market this is broadly true - about three-quarters do so. Early stage investors and bankers are somewhat less likely to do so.

By contrast, more than half of those in the upper mid-market either carry out no specific management diligence or leave it until a relatively late stage. This finding is supported by the data gathered in my 2004 study where upper-mid-market firms were less inclined to use outside consultants for assessment purposes and more reliant on references alone. That in turn may be because the risk of removing individual executives may be seen as lower in larger companies where management resources are deeper and the assessment decisions less worrying than for transactions at lower levels.

Figure 11: *If you bring in outside management due diligence providers, when do you typically start them?(% before, same time, or after, other types of due diligence)*



Since due diligence costs for UMM firms surveyed last year averaged about £2.1 million per transaction, and since 80% of respondents to the current survey reckon that management DD results in deals being aborted at least sometimes, there is an economic argument for hearing the results of management diligence as soon as possible. In 2004, one UMM firm wrote off £3 million of DD costs due to last minute revelations about management. On a more positive note, I was recently involved with a smaller transaction where the client was able to save a large proportion of DD fees by hearing bad news about management quickly - in fact even before referencing had begun.

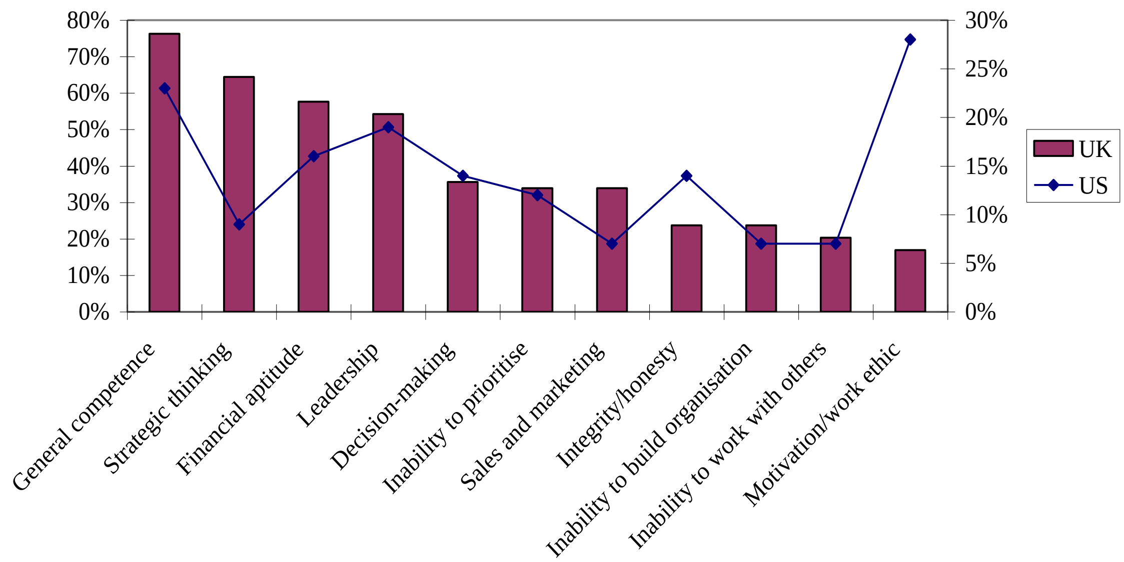
For this reason it only makes sense to think through potential business and management risks early on in any process and then use any available data and meetings to measure managers against specific benchmarks. Making any third party consultants on management work early and present their initial views quickly in verbal form is harder work for the consultants but leaves time in which any suspicions can be explored by the investment team during dinners or more formal discussions.

2. Management weaknesses through UK and US investor eyes

One diagram some respondents will have seen me using in presentations summarises some work carried out by ghSmart in the US laying out management issues that mid-market private equity investors have been blind-sided by.[2] A number of people who saw that thought the UK results might be different - and results from this survey give partial backing to that sentiment.

Figure 12 shows which proportions of respondents had experienced which management weaknesses. The first thing to note is that UK figures for all except one dimension are significantly higher than those recorded in the US probably due to different survey methodologies. Indeed a different scale has been used. Nonetheless, this exercise shows how the *relative* allocations resemble each other and differ.

Figure 12: *Where you have experienced disappointments with management teams post-deal, what is it that has been lacking?*(% respondents reporting the issue)



Based on these figures both UK and US investors seem to agree that general management competence is more of a risk area than financial aptitude, leadership, ability to prioritise and make decisions and basic integrity. There are, however, two major areas of difference. Firstly, whereas US investors found that motivation/work ethic was their number one blind-spot with investee management teams, UK investors rate this much lower. Secondly, whereas UK investors worry about problems with strategic thinking, US investors seem much less bothered about it.

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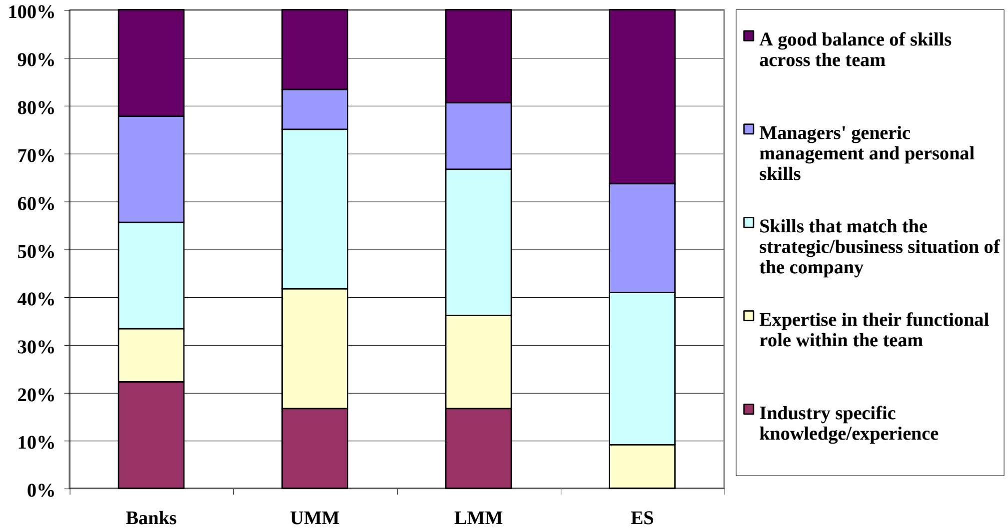
[2] Source: Smart GH, *The Art and Science of Human Capital Valuation* (1998), p. 16. N=48 investments

Figure 13: *In sizing up a management team, what is more important in predicting their effectiveness?* (No. ranking 1st or 2nd)



Investors often tend to think about management skills in larger groupings. Figure 13 considers the relative importance of five frequently-encountered ones. None of these is intrinsically more important than the others and they clearly overlap. Within each group of investors at least someone ranked each of them first or second in importance, with the single exception that none of the early stage investors rated industry specific knowledge as a top two factor.

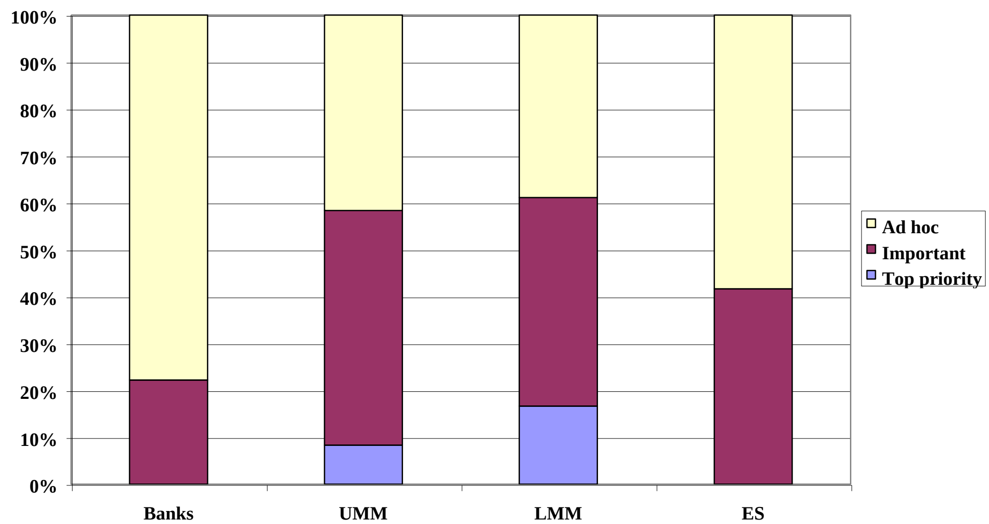
What does emerge, however, is the extent to which investors are seeking more general or more specific skills from their management teams. In the figure above the answers are placed in approximate order with the most specific kind of skill (industry specific) at the bottom while more general ones (balance of skills, generic skills) are at the top. Seen in this way it becomes clear that middle market houses are more likely to seek industry and role specific skills than banks and early stage investors. In the larger types of companies into which UMM and LMM firms invest, general skills are assumed to be present in any serious proposition and the key to competitive advantage lies more in deep knowledge of specific niches and functional roles. By contrast general management competence is more of a struggle in much smaller transactions.

The single most popular category amongst all respondents, and for most investor types, is the middle one of skills that match the strategic/ business situation of the company. In some respects this encompasses the other categories and suggests the truism that a successful team will represent a combination of generic and specific skills and that the job of investors and their advisers is to work out the specific combination that will best serve the transaction in question.

3. Handling MBI and non-executive candidates

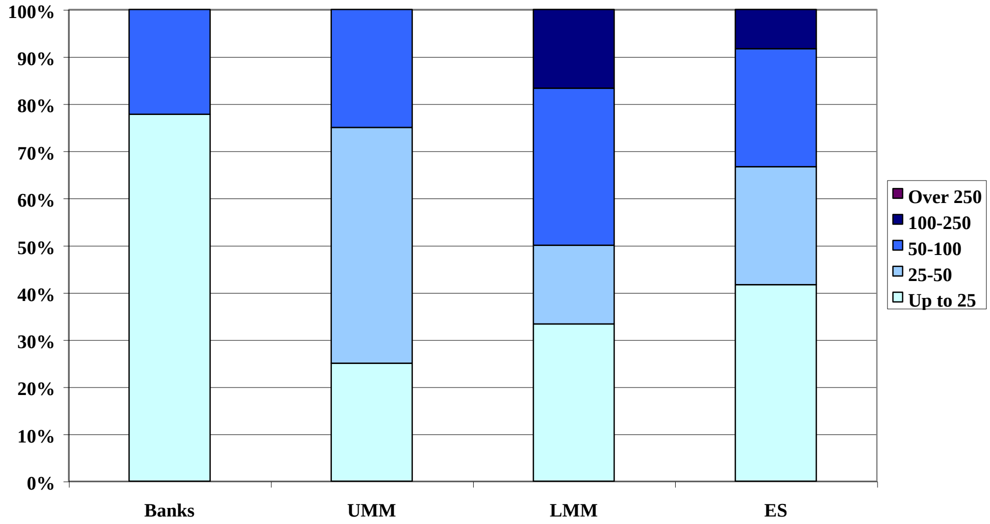
Private equity firms seek to cultivate possible MBI and non-executive candidates for several reasons. Firstly, they represent a source of motivated talent for use in existing or future transactions. Secondly, they also represent a tool for originating transactions, whether just as eyes and ears in sectors of interest, or as active deal creators. Investors can also do a quick temperature check of a sector by talking to some experienced executives. Even if a company is being sold via a structured process, having the right allies may provide greater insight or personal connection to facilitate a winning bid. Most likely it is the search for an angle in such processes that influences why the middle market firms appear to give the greatest priority to the cultivation of contacts of this sort.

Figure 14: *How much of a priority is given to the active cultivation of potential MBI and non-executive candidates within your firm?* (% respondents by level of priority)



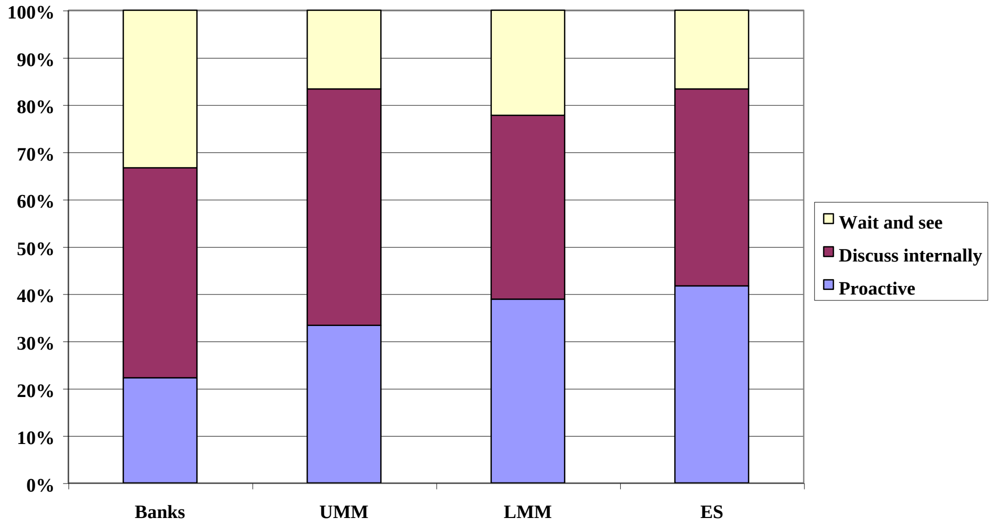
A sense of priority can translate, however, into very different numbers of meetings depending, amongst other things, on how many industry sectors a house is trying to cover. Figure 15 shows estimates of how many meetings private equity investment teams have of this sort on an annual basis. It suggests that firms vary quite widely in the amount of effort made in this area. Banks seem to find least reason to meet such candidates – most meeting fewer than one every other week. By contrast half of lower mid-market firms reckon they meet at least 1-2 people a week of this sort, with a minority seeing anything up to someone every day on average.

Figure 15: *How many MBI/non-exec candidates do your team meet in an average year in the UK?* (% respondents by number of meetings)



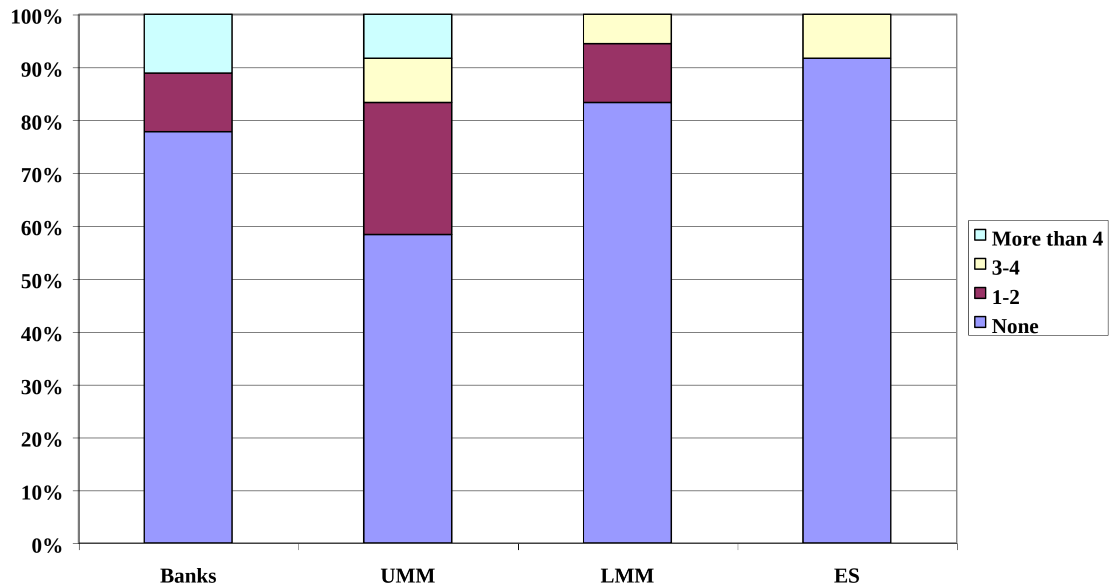
Squeezing the flesh and collecting CVs is clearly not an end in itself. In principle one would expect that more can be obtained from active follow-up with those candidates who seem to fit the culture of the house and the kind of deals being pursued. Figure 16 suggests that private equity investors are more likely than banks to follow up with candidates met and that, amongst the equity houses, it is those doing the smaller transactions who are most proactive. This is curious since the mid-market houses are more likely to claim that this issue is important for them. The explanation for this apparent anomaly may be that early stage investors have traditionally been less reliant on intermediaries and auctions for deal origination and so are more habituated to using meetings (and follow-ups) with interesting management candidates as a way of generating deal-flow.

Figure 16: *After meeting MBI/non-exec candidates, what follow-up do you initiate to maintain contact with them, if any?* (% respondents by level of proactivity)



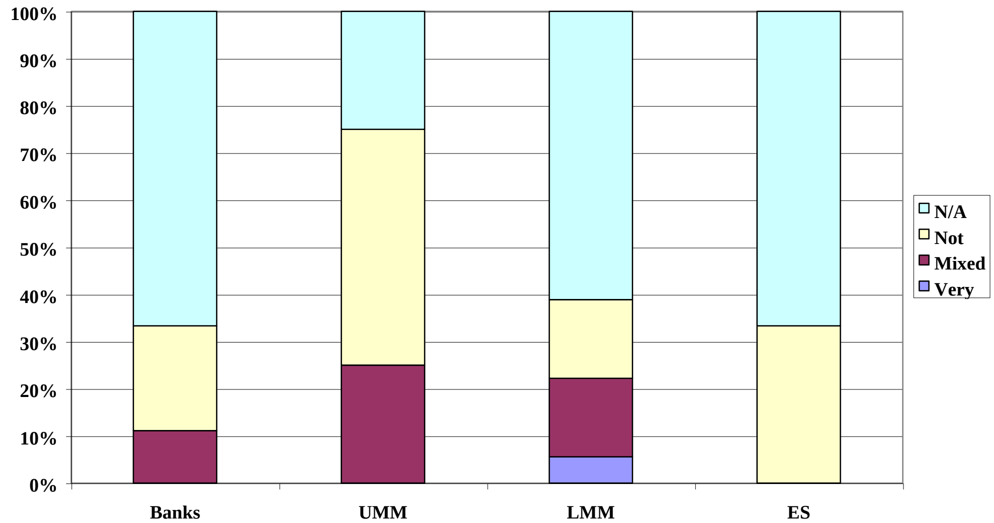
One very concrete way of keeping in touch with managers is to pay them to act as deal scouts. Figure 17 suggests that whilst most respondents have not paid retainers to executives, the practice is becoming less uncommon, especially in the upper mid-market. It came as a surprise to me, at least, to see that more than a fifth of banker respondents mentioned paying retainers. Early stage investors seem almost never to pay them. The concept of retained executives can blur in practice with that of operating partners who a number of firms, notably within the middle-market, have appointed. If such operating partners were included in the figures it is likely that the number of UMM firms with hands-on support from seasoned industry figures would grow. If more active members of advisory boards were also added to the equation then the throng of seasoned corporate executives acting as a support network for PE houses would seem even larger.

Figure 17: *Over the last year, how many MBI/non-execs have you had on some kind of retainer?* (% of respondents by no. of retainers)



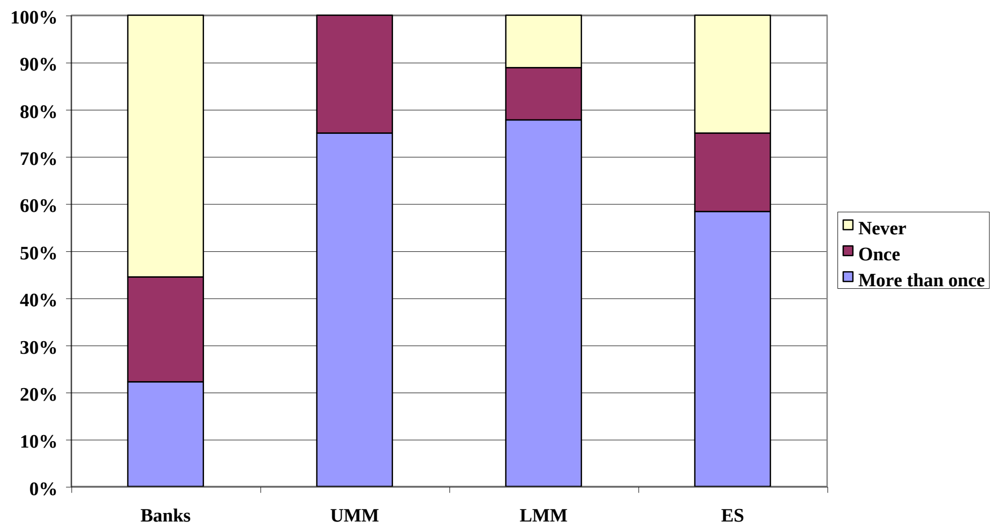
The apparent growth in popularity of paying retainers is not yet matched, it seems, by success in obtaining value for money, as Figure 18 shows. Almost no-one was prepared to say that their experience had been successful. In the LMM about half and half of those providing an opinion reckoned the practice had been either mixed or unsuccessful. In the UMM just a third of investors giving an opinion were prepared to grant even mixed success. Bankers and early stage investors were even less enthusiastic. This is an area where the key to success is still being cut.

Figure 18: *How successful in terms of deal origination would you say it has been to pay retainers?* (% of respondents by declared level of success)



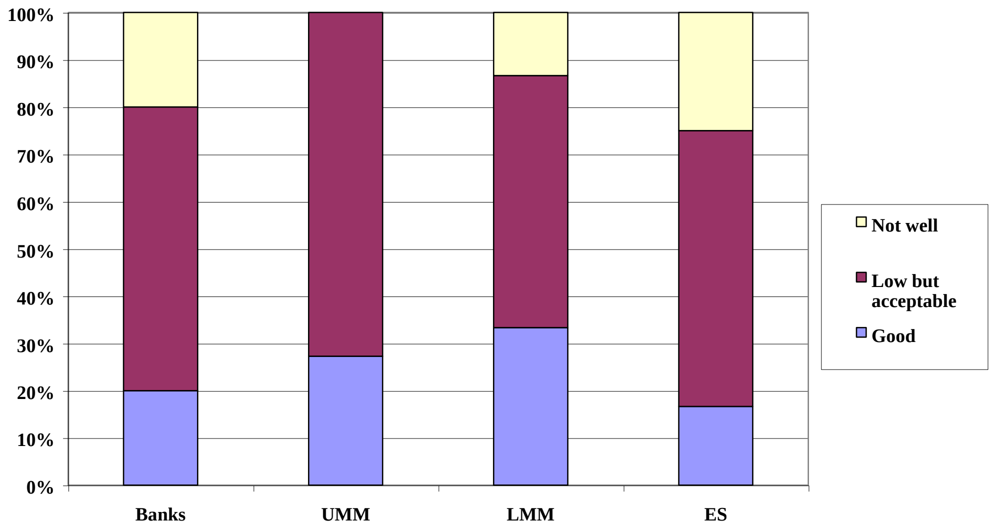
A different measure of the success of efforts with MBI and non-executive candidates is whether individuals met in one context have been used subsequently in a different context. However achieved - proactively or less formally - these represent a constructive use of contacts. Figure 19 demonstrates that most private equity firms have experienced this more than once and those doing larger transactions are more likely to have done so. Bankers by contrast seem much less likely to see such cross-over.

Figure 19: *How often have you contacted an individual (or team) whom you met linked to a deal you rejected to get them involved in another deal?* (% of respondents by number of cross-overs)



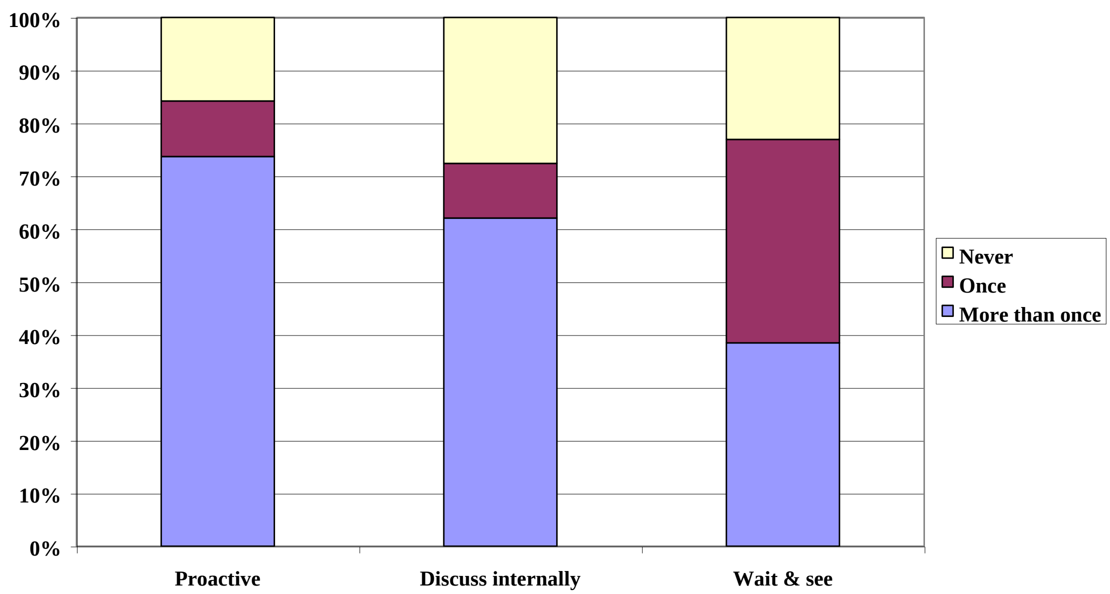
Overall, the success of efforts dealing with senior executives for MBI or non-executive positions has been modest so far. Three-quarters of respondents rate this as providing low or no value.

Figure 20: *How well do you think the cultivation of exec/non-exec candidates has gone?* (% of respondents by declared overall success)



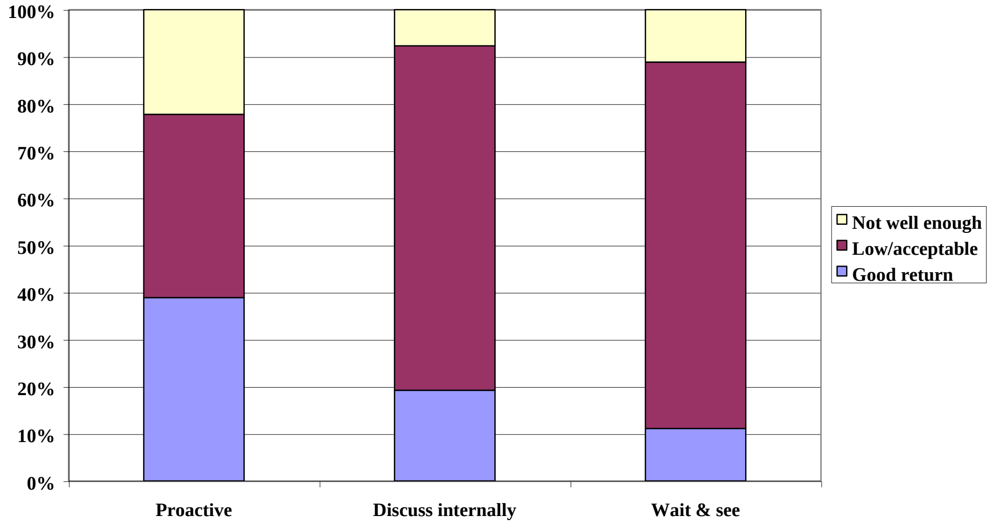
This general lack of satisfaction, however, does not mean that efforts are pointless. Figure 21 shows that those firms who have been more proactive in following up with those managers they do meet are also those more likely to report that they have seen more cross-over of executives between deals.

Figure 21: The proportion of respondents who have generated cross-overs, by proactivity.



More proactive firms also appear happier with what they have obtained overall. This suggests that in order to produce value for investors, some kind of structure and pro-action pays off.

Figure 22: The proportion of respondents by category of proactivity with MBI/non-executive candidates and their level of satisfaction with the results they have seen

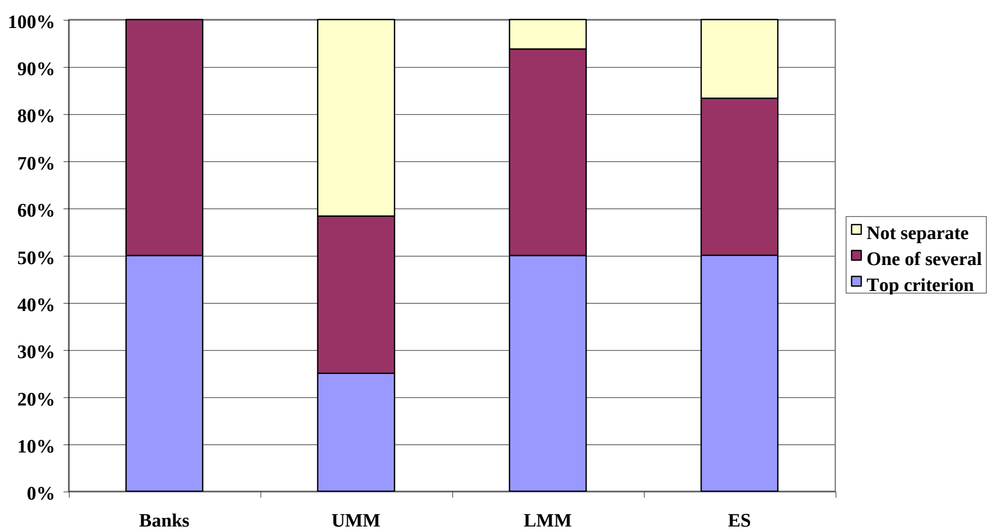


4. Assessing managers as a core private equity skill

Private equity investors frequently state that the assessment of management teams is part of their core competence. There is good evidence, and intuitive logic, to the idea that the assessment skills and processes of private equity investment teams are the single largest determinant of whether management outcomes are likely to work out well (the others are referencing and the use of robust third party cross-checks). The figures below measure whether actions in this area match words.

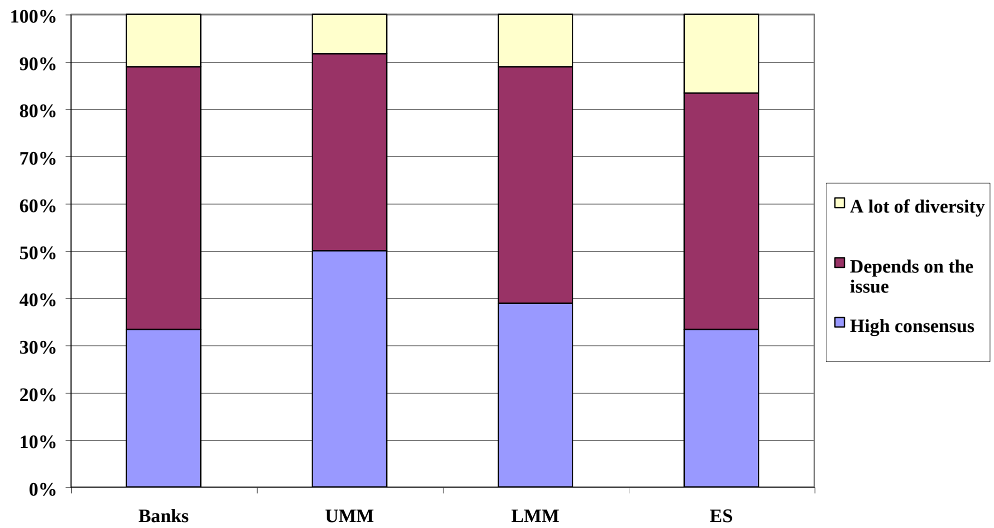
Figure 23 suggests that most houses consider skill at assessing or handling management as either the top or one of the top criteria for advancement within firms. Curiously, however, enthusiasm for this skill seems lowest amongst UMM investors. Perhaps this reflects the finding in the previous report that UMM (and top bracket) investors give somewhat less importance to management quality than those handling smaller transactions.

Figure 23: *How important is the skill of assessing and handling managers/teams for advancement within your firm?* (% of respondents by level of perceived importance)



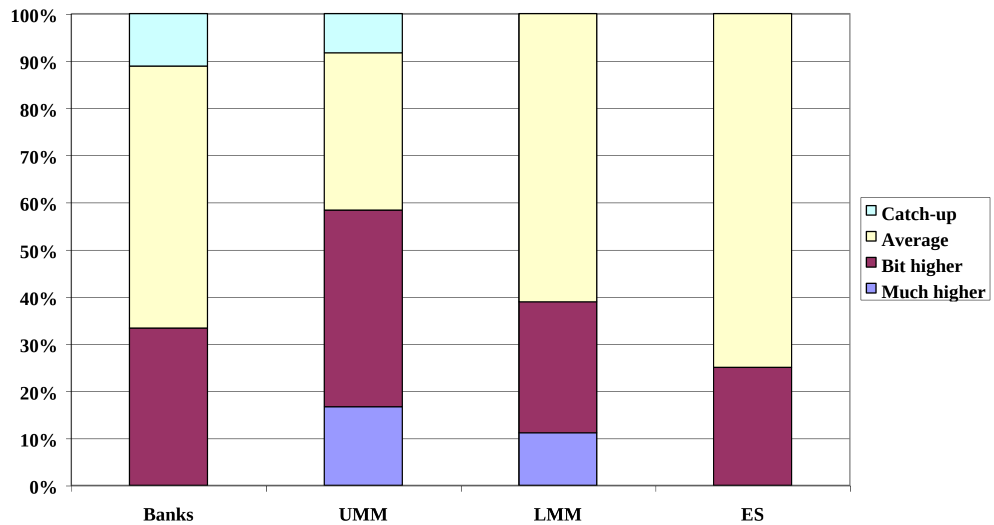
Given the high profile of management assessment skills one would expect that discussions on carrying out firm-wide approaches/best practice would lead to high levels of consensus on how to handle the issues. Figure 24 shows the ambiguous reaction to this assumption. Between a third and a half of respondents reckon that there is such a consensus leaving, however, a majority where views either vary a lot or where consensus depends on the issue. The form of the question may itself have contributed to this ambiguity since consensus is not defined and I did not intend it to imply a rigid agreement on all matters of detail. Nonetheless, my experience of talking across the industry is that very often even undemanding types of agreement fail to exist due to an absence of any kind of forum at which even the principles of consensus can be reached.

Figure 24: *How much diversity of opinion is there within the investment team on the best ways of assessing managers?* (% of respondents by level of reported diversity)



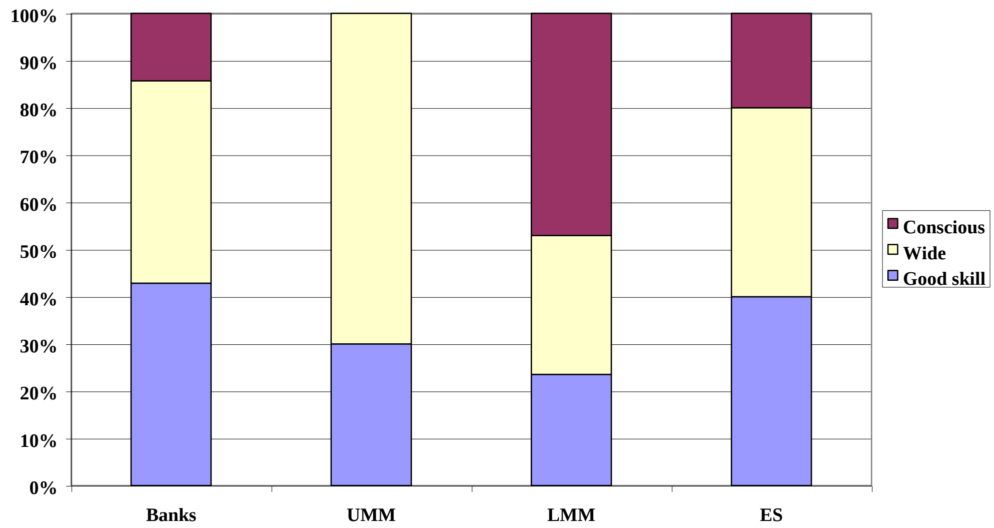
One way of trying to gauge how investment teams perceive their skills is to get feedback on how they think they compare with other investors they may have dealt with or worked for. Bankers and early stage investors seem most modest in their view of handling managers. Within the middle market UMM investors seem most likely to think that their team is well above average but also that they have catching up to do.

Figure 25: *Compared with other private equity firms you have worked for, or dealt with, how much importance is attached to skill in assessing managers at your firm?* (% of respondents by level of perceived importance)



Another useful measure is the degree to which interviewing skills vary significantly within teams. Figure 26 shows that only about a third of investors reckon that interviewing skills reach a decent level across the whole team. The rest either see disparities between team members or see an overall need to brush up skill levels. Curiously UMM investors, who as a category are most likely to consider themselves better at interviewing than other firms, are the most likely to observe wide skill differentials within their own team.

Figure 26: *How big would you say is the gap in skill between the best and worst interviewers within the team?* (% of respondents by perceived size of gap)



It seems reasonable to assume that, given the skill gaps in interviewing in the private equity community, and the overall importance attached to handling management, firms would take corrective action either internally or by bringing in outside advisers for skills training.

Figure 27: *If there is a gap between the interviewing skills within the team, do you consciously try and team up stronger and weaker performers in meetings?*

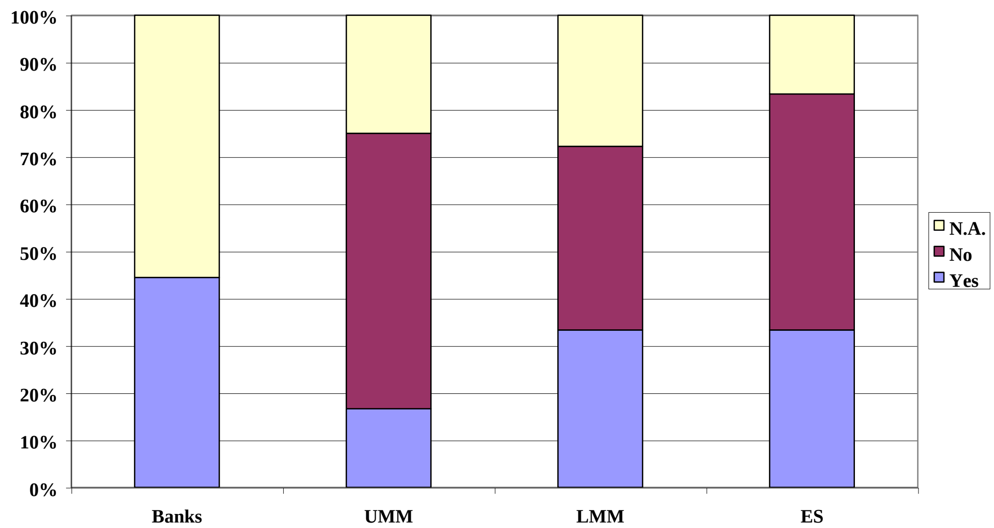
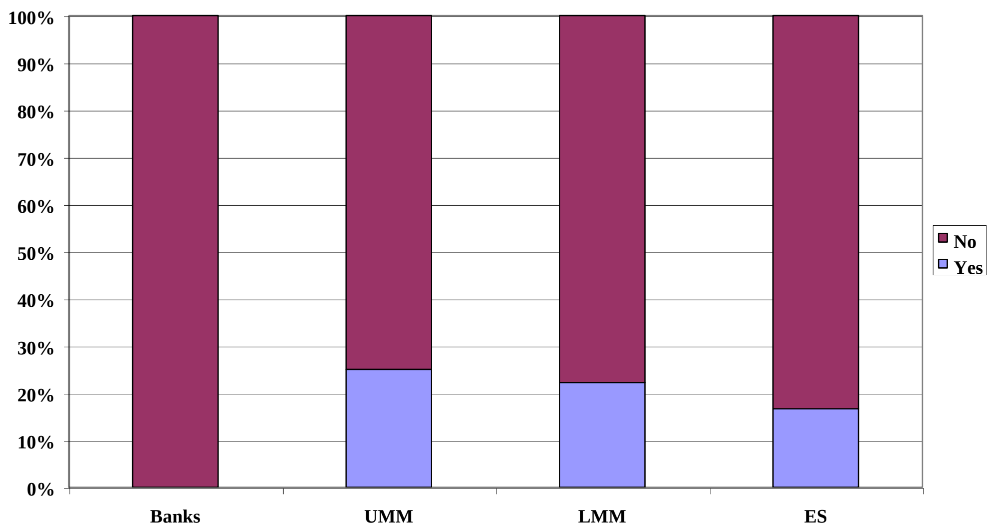


Figure 27 tries to test the first option and finds that a significant minority have tried to put stronger and weaker interviewers together to equalize skills.

The alternative would be to bring in outsiders to facilitate consensus on management skill issues or provide specific skills training. Figure 28 suggests that this is definitely a minority pursuit. Although the ability to interview, like sexual prowess, is a skill where discussion about skill levels may be awkward, in practice neither of the solutions discussed here need be controversial.

Figure 28: *Has your firm organised any interview or assessment training for the investment team over the last three years?*



The potential pay-off of taking action is suggested by the fact that those respondents who reckon that their teams have good overall interviewing skills are also somewhat more likely to report matching-up interviewers and having organised training on the subject. Put the other way round, those firms who report doing either training or matching of interviewers are more likely to report better interviewing skills across their team.

5. Conclusion

Given the wider scope of this report than its predecessor, it is more difficult to provide a simple list of conclusions. One key take-away, however is that management due diligence scores respectably on certain dimensions but is widely seen as having plenty of room for improvement in the future. The agenda that implies has partly to do with refining diligence processes and using outside expertise where appropriate. However, getting the management piece right across the deal cycle also implies getting more value from efforts interacting with MBI and non-executive candidates as well as finding ways of increasing investment team consensus on the principles of assessing managers (not necessarily all the details) and ensuring that team interviewing skills are consistently high. As an adviser to private equity firms in various financial and non-financial capacities, Grant Thornton is happy to provide input - formally or informally - on ways to achieve these goals.