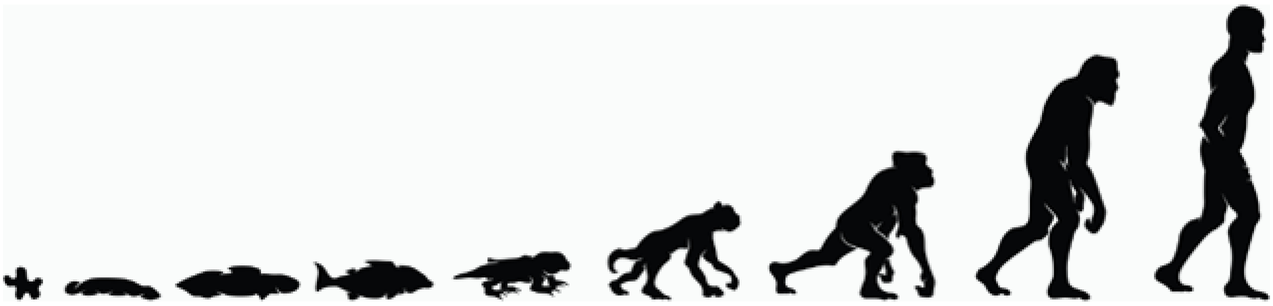

The management team dimension of Private Equity investments:

Evolving the mid-market model

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About the author

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Working as Catalysis since 2010, Mike has worked on about a hundred transaction situations and a further 150 post-deal projects across most sectors.

The Catalysis approach to management due diligence brings together a range of tools and techniques to provide a more comprehensive and integrated assessment compared to traditional approaches. We test the general and functional fit of senior managers; top team and organisational effectiveness; core management practices and the executability of strategy. This holistic approach generates a more robust view of the targets' ability to create value, provides recommendations of business issues to be addressed, and sets out a tangible roadmap for management post-deal actions.

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Catalysis helps mid-market investors and business leaders build great companies together:

- Transactions – management/organisation due diligence; 100 day/integration planning
- Building teams – high stakes assessment & referencing; top team building; succession planning
- Dynamic organisations – strategy facilitation; organisational diagnosis and design

EXECUTIVE SUMMARY

1) The insights in this report are based mostly on conversations with 37 very experienced UK mid-market investors and partly on my own advisory work over the last decade.
2) The context for UK mid-market investments has grown tougher and more deal flow now involves founder-managed businesses, so assessing and improving management quality has become more critical to success.
3) Although there are different schools of thought about handling management teams ('backers' and 'shapers'), the centre of gravity has moved towards greater investor interventionism and less concern about management churn.
4) PE houses have put more effort into handling management issues, and have developed more nuanced views and approaches. However, this area remains patchy compared with other due diligence domains.
5) A greater need for overall investment differentiation has led to more work on tailoring investment processes and consequently more bespoke approaches to handling management issues.
6) Management teams are often sceptical or even hostile to management DD because it is typically not configured or positioned to provide value to them.
7) Certain practices (e.g. maximising senior face-time) have become almost universally employed. However, in other aspects, some revised practices are prevalent but still finding their shape and contribution (e.g. referencing). There are more examples of innovative practice worthy of adaption by other firms – with plenty of room for relatively low cost value gains.
8) There is interest, but little action, in understanding second tier management or the wider organisational ability to deliver a strategy.
9) The use of third parties for management DD has progressed little quantitatively or qualitatively in ten years and requires development by both providers and buyers to meet current investment needs.
10) Methods to digest all the inputs from management DD so as to extract calibrated conclusions about management quality – and build a post-deal roadmap – remain under-developed.
11) Senior investors worry about how to maintain a more sophisticated approach to management diligence at a time when succession within PE houses involves promoting people who have had comparatively less deal and board experience to learn the skills of handling management. Improving processes, as well as deploying and developing existing talent, can help, but the best foundation is a healthy investment culture and framework.

1. Background – what has changed in 10 years?

In 2004/5, I carried out an extensive piece of research looking at the way 78 PE and VC firms, in the UK and US, interacted with management teams across the deal cycle. Annex 1 provides the executive summary and data summary. Since then much has changed in the industry and my own thinking about the challenges of making the investor-management relationship work has evolved across my involvement as an adviser in hundreds of assignments for investors and investees.

The current exercise revisits some of those topics from ten years ago but with a tighter focus on the UK mid-market because, (a), this improves the relevance of the findings, and (b), the management of mid-sized companies and investments, despite the volume of transactions, is relatively little studied and so more mysterious than large buy-out and VC activities.

In the previous work, I made a lot of effort to quantify different houses' stance on their management team related activity around the transaction, at the risk of shoe-horning complex activities into sometimes arbitrary boxes. This time round, I focussed on gathering views on changes over time and the logic behind stances towards management. I sought conversations with the most experienced – but still active - investors in the UK and the group involved had an average of just under twenty years of investing experience – or almost 700 years collectively. The findings should allow the reader to compare notes on these issues with a wide range of peers.

See the list below of the PE houses with which interviewees are associated. To retain anonymity, and for the sake of brevity, I refer to interviewees through reference numbers covering all 37 participants. The numbers are essentially random.

Interviewees worked at:	
3i	Inflexion
Altitude Partners	Kester Capital
August Equity	Key Capital
Baird Capital Europe	LDC
Barclays Ventures	Living Bridge
Business Growth Fund	Mobeus Equity
CBPE	NorthEdge Capital
Connection Capital	Nova Capital
Downing VCT	NVM
Dunedin	Oakley Capital
Electra PE	Phoenix Equity Partners
Encore Capital	Pioneer Point
Exponent	Primary Capital
Graphite Capital	Risk Capital Partners
Green Investment Bank	Rutland Partners
Growth Capital Partners	Silverfleet Capital
HgCapital	SVG Capital
HIG Capital	Vision Capital
Independent	

2. Industry trends

A. The investment context has grown tougher…

In describing how their houses' approach to management issues have evolved over the last decade, interviewees pointed to important changes in context which have shaped views and methods:

- An economic environment which has offered less easy growth for investees – especially since 2008 - and less dependable multiple arbitrage. Many felt the recession had exposed high proportions of 'fair-weather' management teams and chairmen.
- Investment hold periods which have stretched beyond, say, 3-4 years to 7+ years in many cases. Some felt this was a structural trend rather than a passing phase.
- Pricing multiples for mid-market deals has shifted higher and is sustained by the amounts of 'dry powder' and on-going pressure by intermediaries to railroad sales processes (and incidentally reduce access to management teams pre-deal). Some felt that deal execution timings have stretched out.
- Although views varied on their competence, some interviewees felt that LPs had become more rigorous in checking on the robustness of deal and other processes (other reckon they remain primarily herd animals).
- Several interviewees noted that, whereas 15-20 years ago many opportunities were related to corporate disposals/MBOs, more of the deal flow now appears to consist of founder-managed businesses which have a less formalised type of management.
- The shape of the industry has evolved too, with the demise of multiple houses, fewer volume players, and a drop in average deal volumes, partly due to a longer tail of smaller houses doing just a couple of deals per year.
- Several of these factors have made it harder to produce previous levels of returns. In the absence of supportive multiple arbitrage, and less appetite for leverage, so other drivers of value – strategic, operational, and organisational (all more management quality dependent) - have received greater attention.

B. …so the handling of management issues has needed to change too

A number of consequences for dealings with management teams appear to have flowed from this evolving context:

- Although there are still different schools of thought about the balance between backing teams and seeing teams as a tool to deliver a strategy, the overall centre of gravity has moved further towards a willingness to engage with management/organisation issues and to intervene in them.
- There is more appreciation of the difficulties and nuances involved in working well with management teams, and more effort overall is being devoted to resolving the various issues – although this area remains less refined overall compared to others.
- A greater need for overall investment differentiation has led to more work on tailoring investment processes and consequently more bespoke approaches to handling management issues.
- Certain practices (e.g. senior face-time, referencing) have become generalised across most houses.
- In other areas, practices are prevalent but still finding their shape and contribution. That includes the use of third parties for management DD where progress in growing value-add has been slow.
- There are more examples of innovative practice worthy of adaption by other firms – but still plenty of room for relatively low cost value gains.
- Growing worries about how to maintain this overall more sophisticated approach to management in the situation where succession within PE houses involves promoting people who have had comparatively less deal and board experience to learn the skills of handling management.
- The growth in the number of founder-oriented transactions and of smaller cap deals has increased the importance of professionalising management to the success of the deal and delivery of value to investors

The sections below expand on these points and add some of the inevitable variation and ambiguity to the simplifications above.

3. Attitudes to management teams

A. There are two main philosophies of dealing with management: back or shape

As was the case ten years ago, investors vary in the degree to which they perceive themselves as more or less 'management friendly'. Although there are many shades of nuance between them, there are two poles we might identify: those investors looking to back a team and tweak later if necessary ('backers') and those more likely to second guess and actively shape teams ('shapers').

'Backers' can be characterised as:

- Especially prevalent in funding MBOs and growth capital deals - and often sensitive to the fact that many managers arrive empowered because they have brought the deal to the investors – and may still be able to remove it.
- Trusting in, and investing into, the incumbent team. As interviewee No. 17 states: It is rare that we invest in something when we don't believe in the CEO - we are backing his judgement. For No. 18, 'Our mantra is to support the CEO'.
- In terms of the old strategy debate about whether strategy should emerge from management capabilities ('inside out') or should define management needs ('outside in'), they clearly tend to the former position.
- Faced with a dilemma whereby they need to get comfortable with the incumbent team but may be unwilling to lose management support (and therefore reduce the chances of gaining exclusivity) through perceived too strong pre-deal scrutiny. Better, as No. 2 says, to get the deal done and then amend things as you go along. Moreover, as No. 22 notes, you don't always have the luxury of abandoning a deal because of one weak individual. Instead, more reliance may be placed on post-deal coaching, using influence around the board table and fixing agreed weaker areas.
- Typically, suspicious of MBI/BIMBO deals where existing managerial relationships are likely to be disrupted – and where new appointees (to quote No.35) don't know where all the skeletons are hidden.
- See the spheres of executive management and investment governance as separate and want management 'to stand on their own two feet' (No.15).
- When it comes to post-deal personnel changes, relatively high discretion is accorded to the Chief Executive, and perhaps Chairman. No.30 gets involved only in the later stages of processes to provide a cross-check. No. 25 wants to avoid the situation where someone 'blessed' by the investors turns out to be no good and the team can dilute their accountability – and anyway 'What do we know about sales?'.

Shapers, by contrast,

- See themselves as crafting management solutions to fit an asset and a strategy. Consequently, even if management is still important, the starting point is asset selection (says No.1) – and No.32 adds that it is less implicit that you are backing a team. No. 18 reckons this is a 'habit' acquired from the big buy-out firms.
- Are comfortable with the blurring of the investment and managerial spheres – and more likely to appoint people who are hybrids: operating partners or their equivalents.
- Are more comfortable with MBIs (or in the case of No. 21 actually see them as lower risk than MBOs) because they get to choose the management team – and may tap the growing number of serial PE chairmen/CEOs.
- Are more sceptical about the ability of incumbents (and chairmen) to find the best solutions to issues. No. 28, for example, was marked by the failure of a CEO (which set the business back a year) who had been recommended by a chairman with an operational background. Whereas many of the previously frequent corporate MBOs managers had been formally trained, many founder managed businesses can lack managerial skills and processes.

B. There are various views on the relative importance of incumbent team quality

Another area where views were divided ten years ago – and still are – is in regards to the relative importance of management compared with other factors in determining investment success.

It was pointed out by a number of interviewees (e.g. Nos. 10 and 25) that the attention to management may vary inversely with deal size since there is less to fall back in terms of second tier managers and established processes in smaller companies. Some houses (e.g. No. 12) mentioned a deliberate move to doing fewer, bigger deals where management weaknesses were less prevalent and the companies more resilient. However, views on the importance of management remain highly varied even between firms doing similar sizes of deal.

The two poles can be defined by comments from interviewees: No. 6 paraphrased Warren Buffett, namely that when a well-regarded management team meet a bad business, it is the business which retains its reputation. No. 19, by contrast, reckoned that his house would always prefer a good team in an average sector over a less good team in a red hot sector.

No-one denied the importance of management quality but there were a few interviewees who felt it should be kept in proportion. No.8 described an evolution in his views over the last decade towards a greater belief in the necessity of good commercial understanding by investors – partly because he had seen mediocre teams building value when riding the right strategic wave (but noted that in tougher times, and for more complex strategies like buy-and-build, management quality became more salient). No. 11 reckoned that without the right market focus, high quality talent would not want to join an investment – so opportunity selection was paramount but thereafter management was the next most important aspect. No.3 noted that if a bad commercial judgement was made then it could be very hard to recover even if a good team would be more likely to reduce the downside. Both Nos. 35 and 1 felt management's importance had stayed about the same and remained one of several success factors.

Some offered a more contingent perspective: Several people echoed No.34's observation that in a decent business in a good market, a monkey could probably run things – but harder challenges demanded better management. Both No.34 and No. 2 noted that despite backing many businesses, teasing out management's risk or contribution was far from easy. Nonetheless, No.2 felt there would be some kind of correlation between team strength and investment success on average – but then related the story of one investee with a C grade CEO (he was the weaker of two founders – but was the one who stayed on post-deal) whose company was likely to deliver a better than 3x result – albeit with a lot of work by the investor to mentor other managers.

The passing of time has allowed more houses to study their track records for trends and, of those who reported their findings, most were convinced that better management team quality produced better results (No. 28 who mostly backs entrepreneurial teams was an exception – he saw no correlation). Exactly what was looked at differed: No. 16 had 'lifted the drains' on failures and found most traceable to management. In his previous (technology-focused) house, No.13 saw analysis suggesting a correlation between CEO quality and outperformance. No.14 saw best deal returns – and better responses to difficult trading - where excellent teams were present. No. 26 reckoned that over-investment into management produced better investment results. No.7 reported on a review of 28 investments whose conclusion was that backing the right team was highly correlated with success. That review caused various internal process changes including better definition of what makes a good manager and a more explicit definition of what investment committee should be looking for in deal presentations.

Others, without having done any reviews, have an institutional bias towards giving importance to management issues: No. 33 reckoned his house debates management dynamics 'to death' because most deal decisions are close calls and the readiness of the team for accelerated growth is a key decider.

A significant minority of interviewees reported that they had evolved towards a greater focus on management over time. No.26 saw that as a trend across his career (and indeed that reflects my own experience of more experienced investors being generally more interested to ruminate on management issues than younger investors keener, perhaps, to acquire more deal scalps). Nos. 27, 25 and 19 all reported greater prominence of the management piece – and a greater fussiness about team quality. No.9 was eloquent in explaining why his house attached a heavier premium to management than ten years previously, namely that recessionary times had shown up weaker teams whilst the current up-cycle is more tentative and difficult to navigate that the late 1990s or mid-2000s. No. 9 wonders, with a self-admitted dose of cynicism, whether such hard-won lessons will fade with greater market optimism.

C. Overall there has been a shift towards more intervention by investors

Despite all the varieties of views, however, there has nonetheless been a tangible shift in the centre of gravity over the last ten years towards both a greater ideological acceptance of intervention in the management sphere as well as the higher levels of management churn caused by investor intervention.

The reasons for this are several:

- The recession showed up weaknesses in the quality of teams, and in the ways management teams were being assessed and handled. No. 27 describes how, over 10-15 years, a panel of successful chairmen was used to guide investments – but then became so non-exec that when the downturn hit not only were those people getting long in the tooth but had no real time to help turn around struggling investees. Those people 'didn't make time for us, or were too industry embedded and were too sympathetic to management' – so the investors found they had to make the hard decisions themselves.
- Others like No.22 were forcefully reminded that whereas chairmen might invest £100k into a deal, that compared with tens of millions from the investors and so management issues couldn't responsibly just be delegated.
- No. 21 describes evolving away from a bias in favour of long serving teams due to experiments with MBIs which went well and created an appetite for more. Their understanding of business processes grew and, supported by more sophisticated support from recruiters like Directorbank and Skill Capital, they grew more confident in constructing teams. No. 24, a specialist investor, expects most teams from companies its buys to be sub-optimal and indeed very high proportions of CEOs and FDs are replaced. The 100-day process can be considered almost a three-month interview of management who, however, learn a great deal if they survive.
- No. 2, a sector specialist, has bought several companies without having a management solution at hand. They do have a network, however, and a good sense of what will work for their kind of companies. In one case, a friend of the managing partner was put into the CEO role at an underperforming multi-site company and he set about changing most of the middle managers.
- No. 26 points to another reason for greater interventionism – a sense that when incumbents deal, for example, with senior hiring, they get things wrong. He cites a chairman getting an MD decision wrong, and another case where a divisional MD was brought in without even referencing him (which led to problems). His house now keeps tighter control of recruitment processes for CEOs, FDs, Sales, Ops and IT. On the same topic, No.27 feels that management teams need some guidance in constructing a shortlist and in dealing with head-hunters – who the investors tend to know better that teams.

The manifestations of the shift towards great interventionism within PE houses are multiple:

- The number of 'operating partners' working within the wider PE space has continued growing apace according to Prequin (FT 5/5/15), near doubling over the last three years.
- New roles – such as the in-house talent manager at No.11 – aim to bring greater robustness to management processes which exec teams (and investors) might otherwise run inadequately (although, even so, the success rate is still only 50% in appointing the right senior executives).
- No. 32 puts in place not just a chairman but also additional NEDs for specific functions. No. 21 is explicit that Chairmen should be prepared to get their hands dirty and get involved at exec level. No. 34 goes a step further and meets up with all NEDs on a quarterly basis and issues written instructions on what they are expected to achieve over the next three months.

- No. 4 found that it had some large investees (some of which inherited) who, however, had never indulged in much strategic thinking. The investors applied themselves to carrying out strategic reviews and ended up - in one food investment - changing the chairman, CEO, and various divisional managers.
- No. 31 keeps an overview of post-deal actions and pushes to ensure that the plethora of management initiatives are boiled down to the crucial five. No. 34 writes the 100-day plan into the legal documents as conditions subsequent.
- No. 27, having moved from being 'backers' towards a more critical stance now, sees the first six months of co-existence as a test, and expects CEOs to offer succession plans for key subordinates.
- No. 21 have an internal expectation that many of their investments may need to go backwards financially while they are 'rewired' before they can start to scale properly.
- No. 1 Specifically seeks out businesses which currently suffer from major constraints which they can address – often through major change in the team. In one investment the entire top team was replaced.

D. Investors are becoming less concerned about management churn

The real test of investor attitudes to management lies in churn during the hold period.

- What has not changed is that change in some roles is regarded with more equanimity than others – as No. 2 put it, whereas changing FDs is 'commonplace', Sales can be painful while changing MDs is a 'nuclear' risk. Consequently No. 18 reckoned that in addressing business under-performance you probably remove an FD first, then the chairman and the CEO only as a last resort. No. 28 always tries to supplement the team around a struggling MD before contemplating a removal.
- FD roles remain the epicentre of change. No.1 voiced an assumption that most incumbent FDs will be weak (shared by No. 34) – and reports changing a majority of them - as has No. 16. No. 28 had seen all except one FD disappear across the last five deals. No. 17 reckoned this vulnerability was mostly due to an inability to grow with the business. It was interesting to note, however, that several interviewees argued strongly against the perception that 'FDs are just FDs' or that they are 'two a penny' – at least if you want someone who is more than just a number cruncher and can support a CEO. No. 25 has become less parsimonious in paying for quality FDs and reckons you roughly get what you pay for. Whereas No. 23 reckoned most of their FD appointments have worked out, No. 34 had yet to see a decent assessment report on an FD – and felt it was hard to test the technical side.
- A couple of interviewees (Nos. 8 and 11) were concerned about sales director positions due to a shortage of high quality candidates.
- Investors' involvement is generally higher the more senior – and equity-related – the appointment. To the extent that a business is performing well and there is trust between investor and CEO, more discretion may be provided on recruitment decisions. However, if a business is struggling, then investors get more involved – handling job descriptions, appointing head-hunters and negotiating terms as No. 16 does. No. 3 might limit its direct involvement to the top couple of positions but insists that robust referencing be carried out on candidates for other positions.
- But these contingencies do not hide the fact that there is a noticeable shift in tone regarding management churn. Even without a systematic approach to checking levels – which is anyway made more complicated by longer hold periods and the impact of recession – levels of change appear significantly higher than those I recorded in 2004. No. 19 describes how in his first 15 years of investing until 2008 he saw very little management change whereas, thereafter, a lot has shifted in every investee including three changes of CEO and two-thirds of FDs replaced. No. 9 reports changes in 70% of investees – and sees this as clearly higher than previously. No. 11 records changes in 60% of CEOs, of which half were 'taken out and shot'. No. 26 records 'significant' change in 20-30% of investees and worries that this is higher than advertised externally or expected internally. No. 1 states that, from ten investments, two lost their chairmen but half of all CEOs left, of which half unplanned. Across 20 investments, No.7 reckons 25-30% of CEOs were replaced.
- What is no less striking is the widespread conviction that despite some inevitable 'chaos and carnage' (No.22) from senior changes, action should be decisive and is rarely followed by regrets. No.4 couldn't think

of a situation when such a change had not been an improvement. No. 26 counselled that if you are starting to have doubts then a plan for change is almost certainly needed – and No.7 notes that a change left too late undermines its success. Nos. 31 and 19 offered the aphorisms that 'you are going to something, then do it quickly', and 'if in doubt then act'. No. 18 reckons changes always turn out to have been too slow.

- The only kind of haste which seemed to be regretted was around original deal decisions: No. 2 bought a company outside of their usual sectors at great speed, ended up having to change the MD and will just about recover initial cost. Nos.21 & 25 had both had similar situations where reality-checking was rushed and paid for it with management surprises. No.3 blamed deal fever for some surprises (while noting that some things are hard to spot pre-deal – illicit relationships, alcoholism, fraud, marriage problems – and management change can often just be a function of requirements shifting over time).
- The provisos about fast change related to the need to retain exiting managers' dignity (No.26) to everyone's benefit – but also to realise that disruption could be long-lasting: No.3 reckoned one CEO transition was fully complete (including subsequent team changes) only after two years.

4. The consequences of greater intervention by investors

A. Getting the approach to management right is not easy to achieve…

The apparent shift – on average - towards more interventionist approaches faces, however, some challenges, especially human complexities and a need for more nuanced understanding of the managerial and organisational territory.

More specifically:

- Whereas Finance is a well-spoken 'language' for investors, with a well-established grammar and vocabulary, the same is far from true with management/organisation issues. That is partly because there is no equivalent standardised terminology and conceptual framework: that is tricky especially because there are well over a hundred significant factors which can exert themselves at individual, team and organisation level. It is partly because investors – especially less experienced ones – have often had limited exposure to the way companies operate. This problem – and some approaches to addressing it - is discussed in greater detail in section 6.
- On a similar note, No. 32 observes that diligencing management teams is clearly much more qualitative than quantitative compared with FDD. Various specialists do present frameworks to explain people, organisational and strategy topics – but these tend to be more ad-hoc in nature. Consequently, organisational analysis is much less scripted by investors than business analysis.
- That imprecision matters because management and organisational issues are awash with imperfection: No. 34 reckons 99/100 managers are not a perfect fit and investors need to supply the missing elements. No. 20 notes that 50% of management transitions go wrong while No. 10 records a majority of deals presenting problems with management. No. 28 notes that a constant across the last decade is that people decisions remain difficult and unpredictable – but remains at the heart of what investors are supposed to do. Some apparent solutions, like bringing better trained executives from larger companies, can actually backfire because many corporate managers are unused to 'rolling up their sleeves' (No.12).
- Plenty of deals involve bringing managers into situations – and especially levels of growth – they have not experienced before and so investors such as No. 23 need to make educated guesses on whether a team can take a business from start to finish.
- The complexity of the task, and the bluntness of the tools available can make the management piece hugely time-consuming, as No.28 points out. The temptation, therefore, to rely on instincts and rules of thumb can be high. But that can lead to important but awkward evidence being ignored.

B. …more effort is clearly being made…

The response of multiple houses has been to put more effort into getting a grip on their work in this area:

- No. 3 reports little philosophical change in handling management, but more compliance with internal processes. No.2 sees a greater determination to avoid previous mistakes through hard graft and analysis, as did No. 35 due to a lot of 'accidents' and the realisation that post-deal there is less power to deal with frictions and weaknesses.
- No. 17 was not alone in reporting that overall investment processes have been upgraded over fifteen years, and that the demands on DD providers have risen.
- No. 12 notes that investment criteria have been continuously evolved to take account of previous mistakes. For example, the selection and deployment of chairmen has been sharpened after a perception that some investors had been lulled into passivity by the halo of perceived sector experience – while some chairmen were on a gravy train.
- No. 27. Observed that there is a generational issue at work with one older partner much less likely to entertain the idea of carrying out any kind of MDD.
- Those who have invested more time in looking at this area are rewarded, like Nos. 12 and 27, with a more granular sense of what kind of managerial attributes they are looking for, and less risk of unhelpful oversimplification.

C. …but investors are still less advanced in this area than most other areas of due diligence

Despite such efforts, however, a clear majority of interviewees felt that dealing with management issues remains a less well-understood and handled area than other parts of the PE investment model:

- After 20 years of investing, and having worked in three different PE houses, No. 14 concludes that, despite investors talking about 'management, management, management', they still didn't really follow through in practice and admits that his own house approach to MDD was 'as unstructured as ever' and was unlikely to change because it is hard to sell and buy at the same time.
- Nos. 22, 16 and 27 noted that assessing management during deals is an area which is least packaged and where investors start from a lower point of knowledge with relatively informal approaches. No.4 attributed this problem to the idea that PE had never really thought hard enough about the problems involved while No.27 attributed the problem to an over-focus on the more familiar commercial aspects.
- The result, felt No. 8, was that when things went wrong, investors had not got much better at corrective action and tended to reach for knee-jerk responses.
- No. 34 observed that there was still much to improve in handling management issues – and felt that 'the big guys' do things better. No.6 felt more progress had been made in the early stage world with approaches such as 'lean start-up' which puts a high premium on management, whereas in classic private equity he wasn't sure processes had improved much.

D. Many investors are seeking to define their own best practice

A couple of interviewees asked for my thoughts on what best practice in management DD had become. Whilst one answer to that question is contained in Annex 2 where I have offered some generic thoughts for the majority of mid-market funds, in reality there is much which depends on individual PE house investment approaches. Much as the US PE market has been doing for longer, the UK and European scene is seeing more specialisation and differentiation. So No.6 states that to remain competitive against competitors deploying more debt in auctions, he reckons houses must focus on sectors more to gain advantage through special knowledge. In the context of a scarcity of decent deals, No.2 reports aiming for less competitive types of deal where there is also better access to management pre-deal.

The interaction between investment specialisation and approach to management can be seen in some of these examples:

- No.13 focuses on just a couple of sub-sectors and, as deep experts, lead on company strategies and see themselves as quasi-management hiring a CEO mostly to execute. They source good people by interviewing executives who have exited larger companies in their sector and keeping in touch until the right opportunities appear. They have developed bespoke tests of management competence for their sector. The pools of talent available to tap are not great, but the model avoids a lot of complexity experienced by multi-sector funds.
- No.30 found itself struggling to deploying capital in its traditional size segment and so shifted towards buying smaller platform companies which could be used for buy-and-build purposes. That implies a lot of top down research and then deep diving into specific sub-sectors, building communities of contacts along the way. Those then furnish opportunities and management teams since deals can take 18 months to construct. Scaling methodologies are adapted and transferred between similar sectors. Sophisticated individuals are brought into initially small companies to build systems and processes on top of high quality platforms.
- No.29 has undergone major investment process change in its pursuit of efficiency in processing transactions. Networking with potential deal introducers and NEDs is carried out on an unusually large scale and each investment professional is allocated a quota of relationships to keep warm. Those contacts are used to handle much of the CDD and either become or introduce post-deal chairmen (no head-hunters have been used for that purpose in over 2.5 years). Interim FDs are used to carry out a first cut FDD. The internal team carry out pretty much all commercial and management referencing. An internal specialist advises investees on high level organisational issues. To keep costs down for investees, strong FCs or part-time FDs are used in preference to full time FDs. Smaller investees may be helped to find part-time sales directors until they can afford a full-time.
- Nos. 25, 23 and 28 all talked about deliberately avoiding competitive secondary deals and investing more time into digging out primary transactions. That implies, on average, less mature management teams, a greater need for change and supplementation – but also the prospect of bigger uplift in value. No. 20 had an even more specific focus on working with entrepreneurial founders which can bring higher perceived risk but – based on the development of specific approaches (including really getting to know the top individuals) – a less competitive niche. No.7 have made management talent an explicit centre of the investment thesis. They ask themselves which sector niches to invest into and then hunt key managers to make that strategy work – and identify off-market acquisitions. They have become more daring in deploying management talent: in one oil & gas investment they brought in a chairman with no sector experience but who brought a really entrepreneurial track record to add energy to a sleepy business. This approach echoes that of a couple of US firms who pioneered a 'management first' strategy a decade ago: http://www.gtcr.com/the-leaders-strategy/ who market themselves to ambitious MBI types and create partnerships to then construct acquisition plays. That is quite similar to http://www.wppartners.com/strategy/strategy who, additionally, focus on buy-and-builds.

5. How investors are handling different aspects of management

The sections above describe how attitudes towards dealing with management issues have evolved over time – and some of the variations between investors, e.g. 'backers' and 'shapers'. What unites all groups is a desire to find ways to cope as well as possible with the complexities involved. Backers may focus more on getting to know incumbent teams and their peculiarities before they commit to them; shapers may give greater emphasis to how to build the best team to fit their opportunity – but both need ways to build insight and then act upon them.

Consequently, the sections below examine some of the specific approaches and tools.

A. Management teams need to see that MDD can add value

The first step in getting any kind of management due diligence moving is setting up mutual expectations of what is required and what it is designed to achieve. Guiding managers is tricky, of course, if the PE house itself has not really defined what it is trying to achieve – and No. 23 wasn't convinced that investors had really nailed that. Asking managers to dedicate scarce time to potentially intrusive conversations or tests will always be tricky if the explanation doesn't extend much further than 'this is what we need' stated without much real conviction – and underpinned by only a vague hope that an assembly of blunt tools might offer some interesting insights.

Some investors, such as Nos. 1 and 22 worry that coming into a competitive deal process asking for much by way of management DD can create a competitive disadvantage. No. 17 worries that some teams find face-to-face interactions with non-investors 'quite threatening'. Several interviewees made specific mention of psychometric tests – both Nos. 27 and 32 reckoned teams hate it - while No. 34 mentioned managers simply refusing to cooperate on testing. Some investors (e.g. Nos. 18, 23 and 28) find such allergic reactions instructive and perhaps even a reason to avoid those exhibiting them, especially since advisers should have prepared to ground in advance.

Nos. 9, 33 and 19 note that some management teams just treat MDD as a hoop they need to jump through in order to get the deal done – and will tolerate that grudging cooperation.

For some interviewees, the 'sell' has not been as painful or the acceptance as grudging. That is partly because advisers and (some) management teams are more used to the concept (as Nos 17 and 26 point out): some serial CEOs may have been through previous such exercises. No. 35 goes further and reckons most teams say they got a lot of value from it.

More investors, though, described working hard to find angles to make MDD more palatable. No. 3 used existing investee CEOs to explain the potential benefits. Nos 26 and 16 underwent psychometric testing themselves to demonstrate a level of reciprocity and mutual sharing. No. 14 asked management to reference them as a PE house (something other PE houses also offer – but can observe that teams don't get around to).

A stronger argument is that the MDD process, broadly defined, will be of direct benefit in developing the investee management and organisation, and in setting up the investor-investee relationship. No. 11 describes the mutual construction of a 'roadmap' for post-deal activity which the MDD will create the foundations for – and reckons that 9/10 teams are responsive to that. No. 17 finds similar positivity to the request for a four-hour pre-deal session to do some 90-day planning, and involve the internal portfolio management team in a dummy board meeting, for example. Nos 23, 33 and 30 play variations on this theme by talking about different aspects of capability building, finding the right chairman and team dynamics.

My experience as a MDD provider is that whereas less than a tenth of DD exercises lead to serious red flags, the large majority identify management/organisation issues worth addressing together post-deal. Moreover, when managers treat, say, interviews as an opportunity to brainstorm solutions to the inevitable organisational growing pains, a less glossy picture of team and organisational limitations emerges which can assist the risk management aspect of the DD too.

B. There are various styles – but senior face-time is still the key approach

One thing on which there must surely be almost universal agreement is the need for senior investors to spend as much time with target management teams as possible. Apart from formal presentations and interviews, site visits, and sitting in on DD meetings, this typically takes the form of informal dinners or other social contact (e.g. playing golf together, as No.26 mentioned), aimed at building a trusting relationship and identifying underlying objectives, resilience and characteristics.

To 'peel the onion' of the team (No.31), have properly granular conversations (No. 9) and achieve 'total immersion in their space' (No. 16) quantity of face-time really matters. Post-exclusivity, No. 27 expects 'unfettered access' including potentially sitting down with the team three times a week, and above all the CEO. On one transaction, No.

15 calculated that he and another partner spent 62 hours with management before its conclusion – a huge amount more than he reckoned he had dedicated in the high volume house he previously worked for. No. 25 observes that some people crumble under the intensity and rigour of the process, especially if they are not strong at explaining what makes the business tick.

The scale of senior investor involvement can vary: No. 18, talking about his previous PE firm, reckoned all partners would attend management presentations to allow a well-informed team discussion about management. Nos. 2 and 30 arrange for all partners to meet with target team members. No. 23 offered an interesting litmus test for partners to consider (all of them meet management before DD kicks off) – how would the team likely cope with the annual LP meeting and the scrutiny that brings? In the case of No. 10 all members of the full IC meet the management team. At Nos. 28 and 7, three-quarters and respectively half of the investment committee join management presentations. At No.9, any two of the three most senior partners can elect to 'kick the tyres' before the formal IC meeting. At No. 33, a third of IC will have met management – but there is an explicit belief that it is helpful if there are people who are working from the data alone in case everyone is seduced by an especially plausible presenter. No. 37 concurs – it is important to assess people not just by the stories they tell but more by whether they have done what they said they would. One proxy for that, No. 10 explains, is how people react to requests for information.

Another area of almost total consensus is the importance of understanding motivational factors – why do the management team want to do this PE deal and do they really want to work with us over the next years? No. 18 points out that asking questions about this early on is hard – but actions speak louder than words and seeing a team, in one recent case, raising mortgages for their cash contributions shows real skin in the game. Are there warranties which slightly frighten them? Motivation, in No.8's view, trumps skill and knowledge, and so No. 12 wants the PE house to represent a lifetime opportunity for management and for any cash out to be clearly less than 'beach money'. In consequence, investors can send a lot of time on deal structure as much to build alignment as to ensure the right returns model. No. 33 may allow certain other corners to be cut if management will roll more of their equity, preferably more than what he sees as a market standard of 50%. No. 18 inserts additional questions into the legal DD managers' personal status questionnaire to gain additional insights into motivations, on the basis that it is a signed document and managers are less likely to demur given its official status.

Apart from the investor team itself, there are other sources of insight which can be tapped during deal processes:

No. 33 uses a sales director from other investee company to visit a target, then produce a memo for IC and sit down with the deal team. Presumably target management can also gain their own feedback about the PE house which may assist buy-in.

No. 11 (and others) use potential chairmen as a source of industry and company insights and even cheap stage 1 CDD. Nos 12 and 22 tap both their own networks but also expert networks via Cognolink or Skill Capital.

C. Referencing is widespread but generates varying enthusiasm depending on how it is done

After senior face time, probably the most frequently method of carrying out MDD is referencing. My sense is that its profile has grown somewhat over the last ten years – e.g. No. 21 describes how it was introduced to his previous firm when a new boss from a business rather than finance background insisted it be carried out. However, views differ on the value it can deliver: Nos. 16 and 21 point out that it can be hard to deliver great insights when an MBO team has been in place for a long time. Nos. 15, 17 and 21 can be considered soft sceptics – they are not averse to some defensive/confirmatory referencing but haven't seen much real negative insight or ever decided to abort a deal due to what they have found. No. 10 goes further and reckons that references can be 'bollocks' (while No.1 described his method – when acting as a referee - for avoiding answering any questions in ways that might be critical). No. 28 has withdrawn from using referencing because little of consequence was emerging and much seemed to be 'arse-covering' or even downright misrepresentation.

As an aside I would offer the thought that this reflects more on the approach to referencing than the potential of the method if done right. Robust referencing of both named and independent referees has revealed gross incompetence, fraud, bullying, illicit relationships, chaos and misrepresentation. No. 34 reports something similar – it can take '15 references' worth of calls until a fraud emerges.

One ripe question relates to who should carrying out referencing. Some firms, such as Nos 1, 5 and 25, always outsource, partly due to their ability to access independent voices and to help provide tie-breaker information when a deal team has divided views. However, others such as No. 19 has had mixed experiences with various providers, and now pushes for referencing calls to be of sufficient length – about half an hour. No. 3 wants calls to cascade iteratively to catch referees who might otherwise not be touched.

By contrast, some firms (Nos. 2, 30 and 34) have concluded that referencing is too valuable for potential nuances to be lost by outsiders – and so go out to their own networks where insights can be better trusted. No. 14 do much of the named referencing in-house but pass the independent referencing to outsiders.

There can be other angles: No.3 (and No.35 sporadically) use referencing pre-exclusivity to assist their bidding approach. No. 31 makes use of Kroll-style referencing and data gathering to probe deeper risks.

D. There is more curiosity than real action in looking below the top team

Management diligence (encompassing efforts from both the deal team and any third parties enlisted by them), traditionally focused almost exclusively on the top team. That was partly because of limitations placed on access during the process, but also because many investors equated the management team with the SMT and considered anything else as a black box outside of their sphere. No. 25 expresses the traditional view on this: that investors should focus especially on the CEO and FD and judge whether they surround themselves with good people – and hold them accountable for the team they build.

Likewise, the early management DD providers were mostly head-hunters and psychologists by background, used to analysing individuals and small teams rather than wider organisations and strategies. Both investors and providers have tended to take 'management' to mean a group of people rather than the processes and practices through which a business is mobilised and directed. That is unfortunate because organisational effectiveness is typically the least optimised aspect of most businesses, and so offers some easy wins for higher productivity.

More recently, though, there appears to be a greater interest in looking deeper through the management ranks in the search for insights into wider capability and capacity. No. 27 hopes to identify potential directors in the 2nd tier, No. 3 to add in additional touchpoints to throw light on the overall business. No. 35, although sceptical about claims of competitors to actually dig much deeper, does admit that tier 2 contact can help provide indirect reflections on the top team.

Several interviewees did say, though, that they are giving more attention to non-SMT managers: No. 16 aims to identify organisational issues which can be addressed post-deal; No. 26 is especially interested in key client-facing people; No. 34 thinks such insight is especially relevant in service businesses. No. 23 notes that getting access can be harder – and depends on the confidence of the SMT - but is asking for it more forcefully.

E. The use of analytics in general is still limited and psychometrics remain controversial

Although talking to people, in all its various forms, forms the bulk of MDD activity, there has been a slow infiltration of analytical tools into supporting decision-making.

The most frequently encountered, but also controversial, are psychometrics. Competence testing is relatively accurate and at least partly predictive – but some teams can strongly resent (or even resist) participating in tests, regarding their careers as sufficient indication of their capabilities. Personality profiling is less provocative but has its own dangers – there are tests still widely used which have mostly survived because of their familiarity, despite serious flaws (Myers-Briggs and DISC being the most obvious examples). As No.16 observes, the problem lies in interpreting raw personality data in the absence of relevant calibration and application to managerial performance. That calibration is possible but escaping personality-related waffling requires the right tools and approach. For example, predicting success is hard (because research shows that managers can succeed in all sorts of different ways) whereas spotting failure risk is easier (because certain traits can predict damaging behaviours) so analysing 'derailers' is useful. More generally, psychometrics need to be treated as a useful hypothesis generator for subsequent validation by others mean.

The world of psychometrics continues to evolve, driven by the ability to crunch ever greater data (allowing, e.g. prediction of competencies) and to make visible new distinctions (hence the appearance of tests or risk attitudes or judgement).

Other analytical tools are less well known but becoming more common:

- Measures of organisational effectiveness such as McKinsey's OHI, Humatica's Altus or my Organisational X-ray. All of these allow results to be benchmarked.
- Experience maps to squeeze insight from CVs and other biographical information.
- Measures of top team effectiveness using questionnaires, based on relevant research.
- No. 29 uses a board effectiveness tool adapted and simplified from something developed previously by 3i.
- A couple of MDD providers have built business case studies with which to test executive judgement (which No.3 make use of).
- A greater use of benchmarks, based on previous projects, to help highlight differences and similarities inside teams and between them.

F. Use of third parties has not improved in quality of quantity in ten years: both providers and buyers have work to do

Comparing the situation regarding the use of outsiders for MDD now with 2005, what is striking is more continuity than any major shift – despite a sentiment at that time that the growing prevalence of the early 2000s would continue. Although I don't have a statistic to offer for 2015, I would be surprised if the proportions then using external MDD provision on most deals (26% of all 46 mid-market firms in 2005, higher amongst the 25 lower mid-market ones), or those using it sometimes (63%) had moved higher. That puts firms such as Nos 27, 35 and 10 – who are consistent users - in a minority. Firms such as Nos.1 and 18 would be more typical, with some deal doers keen to involve outsiders and others not. Likewise, firms such as No. 12 are also frequently found taking some elements (in their case, referencing and some interviewing) in some situations but not others. No. 17 would likely use outside support where there is significant management change contemplated – but not for a simple MBO. No. 31 reports that, if anything, the practice of his current house has moved against external MDD when compared with what happened in a previous role – something he attributes to a more 'American' mentality that if management doesn't work out then it can be changed post-deal.

The model of having an in-house specialist - which was then confined to Catherine Wall at Barclays PE - has grown to two firms (Nos 32 and 29), although No. 11 did also have a short-lived trial. So although firms have enhanced their general investment processes, there has not been a shift to in-house provision. Nor is the move to carrying out assessment post-deal (fairly typical amongst large buy-out houses who buy an asset first and then decide if they like the top team later), although No. 32 did mention that this is their preference.

The question is why firms such as No.21 - who think MDD is the most important type the DD support they buy - is relatively unusual. Cost is presumably not the reason – MDD fees are usually a small fraction of deal fees: No. 36 referred to one recent case where they represented £30k on total fees of £4 million. So those who like the offering, such as No.35 reckon MDD gives them their best value for money.

But the key word in that equation which appears problematic is value. MDD hasn't made itself indispensable for deal teams and investment committees and, moreover, can create a potential risk to managerial goodwill if presented or executed without care. One major issue appears to be that MDD is often seen as lacking 'teeth': No. 34 reckons reports can say the right things but not in your face and using too soft words. No. 28 has tried lots of ways of assessing teams up-front but never found a method to predict the outcome or get calibrated results. A senior partner from one high volume house once explained to me how he had carried out a review of tens of MDD reports and tried to correlate them with subsequent events – and found essentially no useful relationship. No. 14 reckons he has never pulled out of a deal due to MDD findings: only trading issues have caused that for him. All in all, thinks No. 26, management assessment has lagged behind other areas of DD.

If such views should give pause to MDD providers, the problem is as much one for investors. After all, if management issues remain as important as investors described above, then to leave standards as unclear as they are represents a buyer failure too. To improve matters probably involves:

- Investors thinking harder about what they need, like No. 17 who gets better results by having clarified their assessment objectives, or No. 11 who has redefined their main objective as being the construction of a management 'roadmap'. However, for most houses, defining managerial needs into a 'scorecard' or something similar (which was one of the key recommendations back in 2004) remains very rare.
- Secondly, providers need to be told what is needed. No. 33, for example, who regards most providers as being insufficiently aggressive in pointing to weaknesses, wants to hear off-the-cuff remarks about the edges of management quality, not just descriptions of the mainstream, and know what are possible causes of failure.
- Thirdly, investors need to want to hear – and then act on – any warnings. No. 23 noted that in his previous house investors would sometimes try to rewrite reports – to be more favourable – and consequently (a) reports were never very challenging and (b) the main provider seemed to be regurgitating our views back to them. He, as well as Nos. 21 and 35, reports that points raised were ignored. No. 16 notes wryly that in the deal reports he receives, management teams are always steeped in their industry and generally first class.

G. Digestion of MDD inputs is a real challenge

Investors need to find better ways to synthesise and digest the vast amount of data hitting them. With final investment committee papers reaching tens of pages, or in some cases well over a hundred, and DD reports totalling many hundreds, keeping on top of cross-cutting themes and risks requires a robust system given the typically short timelines involved. At a general level, firms such as No. 34 and 10 (which have historical connections) insist on an all-providers feedback meeting to explore issues which cut across the financial, commercial, management etc. siloes. Although some other firms, such as No. 33, do get FDD and CDD providers to talk, and some of my clients are happy for me to talk with CDD providers, this approach has surprisingly not been copied by other houses. There are, of course, other ways to interrogate DD stories by asking, for example (from No. 28), how the current team compares with other encountered in previous transactions – and what inspiration or warnings that might imply.

H. The use of MDD outputs to guide post-deal actions is mostly tactical and focused on individuals

More specifically on management DD, the challenge (apart from the issue of robustness discussed above) is how to connect diligence reports with post-deal actions. Different houses seem to prefer varying levels of transparency. No. 27 wants to share everything, 'warts and all' to the CEO rather than just the nice bits. No. 28 uses the MDD provider as a neutral intermediary to talk with management teams about how to take post-completion improvements. No. 34 always offers – and indeed imposes – feedback to teams.

The second line of attack is to define mitigation and development actions, e.g. as No. 28 describes, putting the right people alongside potential high risk individuals. No. 2 describes a situation where a rather meandering CEO was helped by having a strong FD appointed to keep him focused. Nos. 4 and 23 try and put in place structures to encourage strengths and mitigate weaknesses and put in place plans to fill any managerial gaps. No. 26 encourages the use of coaching for managers - especially newly appointed ones - and sends second tier managers to business school as part of succession planning.

6. What is happening inside PE houses?

The sections above addressed the various techniques and approaches being used (or not) by investors. However, those things are irrelevant in the absence of an investment team with the understanding, skill and inclination to engage with managers and improve practices.

A. Senior investors worry whether the next generation will have enough experience of handling management- issues

The concern expressed by multiple interviewees was that, in certain respects, the PE industry is creating investment teams with lower management orientation than previously. Some (such as Nos. 10 and 23) felt this was a feature of a new generation and that younger investors were seduced too easily by numbers and process and gave too little attention to the messy realities of management teams. No. 10 added that younger investors seem ever more likely to have MBAs and derive from CF/investment banking backgrounds. No. 22 admitted that indeed CF has been a major recruiting ground and that the result was that process discipline had improved - but at the expense of the more nebulous management aspects. No. 32 offered the thought that there is no real substitute for experience and that this constituted an element of difference between investment banking process and investment judgement. So, said No. 15, younger investors are more credentialed but with lower likelihood of having worked 'at the coalface' whereas he had been an FD and his partner had run a business – and there is a risk of breeding commerciality out of investors.

Others wondered what was behind such a shift. No. 21 noted the 65 transactions made by his previous house which had provided him with a real training ground. No. 14 reckoned he had been involved in 50-60 transactions in his time and that this created an ability to connect with managers, calibrate impressions and work from a deep conviction that management matters – but worried that passing on this trade craft was difficult to do. Although No. 33 still experiences a sufficient transaction volume to puts its people in the firing line quickly and often, most houses now are lucky if the can expose their team members to, say, two full deals a year. No. 6 also felt that inter-personal skills are hard to teach – and that empathy cannot be turned into a process. No. 35 observed that the whole investment process is more tightly overseen by senior people than previously, while No. 36 added that meetings with management are more chaperoned now and that, anyway, learning about management is hard if you are only working on buy-side transactions. Likewise, the number of transactions a younger investor will become involved with is fewer than historically and will be executed by larger teams.

B. Houses are deploying and developing current people as best they can…

Dealing effectively with this experience challenge can be approached in various ways:

<u>Improve processes to reduce the need for sophisticated individual judgement calls.</u> This honing of process has been happening in most firms anyway. No. 10 brought in a former managing partner from another firm to chair his house in order to add structure – and eliminate some blind spots which had caused problems. No. 7 has a conscious process to iterate processes to keep them relevant and avoid being over-prescriptive. No. 19 has built tick sheets to help structure the process flow – and combines those with common sense. No. 9 uses its 180-day plan, built on a series of spreadsheets, as a bible for the younger investors, providing a vehicle for conversations with management, although it also makes big efforts to use incoming business challenges to build team skills.

<u>Recruit people who are more likely to be on the wavelength of management teams</u>, based on No.10s observation that in assessing people 'you either get it or not'. In No. 20, all of the team have worked outside PE, for example and are then exposed to entrepreneurs as early as possible. At No. 19, they are generally fussy in their recruitment and although many of the team are accountants, they are selected for their people orientation. No. 16 recruits people with less investment experience but who have proven experience in transactions and handling management teams. Nos. 26, 31, 32 and 36 all try to promote a good mix of different backgrounds – with Nos 26 and 31 having seen the

creation of teams with fewer accountants. Instead they have an enhanced mix of operations, strategy, investment bankers, distressed accountants – each of which can bring different perspective on investment. No. 36 still sees a special role for the grey haired cynics to focus on management, however.

<u>Allocate those with more empathy to management issues</u>. At No. 23, the partners categorise team members on their level of human judgement and deploy the skills accordingly. At No. 3, some of the team are better at bringing high quality awareness to conversations with management whereas others are good at just pushing fast growth, while others with limited patience are good at driving cost out strategies or financial engineering. No. 1 reports different relative skills there too with one junior good at empathy while another is more of a 'quant' (although he has been given training on relating and influencing).

<u>Develop team members consciously to improve their judgement regarding management</u>. This is approached in several ways:

- Through formal training: e.g. No. 32 has sent people to programmes at Cranfield, used the BVCA and asked advisers for help. No. 3 uses internal academies to train people at their various levels – and finds this also helps socialise investors between offices. No. 35 has worked to create an internal university to share learnings from previous deals.
- Most firms use some kind of apprenticeship model whereby younger investors are involved with deal processes and see how their more experienced colleagues handle different situations. No. 28 notes that the more time juniors are exposed, the better their judgement gets. Several houses mentioned actively soliciting younger investors' views and giving them issues to chew on. No. 4 tries to find excuses to mentor his junior colleagues on business and management topics, especially on how to have influence without needing to reach for legal or financial levers. No. 13 was taken by his boss, when younger, to most of the external meetings related to a specific sector. No. 22 isn't the only house where war stories are used to spread good practices.
- More specific developmental activities. One smaller firm, No. 25, appoints one senior and one junior onto each investee board. Nos. 3 and 9 both place younger investors onto change projects in investees to give them hands-on experience of business problems. No.9 mentioned a case where an investor returned 'a changed man' after spending some months working on an investee store refit programme.

C …but the most powerful tool is building the right investment culture and framework

The broadest foundation for good work on management topics is a high performance PE team. Such a team probably possesses at least three key elements:

- A culture where difficult issues can be raised and addressed. Strong teams, within PE houses or more generally, are able to balance supportive collegiality with vigorous debate around ideas. No. 36 notes that beyond the quality of the debate is also the question of whether the right topics are being debated, making it a 'three-dimensional' issue, to avoid the temptation of over-simplicity. In the words of No. 34, the challenge is how to help your colleagues examine situations without them wanting to batten down the hatches. Some find this easier than others: No. 16 finds that, inside a small team, getting sufficient challenge is difficult - because being too adversarial can be damaging – but is needed because mistakes appear when you believe too much in what managers are saying. Consequently, he is keen for the external MDD to provide plenty of provocation. No. 3 finds a similar issue – people acting as devil's advocate is difficult culturally so big differences of opinion are rare. However, in the context where, as No. 33 says, 'There are no no-brainer deals', what methods do houses uses to tweak the balance towards sufficient challenge? No. 15 brought in a couple of experienced and independence-minded NEDs to bring sceptical questioning. No. 18 benefits from a structural solution insofar as the senior team have come together from a variety of other houses and so (a) have all been independently successful and (b) bring their own styles – but are united in their conviction that the focus should be on avoiding doing stupid deals. No. 22, by contrast, has seen much more continuity within the team but has slowly refined the quality of interaction by (a) chewing on previous mistakes; (b) making investment decisions a collective responsibility; (c) clamping down hard on anyone who hides things from IC and, (d), discouraging a salesy approach to deal presentation.

- A team who know each other well enough to allow easy flow of information and knowledge. This is especially important in the context where much decision-making depends on tacit understandings, shared vocabulary and joint experiences. Both Nos. 26 and 22 noted that they do not work from an explicit playbook but depend more on having a way of doing business. Clearly that is facilitated by team face-time so making sure all or most people are around for Monday morning meetings to discuss the deal pipeline (as Nos. 13 and 17 do) helps. Those with more than one office in the UK, like Nos. 7 and 11, need to work harder to ensure team members mix both at office level but also across teams. No. 11 created 'super-Tuesday' where people need to be in their office and available to colleagues both generally but also, more specifically, to work on sector development and internal projects. Team members get to work with more colleagues which then helps when they are doing deals. Those working in multiple countries have to prevent a drift into national siloes (of which there are some unhappy examples). No. 22 has kept a core of seniors together for more than 11 years and consciously brings members together as often as possible. No. 31 gets the seniors together once a month but also insists that all team members, whether financial or operational by background, are involved with the whole deal lifecycle: Origination, execution and post-deal. No. 12 creates a deeper sense of team through fixing remuneration based on team rather than individual performance, and reduces the incentive to push money out into dodgy deals.

- An environment where improvement mechanisms are institutionalised. The important, but not always most compelling need, to think about management issues relies on reinforcing and improvement mechanisms more than other areas of PE. That can be provided by senior people who act as gadflies: No. 35 'kicks off' if deal teams come to IC without adequate third party MDD for example. No 26 prefers the 'drip drip' Chinese torture method of getting his messages into people's heads. However, depending on single individuals can be risky – No. 5 describes how in a previous role the managing partner was fully committed to improving the handling of management teams and achieved some success. However, after he was replaced, the emphasis moved to 'rushing out to do deals' and management aspects were downgraded. No. 8, lacking such a key sponsor, worries that corrective actions on recurrent issues are not taken. At No. 24, there is also no formal rule book, intranet or templates and there is a risk of fragmentation between teams. There was a plan, for example, to educate the whole team on how to structure management equity but no-one ever got around to it. No. 7 have gone down a more explicit route: the chair and deputy heads of the IC have responsibilities for ensuring learning/feedback loops from each bid/deal, and an operating partner acts as guardian of the 100-day planning process.

Annex 1: December 2004 report: Taking Management to the Next Level

Executive summary

Over the past five years more attention has been paid by private equity firms to the ways in which they assess managers of potential investees, notably during due diligence. However, despite some individual success stories, overall results remain mediocre: a quarter of judgement calls about management produce unhappy surprises for investors, with many firms experiencing disappointments significantly above that. Such misjudgements have very tangible effects in terms of write-offs, lower IRRs, and a variety of other financial and human costs provoked by management changes. These links between management quality, assessment process and results are explored in Sections 1 and 2.

Interviews with private equity funds operating in the British market showed an evident desire to improve matters but, also, scepticism about some current approaches and considerable confusion about reliable alternatives. The current report draws on quantitative and qualitative input from interviewees – more than ninety senior private equity professionals and their advisers – as well as on a wide range of research on management assessment and private equity decision-making. It analyses options for improvement and make recommendations where appropriate. Some key conclusions are that:

- Gut feelings can be a complement to good assessment when the specific advantages and weaknesses of such instincts are considered and integrated into an overall process.
- Funds are rightly sceptical of much that emanates from the world of HR, but potentially damage their own interest when they reject on principle potentially useful external inputs into their decision-making.
- There is not currently a single 'best practice' for management due diligence. However, creating a scorecard of what is being sought in management for each transaction is probably the single technique which would produce benefits for most funds in most transactions.
- Psychometric testing probably occupies too prominent a role in private equity management assessment and is likely to migrate towards a more appropriate supporting role.
- Structured interviewing methods are currently less well known in the UK private equity world, but best fit the need for improved accuracy without irritating management teams.
- Energetic referencing can offer more substantive results than is realised by many and some funds would benefit from outsourcing it.
- Apart from management due diligence, there are several other management-related areas which, if addressed, could produce significant benefits. The best starting pointing point for any such efforts would be measuring current results.

Annex 1: December 2004 report: Taking Management to the Next Level

Summary data

	Table 2 – Summary Results by Type of Private Equity Firm	Top-Bracket	Upper Mid-Market	Lower Mid-Market	Early stage
	BACKGROUND INFORMATION				
1	Number of private equity firms included in analysis	11	21	25	21
2	Average founding date of private equity company	1987	1986	1988	1988
3	% of firms with generalist industry approach	91%	90%	71%	33%
4	Average number of investment professionals	10.1	18	20.5	7.9
5	Average total funds invested to date by firm	£3.2 bn.	£1.03 bn.	£534 mn.	£61 mn.
6	Average deals completed/year	5.3	5.7	6.5	9
7	Average size of current portfolio	26	29	33	46
	AVERAGE DEAL CHARACTERISTICS				
8	Average target deal size (equity at cost)	£142 mn.	£37 mn.	£10.5 mn.	£1.78 mn.
9	Proportion of business proposals seen that are eventually done deals	3.62%	2.07%	2.50%	1.44%
10	Average time in months that a deal takes to process to closing	4.8	5.08	6.36	3.85
11	Estimated man months taken to process a deal to closing	10.22	10.4	6.2	2.26
12	Estimated average cost of formal due diligence	£3 mn.	£2.1 mn.	£335,000	£91,000
	MANAGEMENT ASSESSMENT FEATURES				
13	Importance of management quality as % of all influences on deal outcomes	53%	53%	51%	72%
14	Score between 1 & 10 (1 is v. hard) for the difficulty of accurately assessing management quality	6.25	6.19	6	6.53
15	Estimated proportion of judgement calls on management that prove to be materially incorrect	21%	16%	30%	29%
16	% of respondents who do not specifiy the qualities/competencies needed in management teams	90%	50%	58%	67%
17	% of respondents who have a mental checklist of qualities sought in in management teams	10%	43%	28%	19%
18	% of respondents who have a formal system of qualities sought in in management teams	0%	10%	16%	14%
19	Average time spent in investee committee discussing management quality issues	14%	19%	22%	26%
20	Average no. of firm staff who will have met management before a deal reaches final approval stage	5	4.62	4.38	3.4
21	% of firms using psychometric tests at least sometimes	27.0%	14.2%	60.0%	52%
22	of which % using frequently or always	18.2%	4.8%	16.0%	24%
23	% of firms using outside consultants for management assessment at least sometimes	55.0%	47.0%	76.0%	62%
24	of which % using frequently or always	27%	14%	36%	19%
25	Average number of references collected on a CEO by the time a deal reaches final approval stage	6.90	8.90	7.20	6.88
26	% of firms who outsource referencing at least sometimes	73%	67%	64%	52%
27	of which % using frequently or always	45%	48%	20%	29%
28	Average ratio of portfolio companies to investment staff	0.8	1.7	1.92	5.1
29	Proportion of firms employing specialised portfolio managers	27%	14%	32%	10%

Annex 2. A suggested approach to interacting with management teams during transactions

Objectives

The challenge for most PE houses in this area lies not in major innovation but rather in steadily improving their ability to:

- Spot the small minority (in my experience: one in 12, or 15) of potentially toxic managers – and allow mitigating actions to be put in place where possible.
- Gain a sense of the wider management team and organisation and their fitness to deliver the strategy.
- Ensure that the overall deal process - and more specifically the management DD - add value to management and investment (through a 'roadmap') rather than just tick a box.
- Build goodwill with the management team - rather than eat into it - across the transaction.
- Ensure that any documentary outputs and feedback are designed to be digestible in the context of information overload and support a holistic understanding of deal risk and opportunity.
- Assist non-partners to develop their skills in dealing with management issues, as part of broader succession planning.

Different houses have addressed these issues to varying degrees. The points below offer generic suggestions on how mid-market houses can gain significantly greater value with only incremental changes in effort.

Internal set-up

Making up an approach to management each time a new transaction appears is tiring and/or potentially sloppy. Creating a general framework within which individual investors can still bring their own style - and adapt to the transaction situation - can be assisted by:

- Carrying out some analysis of the house history of dealing with management teams – the good, bad and peculiar. What has worked; what led to unpleasant surprises; how useful were deal papers in spotting issues?
- Asking what kind of management arrangements fit the house investment and post-deal value-adding style. Are we building a deep partnership or assembling a team to deliver a plan? Are we better dealing with entrepreneurs or professional managers? How much do we expect to be involved in developing the strategic and change agenda?
- Reviewing any MDD provision and asking whether (a) DD reports have really added value in understanding individuals, team, and organisational ability to deliver a strategy and (b) whether provider relationships are just an old habit or really represent best in class for house needs.
- Ensuring that non-partner investors are equipped with training, experience-sharing, shared vocabulary, and hands-on development to act effectively on management issues as much as technical transaction ones.

Early stage analysis

IMs and initial management presentations can be a sterile source of information regarding management and organisation. To gain a better sense of what managerial horsepower is available – and what issues there may be - try:

- Carrying out initial analysis of CVs (or Linked-In profiles) and analysing years of sectoral, managerial, and functional role experience, as well as exposure to growth, challenge, change situations, joint working.

- Gathering whatever insight can be taken from 'friends of the firm' – chairmen, former investee managers, operating partners, key advisers etc.
- Using company house data not just to check current firm financial performance and legal issues but also those at previous employers of key managers.
- Ask at least two questions in the management presentation to get a first sense of whether the team have really thought about the consequences of ownership change and on-going growth: what role changes/shifts are expected in the next 6 months? How will the broader organisation structure and processes need to evolve to achieve the growth plans?

Based on these inputs, as well as the management and growth opportunities sections of any IM, the deal team - plus additional people with post-deal experience – would spend at least 15-20 minutes brainstorming the managerial assumptions behind the plan (e.g. what do we have to believe to be true to have confidence in this management/organisation set-up) and create an initial 'issues list' (where are the potential vulnerabilities, what may take more time/resource to get sorted?).

Such an analysis then allows both internal and external due diligence to be focused onto the crunchy issues. Otherwise the risk is that the management sections of deal papers end up being heavy on uninteresting description and light on risks, mitigants and post-deal requirements.

Due diligence

The deal team will likely spend more time with the target team than any outsiders, and maintaining the management relationship is of strategic value, so management DD cannot simply be outsourced. Consequently, there are some tasks which the deal team need specially to take specific responsibility for:

- Educating management teams – especially those for whom this is their first PE exposure - on how things work and the mutual expectations involved. This used to be largely handled by the CF advisers but my impression is that teams seem to be less prepped than formerly.
- More specifically, explaining how any external management DD work is designed to add value to the company's development rather than just 'audit' the individuals. Just saying that 'this is part of our process' risks achieving only grudging involvement and perfunctory results. Instead, explain that this is mostly preparation for the post-deal roadmap.
- Getting the best value from tools under the investors' exclusive control, e.g. carrying out or mobilising references from people who might otherwise be reluctant to speak; using the management legal questionnaire to ask some additional pertinent questions beyond assets, bankruptcies etc.
- Spending informal time with the team to build mutual trust and gain off-piste insights into motivations and future intentions. One area worth particular probing is the extent to which individuals have been shoehorned into roles by vendors/advisers purely to make a transaction better fit a template.
- Ensure that scopes for external providers - FDD, CDD as well as MDD – provide insights into management insights that actually matter for the deal, and require providers to compare notes on cross-cutting issues and then join up the dots.
- Seek opportunities to better understand the business by, for example, accompanying a salesman or discussing technical challenges with a more junior specialist. The rationale may relate to the functional insight, but a great deal can be learned by seeing through such people's eyes rather than the more scripted interactions with the senior team.

Complementing the internal MDD, external providers should be able to bring:

- Fresh eyes and dedicated time for semi-structured discussions with the senior team, and shorter discussions with other key managers/specialists to add granularity. Senior interviews should provide the raw material for referee identities and topics for investigation.
- Work out the right mix of tools and approach to (a) fit the situation, (b) allow robust analysis and actions and (c) maintain management goodwill, especially via adding value to them.

- Technical expertise in deploying psychometrics and team questionnaires (when possible and appropriate) – and then making findings relevant by drawing on external evidence, relevant benchmarks.
- Deeper organisational understanding, especially around the means by which strategic intent is transmitted from the senior team through functions, the wider management team and the wider business – and then organisational effectiveness is sustained and improved over time.
- A referencing approach which provides detailed insight rather than general approbation – and can handle situations where classic referencing is more difficult. Some kind of benchmarking is important to allow calibration of results between individuals and across transactions.

Digesting and reacting

One of the major challenges for deal teams (and investment committees) during fast moving transaction processes is how to digest large amounts of potentially relevant information. The area of management/organisation is especially problematic in this respect because there are many dimensions, a limited consensus in describing them, and wide variations in reporting approaches. To improve the odds, some approaches are to:

- Organise a meeting of the main DD providers and ask for multi-disciplinary answers to the big cross-cutting issues: how do the commercial prospects of the business look and does the strategy make sense? What are the risks of under-performance and how can they be mitigated? What opportunities are there for growing business effectiveness? How well set up is the management and organisation to deliver the investment thesis? The reality is that DD providers pick up many more insights than just what is within their scope and may not always think to share them in the rush to produce reports.
- Ensure that at least one person in – or close to - the deal team is summarising likely post-deal actions to provide a sense to IC about the level of change and support needed.
- Consciously deploy contrarian questions to avoid the risk of being carried away by a single interpretation of the DD results: in what circumstances might individual/organisational strengths become weaknesses? How might the team cope if a key leg of the strategy proved intractable? Do we really have a good calibration of the extent and capability of managerial resources or are we relying on a warm glow from some impressive individuals?

Post deal issues

In my experience from working across 100 transactions and 200 other situations, bad <u>managers</u> are less of a problem than bad <u>management</u> in mid-market companies. That is partly due to lack of knowledge of effective practices and just as much the crowding out of important people and organisational issues by urgent commercial and operational ones. That is a shame because small pragmatic actions can have a major cumulative effect on growing companies. Consequently, recommendations for investor involvement post-deal are:

- The simple fact of including an explicit managerial and organisational stream in any 100-day plans/workshops, and general board agendas, can provide an important stimulus to teams to give serious consideration to improvement activities.
- Given the general lack of data on managerial/organisational issues – compared with financial/operational/commercial ones – any ways of identifying them (e.g. surveys, working groups, suggestion schemes) can offer real insights. Then, assuming even limited effort to address a few areas, those insights can deliver quick and cheap benefits.
- The majority of management teams seem to overload themselves with too many commercial/operational/financial initiatives too quickly post-deal and create an imbalance between what is being attempted and how it can be executed. Any proposed initiative should be interrogated by non-exec directors for its achievability given everything else going on, and in the context of managerial resources.
- There are rarely 'silver bullets' to organisational issues but serious attention and even partial solutions are usually sufficient to create momentum for subsequent iterative change.

- When performance issues emerge, it is usually more sensible to start by trying soft interventions (e.g. changing role boundaries, mutual expectations, coordination mechanisms) than reaching automatically for hard ones (firing people, major reorganisations). That is not to argue against hard interventions when needed, but they often cost more in time and money than expected.
- Involve deal juniors in post-deal organisational discussions and activities to build understanding and skill.

Key person changes

Getting new senior managers into place is frequently an important part of post-deal actions – and there is often urgency required in moving forward. However, the general rule that about half of all senior appointments disappoint remains as true in PE-backed companies as elsewhere. So cutting corners can be expensive and disruptive. Some quick pointers on reducing the risk of a dud appointment:

When a role description is being assembled, the majority of managers, HR people and head-hunters tend to start waffling on paper. This is an area where PE investors can usefully impose the use of templates for crisp descriptions which can be used by recruiters and those involved in selection. Making use of pre-existing lists of potential role activities can help focus minds rather than starting with blank pieces of paper. Vague generalisations (a change manager, good leader) need to be turned into useful distinctions by sustained questioning.

Asking the question 'Why might this appointment fail?' is worth asking at different stages during the specification process, at short-listing stage and thereafter. Focusing only on positives is dangerous for candidates as well as the business – and, since most head-hunters seem to have optimistic personalities, their enthusiasm needs to be double-checked.

A series of short general discussions adds insights only slowly. Dividing topics up between interviewers who dig deeper is far better. Those involved should then sit together for a wash-up discussion to check what has really been learned – and what is means when put together.

Leaving referencing until after offer and talking only briefly to a few named referees is not only largely pointless, it is actively dangerous because it makes investors and hiring managers think they have managed their risk whereas in fact they have just followed irrelevant process. Any director level appointment should involve at least 5-8 references, checked for quality and supplemented by a couple of independents. Where possible (usually) some referees should be taken pre-offer.