Taking Management to the Next Level

Current Practice and Future Directions in the Assessment of Management Teams by Private Equity Firms

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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 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.

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Albany Venture	Ingenious Media
Alchemy	Interregnum
Alliance Fund Managers	ISIS
Alta Berkeley	JP Morgan
Amadeus	KKR
Apax Partners	Lazard
Bain Capital	LDC
BancBoston	Legal & General
Bank of America	Mid-Ocean Partners
Barclays	Montagu Private Equity
Barings Private Equity	Northern Venture Management
BC Partners	Permira
Beringea	Phoenix
Blackstone	Piper
Botts Company	PPM Capital
Bridgepoint	Prelude Ventures
Cabot Square	Promethean Investments
Cazenove	Quester
Charterhouse	Rutland
Close Brothers	Sand Aire
DN Capital	Standard Life
Doughty Hanson	STAR
Duke Street Capital	TDR
Dunedin	Texas Pacific
ECI	Thompson Clive
Elderstreet	Warburg Pincus
Electra Europe	West Private Equity
European Acquisition Capital	WM Enterprise
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the study, and gave me access to its people so that I might get a better idea of American best practice. Their website at www.ghsmart.com is a great source for further insight.

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About the Author

Mike Hicks spent eight years setting up and running offices for Deloitte and EBRD in Eastern Europe, spending time in hundreds of companies in every conceivable industry. Latterly he was managing director of Creditanstalt Investment Bank's Romanian private equity company and led collaboration with Advent International on deals. He then completed five years of doctoral research at the University of Oxford on the development of management recruitment in the UK, France, Germany, the USA and Japan. In parallel he has led exits/capital raisings for founder managers as well as recruiting CEOs and other executives. As head of Management Assessment at Grant Thornton his main activity is working with private equity funds to squeeze more value-added from management assessment processes.

Study Methodology

Seventy-seven semi-structured interviews were carried out with senior investment professionals from private equity firms operating in the UK, mostly by telephone. To allow more detailed analysis, firms were categorised as one of the following types based on their typical transaction size (in terms of equity invested) – 'Top Bracket' (£100 million or more); Upper Mid-Market (£20 to £100 million); Lower Mid-Market (£5 to 20 million); Early Stage (below £5 million). To retain anonymity, interviewees were coded by the type of firm they represented (TB for 'top bracket', UM for upper mid-market, LM for lower mid-market, E for early stage) and a number (based on the alphabetical order of their first names).

Some interview questions were common to all respondents and provide the basis for the statistics provided. However, questions were kept relatively open to allow individual house styles and case-studies to emerge. The resulting comments provide much of the most interesting material below, generally provided in the form of paraphrases based on my notes. A risk of this approach is that some quantitative information must be treated with caution – only detailed and fully systematic data collection can increase the chances that what A understands by 'business proposals' or 'material surprises from management' is the same as what B understands.

To provide general background, as well as a robust basis for analysis and recommendation on certain features of management assessment practice, I also had the advantage of (a) sixteen interviews with leading advisers on assessment from the UK and the USA (coded C for Consultants) and (b) a wide range of pertinent research studies.

Much of the research on private equity investors and investments focuses more on early stage deals and venture capital than the larger buy-outs that have become prominent in recent years. To some extent I have covered that gap by citing work on mainstream corporate M&A activity and large corporate hiring activity.

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1. Why Reassess Management Assessment?

There is a spirit of experimentation within the private equity community. In some respects this is surprising since, after all, the industry has reached relative maturity in the quarter century since it became a significant force, and continues to develop successfully. The press is full of news about healthy exits and new fund-raisings while banks are again competing to offer gearing of seven times EBITDA (and more). The issue of assessing potential investee managers was frequently revisited in the 'down' years of 2001 to 2003 and due diligence techniques were upgraded. Investment professionals have said their collective *mea culpa* for past mistakes and added to their stocks of relevant experience.

Nonetheless, changes in the industry and its practices appear to have kept up the pressure for extracting more value from due diligence on management teams. Even if more money is available for private equity investments, LPs can pick and choose between an ever larger array of firms, noting that variability in returns between private equity houses is not only higher than for other asset classes but has also grown over time.[1] Competition for deals has also become more intense, especially in the medium and larger sizes. LM23 notes that they lost their last three target deals due to price competition. LM2 works on the assumption that, even if there is no formal auction, every deal involves some kind of competitive element. This has led either to an increase in risk accepted for a given return (which UM9 perceives) or to some erosion of potential returns: LM18 says that whereas target IRRs used to be above 30%, now even 20% is commonplace. LM24 sees this trend extending forwards too. At a recent conference Guy Hands of Terra Firma reckoned that buy-out funds were unlikely to generate more than 14% IRR despite hopes of 20%, and saw this as forcing 'a change in the culture, personality and models that managers have traditionally employed.'[2]

Growth in size, and more competition both for raising funds and for deals, has pushed many firms towards new attempts at differentiation, institutionalisation, and risk management: [3] The need for greater differentiation has become relevant in the context where innovations from previous periods – such as smart cashflow management, tax efficient legal structures and the use of high leverage – have become commoditised and no longer represent such a source of competitive advantage.[4] A greater number of players has also encouraged specialist strategies by sector, stage and style. Institutionalisation has occurred through increasing resources devoted to investor relations, business development[5], and internal management. Some firms have embraced risk management by systematising processes and reducing individual discretion. Another perspective, cited by UM7 & E17, is that where reasonable skill and EBITDA arbitrage were previously a sufficient business model, now new angles are required to produce returns. With fewer unspotted bargains

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[1] 'Money to Burn', *Economist* (27/05/2000), p. 105; 'Kings of Capitalism: A Survey of Private Equity', *Economist* (27/11/2004), p.6.
[2] 'Hands Urges Focus on Investments', *Private Equity News* (08/11/2004), p.4.
[3] e.g. Harper NWC & Schneider A, 'Private Equity's Challenge', The McKinsey *Quarterly Newsletter* (September 2004); 'TPG's fundraiser', *Private Equity Online* (05/02/2004); Townsend G, 'Find the Young Guns', *Real Deals* (19/06/2003), p. 16.
[4] 'Kings of Capitalism: A Survey of Private Equity', *Economist* (27/11/2004), pp.5, 9.
[5] Rivlin R, 'The Proprietary Spiel', *Real Deals* (13/02/2003), p. 17.

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available the probability of a few real star deals to cover mediocre performance by the rest of a portfolio is reduced, and so each transaction has to pull its own weight.

Within this context more is put into, and expected back from, due diligence activities. It has been claimed that, beyond its traditional function of identifying potential black holes in the investment, due diligence is increasingly tailored to individual transactions in the hope of identifying extra upside and preventing rash approvals.[6] Certainly the scope and depth of diligence activities has grown – involving more emphasis on commercial, environmental, and management issues.[7]

The rest of this report will describe (i) the current state of play in assessing managers of potential investees, (ii) trends in improving the accuracy of individual assessments, and (iii) approaches to extracting additional value from collateral processes.

1.1 How Important Is Management Quality?

Before considering the methods used by private equity houses to assess managers we must first consider the importance and difficulty of the task those methods are confronting. Many interviewees recited the 'management, management, management' mantra when asked what is important in making deals succeed. But is this really true given all the other factors involved, and are the challenges involved perceived clearly?

Considerable evidence appears to support a strong role for management in influencing business performance and investment returns. The American venture capital pioneer, Arthur Rock, has been much quoted as saying that 'Good ideas and good products are a dime a dozen. Good execution and good management – in a word, good people, are rare' and, moreover that 'Nearly every mistake I have made [in this business] has been in picking the wrong people, not the wrong idea…'[8] Likewise, a classic study of 102 American venture capital firms in 1985 found that the top two criteria that venture capitalists considered "essential" when making an investment decision pertained to entrepreneurs' capability of sustaining intense effort, and their familiarity with the relevant market.[9] A more recent European study found that when VCs were forced to make trade-offs between various influences on deal outcomes, five of the top seven factors (out of a total of 35) prioritised were linked to the management team.[10] Another found that management quality was cited as the principal reason for deals failing across Europe.[11] This echoes the findings of an analysis of deal failures, at a time when a quarter of deals were typically written off, which devoted more than half of its analysis of causes to problems with management.[12]

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[6] Bruce R, 'Making sure 2+2=4', *Real Deals* (11/07/2002), pp. 23-26.
[7] Bartram P, 'A Clean Slate', *Real Deals* (05/09/2002), pp. 23-27; Eastwood G, 'A Diligent Attitude', *Real Deals* (09/10/2003), pp. 29-33.
[8] Camp JJ, *Venture Capital Due Diligence* (2002), pp. 24-5.
[9] MacMillan, Siegel, and Narasimha, cited in Smart GH, 'Management Assessment Methods In Venture Capital: Toward A Theory Of Human Capital Valuation', (Claremont Graduate University Ph.D. thesis, 1998), p. 30.
[10] Muzyka D et al, 'Trade-Offs in the Investment Decisions of European Venture Capitalists', *Journal of Business Venturing*, Vol. 11 (1996), pp. 273-287.
[11] SJ Berwin, *The Human Capital Equation* (2003), p. 7
[12] EVCA, *Lessons Learned from Past Mistakes* (1998).

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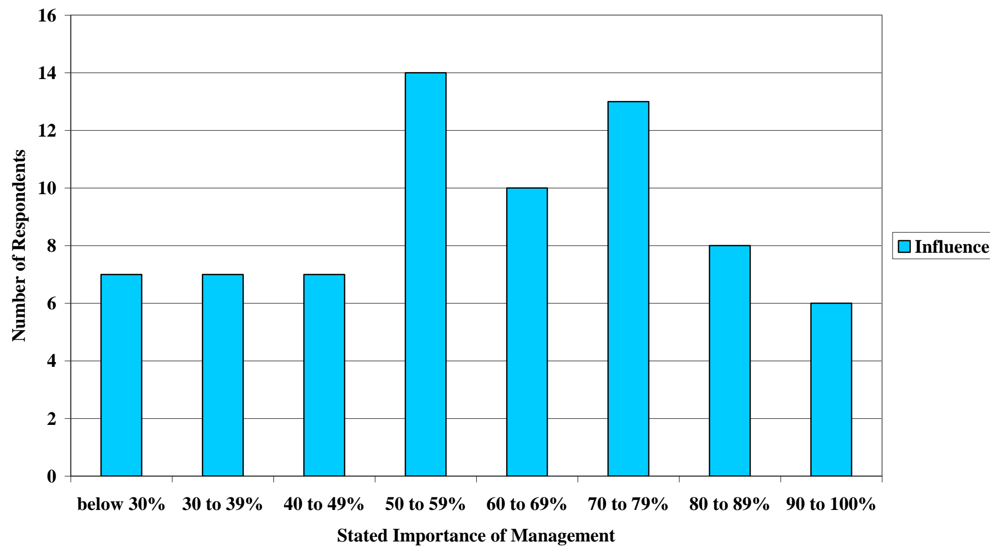
As for direct evidence of a link, one study of fifty-two entrepreneurial firms in New England found that 'human capital' was a stronger predictor of venture performance than factors related to the product or service of the new venture.[13] Within the more general business world, it is known that variability of individual performance seems to increase as the levels of responsibility increase, so that the difference between top performers and the average in terms of output increases from 19% in clerical work to between 32-120% in managerial/sales positions.[14] Back in the 1960s a major British study, distinguishing between companies described as 'Thrusters' or 'Sleepers' depending on their sales growth showed that many of the key differentiators related to executive attitudes and quality.[15] More recent studies, including Gallup's huge longitudinal research, have shown the relationship between management quality and workplace productivity across many industries.[16] It is true that a study at Harvard found a rather low proportion of profitability (14% overall) attributable to management, but it looked mostly at mature industries like paper and hotels.[17] Relevant to risk management is a detailed study on slow downs in the growth patterns of fifty American companies, over the last fifty years, which finds that senior team composition, as well as general talent shortages, directly represented 18% of the explanations for slow downs in growth, but indirectly rather more due to categories such as 'strategic mistakes' which are strongly influenced by management.[18]

Interviewees for this report assigned a high level of importance to the effects of management on the performance of the transactions they invest into.

Figure 1.1: The Influence of Management Quality on Deal Outcomes/Returns



Source: Interviews

[13] Stuart and Abetti (1990), cited in Smart GH, 'Management Assessment Methods', p. 30-32.
[14] Butteriss M (ed.), *Reinventing HR* (1998), p. 254; Axelrod EL et al, 'War for Talent, part two' *The McKinsey Quarterly* (No.2, 2001).
[15] PEP, *Thrusters and Sleepers* (1965), pp. 189-195, 207.
[16] Buckingham & Coffman, *First, Break All the Rules* (1999), passim.
[17] 'Survey of Corporate Leadership', *Economist* (25/10/2003), p. 7.
[18] Corporate Executive Board, 'Stall Points' (1998).

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As Figure 1.1 illustrates, a median of about 60% of influence over deal returns was attributed to the quality of management. There are outliers, of course: TB10 thought the influence was something between ten and fifteen percent only. Nonetheless, of 72 views on this question, no fewer than 51 reckoned management represented at least half of total influences. Moreover, some interviewees reckoned that the influence of management quality had grown in recent years: UM16 saw this as due to debt-providers' desire to control their risks; TB8 as a result of increased competition in product markets; UM20 saw this as an inevitable consequence of the decline in deals where simple financial engineering could produce reliable returns.

This measure is an entirely subjective one and should not be taken too seriously. However, no-one argued that the issue was over-rated, or joined Don Valentine of Sequoia in saying that 'I don't even care about the people. Give me a huge market'.[19] By contrast, E16 admitted their previously rebellion against the received wisdom that people are key - but then 'repented' following deteriorating results.

Apart from this general declaration about the importance of management, interviewees provided ample evidence of the costs of getting management assessment wrong. Above all churn in senior management ranks can have direct and indirect effects. Although there are exceptions, many firms will be able to identify with TB1 and UM20's experience that half of all management teams will have been changed by exit. While LM9 and UM16 emphasised that removing non-performers had positive effects eventually, and was often due to changing skill needs in the investees, in the short term they concurred with the views of UM20 and TB11 that CEO removals could delay business plan execution by a year or more, with huge implied lost value. E10 argued that replacing the CEO may mean finding a great replacement and E12 thought that recruitment provided opportunities for networking, but these seem like insufficient compensations for the primary failure. Some costs have been quantified: the costs of executive mis-hires in large American corporations, in direct costs and business disruption etc, have been estimated by CEOs at an average of $4.7 million each for executives in the base salary range of between $100,000-250,000.[20]

Management clearly plays a major part in the 40% of venture-backed deals which provide unsatisfactory returns.[21] Perhaps the most dramatic confirmation is provided in the research by Geoff Smart in the US which tracked individual private equity transactions, assessment accuracy, and the resulting IRRs, the results of which are reported in Figure 2.4. In extreme cases management failure can lead to total write-offs of investments. UM12 note that they sometimes get away with an operational plan that is not quite right, occasional managed alright if their investment turned out not to be as distinctive within the market place as they expected, but never escaped unharmed when an inadequate management team was in place.

The time of investment professionals also has high opportunity costs, especially when UM8, UM9 and E19 estimated that between a third and a half of their time is taken up digesting management changes of various types. Another direct cost of management churn relates to ever increasing financial costs (due to legislation) of removing failed CEOs (E15). There is another risk when some funds have configured themselves as 'management

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[19] Camp JJ, *Venture Capital Due Diligence* (2002), p. 24.

[20] Smart BD, *Topgrading* (1999), p. 50.

[21] Zacharakis AL & Meyer GD, 'A Lack of Insight: Do Venture Capitalists Really Understand Their Own Decision Process?', *Journal of Business Venturing* Vol. 13 (1998), p. 74.

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friendly': too many post-investment CEO removals risk not only 'creative tension' (as LM2 put it) but damage to reputations (LM24). One competitor cited a recent front-page article about Montagu's removal of Linpac's CEO as the kind of publicity no-one could want.[22] LM24 mentioned another possible consequence of insufficient management due diligence – the painfully negotiated split of equity for one deal failed to reflect subsequent relative contributions from senior managers and presumably created a source of frustration within the management team ranks.

Despite this impressive consensus, it is worth considering two nuances. Firstly, the abstraction involved in assigning a simple percentage to such a complex reality makes the results slightly unreal. This has been noted in other studies comparing espoused beliefs of VCs and their actual practices – one found that in practice there was more focus on markets and less on management than stated.[23] UM2 reckoned that placing too much emphasis on management was a way to excuse investors' own deal assessment mistakes. UM16 thought that blaming management allowed the (too easy?) satisfaction of changing the one thing which can be changed swiftly – the faces of management – as opposed to markets and pricing initially analysed and agreed to. UM11 reckoned that in Europe, as opposed to the US, private equity houses tend to give excessive attention to market rather than management issues. A BVCA course, 'What do venture capitalists really do?' (for support staff), in 2002, repeated the 'management, management, management' mantra but then dedicated almost no further time to the topic at all. An explanation for this may be found in the fact that management is often treated as a 'hygienic' issue – i.e. is the management good enough to avoid messing up the investment thesis. Extra contributions of capability to generate additional upside are, in effect, discounted. Despite optimistic comments to the contrary, there is some sympathy for the famous dictum of Warren Buffett that 'When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.' Indeed, several interviewees offered paraphrases of it.

The second nuance is that views about management importance clearly depend on context. The importance of management was seen as relatively lower where investees are larger, asset-backed, cash-generative, and do not require much restructuring (E7, UM17). The need for a first class management team was seen to increase by deal types from MBOs, expansion funding, BIMBOs, MBIs, early stage and culminating in start-ups (LM4). Management quality was perceived overall as having been pushed into second place in the late 1990s and having reappeared more recently.

[22] 'Montagu Dismisses Linpac Chief', *Private Equity News* (08/11/2004), p.1
[23] Zacharakis AL & Meyer GD, 'A Lack of Insight', p. 72; Mason C & Stark M, 'What Do Investors Look for in a Business Plan?' (2004) cited in Cavill J, 'Venture Capitalists and the Assessment of Human Capital' (2004).

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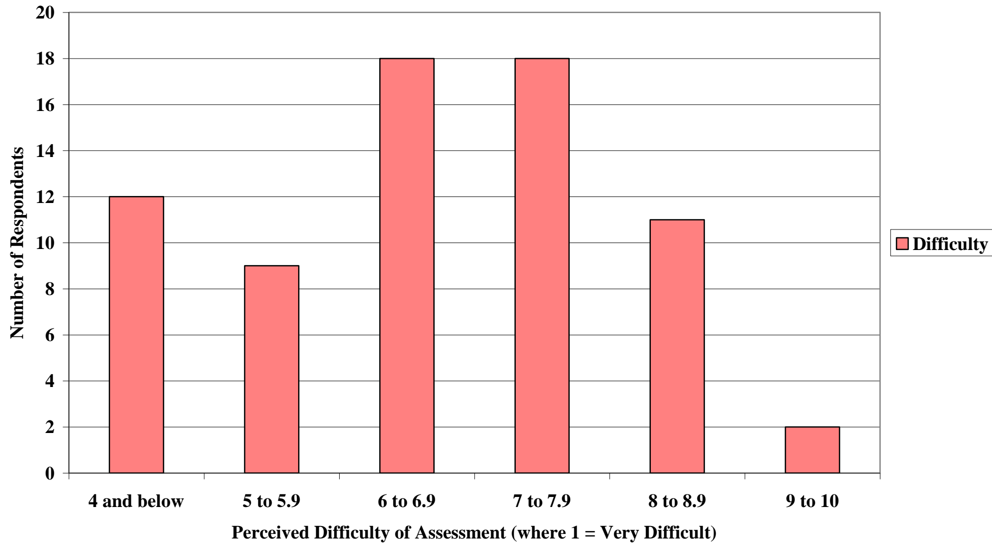
1.2 How Hard Is It To Assess Management?

The second impressionistic question asked was how difficult is the task of reaching an accurate view about management quality, where 1 would be very pessimistic and 10 very confident. On this scale, interviewees were fairly optimistic overall about the nature of the task confronting them, although there was a noticeable minority whose scores fell below 6. Moreover everyone cited reasons why assessing managers is a tricky business.

Figure 1.2: Perceptions of the Difficulty of Assessing Management Quality



Source: Interviews

These ranged from the common-sensical observation that people present inherent complexity which does not yield easily to traditional analysis (e.g. LM4); that metrics are imprecise (UM18); and that no team is ever perfect (E8). Interviewees worried that management assessment was harder than equivalent work on markets or technologies (E10), involved more subjectivity and weaker tools (LM3, E23) and that they were worse advised on this than on other matters (LM19). Consequently, some respondents were resigned to the idea that insight into management quality would only appear post-investment.

Changes in perceived difficulty can occur. On the negative side, several private equity houses (e.g. TB7, UM11, UM3) commented on the difficulties presented by increased numbers of structured auction processes where access to management is limited, at least in the first couple of rounds, presumably to prevent the managers fraternising too much with potential buyers. LM25 were even more downbeat – contrary to their previous belief in their ability to assess managers, they are now convinced that the attempt is futile and they expect that from five key managers in any investment one or two will certainly disappoint.

The single most optimistic fund (E13) was nonetheless worried that, as they expanded beyond their very specific sub-sectoral niche, the task facing them would become more daunting. On the positive side, several interviewees (LM10, LM15, and E20)

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described how the degree of difficulty had fallen significantly over the last several years. In all cases this was attributed to major efforts to improve competence in this area and/or by bringing in specialist help. One fund (E16) felt that the inherent difficulty was about 7 or 8 but that lack of rigour in assessing managers meant that his organisation was actually experiencing 5 or 6. A couple of interviewees (UM14 & LM20) were pleased to feel that the larger deals they had migrated towards made assessments of managers easier, if only because there were clearer track records to base decisions on.

1.3 Why Do Unpleasant Surprises With Management Occur?

In principle, there are two kinds of errors that private equity investors can make when choosing between potential transactions. The most obvious one is to pick deals (and managements) that later prove to be duds. Much less visible is the rejection of potential investments or managers which might have been successful. Since tens, if not hundreds, of proposals are screened for each one taken forward, it would be surprising if there were not errors of this type. Indeed, the normal order of screening – where features of markets and company are used to determine which, say, 10% of management teams are then met – almost guarantees it. This makes the preference of LM11 for ‘better good people in an iffy sector rather than an iffy team in a good sector’ hard to implement, since it is unlikely that management teams from the ‘iffy’ industries will survive screening. LM5 are unusual in remembering deals that have been rejected but which have subsequently prospered.

Interviewees were asked what proportion of decisions when selecting management teams ended up producing unhappy surprises, i.e. managers who performed less well than initially expected. With one or two exceptions where respondents had either carried out recent analysis, or did an immediate calculation by reviewing previous transactions, responses were necessarily impressionistic rather than precise. Standards of expectations or impressions of success may vary by firm, while some individuals are likely to be more self-critical than others. For example, LM16 who thought they had material surprises from 30-50% of management teams, explained this partly by reference to their more demanding standards of performance as part of their efforts to maintain or increase IRRs. UM9 offered a distinction between those management teams where expectations were merely confounded (25-30% of cases) and those where the problems resulting could be considered as serious enough to require serious correction (10%).

Nonetheless, the pattern of responses displayed in Figure 1.3 suggests that despite improvements since the late 1990s, an average of 25% of decisions about management teams produce unpleasant surprises for private equity investors. Moreover, large minorities of firms experience disappointment to a considerably higher degree than this. Only three firms (UM3, UM4 & UM18) claimed that they had experienced no such surprises in the last several years.

It is worth remembering, of course, that a certain degree of surprise is both inevitable and even desirable, in the grand scale of things. High returns involve higher than average risks and many perfectly well-prepared investment theses fail due to reasons beyond anyone’s control.

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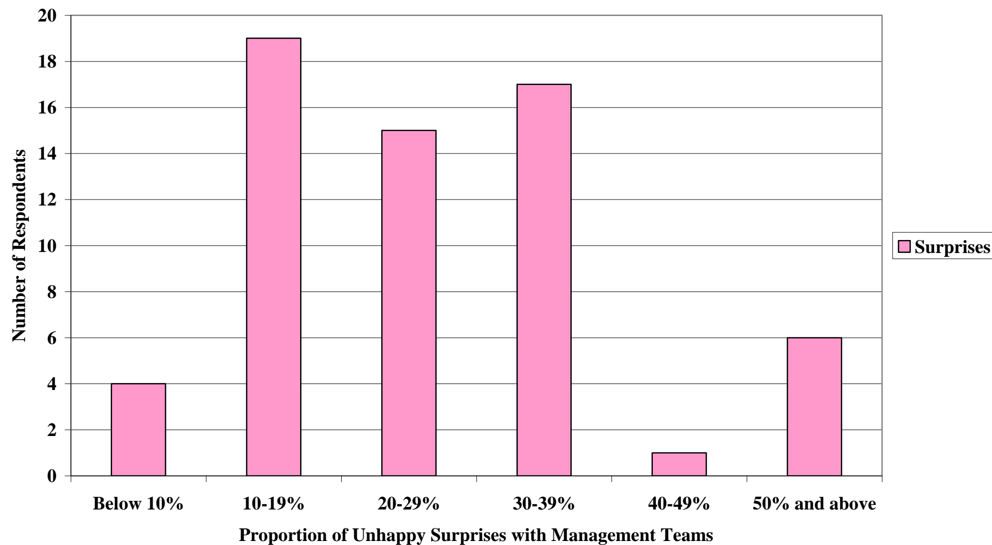
Figure 1.3: Proportion of Unhappy Surprises with Management Teams Post-Investment



Source: Interviews

Furthermore, to put this 24% into context we may note claims that about half of executives hired by corporate America from the external market turn out to be mis-hires.[24] A consultant (C6) to the American private equity world reckons that the proportion of management disappointments amongst firms he has dealt with have averaged 30-40%. Almost 17% of interviewees for Geoff Smart's research on this topic admitted to judgements about management (in identified transactions) that were 'More inaccurate than accurate' and a further 7.7% felt they were 'Very inaccurate'.[25] Using a rigorous system, however, ghSmart & Co claims that its clients (in the US) reduce failure rates below 5%. So whilst private equity firms in the UK apparently do no worse on average than their counterparts in the US, there is almost certainly room for better outcomes for most firms.

Investment professionals within private equity firms are typically bright, well-qualified, and have considerable experience of doing this kind of work. Many firms can show teams with several decades of track record in making successful investments. So it seems reasonable to assume that the reasons for assessment errors are not obvious and easy. Interviewees, and research, point towards certain perennial issues:

Appearances Deceive

Studies over seventy years have repeatedly confirmed the variety of ways in which we can be tricked – and trick ourselves – in interview situations. Training and experience can reduce these effects, but are insidious, especially under pressure. Management teams are, of course, in sales mode when meeting with potential investors and penetrating behind their story can be tricky, especially when they have an agreed line and act like perfect 'buddies'

[24] Smart BD, *Topgrading* (1999), p. 47.
[25] Smart GH, 'Management Assessment Methods', p. 80.

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(E12 & E15). Both LM2 and E9 admit to having been seduced into investments by slick talkers. E23, who previously worked in the US, reckoned the problem was more severe in the US since he found everyone there better polished. The problem reaches the highest levels: Henry Tosi looked at 59 Fortune 500 firms and found that charismatic bosses got higher total pay than their humbler peers, independent of actual firm performance.[26] UM8 mentioned the case of a CEO whose motivation was regarded as excellent because of a great chip on his shoulder and a consequent need to prove himself. However, eighteen months into the investment he decided that this was less important since he asked to become merely a non-executive director. The converse risk is also, of course, that some good candidates may not present well at all - UM5 mentioned a most improbable looking CEO in one East European investment who was, however, a great manager and value creator. UM3 have found that many members of MBO teams provide positive surprises post-investment as they find their wings due to the motivating joy of real ownership.

Courtship Rituals

Managers cannot be interviewed and examined at will. Their confidence and appreciation needs to be earned and, especially in the case of competitive processes, they may be able to effectively disqualify certain private equity firms they do not care for – something noted by both buy-out funds (UM14, UM3 & TB7) and early stage funds who aim to build supportive relationships (E8 & E15). This natural desire to create and maintain a stock of goodwill may lead funds to avoid imposing types of analysis (psychometrics was often mentioned in this regard) that might be seen as irritating. But in other contexts the need to sell as well as interview has been observed to lead to self-limitation on what questions are asked during meetings and to an absence of deep probing on specific competence. Questions, moreover, may tend to the hypothetical and timid rather than designed to explore the candidates handling of actual jobs and situations.[27] The salience of this issue was emphasised by UM3 who felt that market circumstances had moved strongly in favour of management teams, something reflected in the greater financial premium for them too.

The Soft Middle

It is a common observation in personnel selection that both interviews and tests are pretty good in identifying the minorities of candidates who fall into the top and bottom categories. This was commented on by various interviewees: E3 found it easy to get rid of the utter nonsense, LM18 find rating those below the top third difficult. UM17 found that many competent (but not outstanding) managers did not present well. Jon Moulton is famous for claiming to seek ‘bad managers as they are easier to spot’ although, presumably, finding replacements still involves addressing the same issues as less contrarian funds.[28] The real test, therefore, of any assessment methodology is how well it handles the middling cases.

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[26] ‘The Curse of Charisma’, *The Economist* (7/9/2002), p. 76
[27] Khurana R, *Searching for a Corporate Savior’* (2002), p. 176-8.
[28] ‘Profile of Alchemy’, *Real Deals* (19/09/2002), pp. 30-31.

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Overconfidence and Haste

Probably the most thorough research on decision-making by venture capitalists has appeared in a series of articles by Zacharakis and various collaborators, based on observing and recording realistic cases. These have concluded that venture capitalists are almost universally over-confident in their decisions as to whether to reject or pursue investment opportunities, i.e. their hit rate in terms of judgement calls was significantly lower than their expected rate. Counter-intuitively, investors with more information at their disposal were less accurate in their decisions, but also more overconfident.[29]

At the same time, pressures of competition and time may encourage dangerous shortcuts in due diligence. Back in the early to mid-1980s, when private equity grew fast in the US, the extent of due diligence shrank as part of an overall tendency towards deal compression.[30] A more recent analysis of the issue by Bain & Co found that no more than 30% of 250 M&A decision-makers were satisfied that their due diligence delivered the insight needed to make rational decisions.[31] The same accusation of insufficient attention has been made in regard to CEO selection, where 'In many cases, boards, incumbent CEOs, chief human resources officers, and search consultants show less diligence and are more prone to take shortcuts than in the past.'[32]

Ignoring Danger Signals

Slick presenters, a desire to keep management happy, difficulties distinguishing between good and bad extremes, and overconfident haste, can all restrict useful information available to private equity investors. But, as both LM12 and E5 noted, sometimes the problem is more one of using information appropriately and imaginatively than just obtaining it. The Bain study found one third of M&A dealmakers admitting they not walked away from deals where they had had nagging doubts from due diligence.[33] Lots of interviewees mentioned this issue – UM2, TB11 and E5 all mentioned deals where clear negative signals from references had been ignored. E22 mentioned ignoring warnings in a report from selection consultants. This is dangerous because, as UM17, TB3, TB8 and LM6 all said, vague doubts or grey areas almost inevitably turn out to be substantive and black post-investment, with known issues arriving quicker and harder than expected (UM15). A prospective CEO noted that when he was interviewed '...what comes out of the situation is speculation, effectively. I think all involved in the process desperately want to be able to make an appointment. So with the best will in the world, even if a negative comes up, it tends to get minimised and justified away.'[34]

Inevitably, it is much easier to identify these kinds of problems with 20:20 hindsight than it is to prevent them. Sections 3 & 4, though, look at a range of attempts to ameliorate the process.

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[29] Zacharakis AL & Shepherd DA, 'The Nature of Information and Overconfidence on Venture Capitalists' Decision Making', *Journal of Business Venturing* Vol.16 (2001), pp. 311-332.
[30] Bygrave WD & Timmons JA, *Venture Capital at the Crossroads'* (1992), p. 51.
[31] Cullinan G et al, 'When to Walk Away', *Harvard Business Review* (April 2004), p. 98.
[32] Wackerle FW, *The Right CEO* (2001), p. 2.
[33] Cullinan G et al, 'When to Walk Away', *Harvard Business Review* (April 2004), p. 97.
[34] Garnsey E & Roberts J, *Taking Charge: What Makes CEO Succession Work?* (Report by Saxton Bampfylde International, 1996).

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2. A Snapshot of Management Assessment by Private Equity Firms

Table 2.1 displays summary data about the private equity firms whose representatives were interviewed for this report. Background information was compiled from the BVCA directory, firm websites, and other public sources, and was then averaged out. Apart from line 8 (calculated mostly from BVCA data), all the information in the 'Average Deal' and 'Management Assessment' sections was derived from interviews. The points presented are, hopefully, self-explanatory, although many are discussed at more length in the relevant sections of this report. This Section, therefore, will not describe the data provided in the table but rather address three questions:

1. How does the pattern of management assessment compare with practice in related parts of the financial world and other geographies?
2. To what extent can sub-groups of practice be identified by types of fund?
3. Are there relationships between the various aspects of management assessment practice that suggest more, and less, successful approaches?

2.1 How Does British Private Equity Practice Compare?

In the context where a large proportion of this report is devoted to problems for, and errors by, private equity firms in assessing managers, it is worth noting that in comparative terms, practice in Britain is pretty good. Firstly, skill in selection and post-investment activities mean that venture-backed firms in Britain almost certainly repeat the American experience that venture-backed firms outperform those not backed.[35] Secondly, due to the average venture capitalist having had more extensive deal experience than business angels (an average involvement in 23 deals versus just 4), VCs tend to insist on more meetings with entrepreneurs than angels do (9.5 times on average, versus 5.4 times) and take up more independent references (an average of 4.2 versus just 1).[36]

Making comparisons between the UK and US situations is made difficult by the huge size and diversity of the American industry, and the limited data in my hands. Moreover, the different conditions and atmosphere of clusters such as Silicon Valley (where both entrepreneurs and VCs are supposedly better oriented to each others needs and tap the same backgrounds and networks)[37] risk superficiality of treatment. However, as discussed above, overall levels of mistakes in management assessment are broadly similar. One clear difference, as discussed in greater detail, in Section 4.1, is that American private equity firms are much less likely to use psychometric testing than here. Although there are no numbers to back it up, my impression is that, by contrast, structured interviewing has established a stronger presence in the US than in Britain.

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[35] Baum JAC & Silverman BS, 'Picking Winners or Building Them?', *Journal of Business Venturing* Vol. 19 (2004), p. 412.
[36] van Osnabrugge M, *Comparison of Business Angels and Venture Capitalists* (1998), pp. 4 & 8.
[37] Campbell K, *Smarter Ventures* (2003), p. 190.

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One study of American venture capital practice reckoned that only a third of American firms were bringing in outside help for management due diligence. However, this result must be treated with caution because of the very strong representation in the sample of early stage funds who were apparently much less likely than British firms to outsource, for example, even their accounting diligence (just 23% did so).[38]

The same study found that the private equity professionals involved in assessing managers had quite different backgrounds between the US and Europe – the Americans were more likely to have started as investment bankers and then spent relatively more time in private equity as opposed to professionals in French and German funds where backgrounds were more varied and tenure within the industry was typically lower.[39]

American firms claimed greater satisfaction with their management due diligence practices and outcomes than French and German organisations, and the proportion of disappointing deals was also lower (25% US vs. 40% European). Nonetheless, by far the biggest reason given for US deal failures was still management.[40]

A study sponsored by SJ Berwin, covering France, Germany and Spain as well as the UK, is generally flattering to British practice. On a whole variety of dimensions – including total hours spent on management assessment, willingness to bring in outside expertise and openness to novel selection tools - the study found UK practice more sophisticated than that on the continent.[41]

[38] Unpublished Diligencia Ltd. Report (2002), p. 50.
[39] Unpublished Diligencia Ltd. Report (2002), p. 68.
[40] Unpublished Diligencia Ltd. Report (2002), pp. 80, 87-8, 90.
[41] SJ Berwin, *The Human Capital Equation* (2003), p. 13, 20.

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	Table 1 – Summary Results for all Firms	
	BACKGROUND INFORMATION	**All firms**
1	Number of private equity firms included in analysis	78
2	Average founding date of private equity company	1987
3	% of firms with generalist industry approach	69.2%
4	Average number of investment professionals	14.7
5	Average total funds invested to date by firm	£641 mn.
6	Average deals completed/year	5.9
7	Average size of current portfolio	34
	AVERAGE DEAL CHARACTERISTICS	
8	Average target deal size (equity at cost)	£32.3 mn.
9	Proportion of business proposals seen that are eventually done deals	2.13%
10	Average time in months that a deal takes to process to closing	5.14
11	Estimated man months taken to process a deal to closing	6.19
12	Estimated average cost of formal due diligence	£803,000
	MANAGEMENT ASSESSMENT FEATURES	
13	Importance of management quality as % of all influences on deal outcomes	58%
14	Score between 1 & 10 (1 is v. hard) for the difficulty of accurately assessing management quality	6.22
15	Estimated proportion of judgement calls on management that prove to be materially incorrect	25%
16	% of respondents who do not specifiy the qualities/competencies needed in management teams	60.2%
17	% of respondents who have a mental checklist of qualities sought in in management teams	27.0%
18	% of respondents who have a formal system of qualities sought in in management teams	12.8%
19	Average time spent in investee committee discussing management quality issues	22%
20	Average no. of firm staff who will have met management before a deal reaches final approval stage	4.28
21	% of firms using psychometric tests at least sometimes	41.0%
22	of which % using frequently or always	15.4%
23	% of firms using outside consultants for management assessment at least sometimes	61.5%
24	of which % using frequently or always	24.3%
25	Average number of references collected on a CEO by the time a deal reaches final approval stage	7.63
26	% of firms who outsource referencing at least sometimes	62.8%
27	of which % using frequently or always	33.0%
28	Average ratio of portfolio companies to investment staff	2.7
29	Proportion of firms employing specialised portfolio managers	21%

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	Table 2 – Summary Results by Type of Private Equity Firm		Upper	Lower	
	BACKGROUND INFORMATION	**Top-Bracket**	**Mid-Market**		**Early stage**
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%

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2.2 Assessment Approaches by Type of Fund

Table 2.2 confirms what most readers would intuitively guess: not only background characteristics but also features of handling management assessment vary considerably depending on the nature/size of the deals being pursued. So prominent are these size effects that trying to disentangle them from other causes when we consider the effects of assessment techniques is troublesome without unleashing a full statistical repertoire.

What emerges from these figures, and from interviewee comments, are some stereotypes. At one end of the spectrum are large, generalist buy-out funds (TB and UM), many of them American in origin, who are in intense competition for a relatively small number of good deals. They spend large amounts on due diligence but relatively little up-front on external assessment expertise (although some funds have moved this post-investment – see section 5.2f), partly because incumbent management quality may be less critical for them. More people within the firm are involved in each deal and more external sources of references are tapped than by other types of funds. The proportion of surprises is below average, albeit that making judgement calls should be easier with such mature businesses. At the other end of the spectrum are specialist early stage firms (E) whose numbers were thinned after the 1990s boom and where competition for deals is less marked. Such funds rely on sifting between many plans, making use of their specialised industry networks to source deals and get recommendations, and execute relatively large numbers of deals. They are the least likely to bring in outside consultants for assessment or referencing but when they do, they are the most consistent users of psychometric testing. Curiously, early stage funds attach the highest importance to management quality, typically have less management to actually assess, but are most confident in their ability to do so. They have the highest rate of disappointments with management, although there is some inevitability to this. In between these two extremes are lower mid-market funds (LM) which are typically older as firms, and with larger average teams. They are the most inclined to make use of assessment checklists, psychometrics, and outside referencing firms at least sometimes, although often such use is intermittent.

2.3 Associations, Correlations and Causes

The relatively informal nature of the data gathered for this study, together with a limited (by statistical standards) sample of private equity firms means that the resulting information is not appropriate for sophisticated analysis. At the same time, as is often the case with studies about human decision-making, the number of possible causes is high whilst the benchmark of performance (criterion) is a bit vague. This means that whilst I have cut and diced the information in various ways, the robustness of any correlations, and the direction of any causality, is limited. A multiple regression analysis produced nothing that met normal tests of statistical significance. There are, however, some suggestive pointers and it is hoped that, in due course, a more quantitative follow-up to this report can be performed together with the pioneers in such research in the UK at the Centre for Management Buy-Out Research in Nottingham.

In thinking what might explain differences between private equity firms relative success in choosing management teams who meet their expectations, I thought that the following might be relevant: (i) age, cumulated deal experience and yearly deal-flow of the firms; (ii) ownership,

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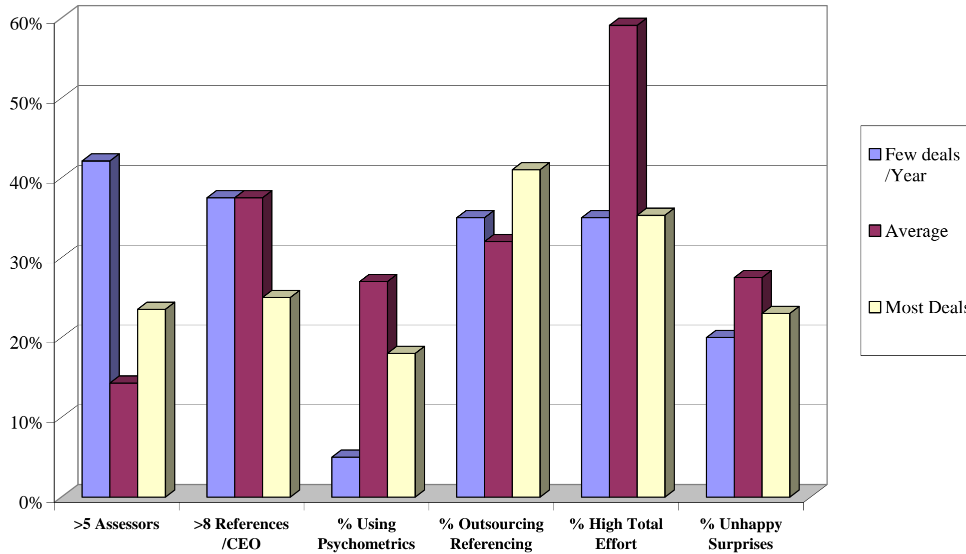
i.e. British or American-owned; (iii) size of investment team; (iv) importance attached to management quality as an issue; (v) generalist or sector-focused orientation; (vi) overall effort put into management assessment.

In fact, many of these proved to have limited explanatory power, especially when the influence of fund type was stripped out of the equation. The most suggestive relationships are presented in the tables below:

Figure 2.1: Usage of Various Assessment Parameters by Typical Annual Transactions Numbers



Source: Interviews

Those firms doing the greatest number of deals in a year had a relatively low propensity to involve many staff members in each transaction but often outsourced parts of their referencing task to consultants. Apart from that help, however, they were less likely to use psychometric testing but have the fewest surprises from management.

Since many of the individual parameters did not seem to explain relative success, I created a synthetic measure of overall effort in management assessment, including internal manpower, external expertise, depth of referencing, and use of scorecards. This overall measure appeared to correlate with the level of surprises that a fund experienced – i.e. the more effort, the fewer errors experienced, although the correlation was not statistically significant.

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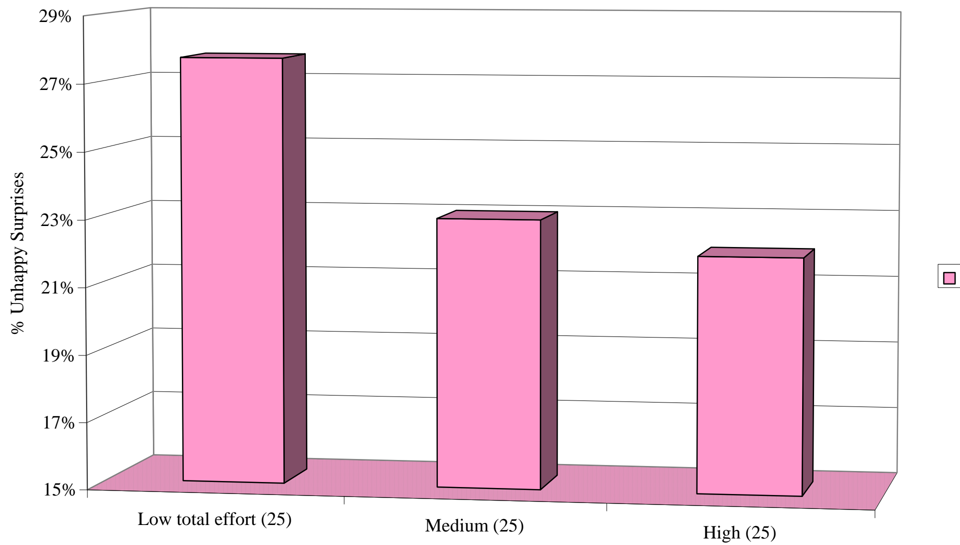
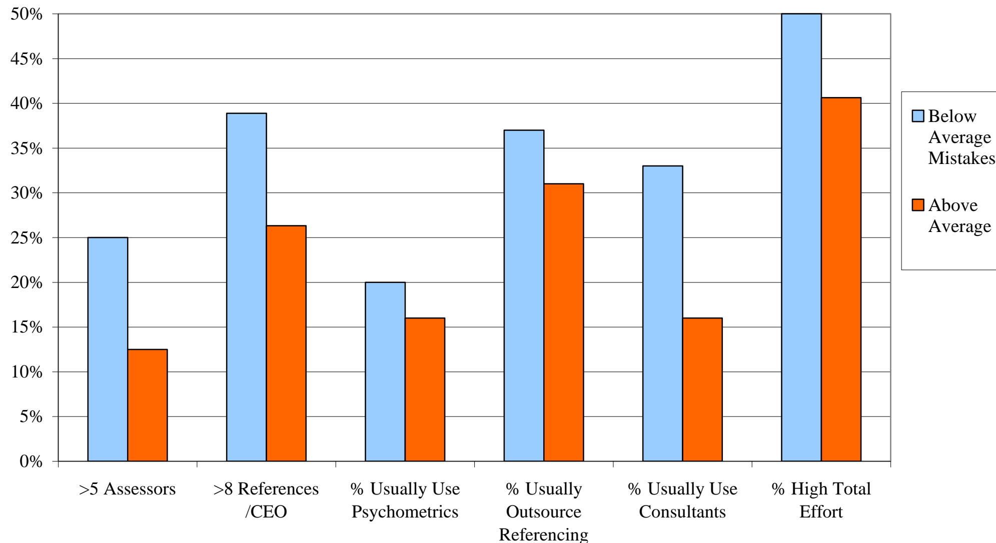
Figure 2.2 Overall Assessment Effort and Proportion of Unhappy Surprises



Source: Interviews

The other way of exploring this issue was to divide firms into those reporting above and below average error rates and then see whether any practices divided them. Figure 2.3 presents this data. It implies that lower error rates are related to involving more team members in management assessment, making frequent use of consultants, taking up more references on managers (and perhaps outsourcing them) and putting in more overall effort.

Figure 2.3: Assessment Practices Associated with Above and Below Average Levels of Surprises.



Source: Interviews

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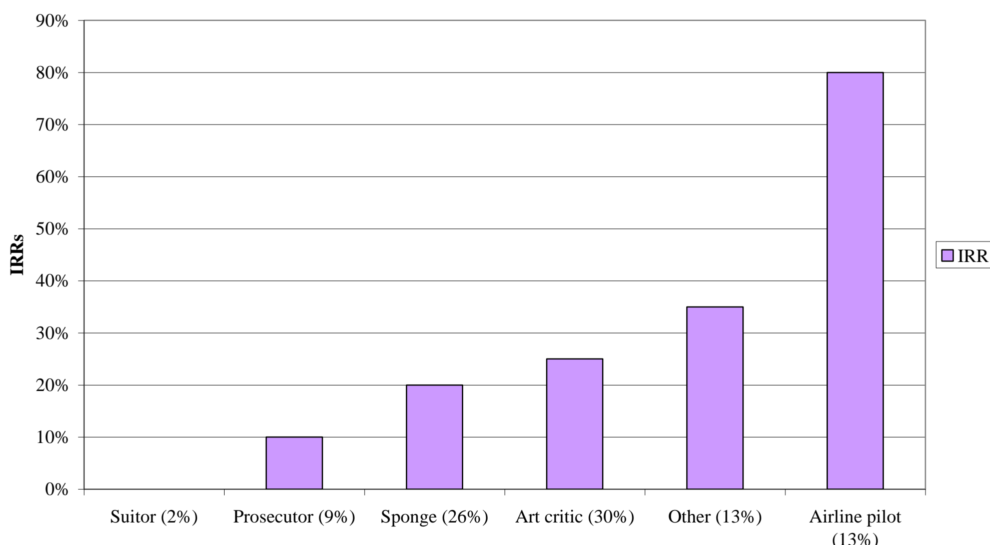
Given the limited time for interviewing, this report did not attempt to gather data on deal or portfolio IRRs. However, Geoff Smart's 1998 study did gather IRR figures for individual deals and related this to assessment practices of firms. His way of doing so was to group firms' practices into typologies based on: belief in the possibility of assessment accuracy; overall quantities of data collected; use of multiple methods; degree of systematic data analysis.[42] He then labelled these typologies. For example, the 'airline pilot' style involved plentiful data collection, focused onto key methods, including in-depth interviewing and a scorecard. 'Art critics' tried to reach holistic judgements with much less analysis and effort but depending on overall experience. 'Sponges' invested plenty of time but were relatively unfocused.[43] 'Suitors' focused mostly on persuading management rather than analysing them. 'Terminators' (not shown here) made little effort at assessment and expected to remove management post-investment.[44] Figure 2.4 shows how deals carried out within these various styles have quite divergent IRRs attached, and constitutes the strongest reason to take management assessment seriously.

Figure 2.4: Assessment Style and Transaction IRRs



Source: Smart GH, *The Art and Science of Human Capital Valuation* (1998), p. 14.

Smart also distinguished between those firms demonstrating relatively high levels of accuracy in assessment outcomes and their less accurate colleagues. This showed that the overall time allocated to management due diligence by the more accurate firms (140 hours average) was significantly higher than for the others (81 hours).[45] Since best practices were used less frequently by investors than worse ones, there is presumably scope to create comparative advantage by adopting the more proven techniques.

[42] Smart GH, 'Management Assessment Methods', pp. 127-8.
[43] Smart GH, *The Art and Science of Human Capital Valuation* (1998), p. 14.
[44] Smart GH, 'Management Assessment Methods', pp. 127-148.
[45] Smart GH, 'Management Assessment Methods', p. 102.

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3. Mars versus Venus? Theory versus Practice?

The Sections above have shown that: 1. management quality is indeed important to the financial success of private equity transactions; 2. levels of unhappy surprises are significant and can likely be reduced, with obvious bottom line benefits. However, before launching into a discussion of tools, techniques and solutions in Sections 4 and 5, certain more basic issues need to be addressed first. Those issues underlie the bemusement of many consultants in this area when faced by resistance to solutions which they believe offer clear benefits at low costs. They also underlie the slight irritation of some private equity investors at having their expertise and experience implicitly placed in doubt by often unproven methodologies which may also antagonise potential investees.

This Section explores these issues by considering three questions. Firstly, whether experience and skill-based decision-making (i.e. based on 'gut feeling') is incompatible with the rigorous assessment of management teams. Secondly, how open should investors be to delegating parts of the assessment process to specialists inside or outside? Lastly, whether systematic selection tools represent part of an overall 'best practice' that private equity firms should move towards.

3.1 Is 'Gut Feeling' Incompatible With Systematic Assessment?

Like other parts of the private equity decision-making process, the assessment of management teams involves the projection into the future of past and present behaviour. Unlike, say, financial performance, present attributes may not be obvious. For example, in one survey of what British private equity investors look for in management teams, only one characteristic ('articulate in discussing venture') is directly observable. The other three ('capable of sustained effort', 'able to evaluate risk and react to risk well' and 'attend to detail') all depend on significant inference.[46] It is in making those inferences that rules of thumb (e.g. UM7: 'We find that management teams that impress us are also good'; LM5 'The model by which a firm is paid by its customers shows how mature the team are as managers') and 'gut feeling' come into discussion. Although rules of thumb are more explicit, and therefore more open to validation, they share an important feature with gut feeling: both involve using environmental cues (ranging from formal documents to body language), then seeing how rules based on previous experience indicate the likely probabilities of favourable or unfavourable outcomes. In this, gut feeling, especially, operates in a similar manner to the formation of emotional responses. It allows quick and probabilistic based reactions to complex information.

This approach is powerful partly because it accesses quantities and types of knowledge that are often hard to articulate and exceed anyone's capacity to hold them in conscious focus. When investment teams like that at LM5 have more than a hundred years of collective experience dealing with entrepreneurial firms, how could all the insights be captured formally? Research on this 'tacit' knowledge has produced intriguing conclusions suggesting that it may predict performance unrelated to that produced by general intelligence or specific job knowledge.[47] The

[46] *CMBOR Quarterly Review* (Autumn 1994) p. 17.
[47] Sternberg RJ et al, *Practical Intelligence in Everyday Life* (2000).

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pioneering management theorist Chester Barnard once described, in a positive tone, senior decision-makers who 'know how to do well what they do not know how to describe or explain'.[48] The capacity to tap such gut feeling is an important part of investors' repertoire. UM1 reckons that one cannot do this kind of deals without some gut instinct, while TB4 reckons his firm's informal process of assessing strengths and weaknesses is more powerful than any formal process.

The comparison with formal process is important because the differences between formality and informality are often exaggerated. Some texts on human resource issues convey an impression that individual judgement based on face-to-face interaction is an embarrassing throwback to pre-modern times, fit only for replacement by paper-based procedures. Within private equity such a view tends to excite derision, not least because the industry took off from the 1980s onwards partly in response to the manifold failures of large centralised corporate bureaucracies. Many investment professionals were themselves attracted to private equity by the opportunity to leave behind such bureaucracies in favour of a more entrepreneurial environment. Apart from being time-consuming, many 'best practice' procedures are not focused primarily on final results and some, by their rigidity, are easily bypassed. E8, for example, rejects procedures that are too predictable since bright interviewees are motivated to find ways of fooling the assessment process. Moreover, there is evidence that forcing VC investors to ignore their instinctual approaches not only reduces confidence in their decisions (possibly a good thing) but can also reduce overall accuracy (definitely undesirable!).[49]

Problems of Gut Feeling

Accepting an important function for gut feeling, however, is not to deny the problems of over-reliance on it. E12, whose highly energetic, but unsystematic, approach involves meeting with one to two hundred management teams per year, claims it is rare that they are surprised by managerial performance post-investment. Nonetheless, six of the last eight transactions have involved changes of CEO for reasons of under-performance. Although this is an extreme case, it echoes the warning of David Gladstone in 1988, when president of the largest public venture capital firm in the United States, "The problem with the venture capital business is that when we analyze people, our perceptions of others are usually wrong."[50] He attributes this to judgements about entrepreneurs that are often 'vague and unverifiable' and which are reached by premature cessation of proper consideration.[51] Curiously, some of the most diligent funds in their overall deal process (e.g. UM15) can be rather quick in deciding whether the managers should be graded as A, A-, B+ etc.

Gladstone's assertion is backed up by research. In carefully structured tests of the 'hit rate' for VCs screening business plans it was found that decision-makers could markedly improve their accuracy when (a) criteria were made more explicit and (b) those criteria were scored actuarially (i.e. by a computer model) rather than by eye.[52] Either step could add value separately,

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[48] Barnard C, *Organisation and Management* (1948).
[49] Zacharakis AL & Shepherd DA, 'The Nature of Information and Overconfidence on Venture Capitalists' Decision Making', *Journal of Business Venturing* Vol. 16 (2001), pp. 311-332.
[50] Smart GH, 'Management Assessment Methods', p. 37.
[51] Gladstone D & Gladstone L, Venture Capital Investing (2004), pp. 40-1.
[52] Mainprize B et al, 'Caprice versus Standardization in Venture Capital Decision-Making', *Journal of Private Equity* Vol. 7, No.1 (Winter 2003) pp. 15-25.

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but both together were even more effective. This finding is partly due to variations between the criteria that VCs believe they are using and those that, in practice, are applied (typically fewer items and with simple weightings). But no less relevant is the fact that, as quantities and dimensions of information grow, intuitive decision-making becomes increasingly unreliable.[53] In this situation, the approach of LM12 in judging management 'the whole time', if taken too far, can lead to increasing problems in integrating too many scraps of impression.

More generally, the limitations of gut feel for making judgements are that:

(a) Past experiences against which managers are judged tend to be unclear and incomplete;

(b) Impressions of managers during discussions are likely to be distorted by inter-personal chemistry and other recent but potentially irrelevant information, so that confusions occur between personality, confidence and capability;

(c) Insufficient attention is given to the causes and context of past successes or failures;

(d) It can fail to provide insights exactly in the borderline cases where, as discussed above, most people struggle to reach appropriate conclusions.

(e) In the situation where investors do not wish to antagonise managers, probing of potential weaknesses (i.e. some of the most critical information) is half-hearted and indirect.

The solution of chasing specific perceived issues through various iterations, which interviewees such as E1 and UM11 mentioned, is generally useful but because it focuses on urgent and salient matters, it can leave many potentially risky areas unexplored and, anyway, can be constrained within auction processes.

Ironically, the lack of a clearly defined role for gut feeling can create hesitations in the minds of decision-makers about accepting potential useful warning signals – Section 1.3 mentioned that many funds complained that ignored alarm signals, both formal and informal, had led to bad investments.

Integrating Gut Feelings

As argued above, gut feeling is not a form of mystical revelation but rather a specific mental process that offers particular advantages within definite constraints. As such, taking its benefits without excessive disadvantages involves:

(a) Creating opportunities for the kind of informal and unscripted interactions which provide rich material for forming impressions - LM8 mentioned sitting in on board meetings but many others (TB3, E12, LM20, LM2, E15) recommended dinner and plenty of wine. In Geoff Smart's study he found that investors with better than average accuracy in their management judgements made greater use of such informal occasions; [54]

[53] Zacharakis AL & Meyer GD, 'A Lack of Insight', *Journal of Business Venturing*, Vol. 13 (1998), pp. 72-74.
[54] Smart GH, 'Management Assessment Methods', p. 102.

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(b) Treating plausible syntheses of managers' attributes with caution until someone has played devil's advocate and tested an opposite interpretation;

(c) Without dismissing the possibilities of obtaining interesting insights at any time during deal assessment, dedicating specific time to talk with management about their track records and bringing the various forms of evidence together subsequently.

(d) Avoid information overload by using at least some specialisation – whether using internal or external people – in focusing on management issues.

(e) Take gut feelings, especially warning signals/discomfort, seriously and then follow them up with proactive investigation to see whether they are genuine insights or misperceptions.

(f) Actively feed and hone gut feelings by making note of cases where intuitions proved right or wrong (something E17 is keen on).

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3.2 Who Should Make, and Who Should Influence, Assessment Decisions?

A number of interviewees (e.g. LM6) stated their belief that not only was management assessment important but that this task constituted a core competence of any private equity firm. UM5 saw its difficulty as a barrier to entry into the industry. E23 felt that whereas deal structuring could ultimately be taught to monkeys, as a fund manager he was paid for reviewing management. E9 reported that the board of their venture capital trust had slapped them down when there were thoughts of outsourcing parts of this process. Nonetheless, around 60% of those interviewed for this report reported that outside consultants are used at least sometimes in assessing managers (24% frequently). A previous study, presumably using a slightly different definition, found that more than 80% of funds used consultants at least sometimes, with 17% doing so for all deals.[55] This implies that most firms see the use of outside resources as a pragmatic decision based on specific circumstances. This marks a big change compared, say, with the situation twenty years ago when UM12 remembers that it was considered a sign of lack of judgement to rely on others for sizing up management.

What remains core, as LM11 urged, is the decision – based potentially on both internal and outside work – to sign-off on the management team as part of the overall deal go/no go decision, as well as deciding what legal and financial structures/incentives to build around management. LM7, who had had some unhappy experiences using consultants, felt that a risk of outsourcing assessment work was that the investment team were then tempted to forget their own judgement. This situation is not unique to management assessment, of course: with legal and accounting work there is usually considerable internal expertise but this is used not to handle all details directly but to examine, and draw conclusions from, the work of specialists bought in. The question, then, is what criteria should determine whether deal-doers should act alone or pass part of the process either to internal experts or outside consultants.

To maximise the chances that assessment of management is done thoroughly by those involved, three aspects are relevant. Firstly, whether the person understands the business context of the decision being made both in general terms but also as related to that specific transaction. Secondly, whether they have enough at stake to real devote sufficient time to getting the assessment right. Thirdly, how much expertise is brought to the task of going through all the various tasks involved in reaching a robust view on managers.

Deal-makers know most about deals in general and current transactions in particular. Details of the specific situation can, in principle, be passed to other people through briefing and/or by passing relevant documentation across. However, a number of interviewees made it clear that they were sceptical about the ability of human resources specialists – whether internal or external – to really add value. LM20, with apparent approval, noted that the first thing many of his investees did was to sack the whole HR department. Apart from their own experience there is considerable evidence from large corporations supporting this scepticism. A dirty secret is that brighter managers have typically steered clear of personnel work because of the lack of status, creating a vicious cycle as the area has suffered from its own lack of talent.[56] Line managers have

[55] SJ Berwin, *The Human Capital Equation* (2003), pp. 13-20.
[56] Herman S, ‘The Personnel Field’, *Personnel Management*, No.365 (1963), p. 111; Harness T, 'From Markets to Manpower: An Investigation into Market Characteristics, Business Strategies and Human Resource Strategies' (University of Huddersfield Ph.D. thesis, 1998), p. 14.

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suspected HR people of an obsession with administrative procedure and 'best practice', and 'too ready a tendency to snatch up bits and pieces of technique without first considering basic principles'.[57] By contrast, many senior HR people (more than a quarter in one survey in the US) have seen little relationship between their activities and the priorities of the firm.[58] This is partly attributable to professional introversion – in one review of thirty years of personnel selection research there was no mention of economic effects at all.[59] For good reasons and bad, HR executives have tended to play a relatively minor role in the selection of other executives.[60] Perhaps for this reason the influential, if hyped, rallying call of *The War for Talent* literature which erupted in the 1990s was addressed primarily to executives rather than toward the traditional HR audience, and an executive talent 'mind-set' rather than HR processes were emphasised.[61]

Financially and career-wise, deal-makers have the clearest incentive to make accurate management assessments. As LM23 put it: 'we write the cheques unlike the advisers'. Nonetheless, with both the best knowledge of the deal, as well as strong motivation, we have seen that deal-makers may still end up with management surprises in more than a quarter of the deals they work on. This suggests that either management assessment is given a lower priority than other matters due to time constraints and/or that focused expertise is insufficient to the task. These two factors explain the main impetus for bringing in outside expertise. Put more positively, the reasons for bringing in outside resources will be higher when:

(a) Insufficient time is available within the private equity house to do justice to the management assessment issue. The evidence provided above (see Figure 2.2) that those firms who put in more effort have significantly fewer surprises, as well as the evident fact that most interviewees saw room for improvement in their performance, suggests that more resources – whether internal or external - are required. Additional resources may be useful not so much to substitute for internal ones but to add depth to the process.

(b) The deal process does not easily allow time to be focused sufficiently into a consistent analysis of management. A multitude of information fragments gathered at different times are no substitute for what a dedicated investigator – whether internal or external – should be able to put together.

(c) The internal people available have limited experience or knowledge of systematic assessment/selection. Most professionals, especially with some years of business experience, can do a good general interview although E4 notes that within the firm some people obviously have a better knack for assessing technology or markets than people. However, in-depth analytical interviewing, at the standard required to reduce avoidable mistakes to 5% or less, is a specialised activity requiring knowledge and skill. LM9 may argue that reading people is the sign of a good VC and that life experience increases likely expertise in this area, but it is risky to assume that the best and most experienced people are always available and working at their peak. C5, for example, notes that in many cases the management due diligence part of the deal process is delegated to quite junior people who may bring more self-confidence than deep managerial

[57] Green K, 'Offensive Thinking', *People Management* (22/04/1999), p. 27.
[58] Pfeffer J, *The Human Equation* (1998), p. 140.
[59] Monahan and Muchinsky (1983), in Duncan D, *The Economics of Selection* (1985), p. 4.
[60] Wackerle FW, *The Right CEO* (2001), p. 14; Khurana R, *Searching for a Corporate Savior'* (2002), p. 124.
[61] Michaels E et al, *The War for Talent* (2001).

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insight to the task. An outsider may bring a different set of business experiences and contexts to the assessment process.[62]

(d) Co-investors or debt providers need comfort before proceeding.

(e) There are issues to be probed where sensitive questions would better be put by consultants rather than deal team members.

(f) The nature of the deal involves higher than usual risk – MBIs, highly leveraged MBOs etc.

(g) When general management and 'soft' personality issues are key factors as opposed to, say, technical competence.

(h) Where information on the management team is limited – i.e. no-one reliable has introduced the deal with a strong recommendation.

In about 10% of the firms interviewed (especially in buy-out funds apparently – e.g. UM17, TB10, UM13), responsibility for management assessment was partially or totally placed in the hands of a specialised person whether that be called 'human capital partner', 'quality control partner' or something else. One such person, an ex-deal-maker from the firm, enjoys the role but worries that too much insularity from leading edge expertise may be harmful. C4 adds that such a person may be accused of a lack of objectivity, being an insider, especially when banks are demanding some evidence that management has been assessed adequately. In some cases, specialised portfolio managers, whose job is focused post-investment, have a role in management assessment too. Where firms have operating partners working alongside the investment team (UM3 talks of being 'religious' in their use and UM16 sees them as the core of their strategy), they are often used as a robust asset for assessing management (e.g. by UM8). In one case (UM14), non-executive chairmen, appointed by the investors relatively early during the deal assessment process, are given the job of deciding whether or not to make use of outside consultants.

A research project in 2003, involving thirteen British private equity firms, looked at the issue of due diligence and found that consultancy services on management assessment were often rated poorly (along with financial due diligence).[63] A similar conclusion was reached in a US study of the US private equity market.[64] The wrong conclusion to draw from this would be that external input is a waste of time. Instead, both investors and consultants need to educate each other about what is needed to produce real value in this area.

One reason for being cautious of mere impression is illustrated by the same study. Firms who sometimes outsourced their management due diligence were less *satisfied* about the costs, nature and practicality of their process and outcomes than firms who kept all diligence work in-house. However, those firms who did sometimes outsource reported that they had lower disappointments from their deals and more stars. In addition, those firms keeping diligence in-house were more likely to feel that their deal outcomes would benefit from improvement

[62] Lisle C, 'Outsource a Core Competency?', *Journal of Private Equity*, Vol. 7, No.1 (Winter 2003) pp. 72-75.
[63] Press release on Burlington website dated 12/02/2004
[64] Unpublished Diligencia Ltd. Report (2002), p. 55.

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diligence activities.[65] The small sample size does not allow strong conclusions to be drawn and we can only wonder what produced this intriguing result. However, my own educated guess is that this is a symptom of an immature consulting market where expectations of value-added are unclear and where data on results is essentially non-existent.

This is still an emerging activity - C2 sees it as at the same stage as financial due diligence twenty to twenty-five years ago - and funds should be pushing potential or actual consultants to:

(a) Deploy tools that are, and can be proven to be, consistent and accurate in their results. This does not mean perfect. E8 was not alone in remembering a transaction that had gone sour but where fees had been paid for a management audit. However, they also remembered another transaction where a large hole was discovered in the balance sheet despite £100,000 of investment into accounting due diligence. Advisers must be convincing, however, that such mistakes are rare. One study of the American scene found that venture capitalists were reluctant to consider outside help because they did not want to 'outsource gut feeling' – any consultants they had talked to had presumably not been persuasive in showing the contribution of an alternative systematic approach.[66]

(b) Make sure that consultants are given every opportunity to understand the investment thesis and the specific demands being placed upon the management team being considered;

(c) Use individuals whose business background and knowledge are sufficient to do a good job without consuming too much investor time and also to have sufficient stature (as C2 put it) to be taken seriously by the management team. LM20 was also clear that the kind of executives they dealt with would not appreciate being cross-examined by juniors. It is already bad enough that the due diligence process is like having 'mother-in-law stay with you for three months'.[67]

Compared with other types of due diligence, management assessment is relatively cheap. Those funds (there were two) who expressed concerns about costs are focusing on the wrong part of the value-for-money equation. Encouragingly, some private equity houses seem to agree: LM8, who had never really had a satisfactory experience with consultants, was nonetheless prepared to spend more money if he knew he would get good value in return. LM3 expect to have some stumbles on its path to improved accuracy and accepts the risk that it may even over-spend before it finds value for money. That begs the question asked by LM19 – how can we assess whether consultants are doing a decent job and adding value? Like many offerings of expert knowledge, direct and timely measurement is always problematic. Nonetheless, there are at least four routes of discovering the likely value obtained from management assessment services:

(a) Does the offering itself demonstrate its relationship to existing research results showing good predictive validity? Are the framework and process proposed intelligible and does it reflect appropriate understanding of business realities? Do examples of scorecards and reports shown provide the kind of analysis and guidance sought?

(b) Does the methodology proposed come accompanied by verifiable examples of success in other organisations. How representative are those successes? The good news is that most of the stories I heard from firms who had decided to reinvigorate their performance in this area (e.g. UM6, LM10, LM15, E20) were linked to consulting interventions.

[65] Unpublished Diligencia Ltd. Report (2002), pp. 85, 91.
[66] Unpublished Diligencia Ltd. Report (2002), p. 51.
[67] Temple P, *Private Equity: Examining the New Conglomerates of European Business* (1999), p. 35.

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(c) What is the value-added? During the consulting assignment, are issues raised by the investment team clarified and articulated (LM5 and E13 both saw this as key contributions)? Apart from the report itself, do the consultants push the investment team's thinking both as regards the current job but also in a longer term perspective (which E6 appreciated)? Do they, as TB1 felt, give input on a set of skills (personal, leadership) that is complementary to the more operational and market knowledge that the fund can assess itself? Is there a good mix of increased certainty on known issues and totally new insight (LM13)? Do the consultants provide concrete recommendations as well as general analysis? E22 thought that some work done for them had been too equivocal in providing guidance, whereas LM13 and UM11 both mentioned cases where advisers had added value by proposing the type of director to be added to the company. One acid test is whether the insight provided is sufficient, at least sometimes, to persuade investors to change their intentions about a transaction. LM21 cited cases where referencing, for example, led to deals being killed. UM8 cited deals within memory where one was aborted just before completion and four involved giving up exclusivity due to information learned during management due diligence. While C4 could cite three instances in the last year where his advice was a similar catalyst, he could also point to a case where an investment team was persuaded to proceed despite a temptation to abort. C11 reckons that whilst they frequently find that management is of low quality operationally, and their work focuses on identifying potential risk factors for investors and banks, in practice their work is constructive since in most cases firms can be pushed up a notch or two given early identification of problems.

A nice example of an adviser's potential value-added comes from the US. C7 had a fund client faced with a strong CEO who wished to put a friend into the job of COO. They were cautious about confronting the CEO on this. But the adviser, who confirmed suspicions that the proposed COO would have been overwhelmed by the role, identified strengths pointing towards a less grand, but nonetheless real, role in a different part of the organisation, and persuaded the friend to support the recommendation. E13 mentioned that they saw an increased role for consultants in exactly this direction.

(d) Six months after the deal is done, what do results say about the accuracy of the original assessment. LM2 was rare in having looked back at two-year-old deals, and was pleased to find that many consultant comments had been prescient.

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3.3 Can Best Practice Be Identified? The Role of Scorecarding

A number of interviewees asked whether this report would offer a recommendation of 'best practice' in doing management assessment. As I understand the concept of best practice – an approach that can be recommended to most funds for most situations with high levels of confidence – I do not think any such thing can be offered. Fund needs vary too widely, assessment solutions tend to be contingent on the specific investment situations, and evidence about the success of particular techniques for this market is still limited. Section 4.5 does offer what I believe is currently the most powerful and coherent combination of tools but I would not pretend that this is suitable for everyone reading this. The real questions to ask, however, are: (i) do we know what we are looking for in this specific investment situation?; (ii) do we have the right assessment tools in place to find out what we need to know?

In this context, however, the one approach that can be regarded as a best practice - i.e. that is relevant for most funds in most transactions with a high degree of confidence – is scorecarding. By this I mean identifying the specific management needs to meet particular investment theses and then using the resulting scorecard to guide subsequent assessment activities during deal preparation and post-investment. Since many interviewees do not use such an approach, and indeed are active sceptics, it is worth dwelling on this a bit.

Scorecarding: Foundation or Preconception?

Interviews revealed that about sixty percent of firms made no attempt at all to identify in the early stages of a potential transaction (after, say, a first meeting with management) the expectations of, and requirements for, management to deliver the business plan proposed.

Most of the remaining interviewees went through some kind of process within the privacy of their own minds but did not produce a written checklist. Just 10% had formalised this in any way. To place this in context, anything up to three-quarters of large corporates in the UK use written criteria for graduate recruitment, which implies a lower level of risk than private equity investments.[68] That this is not just a fad is suggested by high checklist use thirty years ago.[69] In Geoff Smart's study, more than 20% of American private equity firms had formalised their criteria in some way, while 54% at least had unwritten criteria. Just 25% made no attempt.[70] The limited costs in terms of time and money, compared with the multiple benefits from creating a simple scorecard, makes this finding the most surprising from the study overall.

Comments from interviewees suggest that there are four main reasons why private equity firms may currently hesitate before swallowing the medicine of scorecarding:

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[68] IRS, 'Survey of Recruitment Practice' (1999), p. 20; IRS 'The Business of Selection' (1999), p. 20.
[69] BIM, *Selecting Managers* (1971), p. 15.
[70] Smart GH, 'Management Assessment Methods', p. 82.

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1. Competency-type methods are over-complicated and inappropriate for fast-moving deals

High profile attempts to formulate lists of generalised managerial qualities have managed to scare off those wary of bureaucratic procedures. The Management Charter Initiative, launched back in 1987, aimed to create a national list of competencies and has laboured ever since to produce anything of use to business. When BP created a system to track its high-fliers it formulated nine competencies each with twenty-seven underlying indicators.[71] Both initiatives suggest heavy costs and questionable benefits. Yet these are not at all representative of the scorecards used by those who get value from them. Neither, for that matter, are the ten page templates used by C10 in the specialised FTSE 100 CEO assessments. A decent quality scorecard of 2-3 pages length can be created with an hour of discussion, and written up ready for use in less than another hour. E17 provides something similar by providing a succinct brief for his consultants on the management needs of the transaction. Nor does the process need to be wrapped in impenetrable jargon – Smart argues persuasively that it is more useful to think directly of management behaviours needed in the firm and the value they may add rather than to talk of "traits" and "requirements for a job".

The alternative to this fairly minimal effort is to rely entirely on what E11 describes as the 'folklore' about what makes a good CEO. As section 3.1 argued, cumulated experience is a useful start for assessing managers, but it is inadequate by itself to produce consistent and reliable results. Informal methods tend to rely on rules-of-thumb that are dangerous if not re-examined with each new transaction. Most firms are impressed by track record, yet research shows that success in one context can be hard transfer to another.[72] Likewise, track record may not correlate with another prime quality – hunger to succeed.[73] E17 described a deal where his firm backed the same (previously successful) management team for a second time, buying the same firm back from the new corporate owners. However, the assumption that the management were a known quantity was very costly as an over-comfortable team led the company and the deal to disaster. This is why UM1's rule-of-thumb - that the depth of management assessment depends on the initial confidence that they have in the people – needs to be challenged sometimes. The same is true of UM6's approach whereby management may - or may not - appear as one of the critical five deal issues during initial analysis even if, as LM16 argues, it is difficult to assess management needs in a vacuum. The problem, as TB11 put it, is that often private equity people are 'deal junkies' who if they like the deal will quickly come to like the people, or may forget that instinctively liking the people doesn't mean they are not useless for the specific situation (says UM12). The implication is that management should always be treated as a major issue and a thought process enforced within even the early process.

2. Checklists of qualities are over-prescriptive and ignore the varied sources of success

Much of the work carried out by psychologists regarding entrepreneurship has sought commonalities between members of this group. But many of the conclusions are not only of negligible use-value (because they do not reliably distinguish between those who will add

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[71] 'Managing Competencies', *Information Strategy* (July/August 1998), p. 49.
[72] Groysberg B et al, 'The Risky Business of Hiring Stars', *Harvard Business Review* (May 2004), pp. 92-100.
[73] Camp JJ, *Venture Capital Due Diligence* (2002), p. 44.

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value and those who will not) but are scarcely introducible into serious discussion. Few will want to implement Landrum's insights that great entrepreneurs are likely to be 'psychosexually driven', first-born males who experienced transient childhoods, are right-brain gut decision-makers, and are charismatic.[74] Even research offering more sober measures – 'the Big five' personality features[75], Myers-Briggs[76], 'need for achievement'[77] or locus of control[78] - still suffer from limits on the applicability of their conclusions for any specific transaction, because desirable leadership traits tend to vary considerably by situation. Moreover, personal efficacy depends heavily as much on the interaction of a person's various characteristics, so making lists without placing them into context can be unreliable.[79] For this reason, I have not endeavoured in this study to offer any descriptions of generic management needs.

Interviewees' main problem with the perceived prescriptiveness of checklists was the generous thought that successful managers might emerge from various backgrounds and with varying styles. TB5 joined UM2 in dismissing preconceptions and stereotypes. E8 reckoned that predictable checklists would allow sharp managers to act accordingly and pull the wool over investor eyes. UM17 and E2 noted that good managers often tend to have 'strange' or diverse' personalities. LM2 gave examples of one great CEO who was almost virtual, whilst another was usually to be found amongst his people attending to the nitty gritty. C10 emphasised that in the experience of his firm, great CEOs tended to have massive competence in one or two areas, and other aspects of their personality were important only to be worked around. Indeed, the most popular interviewing checklist of the post-war years, the Seven Point Plan, was based on the solid insight that successful people seemed to share only the characteristic of lacking marked failure features.[80]

This critique, however, is based on a misconception about what a scorecard should be doing. If done competently it should not deal with anything except the most fundamental must-haves or must-not-haves. The must-haves will derive quite directly from the specific business and exit plan being pursued. The investors into a company whose success depends primarily on rapid sales growth cannot be indifferent to the sales and marketing skills of its CEO. This is obvious to everyone reading this, but the advantage of writing it down is to keep that point in the limelight throughout the assessment and deal preparation process. Since there tend to be more ways of destroying value than creating it, and since reasons for failure tend to be easier to identify than the opposite[81], the list of must-not-haves is typically longer, but will still be tailored to the company in question. Indeed, some funds

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[74] Landrum GN, *Profiles of Genius* (1993), p. 232.
[75] Ciavarella MA et al, 'The Big Five and Venture Survival: Is There a Linkage?', *Journal of Business Venturing*, Vol. 19 (2004), pp. 465-483.
[76] Ginn GW & Sexton DL, 'A Comparison of the Personality Type Dimensions of the 1987 Inc. 500 Company Founders/CEOs With Those of Slower-Growth Firms', *Journal of Business Venturing*, Vol. 5 (1990), pp. 313-326.
[77] McClelland D, *The Achieving Society* (1961).
[78] Brockhaus RH (1980), 'Psychological and environmental factors which distinguish the successful from the unsuccessful entrepreneur: A longitudinal study'. Proceedings, *Academy of Management*, pp. 368-372.
[79] Pratch L & Jacobowitz J, 'Successful CEOs of Private Equity Funded Ventures', *The Journal of Private Equity* (Summer 2004), pp. 8-31.
[80] Rodger A & Rawling K, *The Seven Point Plan* (1985), pp. v-vii, 3.
[81] Wood R & Payne T, *Competency Based Recruitment and Selection* (1998), p. 46; Finkelstein S, *Why Smart Executives Fail* (2003), passim.

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(like E21 and LM4) clearly focus their criteria onto potential negatives rather than positives.

3. Checklists are too rigid to handle the variety of deals we undertake

UM18, who have certain unwritten expectations of what they seek in management, nonetheless insist that general criteria are hard to establish because what is needed will vary by company, industry and country. LM8 and UM6 both argued against the idea of a pro-forma for management for similar reasons. Moreover, says UM14, the skill sets of managers are contextual – if the environment of the business develops then the skills required may also change. A good synthesis of this view is provided, albeit from a more general corporate view as follows: 'Emphasis on sets of competencies can be counterproductive when they are disengaged from the whole person, especially if no account is taken of the role the person is going to play, the context in which that role will be played out and the way it is likely to develop over time'.[82]

But, as implied above, a checklist that tries to cover many deals is likely to be unhelpful and is not well produced. Scorecards should indeed draw upon lessons learned over many transactions but they must be produced for each individual transaction, and will very likely vary by company, industry and country. No checklist can really hope to predict or handle very much future change. However, it should provide a benchmark which can be used to track changing needs as market or structural change takes place.

4. Checklists are lists of unreal aspirations

Some years ago, John Hunt of the London Business School noted that the typical lists of attributes required by managers were so long and demanding that essentially no-one could hope to match them.[83] A number of interviewees seemed to agree with this sentiment when they mentioned their view that in the real world they never dealt with perfect teams – i.e. that compromise was necessary and that idealised lists were of little help. A more extreme version of this argument echoed a remarkable, if long forgotten, synthesis of intense wartime efforts to measure military leadership which noted that 'Individuals differ too widely in their tastes, talents and temperaments to be readily amenable to scientific analysis and control'.[84]

However, a recognition that management assessment operates under real constraints of information, and within the context of real human beings, cannot excuse a relaxed attitude towards avoidable mistakes. Trade-offs between, or compromises away from, attributes seen as genuinely important to the success of the business should be handled with a level of attention that only a scorecard can really offer. If a threshold level of competence in some area is regarded as vital then a gap on the scorecard demands resolution in some form, whether that is an additional person, a particular kind of NED, or coaching. The overall reality is that private equity backed businesses are already inherently risky ventures due to the high levels of financial stress, tight deadlines, limited investment resources, and demanding objectives. Everyone involved owes it to themselves to go into such

[82] Harvey et al, *Graduates Work* (1997), p. 28.
[83] Hunt J, *Financial Times* 02/12/1998, p. 16.
[84] Vernon PE & Parry JB, *Personnel Selection* (1949), p. 11.

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investments with clear expectations about what management should be, and are, able to contribute.

Scorecarding is more a part of the individual deal process than a stand-alone intellectual exercise. It involves focusing on the appropriate specific outcomes required and the most fundamental requirements in terms of management ability to achieve them. It simply makes explicit - and therefore open to debate – the kinds of implicit theories of deal and management success which both introspection and research tell us that investors use when assessing potential deals.[85] E6, who use a formal framework, put it best. They need to work out, for each deal, what is the big idea and what the investee needs to be good at to deliver the idea in practice. What operational and financial structure is required to ensure that they are good in practice, and what people need to fill that structure with which specific skills.

[85] Hernan R & Watson J, 'Do Venture Capitalists' Implicit Theories on New Business Success/Failure have empirical validity?' (2002) cited in Cavill J, 'Venture Capitalists and the Assessment of Human Capital' (2004).

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4. Assessment Techniques: What Delivers Results?

When interviewees talked about features of their procedures which had changed over the last few years, they mostly referred to the due diligence stage, especially the core assessment methodology, with referencing as a back-up. Due diligence is the period when the greatest quantities of time and money are being focused onto management and so this section considers how private equity firms can consider and compare the various options open to them at this stage.

The techniques used to assess managers need to satisfy at least three criteria. Firstly, the method should predict the likely performance of the managers with reasonable accuracy, what occupational psychologists call 'predictive validity'. Secondly, the application of the method should not create excessive costs for investors, whether in the form of money or time. Thirdly, it should not compromise the goodwill between potential investors and investees – i.e. it should possess 'face validity' with managers. Overall, investors should feel that their confidence in making a decision increases, enhanced with new insights, without producing headaches. None of these criteria is easy to measure in a straightforward way, especially the first and third. Table 4.1 offers, however, an overview of various selection/assessment methodologies and ratings on four criteria.

Table 4.1: Key Dimensions for Seven Selection Methods:

Selection Method	**Predictive Validity (typical scores)**[86]	**Cost**[87]	**Face validity**	**Legal Status**[88]
Unstructured Interview	Low (0.14 to 0.47)	Medium /Low	High	Uncertain
Ability Test	High (0.25 to 0.56)	Low	Low	Major Problems
Personality Test	Variable (-0.22 to +0.33)	Low	Low	Some doubts
Assessment Centre	High (0.37 to 0.43)	V. High	High	No problems
Structured Interview	High (0.44 to 0.62)	High	Untested	No problems
References	Moderate (0.18 to 0.26)	Low	Medium	Some doubts
Graphology	V. low (zero)	Low	n.a.	n.a.

Source: Adapted from tables collating results from well known studies in occupational psychology in Cook M, *Personnel Selection* (1998), 295-298.

[86] Validity coefficients
[87] I use Cook's views here to avoid misrepresentation. However, for most private equity funds, the costs involved per person are much less critical when analysing a handful of managers compared with graduate recruiters. Consequently, cost is a less important differentiator for the purposes discussed in this report.
[88] For general recruitment purposes

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What this table does *not* show is the degree to which *combinations* of methods can increase overall validity. It is certainly the case that scorecarding can add validity to several selection methodologies.[89] It is also likely that reference checking can add confirmation of information obtained by other means.

Until relatively recently, unstructured interviewing almost monopolised management assessment in private equity transactions. It probably remains the single most popular method, as it has within the broader corporate context. However, the main problem with relying on such interviewing exclusively is shown by the relatively low level of validity shown by the method. An extensive literature describes the problems of ensuring consistent and useful results from interviewing in practice, and its weaknesses led one leading psychologist to condemn it as a 'miserable failure'.[90] Interviewers fail to assess each candidate independently; first impressions are given disproportionate weight; candidates similar to interviewers are favoured; interviews tend to match candidates to stereotypes of an ideal; job profiles are often misleading; major errors appeared in inferring behavioural data to general characteristics; past results were over-attributed to character alone when they also result from luck and the environment.[91] Moreover, these unconscious biases are hard to correct.[92] Worse still, the more complex a decision, the greater the methodological latitude given to interviewers, and the greater the reliance placed upon human judgement, the more likely the decision is to be taken irrationally.[93]

4.1 Psychometric Testing

For thirty-five years, the main reaction to problems with interviewing in the British corporate world has been psychometric testing. In round terms, the proportion of medium and large firms using, say, intelligence testing, has risen from about 25% in 1970 to 70% in 2000. Albeit with a time lag, the same appears to be true in private equity due diligence. Fully 41% of interviewees for this report said that their firms made use of psychometric testing at least sometimes, of which 16% used it most of the time. This is high by comparison with continental practice: in one study of practice across Europe, 28% of French funds reported using any alternative means of assessment, including weak methods like graphology, whilst in Germany the proportion was just 14%.[94] It is very high by contrast with the US where, in 1998, just 3% of Smart's interviewees made use of psychometrics.[95] A 2002 study found none of twenty-six US VC/PE firms using it.[96]

This apparently high level of acceptance of psychometric testing as a *principal* assessment methodology is, however, precarious and likely to decline. The reasons for this lie, on the one hand, in the intrinsic limitations of psychometric testing of executive level personnel in the atypical situation of most private equity backed deals. On the other, a high proportion of interviewees for this report display evidence of dissatisfaction with the

[89] Cook M, *Personnel Selection* (1998), p. 34.
[90] Herriot P, *Down from the Ivory Tower* (1984), p. 69.
[91] Ibid, pp. 70-72; Sutherland S, *Irrationality* (1992), pp. 192ff.
[92] Vernon, *Intelligence and Attainment Tests* (1960); Sutherland S, *Irrationality* (1992), Ch.20.
[93] Sutherland S, *Irrationality* (1992), p. 4.
[94] SJ Berwin, *The Human Capital Equation* (2003), p. 13.
[95] Smart GH, 'Management Assessment Methods', p. 82.
[96] Unpublished Diligencia Ltd. Report (2002), p.60.

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method and cannot be considered as loyal users. The availability of methods that are intrinsically better and/or which address those other concerns may well cause a shift away from a prime dependence on psychometrics, even if some tests are retained as secondary tools.

In regard to intrinsic value, consider the evidence from Table 4.1. It shows high validity scores for ability testing and mixed/low ones for personality tests. Ability testing, whilst an excellent tool for sorting between hundreds of lower level candidates offers rather limited value for analysing executives, few of whom are likely to be below average. The research evidence is quite clear that beyond a certain threshold level additional intelligence adds little to performance by executives. IQ scores tend to bunch amongst those smart enough to handle the most cognitively demanding fields, so intelligence alone provides reduced power of differentiation whereas personal skills are more relevant.[97] Stogdill, summarising the results of many other studies, found that leaders tended to be somewhat but not excessively higher in intelligence than those who were not leaders.[98]

While personality tests provide insight that is potentially more differentiating, their usefulness as predictors must be treated cautiously. Firstly, for tests to be validated they require the testing of sufficient subjects to create norm groups. Not surprisingly, the people whom private equity funds are most interested in – performance-oriented executives – are relatively few in number and relatively unlikely to be included in test creation. So finding tests to predict likely successes is tricky. Secondly, personality tests are not tests in the true sense. There are no right answers to the questions and the tests are in fact self-reporting questionnaires. Consequently, faking is a serious issue since executives are highly motivated to give answers that they think will please potential investors, while attempts to spot manipulation are highly imperfect.[99] Thirdly, there are very many tests and even more situations that firms may confront – selecting a test or tests to predict performance in any given situation risks analysing irrelevant factors. That risk grows if those interpreting the results are reluctant to offer a judgement call, or as C6 put it, 'driving instructions' tailored to the deal. Perhaps for these reasons, those funds who reported lower than average unpleasant surprises did not report greater usage of psychometric testing; in fact they used it somewhat less (37% used it sometimes) than those who reported above average surprises (47%), although the situation is reversed for the most dedicated users.

The evidence from private equity interviewees was more compelling than this rather dry discussion of intrinsic validity. Amongst those firms who had either considered or used testing, three main groups of reaction to psychometrics can be identified: a relatively small group of genuine enthusiasts; a larger group of antagonists; then the largest group who might be categorised as reluctant occasional users.

Some interviewees made a case for using tests, saying that managers' expectations had evolved sufficiently such that testing was no longer a surprise for anyone (LM11, E14, LM21), especially for MBI teams (LM15). Resistance where it appeared tended to be from weaker candidates: LM8 mentioned the case of an incumbent chairman who was hostile, tested badly and proved overall to be a weak performer. E14 finds the methods sufficiently useful that up to one in seven transactions are halted because of it. By setting expectations early, and by emphasising the opportunity for team development when the results were shared, LM3 and E17 reckoned that testing added value even in the eyes of managers. LM9

[97] Goleman D, *Working with Emotional Intelligence* (1998), p. 20.
[98] Stogdill RM, *Handbook of Leadership* (1974), p. 145.
[99] Cook M, *Personnel* Selection, p. 160 ff.

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reckons that psychometric tools offer a vital check of basic intellectual horsepower and some insights into the relationship between strengths and weaknesses and motivations. E22 was sufficiently convinced of the value of testing that all potential investee management teams have to pass through a battery of tests – indeed this was a condition precedent. Some funds, whilst not users generally, were prepared to see the value of such tools when it came to hiring a new CEO for a company (UM16) or for hiring new members into the investment firm itself (UM19).

Those interviewees who expressed opposition, or at least strong scepticism, to psychometrics focused primarily on the effect of testing on their relations with management teams. UM13 and UM11 both felt that having built up trust with managers, who are in the midst of an intimidating process anyway, asking them to submit to testing would alienate them. E19 thought many managers would be 'insulted'; LM22 thought testing could be 'somewhat offensive'; TB5 found it intrusive and, if he were a manager, he would refuse to cooperate, while LM20 saw no reason to inflict upon others what would not be accepted internally. LM23 thought that consuming scarce management time with this only diminished the time available for more useful interactions the fund itself could have with managers. Some funds had considered testing, or even dabbled in it, but had quickly rejected it (UM15 & UM10). UM2 and UM3 had had tests done on their own team but found the results so weak that the idea was dropped. One firm (LM19), who had sometimes used testing, nonetheless offered the comment that many financial people had a 'pathological hatred' of psychological methods.

In terms of potential value added, no-one seemed to think that testing would cause active harm – although LM7 did mention some disastrous deals where psychometrics failed to highlight important causes of failure. E4 remembered an ability test which suggested that one CEO was not intelligent but he later proved to be not only a generally excellent manager but a bright spark too. More typical, though, were comments by UM14 that knowing managers were literate and numerate was of little practical use to them; LM6 was simply not convinced from his experience that one learned much new from the tests; LM23 felt the same – tests could not say whether someone could run a difficult business. E16 had previously used tests but had simply fallen out of that habit – the value-added was apparently insufficiently compelling.

The large group of hesitant users offered variations on the observations already mentioned. They typically saw some minor benefits but were also conscious of resistance from management teams (e.g. E10, E20, LM13, and UM6). Whilst that resistance could be overcome, it reduced the likelihood of tests being used for all transactions. TB3 and LM18 found that owner-founders were especially likely to be suspicious of tests. By contrast, LM10 reckoned that it was the CEOs of larger firms who were most 'allergic'. E7 found that while managers never actually admitted to being unhappy about testing, he assumed they were as cynical as the investment team about the value of it. UM6 reported conflicting views within the firm and attributed his own coolness to the fact that the tools were not transparent for laymen. Such ambivalence was not confined to investors – some consultants had mixed feelings too. Ten years ago, C3 said, his firm would rather have 'cut their wrists' than offer psychometric testing. Now, whilst they recommended against it, they would carry out tests if requested to. C4 reported a corporate finance consultant from one of the Big 4 accounting firms who pooh poohed psychometric testing which his own firm also offers. C7, who does not use testing in client work, reckoned that clients who were attracted to it were seduced by a pseudo-objectivity offered in quantitative measures of personality.

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What might hesitant users retain from their experience to date and apply going forward? Perhaps the key lesson is to seek specific benefits other than prediction. UM7 reckoned that making a decision based only on this would be a grave mistake. Tests may offer interesting perspectives and, perhaps more importantly, a way of opening and exploring subjects that might be difficult to ask about directly. E10, for example, are at least as interested in the reactions of managers to the results as the results themselves. Can managers provide coherent explanations if confronted with results pointing to holes in the skill set of the team, or very conflicting personal styles? LM8 often use tests to focus subsequent interviews onto hot issues. Testing may be of considerable help when an investor decides to have a quick look at second tier management and their general capacity rather than predicting their specific behaviour.

A defender of psychometric testing could note that any form of structured management assessment involves some disruption to investee management and therefore potential resistance. C11's approach, for example, involves two full days of on-site interviews across the whole management team. LM24 reports having to justify the value of a non-psychometric approach by sharing the results as a team-building tool. In addition, it has always been the case that psychometric methods provoke knee-jerk reactions that do not reflect the growing sophistication and validation of this methodology. TB8, UM3 and UM4 all admitted that they have not even given the matter thought in choosing not to use it.

4.2 Two Intriguing but Less Likely Methods

One approach to assessing the managers of private equity funded businesses has been promoted in the USA by Leslie Pratch who applies tools of clinical psychology to assess the 'active coping' skills of executives faced by high-stress work situation. To get around the problem of faking often present in personality testing, she employs projective techniques such as getting managers to tell stories in reaction to pictures.[100] However, interpretation of the results is hard, and studies of validity tend to award low marks to such methods. Moreover, it seems unlikely managers who find psychometric testing unpalatable will be more enthusiastic about making up stories with a psychologist. One consulting firm, C10, does include some clinical approaches to assessment, on the basis that they can offer insight into some deeper truths (like a portrait) than the more 'engineering' approach of traditional psychometrics. However, they use them as only one input within a comprehensive assessment.

One approach shown in Table 4.1 is that of assessment centres. These typically combine interviews, psychometric tests and business games as part of an overall assessment of a group of people over a day or two. Quite high validities can be obtained by gathering different types of information, seeing candidates interact with each other on a relevant problem, using multiple assessors, and then thrashing out conclusions by debate between assessors. Although setting up, and thinking through, such assessment events can be time consuming and costly, and some managers may find them too reminiscent of selection aimed at graduate entrants, some variant of an event might prove to be highly instructive.

[100] Pratch L & Jacobowitz J, 'Successful CEOs of Private Equity Funded Ventures', *The Journal of Private Equity* (Summer 2004), pp. 8-31.

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Members of the investment team might join consultants in observing a management team in action working on an issue closely related to that actually facing the investee.

4.3 In-Depth Structured Interviewing

The method of assessment which scores highest on predictive validity but which minimises confusing or upsetting either investors or managers is structured interviewing.[101] Validities reach even higher when interviewers are properly trained and when a scorecard is used.[102] The method has been shown to work with large groups of candidates (and by the late 1990s more than 70% of large recruiters employed it at least sometimes)[103] but the method is especially well suited to the individualised assessments required by private equity firms. The method has been taken up enthusiastically by large numbers of funds in the US and, although I cannot provide a quantitative measure for this, one consulting firm (ghSmart) specialised in this methodology alone has more than a hundred US private equity clients. Geoff Smart found in his original study that those venture capitalists who experienced below average levels of mistakes allocated an average of 27 hours per deal to this kind of interviewing versus just over 6 hours amongst those with lower accuracy.[104] As a result Smart found a statistically significant relationship between the use of 'past-oriented interviewing' and accuracy.[105]

Few interviewees specifically mentioned structured interviewing by name. However, a number of firms do seem to have discovered and made use of aspects of the system. One (LM23) has apparently adopted elements of an American system that has come to its attention by indirect methods. UM11 has considered adopting the same method after discussing it at a global meeting. The most important ingredients are as follows:

(a) At least three or four hours' time focused only on an individual assessment. The time spent in one session seems not only to increase the amount of information but also its quality. Both UM5 and LM9 build this into a full day meeting with management while E9 dedicate a couple of full days just to interviewing management, taking special care to understand management roles and aspirations. Consultants (e.g. C2 & C3) reckon that it takes at least 2-3 hours until people begin to open up, and that more is revealed both absolutely and proportionately the longer the time taken.

(b) The interview, whilst chronological, is structured to deliver information on the priorities identified by the scorecard, although this does not take the form of a verbal questionnaire but rather a flowing conversation which systematically explores key themes. Notes are taken chronologically and later organised thematically.

(c) The interview deals primarily with the facts of a person's career and development, not with more speculative views of what they think about the future. Its hypothesis is the same as that stated by head-hunters specialised in M&A due diligence:

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[101] Spencer LM & Spencer SM, *Competence at Work* (1993), p. 242; Cook M, *Personnel Selection* (2004), pp. 47, 283-289.
[102] Smart BD, *Topgrading* (1999), pp. 245-247.
[103] IRS, 'The Business of Selection' (1999), p. 5.
[104] Smart GH, 'Management Assessment Methods', p. 101.
[105] Smart GH, 'Management Assessment Methods', p. 91.

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'we have found that past performance – whether successful or not – is highly predictive of future performance.'[106] Or, as the American industrialist Andrew Carnegie once put it: 'As I get older, I pay less attention to what people say and more to what they do.'

Using a system based on these elements, C7 claims that major private equity clients have moved from around 25% error rates to a rate that is consistently below 5%. To achieve such a major shift does require (a) a clear understanding of the philosophy and practice of this kind of interviewing, (b) preparation in the form of templates to allow rapid transformation of the interview information into useful insight and (c) links to other parts of the overall assessment process to ensure consistency. That probably means outside advisory assistance, at least initially.

4.4 Referencing

Whereas interviewees and research evidence were more negative than I had initially anticipated in regard to psychometric testing, the opposite was the case with referencing. At one level, of course, almost all private equity funds take up references in some way – one study found that 87% of UK funds take up personal references.[107] No-one interviewed for this report claimed not to pursue references (although LM24 had such positive feedback from customers in one deal that they saw little point in taking up general personal references as well). But both the amount of time, and the numbers of references taken, seem to influence final assessment accuracy. In Geoff Smart's study, for example, funds which showed below average accuracy in assessment spent a total of 14.8 hours doing reference interviews versus 33.6 hours by those who had above average accuracy.[108]

In the UK case, the measure of referencing effort was taken as the typical number of references taken on a potential investee CEO. Those firms with lower than average numbers of mistakes took an average of 8.29 (versus just 6.45 for those with above average error rates). Moreover, they are somewhat more likely to outsource part or all of the referencing process. This may be partly related to size of team: firms with fewer than five professionals tend to take rather fewer references (an average of 5.4) than those with larger teams (about 8). It is partly related to the degree to which firms have their own network of industry contacts – firms with an obvious industry specialisation take fewer references than generalists.

But it is also seems true that those who outsource referencing partly do so to access referees beyond their own reach – outsourcing funds took more references per CEO than those keeping it in-house. E19 notes that their network is fairly hit-and-miss for many investment opportunities it sees. LM11 finds that outsiders do more digging to find sources while E9 commended their advisers on showing great creativity in doing so. LM7 and LM21 were not the only firms to state what good value they thought referencing services offered, especially since this activity is time-consuming. UM4 note that banks seem especially to like evidence of thorough independent referencing.

Despite such arguments, some firms felt that referencing was either an internal core competence (E18) or that the activity was so important that such conversations should be

[106] Carey DC & Ogden D, *The Human Side of M&A* (2004), p. 20.
[107] SJ Berwin, *The Human Capital Equation* (2003), p. 13.
[108] Smart GH, 'Management Assessment Methods', p. 102.

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carried out by firm deal members (E10, E23, LM3). Others had invested into building up their network and thought that no outsiders could replicate this (E6). TB7 had created its own 'internal CIA' for similar purposes.

Apart from quantities of references and the outsourcing decision there are some other aspects of referencing worth mentioning. The first is that because management ability is hard to reference, as E21 mentioned, reference interviews can vary widely in usefulness. Unfocused impressionistic reference discussions are unlikely to produce much. By contrast, interviews structured to address key areas of interest, and then integrated with other assessment data, may be insightful. For this reason, advisers to E19 spend a half day with each manager and use this, amongst other things, to develop lists of appropriate referees beyond anything already provided in presentation materials. LM13 insist that a couple of reference interviews take place face-to-face – their experience is that on the telephone one only gets 70% of the story. Both they, and LM6, begin referencing before they reach the due diligence stage and use the results to guide their main assessment. Advisers C5 note how important it is for advisers to be properly briefed about deal objectives before they prepare their referencing plan and tactics, and they usually expect to receive the investment memorandum as background for this.

Another trend in referencing work is that tight deadlines and a desire to keep management happy mean that consultants are asked to carry out either general referencing (typically executive search firms) or deeper investigations (Kroll or Control Risks) anonymously. The easier and cheaper access to criminal records and county judgements means that some funds like UM10 have added in such checks as a matter of course anyway.

4.5 Best of Class

Although I said above that this report would not offer a single 'best practice' recommendation, due to the variety of fund deal preparation systems and deal contexts, nonetheless I think it is worth providing a synthesis of the previous twenty pages of discussion to suggest what the core assessment process would look like for a transaction where maximum accuracy was desired and where, therefore, appropriate internal and perhaps external resources were brought to bear.

- Once a deal becomes a serious proposition, perhaps after a first management meeting, a scorecard is produced to lay out what is known about the concrete results needed to make the deal a success. Specific must-haves or must-not-haves would be written down – not a long wish list but a short core list.

- Fund staff carry out initial interviews with management on their background, career highlights and aspirations, for perhaps an hour, using the scorecard as a guide. Results are written down on a page, perhaps two.

- Some early references might be taken to feed subsequent analysis.

- Once the deal passes term-sheet stage, a well-prepared structured interview takes place with each key manager. The results are used not only for preparing an overview of the management team but also to feed thinking about non-executive

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director positions, any post-investment developmental activities, and to set priorities for the main referencing activity. Specific psychometric tests might be used to explore particular issues emerging from referencing or interviews.

- Referencing, also based on the scorecard, and any issues that have emerged aims for at least ten sources of information on the CEO, and at least five on each of the other managers.

- The scorecard provides a means to structure a team discussion about what has been learned about the management. Healthy debate hopefully means that any second-raters are not accepted easily and any remaining weaknesses addressed.

In my view, such a process is attractive because it does not require much more overall effort or money than current practices. It does not leave the investors wondering where conclusions have come from or deprived of their proper role as decision-makers. The main gains in accuracy derive from a consistent view of what is being sought in that particular deal and integration of the various steps to maximise insight.

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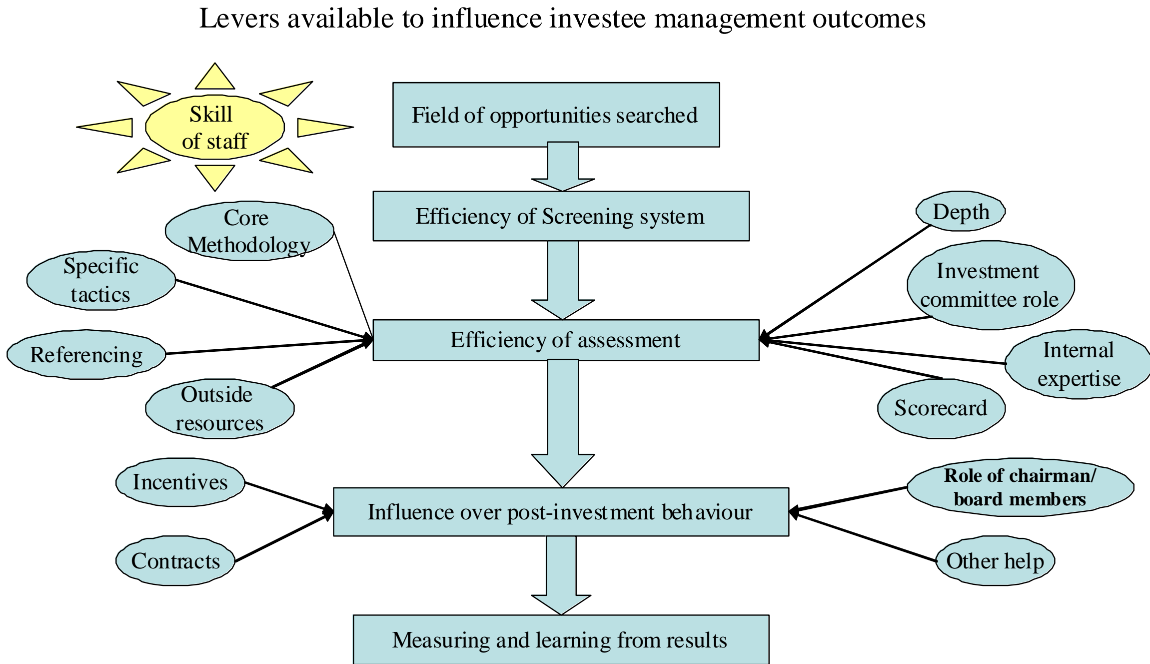
5. Other Routes to Improved Management

This report has dealt so far almost exclusively with the core assessment of managers at a specific stage of the overall deal preparation process. However, as Figure 5.1 shows, there are many different influences at various stages which offer opportunities for improving management quality, whether by initial selection, alignment of interests through incentives, mechanisms of monitoring and contract, or direct assistance to management.

Figure 5.1

Levers available to influence investee management outcomes



The ability to deploy any given tool may vary with the degree of market competition – TB7 is taking more legal risks for example to meet competitive pressure for buyouts, whereas E23 has recently been able to tighten its restrictions on investment draw-downs due to less competition in its early stage deals. Nonetheless, it remains the case that all funds probably have a number of ways in which they can tweak these non-core processes to their advantage. Interviewees cited a host of possibilities and on-going change will doubtless ensure that even the best system can always be fine-tuned along some dimension. The rest of this section, therefore, will address the question of how private equity funds can create an on-going agenda of improvement in management quality. More specifically it will consider how ideas for improvement can be generated and spread internally (section 5.1); and what might be some initial areas of interest (section 5.2).

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5.1 Process Improvement

Interviewees mentioned several ways in which old approaches are critiqued and new methods generated.

(a) Dedicated learning time: LM13, UM11, LM5 organise regular team retreats at which issues of more general relevance than current portfolio and pipeline are discussed. UM11, for example, has dedicated parts of at least two meetings in the last 18 months to management assessment issues. LM22 arrange retreats at which investee managers participate too.

(b) Deal reviews: E3 and LM23 produce deal reviews when they go sour and draw lessons from that process. LM8 also does but not all his colleagues are as diligent. UM14 worries that doing this too formally may make it harder for 'post-mortem' lessons to be spread and suggests instead informal chats over coffee. Although LM18 has a large team he reckons that failed deals are sufficiently interesting for everyone that the lessons spread quickly on the grapevine. UM2 does occasional surveys of investees to get their feedback. LM20 has backed away from formal deal reviews but admits that it risks repeating the same mistakes. LM1 has standard due diligence lists and periodically updates them with insights gained from transactions.

(c) Create metrics: Given a group of interviewees who are highly numerate and fact-based decision-makers, it came as a surprise to me that decisions about the single biggest stated influence on investment returns – management – are apparently made with scarcely any hard data at all. A couple of firms (UM9 & LM24) have carried out ad hoc reviews of old documents but neither mentioned gaining much from the exercise, probably because historical views were not used to draw lessons about past (and present?) processes. No-one suggested the existence of metrics for measuring management performance separate from company financial results or any review of relative success using different techniques, for example. It is true that creating such metrics may take some time and debate and that any tools will be imperfect. Nonetheless it is impossible, except in purely impressionistic terms, to say how good current practice is, whether and how much it has improved over time, what the effects of experiments might be, how different consulting offerings vary in their usefulness, how happy investee managers might be with different approaches.

In the US, C9 cites the case of a client who began tracking, with consultant assistance, all decisions that were made about investee managers, i.e. final conclusions reached pre-investment together with any specific observations. These have then been followed up at various intervals to see how the various decisions have worked out subsequently. This serves a dual purpose of improving decisions over time and also tracking how well the consultants have performed their job.

5.2 Issues to Consider

As regards issues to work on, interviewees provided a wide variety:

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(a) Improving internal expertise on management assessment issues. A previous survey found that 45% of UK private equity funds provide formal training on interviewing or management assessment.[109] This compares with about 90% of traditional corporates who claimed, back around 1990, that they trained all staff who carried out recruitment activities.[110] There was no specific question on this aspect for this study, but the proportion who volunteered a comment was rather low. LM18, LM19 and UM14 all mentioned specific courses on interviewing. C5 mentioned, though, one prominent investment organisation that had cut most of their training in this area. The other way to influence team skills, of course, is to select for skill in this area at entry into the organisation.

(b) Adjusting initial screening of opportunities. All those interviewees who provided a view on the subject confirmed that the first cut of business plans is the severest, is typically carried out on market and size criteria, and is done at high speed. The probability that good management are excluded prematurely on this basis is very high. At least one leading American firm cited by C9 has reoriented its screening process to start with managers and only then consider market opportunity, calling it ‘CEO first investing’. UM7 sees some signs of this appearing in the UK too.

(c) Organisational depth of assessment. One trend from the US mentioned by C8 is to assess more people within investee companies, on the basis that management quality is not determined by just the top three to four executives. Since there is a possibility that those top individuals may be removed at some point it makes sense to discover how stable the organisation may be without them. Such an exercise also offers the opportunity of getting some further views on company development and the quality of the senior team, as well as providing a reflection of the top team’s ability to attract and motivate talented subordinates. LM7 mentioned that it is moving in this direction while UM15 already insist on interviewing the top fifteen managers. TB1 typically look at anything between the top ten to thirty people. C11 suggest an alternative method too: they find that interviewing a group of low level staff almost always produces real insight because they are the least likely to varnish the truth. UM19 look in another direction by asking their consultants to generate a view about senior managers at competitors to provide a point of comparison.

(d) Team dynamics and composition. A number of interviewees expressed interest in understanding the dynamics within management teams as well as analysing individual managers. For example, UM19 felt that more of the surprises they encountered were due to interactions within the team than anything else. But views on the subject tended to be vaguer, even if psychometric instruments are being used to try and offer answers in this area. Interestingly, none of the consultants interviewed felt that they could offer as deep insight on this topic as on individuals, even if a view could be built up by combining multiple individual assessments. One consultancy has commissioned research on this area to improve the quality of its offering. A recent review of the research literature points towards a variety of (mostly positive) effects from diversity within the team in terms of education, background, knowledge, skills, cognitive styles, functional experience, but also

[109] SJ Berwin, *The Human Capital Equation* (2003), p. 13.
[110] IRS, ‘The State of Selection’ (1991), p. 9.

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towards the tension between too much or too little conflict and cohesion within top management teams.[111]

(e) Who assesses whom when? One measure of overall effort in management assessment by funds I had initially intended to use was the proportion of time spent discussing management issues within investment committee meetings. However, the results were so varied (between 1% of the time and 60%) and uncorrelated to anything else (although buy-out funds tend to spend slightly less time than other types of firms) that I realised that the *role* of such meetings in general varied greatly between firms. Some firms (E5, E8, E11, E21, LM1, LM22, and LM6) involve investment committee members and/or partners quite early on in seeing management and provide plenty of written information about management and so, by the time of formal meetings, there is little left to discuss. Others deliberately keep managers and investment decision-makers separate and allow a longer debate in formal committee. UM14 felt that allowing everyone to meet everyone early on would make an objective decision harder to make. LM20 felt that involving more than just one partner on a deal would be a bad sign for the deal, i.e. that it was a complicated case. Likewise, large numbers of assessors may mean a dilution of responsibility for the final decision. Nonetheless, Figure 2.3 showed that involving more than five assessors is associated with below average unhappy management surprises.

(f) Management due diligence timing. Views and procedures varied in terms of the timings of spending time and money on assessing managers in depth. The majority of firms are probably like LM23 in proceeding to in-depth assessment only after exclusivity has been obtained and an overall due diligence button has been pressed. Other firms involved in auction and beauty parade processes reported the same – why spend money before the probability of a deal has reached some minimum level? Nonetheless, there is an issue about the respective timings of (relatively cheap) management due diligence and accounting/legal work. UM14 was not very pleased that they are often forced to do accounting diligence before commercial and management work. The reason why can be gathered from a case mentioned by UM11 where, after spending several million pounds on due diligence, doubts about management led to supplementary work being done on them and the whole deal being abandoned. It might seem excessive to spend money on management due diligence for each deal, but if that were to prevent even one deal per decade at an early stage it might still save money. Indeed there are signs that this argument is persuading more interviewees: LM17, LM7, LM13 and UM6 all mentioned that they were increasingly inclined to spend money on management assessment earlier on as the cheapest way to avoid other kinds of unnecessary due diligence. This is an illustration of LM16's philosophy that initial due diligence should focus on a small number 'red flag' issues to keep potential abort costs down. UM15 mentioned that they have moved to bring all sorts of advisers into meetings and to look at documents earlier on in this process to spot warning signals.

As mentioned previously, though, strict auction procedures, or reluctance to inflict an additional task for managers during due diligence, can make it hard to perform proper diligence on management teams pre-completion. One answer is to carry out covert referencing work. Another is to follow TB1, TB8, UM20 and others in carrying out a thorough management audit post-completion. Assuming that the companies involved are

[111] Cavill J, 'Venture Capitalists and the Assessment of Human Capital' (2004), pp. 24-26.

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large enough that their valuations do not depend that much on incumbent management quality, this still allows for decisions to be made early so that they will then impact the remaining period of the investment. UM3 follow a similar approach by putting management into a probation period.

(g) Post-investment value-added. A recent American study highlights the situation that, despite a growing emphasis on post-investment value-added, investee companies remain unimpressed by delivery, mostly due to lack of investor time to transfer good intentions into actions.[112] Nonetheless, in the UK, there are some positive signs – one study found that buyouts seem to lead to greater adoption of innovative personnel practices as part of attempts to improve competitive position.[113] Such practices were involved in some of the greatest growth stock stories in the US over the period 1972-1992, firms such as Tyson Foods, Circuit City, Wal-Mart and Southwest Airlines, none of whom benefited from other great strategic advantages.[114] One survey finds that an increased focus on post-investment activities and operational value-added has become a major trend, although LM24, at least, remains cynical about the ability of private equity houses to do this as well as the initial selection of investments.[115]

One area where investors may help add value without necessarily spending much time or money is to encourage investees to recruit and appraise their own managers thoroughly. After all, one study (within the large corporate arena) found that only 19% of top managers in surveys strongly agreed that they consistently brought in highly talented people; 8% that they retain high performers; 3% that they removed low performers; and 16% that they knew who high and low performers were.[116] Likewise, a study of CEO failure by one of the architects of the Honeywell turnaround argued that: 'So how do CEOs blow it? More than any other way, by failure to put the right people in the right jobs – and the related failure to fix people problems in time.'[117] Within the private equity world, one fund manager argues that one of the key ways to extract value from active portfolio management is to ensure that talent is tracked within organisations.[118] Some interviewees clearly do focus energy on this: E6 mentioned that a lot of work is done discussing with the managing directors regarding the development of the rest of the investee management team. E20 and E23 help organise workshops and courses on relevant topics for investees. E3, LM1 and others become involved in senior investee hiring decisions. C5 report that more of the referencing work they do focuses as much on how to prepare post-investment support as on a go/no-go decision.

(h) Post-investment management optimisation. Although most interviewees were keen to emphasise the energy and attention put into interacting with management teams post-investment, most also appear to adopt a passive stance towards management quality. For example, UM4, UM9, UM12, UM16 and UM19 all mentioned that if the deal is generally

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[112] Cited in *Private Equity News* (19/7/2004), pp. 1-2.
[113] Bacon N & Wright M, 'Buy-Outs and Human Resource Management', *CMBOR Quarterly Review* (Summer 1999), pp. 35-45.
[114] Pfeffer J, *Competitive Advantage Through People* (1994), pp. 3-4.
[115] 'Kings of Capitalism: A Survey of Private Equity', *Economist* (27/11/2004), p.12.
[116] Michaels E et al, *The War for Talent* (2001), p. 9.
[117] Charan R, 'Why CEOs fail', *Fortune* (21/06/1999), pp. 68ff.
[118] Lieber D, 'Proactive Portfolio Management', *Journal of Private Equity*, Vol. 7, No.2 (Spring 2004), pp. 72-82.

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going well then there would be little further discussion of management performance. The implication of this is that, in UM9's description, some essentially useless teams are in the right place at the right time and are left in place. UM3 was more graphic – if the numbers look alright then even a 'total prick' would be left alone. UM12 felt it would be difficult to change managers after the initial investment unless there was some specific excuse. Perhaps for this reason UM8 considered that part of their skill as investors is managing imperfect teams to produce results.

But relying on trading data to reflect management performance, as E15 argued is reasonable, may be risky. Financial statements can be misleading, their specific causes uncertain in the short term, and the skill of interpretation varied (E4 mentioned one investment professional who was finally removed for glossing over problems at various investees). So this approach may not catch managers getting out of their depth until bad results appear – rather like never servicing a car and simply scrapping it when it breaks down. This is imprudent because 91% of funds in one survey felt that management changes they ultimately made would have produced better returns if made sooner.[119] Moreover, this stance is adopted in the context of an accusation that many firms have little in the way of intermediate steps between fairly passive monitoring and sacking management teams.[120] Certainly, several interviewees provided views that their inclination to try and fix management had diminished over the last years. C3 saw the same issue and felt that with more systematic appraisal some such situations could be avoided.

An alternative is to ask, as TB8 have started to do, what investments might look like if management teams that were decidedly B-grade in performance were migrated towards A-class performance by one method or another. Especially if handed in a planned manner disruption might be limited and gains maximised. In practice that would probably involve a pre-announced management review, say, 18 months after completion within the context of an overall deal review. That might also be the moment for something that C11 advocates – a bit of scenario planning to imagine where value might be created or destroyed by specific opportunities and threats over the remainder of the investment.

6. Conclusion

The introduction to this report described some of the competitive pressures facing private equity funds and the need to identify and extract value from new parts of what firms do. My contention is that considerably more can be done in the area of management assessment to assist that overall objective. I think the right approach is that of UM8 who are 'Getting better but could be a hell of a lot better'. Some current strategies, such as TB1's desire to generate returns by reconfiguring assets into more attractive formats, anyway imply smarter managers to act as change agents. The Holy Grail is to do what LM16 claim – to have increased returns on each successive fund despite rising prices of the assets they buy. Their strategy has been to optimise their processes, not least moving from being deal junkies to longer-term value-adders and especially by deepening their understanding of management performance.

[119] SJ Berwin, *The Human Capital Equation* (2003), p. 9.
[120] Campbell K, *Smarter Ventures* (2003), p. 256.

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