An Investor's Least Favorite Statement – "Oops, Wrong CEO"

How do you monitor your human capital?

While you own a company, you need the right people to execute and adjust the plans that will achieve your financial targets. When you go to sell, the team in place must be strong enough to convince buyers there's still substantial upside ahead. Managing human capital proactively and systematically can prevent problems and make your investments much more valuable. Unfortunately, talent management is not the forte of many in the PE world. A few larger PE firms (like KKR and Blackstone) have added a topflight resource to oversee human capital management in their portfolio companies, and they are onto a good idea. I'll describe:

- The problem (briefly)
- The key components of proactive human capital management for PE firms, and
- Some of your choices to provide proactive human capital management

OOPS – WRONG CEO – AND YOU NEED MORE LEADERS

Most PE firms need a more effective means of vetting the CEO prior to buying a company or hiring a CEO. Most investors only buy a company when they think they have someone who can run it. But many investors discover they are wrong. One highly experienced PE firm demonstrates an unfortunately typical track record. Its seventh fund had 14 companies. It had to replace nine CEOs, and then within a year, replace eight of the nine replacements. Its eighth fund now owns seven companies with plans to add more. In 2014, three of the seven CEOs were replaced and searches are underway to replace the remaining four.

Portfolio companies also have to replace VPs and fill leadership positions in order to grow. Often the CFO and heads of sales and of marketing have to be upgraded. With or without a new CFO, the CFO's direct reports also often prove to be inadequate in the face of demanding private equity goals and investors.

A PROCESS FOR MANAGING HUMAN CAPITAL ACROSS THE LIFECYCLE

Different actions are called for at different stages of an investment.

Before you buy the company: Invest in a solid assessment of the CEO to make sure he can run the business. A "track record" is not enough. You need to know how he will work with demanding PE investors and how he will cope with unexpected changes that (unbeknownst to any of you) are zooming towards you.

Just after you buy a company: Do an assessment of each member of the management team. Your choices include:

Table 1

Approach	Example	Typical timing	Typical cost
Full psychological or skills and experience assessment	Pratch, RHR, Green Peak, GH Smart	4-6 hours in person	$18,000-$30,000
Basic personality, skills and experience profile	Someone to administer test and interview candidate	1 hour online	$2,500
Critical thinking, judgment and problem-solving tests	Watson-Glaser	40 minutes online	$25-$70
Cognitive ability, numerical reasoning and critical thinking numerical reasoning tests	Various tests for specific types and levels of intelligence, choice thereof depending on requisite cognitive ability	25 minutes online	$45
Behavioral, management and influence styles — quick assessment	Predictive Index	10 minutes online	Practically free

When you are looking to hire someone into the company: Do the same level of testing to weed out obvious misfits. Some investors have data showing that more than 50% of the candidates surfaced by recruiters do not have the mental capacity to handle the job. For new hires, manage risk at reasonable cost by using a mix of pre-interview and post-interview tests, along with a behavioral interview that is informed by the pre-interview tests results.

Table 2

Role	Planning step	Pre-interview tests	Post-interview tests
• Any management role	• Job scorecard — what are the key attributes the person needs to succeed	• Test of critical reasoning	• As appropriate, decision making, coping, and influencing styles; motivational orientation
• Finance roles	• Job scorecard	• Numerical reasoning	• Numerical reasoning critical thinking to map developmental potential
• CEO	• Company scorecard — essentially KPIs linking to value creation plan	• Raven Advanced Progressive Matrices	• Select approach from Table 1 depending on questions that remain
• Direct reports to the CEO	• Job scorecard	• As appropriate, tests of cognitive ability, motivational orientation	• As indicated by questions raised by interview

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Proven match with job scorecard

OR

Slight mismatch that allows hiring but requires “action plan” to work around

For the CEO you would use the company scorecard. Investors know very specifically what they aim to achieve with a company over five years. You look at the numbers today and what they need to be in five years, and the key strategies to be implemented to achieve those goals. You should also have goals with respect to the quality of the management team.

Monitoring and improving the CEO's performance

The CEO's scorecard has quarterly targets. Failing to hit those targets should mean that different CEO actions or a different CEO might be necessary. Don't let the loyalty of the deal team to the CEO in whom they have put their faith and trust stop timely change: create a process that rapidly escalate anything that might look like a CEO issue to a broader group than just the key partners on a deal – to include people with less interest in maintaining the status quo.

Even if the CEO is doing very well, a smart investor would ask if there are ways to support and improve the CEO's performance. What would it take to grow faster, or to be more profitable? What would it take to get more out of the existing team, or to have the confidence and commitment to upgrade that team? If the CEO is doing less well, a smart investor would consider providing support for the CEO. That support could come in the form of, for example, a coach or a board member.

Monitoring and improving the quality of the management team

As the company grows and faces new challenges, each of the CEO's direct reports will need to be strong and become stronger. Some will grow on the job but many will not. To keep on track with investors' aggressive goals, the CEO often needs to change out the people in these key roles. CEOs who come with an acquisition are often loyal to their pre-deal team members, and that loyalty can slow or stop needed changes. The PE firm needs to establish its own process (as a team of investors) for regularly evaluating the whole management team. It needs to be clear that it views keeping sub-par people as a serious failure of the CEO.

Even if individuals are performing well, the team may not be functioning optimally. Or there may be opportunities to improve the performance of the individuals or the group. The PE investors should be identifying these opportunities and calculating the return on investing in capturing them.

Your choices for assessment, monitoring and improving

Outside consultants can help with parts of the process proactive human capital management process, such as onboarding CEOs or even onboarding an acquisition. Such consultants can work with management teams to align employees to a common goal and set of values (what's the vision and the goal, what are our defining principles as an organization). The resulting culture can powerfully support aggressive growth.

Some firms now use a partner-level internal specialist in the place of outside consultants. Creating this position may require amending the LP agreements, and require portfolio companies to pay for the expense. Typically, the person comes from a recruiting firm and/or has served as a human resources officer and has experience integrating acquisitions. His job includes building an internal database of strong operating executives and staying in touch with them. When a leadership problem arises, he can quickly locate interim or replacement candidates. As the one person responsible for human capital management, he holds the search consultants accountable, benchmarks them and makes sure they surface appropriate candidates. In addition, he advises each CEO on organizational structure – where does it need to be upgraded – and helps counsel the CEO on what kinds of people are needed and how to bring about change. He is also responsible for constantly reviewing and upgrading portfolio company management teams.

You could also use an outside advisor who works closely and continuously with you on orchestrating assessment, monitoring and improvement. Without paying for a full-time resource, a smaller PE firm can get the benefits of a continuing and knowledgeable focus on proactive human capital management from someone who is familiar with the details and intricacies of each company than a more itinerant consultant would be. That advisor may also deliver some of the services (e.g., assessment or coaching) that are part of your proactive approach.

Your process should be continuous

If your process is continuous and ongoing, you'll find problems early and won't be reacting to disasters and always feeling it's too late.

WHAT YOU CAN DO

If you're supervising and doing deals in a time-sensitive environment, make someone responsible for ensuring the human capital sides of deals are being managed effectively. Deal people are not typically ideally suited for the slower work of repeatedly executing a process, especially when faced with the challenges of raising money and finding and doing deals, and with the time pressures of doing deals. You'd benefit immensely by implementing a proactive process and finding a good way to keep it going.