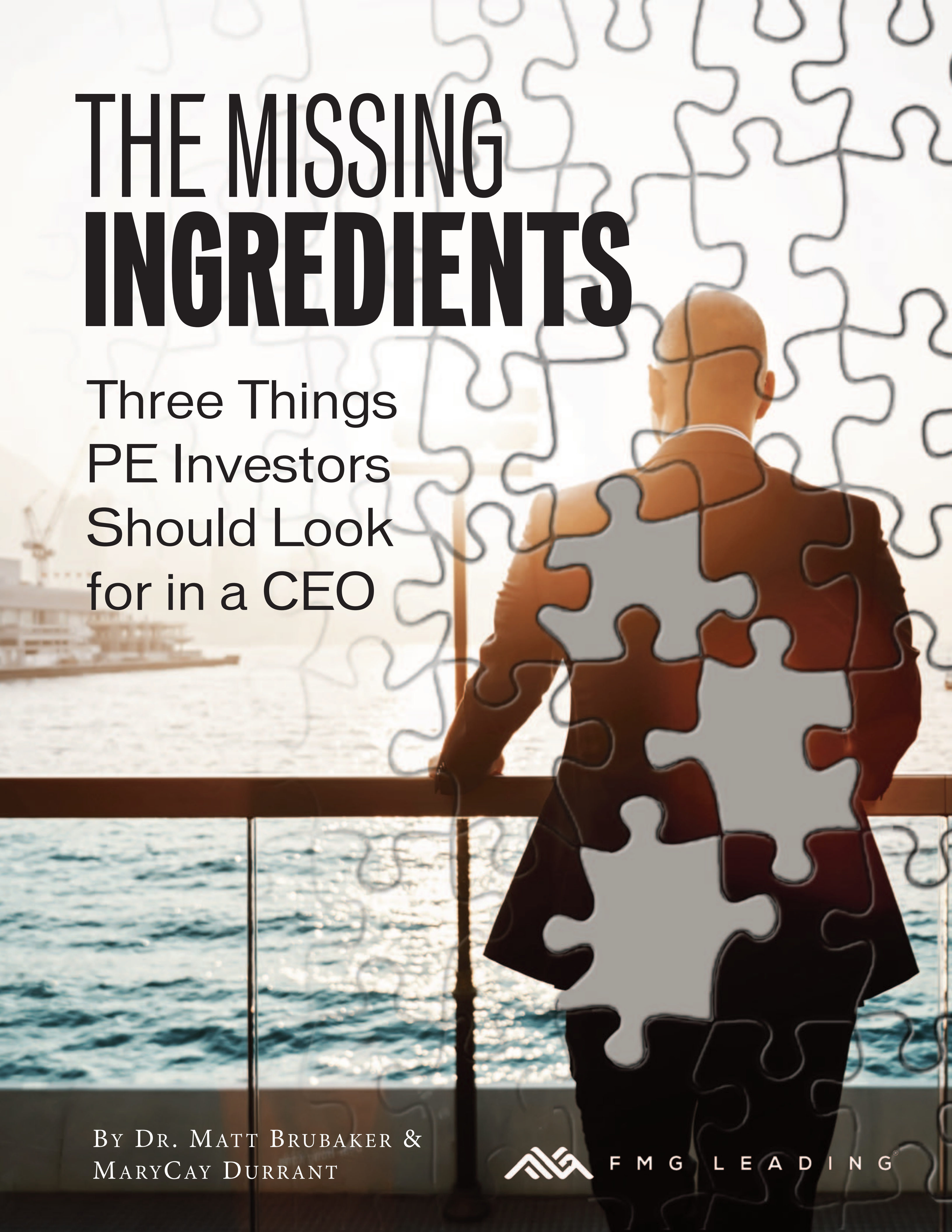

THE MISSING INGREDIENTS

Three Things PE Investors Should Look for in a CEO

By Dr. Matt Brubaker & MaryCay Durrant

FMG LEADING

THE MISSING INGREDIENTS

EXECUTIVE SUMMARY

Private equity firms conduct rigorous due diligence in assessing acquisition targets. Those with the best track records place high trust in their ability to size up a prospect's financials, operations and market position. But in our experience, many mid-sized PE firms are less successful in choosing the CEOs who run their portfolio companies. Does the founding CEO have what it takes to turbo-charge the type of growth that a PE firm requires? Not always. Does his or her replacement work out? Often not. In fact, one recent study of PE firms found a little less than half had to change the CEOs who ran their portfolio companies.

How does this happen? From our research and consulting experience in assessing the leaders of dozens of PE-owned firms, investors can overlook three leadership skills that are crucial to rapid, profitable growth: thinking strategically and systemically; building alignment and commitment to the firm's strategy; and developing essential team members.

In this paper, we first explore why it can be difficult for companies to consistently choose the right CEO. We then dive deep into the three leadership qualities of the most successful CEOs we've seen at PE-backed companies, and provide examples including the CEOs at Health Integrated Inc., Surgical Care Affiliates (which became a public company in 2013), and other highly successful firms. Finally, we explain how to begin to assess whether a CEO or CEO candidate has these three requisite skills.

Any private equity firm that has lasted long enough to raise more than a single fund has developed an effective process for sizing up acquisitions. The best PE firms have spent years perfecting how they assess the financial, operational, market, competitive, legal, and other conditions of prospective companies. Because of that, they have solid track records of turning around or accelerating already-growing firms in a short period of time. They choose businesses with great growth or turnaround potential. In short, they buy right.

"Buying right" has become more important in recent years for PE firms, yet also more difficult. As a 2016 study on the PE industry by management consultancy Bain & Company said, the immense amount of uninvested funds ($1.3 trillion) means more competition on every deal, and shorter time horizons from banks that bring the deals. As a result, "today's auctions often leave potential buyers with little alternative but to 'bid the book' – that is, to accept on good faith the seller's assertions about a target company's market position and growth potential." [1]

In addition to facing increasing competition on deals, many PE firms struggle to determine whether they have the right CEO for the job. One PE firm (Welsh, Carson, Anderson & Stowe, with 16 limited partnerships and more than $22 billion in capital) recently conceded that its success rate in CEO selection was only about 60%. [2]

Welsh Carson's CEO success rate is not unusual. A 2015 Bain & Company study of the PE industry found a consistent struggle in placing the right CEO to fulfill the growth strategy of the investment. A little less than half of PE firms switched CEOs while they owned the firms. The study also found that in 60% of those cases, the PE firm never suspected it would need to replace the CEO when it bought the firm. What's more, the Bain report said, in nearly every case, the CEO was removed following the first year of ownership – "after the honeymoon period had ended and the opportunity to build early forward momentum had passed."

[1]Harvard Business Review, "How Private Equity Firms Hire CEOs," June 2016. https://hbr.org/2016/06/how-private-equity-firms-hire-ceos

[2]Bain 2015 private equity report, p. 56. http://www.bain.com/Images/BAIN_REPORT_Global_Private_Equity_Report_2015.pdf

Whether or not a company is owned by a PE firm, its chief executive has a massive impact on performance. As CEO consultant Ram Charan said in a classic Harvard Business Review article, "CEOs' performance determines the fates of corporations." [3] The choice of CEO is even more critical in PE-owned firms. Investors have far more to lose if they choose unwisely, since their average hold time is 5-6 years[4], and because generating a strong return on a portfolio company exit requires stellar financial performance. "A delay in replacing an underperforming or ill-equipped CEO can significantly undermine even the best formulated value-creation plan," Bain said in its report.

Larger private equity firms are more likely to be prepared to evaluate CEOs and CEO candidates. They have developed the infrastructure to employ seasoned HR experts, resources and processes to incisively size up their portfolio firm CEOs. However, midsized PE firms typically lack the resources and don't have the time to develop proprietary tools in the human capital arena.

How CEO Evaluations Can Go Astray

In our work with PE firms over the last 20 years, we're not surprised that many mid-market PE firms struggle to assess the CEOs of their portfolio companies. Why? Frequently, their well-placed confidence in their ability to size up companies simply doesn't translate to sizing up people.

PE investors should take pride in their skill at rigorously assessing companies. The PE sector has been strong over the last five years; global buyout-backed exits, capital raised and deal value were significantly higher in 2015 than they were in 2011.[5] Along with reflecting a general economic rebound, this success shows that PE firms can size up acquisitions and improve their businesses in relatively short order. Many PE firms have thrived by specializing in a unique investment approach – for example, deep expertise in a few sectors (even just one), or acquiring companies in a similar financial condition (e.g., highly distressed firms).

Good investors trust their instincts, and often those instincts are sound. But relying only on those instincts can be faulty, as the statistics on CEO turnover at PE-backed companies demonstrate. This is especially the case with CEOs who look, talk and act like the investors who conduct the interviews.

[3] Ram Charan, "Ending the CEO Succession Crisis," Harvard Business Review, February 2005.
https://hbr.org/2005/02/ending-the-ceo-succession-crisis

[4] Bain 2016 private equity report, p. 1. http://www.bain.com/publications/articles/global-private-equity-report-2016.aspx

[5] R. Charan, "Ending the CEO Succession Crisis," Harvard Business Review, February 2005.
https://hbr.org/2005/02/ending-the-ceo-succession-crisis

We've seen four ways investor instincts about CEOs can lead to incomplete assessments (Figure 1):

- ***An acquisition with great financial performance creates a halo effect.*** These CEOs often appear to have strong leadership capabilities. The thinking is, "How else could they get to this point except through strong leadership?" Financial success is equated with leadership success. However, the leadership skills needed to take a mid-sized company to the next level are different from the skills needed to start a company and make it profitable. The founding CEO may not have what it takes.

- ***Interviews focus on the dynamics of the business, not on the leadership quality of the executive team.*** In interviewing CEOs, investors look for facts about the state of the business: the sales pipeline, customer concentration, new products under development and when they will emerge, and so on. The focus is on the company, and less so on the CEO who is explaining the company's current conditions. This is because investors are highly skilled at recognizing good business opportunities and sound strategies.

- ***CEO evaluations can center on the wrong factors.*** When PE investors evaluate a CEO or candidates for the job, they often focus too heavily on such qualities as intelligence and business approach rather than on the leadership capabilities necessary for rapid growth. A CEO or candidate who articulately answers questions about the business can be highly impressive to investors. A charming CEO can falsely signal that he is effective with his team. But raw intelligence and charisma may not necessarily mean a CEO has emotional intelligence: the ability to read other people and deal with them effectively. In addition, other members of a CEO's team might be so afraid of retribution that they present a false positive view of the CEO during interviews. Finally, these evaluations rarely match the CEO assessment criteria to the specific capabilities that are critical to fulfilling the growth strategy.

- ***PE investors' judgments can be clouded when the founding CEO is an esteemed innovator in his industry.*** Many of these CEOs invented the core product, service or process that built their companies and, in some cases, transformed their industries. But technical achievement and hard work do not always qualify these leaders to scale their companies for rapid growth.

Figure 1:

Even investors who are attuned to human capital issues sometimes have little time to probe below the surface of a CEO's personality and gauge its impact on an organization. This is especially true when they are under the gun to decide whether to acquire a company or how to scale it rapidly. They feel more pressure to focus on strategic, operational, financial and marketplace issues rather than leadership matters.

Leaving the CEO selection to gut instinct alone is risky, for four reasons: compressed time frames of ownership; acute pressures on generating returns on every investment; big infusions of talent; and the need to ramp up growth. Let's look at each factor.

First, PE firms operate under some form of a compressed time horizon. Replacing a problematic CEO midway through the ownership period can wreak havoc and throw a portfolio company off course. Replacing a chief executive is never simple, and it can have enormous cultural, operational and marketplace impacts. Realistically, an unplanned CEO transition can add a year or more to an investment timeline. Or even worse, can cause a portfolio company to miss a market window and never realize anticipated value.

Furthermore, every dollar invested – especially in a new CEO – must generate a big return. CEOs have pervasive impact, so a poor choice could be a PE firm's worst investment, according to Charan, Bain and others.

In addition, CEOs of portfolio firms must frequently deal with big infusions of talent — new members of the executive team who replace those deemed unable to pull the company forward. Other times CEOs must manage acquisitions made by a PE firm to strategically strengthen their portfolio companies. Integrating such acquisitions can be time-consuming and distracting.

Finally, most portfolio companies must be able to outperform their predictive growth trajectory. A CEO who has overseen consistent 5% to 10% annual revenue increases may not have all the skills necessary to turbocharge growth to 30% to 50%. To meet such growth expectations, a CEO needs exceptional strategic and people management skills – building, grooming and nurturing executive team members. These skills may be alien to CEOs who launched their company and made it profitable enough to catch the PE firm's attention.

PE firms that want to consistently outperform the market must have strong leadership at their portfolio firms, starting with the CEO, on Day 1. From our research and experience, PE firms must rigorously identify whether a CEO or CEO candidate has strong skills in three arenas.

(CONTINUED ON PAGE 9)

Screening:

Isn't That What Recruiters Do?

Many investors rely heavily on search firms to replace a CEO, as they should. To get the optimal candidate, a PE firm needs recruiters that can locate enough strong candidates. Few options can force investors to make big compromises.

However, our clients have told us their search firms sometimes open up the search too broadly because they are unclear on the key hiring criteria. As Ram Charan said in the Harvard Business Review, "Recruiters must satisfy their clients yet also manage them, helping the search committee to gel so they can extract the criteria they need while keeping requirements broad enough to cast the widest talent net possible ... as a result, that process can be quite superficial." [6]

While most search firms acknowledge the need to assess leadership capabilities, we have found that few can truly size up whether candidates' strengths and weaknesses fit with a portfolio company's present needs and investment thesis for the long haul. Furthermore, even though some search firms leverage a suite of initial assessment and benchmarking services (which typically put candidates through a battery of tests for a few weeks before a PE firm makes the decision), this screening alone is not enough. It is generally descriptive (e.g., how intelligent, flexible or narcissistic a leader is) rather than predictive (how likely a leader will flourish and adapt to a unique business challenge).

Furthermore, recruiters (and therefore investors) tend to be unduly impressed with measures of intelligence. Those metrics actually don't provide much useful information, particularly whether a highly intelligent CEO knows how to deploy his smarts. In any event, the fact that a CEO attended a top-tier business school or has been successful for 15-20 years already establishes that he is intelligent.

There are many ways to size up leaders. However, few show a PE firm exactly which CEO personality characteristics produce good or bad outcomes at the acquired firm. The most successful PE firms we know incisively determine the unique human capital dynamics in their portfolio, and hire leaders who are capable of managing them.

Finally, search firms will always have a conflict of interest in assessing the candidates they bring forth. Rejecting all CEO candidates after running them through stringent assessment processes means the search firm hasn't delivered what it's been paid for: a new CEO.

[6] R. Charan, "Ending the CEO Succession Crisis," Harvard Business Review, February 2005.
https://hbr.org/2005/02/ending-the-ceo-succession-crisis

The Three Skills Every PE-Backed Company Needs in Their CEOs

From our firm's 30 years of experience in evaluating leaders and our research (see sidebar on page 12), we have found the unique demands that PE firms place on their portfolio companies require CEOs who excel on three fronts:

- **Thinking strategically and systemically (the ability to recognize how large-scale change will affect people, processes, and culture)**
- **Building alignment and commitment to the firm's strategy**
- **Developing top team members to accomplish the strategy**

The way we put it, having strong skills in these three domains is the difference between a CEO who is an expert mountain climber (i.e., a technical expert) and a CEO who can guide a whole team of diverse people up the mountain with them (i.e., a leader of people). Those two perspectives and leadership skills are fundamentally different. Because PE firms must constantly pressure CEOs to grow their portfolio firms rapidly, leaders who can motivate, engage and grow their teams to climb up the mountain with them are most prized. The skills of the very best PE-backed CEOs go beyond the "raw intelligence + emotional intelligence" formula that's often thought to be the magic mix.

Let's now look at each skill set, as well as a few highly successful portfolio company CEOs who exemplify them.

Figure 2:

The Three Core Skills of PE Company CEOs

1 Combining Strategic and Systems Thinking

PE firms need CEOs who can help them plot a new, faster-growth course for the companies they buy. Strategic skills are a given. But CEOs must also be able to get beneath the bold strokes of a new growth strategy. They must be able to identify and orchestrate the process and people changes needed to pull it off – i.e., the larger system dynamics.

The first component of a strategic and systemic thinker is the ability to balance strategy and tactics – the big and small picture. This is often missing in founder-CEOs who have successfully built and sold their firms to PE companies. Those founders typically bring deep technical knowledge and entrepreneurial instincts to get their companies off the ground and make them attractive acquisitions. However, the skills to scale that firm for rapid growth – a firm that will become far more complex to manage – are very different. Those skills are about understanding how to make the key working parts of the organization function together like a well-oiled machine.

PE firms need CEOs who don't make hasty conclusions to problems whose roots may lie elsewhere.

CEOs of PE-owned companies must also know how a change in strategy (for example, a new target market or new product) will affect manufacturing, marketing, selling, servicing and other processes. This is often referred to as "systems thinking" – knowing how different parts of an organization relate to one another. CEOs who are excellent systems thinkers are particularly important in PE firms that buy and integrate other companies into their portfolios. Systems thinking is also a vital trait for CEOs in PE firms that push their portfolio companies to enter new products or ramp up product innovation.

The third aspect of an excellent strategic and systems thinker is a gift for identifying the underlying causes of problems and then troubleshooting in a way that engages all stakeholders in the solution. This, of course, is an important skill, in resolving manufacturing, sales, service, product development, accounting or other issues. The hiring profiles of many PE firms can unwittingly screen out such a skill, because in their urgency to turn around or rapidly grow their firms, they favor CEOs who are quick studies rather than deep thinkers.

For example, when sales plunge, a CEO can be too ready to fire the VP of sales, or force that person to fire poor-performing salespeople, rather than investigate whether other factors caused the decline. The real problem may be a product whose price/performance lags behind competitors, or a marketing function that can't explain the product's value to the market and thus open doors to customers. PE firms need CEOs who don't make hasty conclusions to problems whose roots may lie elsewhere.

Many PE investors have told us it is not easy to recognize CEOs who excel at both strategic and systems thinking. It is far easier to spot the red flags. One warning sign is when a CEO seems unaware of how much his actions can affect others on the team. For example, a CEO who likes to preserve his options, holding many possible courses of action open until the last possible moment, demonstrates great strategic awareness. However, that CEO often leaves his executive team frustrated with, and paralyzed by, a lack of clarity about the course they must follow.

Investors need to explore the CEO leadership traits that go far beneath the veneer of eloquence and aura. A CEO might sound like someone who cares about how his words and actions affect others, but that can be deceiving. It's essential to ask a CEO's direct reports, peers, board directors and others who know him whether he understands the impact of his actions on others and if he's able to consistently align his behaviors with that insight.

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Here's an example: A PE firm asked us to interview the founder/CEO of a small company it was going to acquire. Only five minutes into our meeting with the CEO, he showed how difficult he would be to manage, and how little he cared about his impact on others. He was extremely smart and polished but arrived late to the meeting without an excuse. He then gave fast, superficial answers to the majority of our questions. He obviously didn't care how he appeared, even though he was told by the PE firm to spend time and be forthright. He appeared to treat the meeting as an annoyance that had to be minimized.

This was one of several factors that indicated to us that the CEO was underdeveloped as a systems thinker, as someone who might not care about his impact on members of his executive team. In fact, it took the PE firm six months after the deal closed to see that the CEO was wrong for the job. His management team's morale was poor, and they were disengaged. Key initiatives were flagging, and financial growth had flattened. The PE firm wasted six months trying to help the CEO change his style and reverse the firm's performance before giving up. It ultimately sold the firm at a lower price than it would have commanded had it replaced the CEO quickly after the deal closed with a much stronger leader.

In contrast, one of the strongest systems thinkers we've seen among CEOs is K. Shan Padda, now Chairman of Health Integrated Inc. The Tampa, Florida-based company was founded in 1996 by Dr. Sam Toney, a psychiatrist who created a medical-behavioral model that could identify a health insurer's highest-risk patients and provide interventions to improve their health. Upon investment from a PE firm, Padda became CEO and Toney was named Chief Medical Officer.

The company has grown significantly under Padda's leadership, nearly doubling in both annual revenues and number of employees. Padda is the quintessential systems thinker. He adjusted the firm's strategy (its business model needed to adapt tochanges in the healthcare environment) and realized the firm would need new skills in selling and delivering its services.Under his leadership, Health Integrated has identified and installed the people, processes, systems and other key ingredients needed for the new strategy, and the firm's growth has been dramatic.

(CONTINUED ON PAGE 13)

Researching the qualities of *Great Leaders*

FMG Leading has conducted research on the qualities of highly effective leaders – CEOs and other executives – for more than 30 years. Since 2009, the firm has completed comprehensive assessments of 491 senior executives, 37% of whom work in PE-backed companies and 63% who work in non-PE-backed companies.

We have assessed leaders on two dimensions:

1. "Doing" the work – i.e., their ability to do such things as create strategy, set goals, delegate, measure performance, and communicate.
2. Their state of "being" at work - i.e., how a leader's state of mind and self-mastery affects others in the organization, especially their performance.

The inputs to these assessments come from a range of sources: interviews with the leaders themselves, direct reports, peers, supervisors and others.

The assessment includes:

- An online survey with 65 close-ended questions and three open-ended questions. The data is tabulated into an overall score, with category scores (overall and by respondent groups), question scores and verbatim responses. Leaders who are assessed get to hear and discuss the findings.
- Oral interviews conducted simultaneously with the online survey. For these interviews, a leader is asked to identify three to five stakeholders. Those stakeholders are then asked to comment more broadly on a leader's strengths and areas for improvement, as a way of validating and enriching the patterns that emerge from the quantitative data.

We have found it critical to use both quantitative data (from the online survey) and qualitative data (from the interviews and open-ended questions in the online survey) to validate findings, establish patterns and provide a leader with rigorously determined and specific areas for improvement.

2 Building Alignment and Commitment

Every company, PE-backed or not, needs the top team and the managers below them to be aligned on the firm's strategy and be clear on how to execute it. CEOs of PE-backed companies face even more urgency to ensure their management ranks are aligned on the strategy. The systems, processes and cultures of PE-owned companies must be clarified and scaled much faster for rapid growth in a 5 to 7-year timeframe.

To accomplish that, the CEO must be able to communicate clearly, make sound decisions collaboratively, and be a solid business planner. When a CEO is strong in these areas, he enables others to climb the mountain with him – to do the work and be committed to excellence.

The best CEOs know they have far more impact when they equip and empower others to execute successfully. Their thinking differs from the CEOs who believe they contribute most by focusing on the excellence and capacity of their own execution skills. This type of CEO often feel the need to continually demonstrate their competence. With an insatiable desire for personal recognition, they unconsciously discourage others from participation.

In contrast, the best CEOs of PE-owned firms create the conditions that enable their teams to execute with excellence. What's more, they realize that setting operational and financial targets for their direct reports alone doesn't drive productive behavior. Team members, afraid of missing their targets, can quickly shift from collaboration to competition. Excellent CEOs supplement clear, aggressive targets with continual positive motivation.

The best CEOs also build organizations where the highest source of authority is not the leader, but rather their firm's ambitious yet achievable growth plan. They typically operate with great humility. They aren't trying to prove they're the smartest and most competent person in the room. Rather, they have adapted their leadership style to bring out the strengths of each team member. They are also finely attuned to circumstances when team members are not aligned on the strategy or how to achieve it. These CEOs regard those moments as red flags of pending operational (or other) problems that they must address quickly.

All this might suggest these CEOs aren't highly competitive people. Quite the contrary: the best CEOs generally have a fiercely competitive orientation in the marketplace. But they also realize that an unchecked competitive culture can become both unhealthy and a serious liability for the investor.

The best CEOs generally have a fiercely competitive orientation in the marketplace. But they also realize that an unchecked competitive culture can become both unhealthy and a serious liability for the investor.

CEOs who strongly encourage others to express differing ideas and perspectives and then orchestrate action based on the best ideas literally turbocharge their people's commitment to the firm and its strategy. That strategy becomes one that their management team helped develop, rather than a strategy they were only asked to execute.

All of this requires a CEO who excels at creating an environment of cooperating with colleagues, not setting them up to compete against each other. Investors, operating in a highly competitive world themselves, might mistakenly see this focus on cooperation as a sign of weakness. To be sure, every CEO must want to win badly in order to be competitive in the marketplace. But when they turn that competitiveness inward in an organization, they create a cultural wake that vies for internal recognition, respect and power. These CEOs can inadvertently become demoralizing forces – leaders who unintentionally sabotage the team's commitment to their firm's growth strategy.

It's difficult for many investors to assess whether a CEO or candidate can get a management team to agree to a strategy and commit to it.

CEOs who want their executives to embrace the strategy and be hungry to make it work need another trait: the willingness to give executives clear feedback on their performance. This input must be actionable and motivational rather than merely critical. Without it, executives won't know if their performance is off course and how to turn around. CEOs who are great at helping their teams climb the mountain don't wait until someone is a thousand feet behind them before they help.

It's difficult for many investors to assess whether a CEO or candidate can get a management team to agree to a strategy and commit to it. One PE firm wishes it had been able to recognize this in the CEO of a company it acquired a few years ago. The CEO had grown it rapidly and profitably, which quite understandably impressed the PE firm. The PE firm highly admired the processes the CEO had instituted, which yielded high levels of service quality. The CEO was charismatic and engaging; it was hard not to like him. However, after the PE firm talked with his direct reports and saw how he interacted with them in meetings, it became clear that the CEO, while respected and highly admired at the surface level, also was feared and hated. The CEO issued directives by the hour, and no one knew what to expect next. The anxiety caused his team to "lean back" rather than "lean toward" him, and seriously handicapped their performance.

In several interviews we conducted with the CEO, he constantly redirected the dialogue to where he wanted it to be: why his skills were exemplary, and those of his team members were disappointing. After talking privately with his direct reports, we found the CEO led through managing a culture of fear and intimidation. He surrounded himself with inexperienced managers who were unlikely to question his management style. When they were near burnout, he retained them by granting lofty titles, large cash bonuses, and extravagant gifts.

An anonymous online survey of the management team (and a few levels down) revealed employees were afraid of the CEO and not happy working there. What's more, the CEO's peers in the industry were also informally polled, because the PE firm planned to try to acquire similar firms. While those peers respected the company's quality and financial performance, they gave the CEO poor marks personally and said they'd never work for him.

We told the PE firm its acquisition wouldn't grow rapidly with the CEO at the helm. But the PE firm did not want to oust the founder. Instead, it created a corporate entity above the acquired company to be run by a new CEO hired from the outside. That CEO created the management processes, leadership capabilities and organizational "muscle" that enabled the investment to scale. We also assessed the leadership skills of the rest of the founding CEO's team, recommending the PE firm keep three of his direct reports.

How did the company's new CEO gain rapid alignment with and commitment from his team and other stakeholders (the board and investors)? He realized their interests were not at all in alignment when he arrived. There was significant tension between those who wanted the company to grow rapidly (and believed it needed standard processes to do so) and those who wanted the company to maintain its high level of quality services. The new CEO carefully determined each group's unique needs and challenges. He listened deeply to the people he had to influence, both those above and below him. He then created a strategy that showed how the company could accomplish the seemingly conflicting goals of growth and high-quality services. The new CEO realized his No. 1 job was educating people in the PE firm and its portfolio company – of reframing the way they thought about the growth vs. service quality issues. In doing so, he built strong alignment and commitment among all key stakeholders in just nine months.

With a new CEO, a few new executive team members, role clarification for a few legacy executives, and a cohesive organization that was solidly behind the new strategy, the company's value expanded rapidly. In 18 months, its revenue and and profit more than doubled. It was acquired shortly thereafter for several times what the PE firm had paid for it. What's more, the buyer bought the company because it saw that the current growth model would also expand its reputation for high quality.

3 Developing Others on the Team

PE-owned companies too often overlook talent development. Because of the short timeframe in which they hold their portfolio companies, investors may view time dedicated to executive development as a luxury. In addition, the investment required to truly develop talent can be hard to validate using short-term ROI metrics. PE firms frequently view hiring as the answer to talent shortages. Why take months or years to make an executive more effective when you can simply hire new talent?

The best-run PE-owned firms we've worked with emphasize both talent development *and* recruitment. When they develop talent, they do it wholeheartedly and strategically. They focus on skills they believe are crucial to their competitive advantage and not widely available in the marketplace. In other words, they are huge proponents of talent development – but are usually quite selective of which individuals and which skills they develop.

The best-run PE-owned firms we've worked with emphasize talent development, not just recruitment.

In identifying the critical skills that must be improved, these CEOs may even temporarily overlook the development of entire layers of management. By doing so, they can focus investments on executives and managers that will have the greatest business impact.

PE firm CEOs who think this way realize that a winning strategy is not enough to grow a firm, and that not any team can execute that strategy. They are realistic about the ability of their own team to make it happen, and know which skills need to be developed for the strategy to be executed well.

As a result, these CEOs quickly determine who needs to be developed, in what ways, and how. Consider the case of Surgical Care Affiliates. The Deerfield, Illinois-based company was launched in 1982 as a provider of surgical facilities. It was sold to HealthSouth in 1997, and then sold again in 2007 to a private equity group led by TPG after HealthSouth ran into legal and financial troubles. Today a publicly held company, SCA operates 200 surgical facilities in 34 states.

In 2007, TPG hired a new CEO, Andrew Hayek, to rebuild SCA. The company had suffered more than four straight quarters of declining profits. Hayek knew he had to institute a new strategy and culture. He assessed how clearly the executive team understood and agreed with the new strategy and blended that insight with cultural norms, skills and perspectives that would be necessary to get the team and the rest of the organization to support that strategy.

Hayek was committed to creating a high-performance company run by a world-class executive team. He made significant investments in assessing, developing and grooming these executives at the outset. Those who were short on the skills required to execute the new strategy were offered opportunities to develop their skills. But Hayek didn't push training on them. He created a "pull" scenario by instituting a culture that continually raised the bar of executive performance year over year. Leaders who were internally driven to improve themselves stayed. Those who weren't left the organization.

All this talent development took time to yield a return. But Hayek didn't cut corners. He invested in areas that might have seemed dubious to those with a shorter-term focus. He issued hard messages to the team about the performance he expected from them, and he supported them through challenging periods.

The impact began to show in the first year: an 11% increase in profits. And it has continued ever since, to this day (TPG and other investors successfully recapitalized their investment through an IP in November 2013). From 2008 to 2015, SCA's revenue rose 88% (from $690 million to $1.3 billion) and net income more than doubled (from $73 million to $170 million).

We realize some PE companies might consider such executive development superfluous. These investors often view this in a larger context: a PE-owned company has no time to coddle — only to "get stuff done." In other words, urgency outranks empathy.

We believe this is a false and harmful dichotomy. The best leaders, at PE-owned firms and others, create the conditions that generate deep engagement from their followers. The management team lives and breathes the company's mission and strategy – so much so that they put much of their discretionary time toward making the company better. A CEO who leads with urgency and provides no empathy will produce followers who are afraid to get it wrong and thus become cautious.

Urgency and empathy aren't mutually exclusive. In fact, urgency delivered with empathy will greatly increase the odds that the critical work gets done on time and in alignment with expectations. PE firms need CEOs who know how to use empathy to generate a highly positive sense of urgency, thereby generating greater momentum toward their strategic and financial goals.

The best leaders, at PE-owned firms and others, create the conditions that generate deep engagement from their followers.

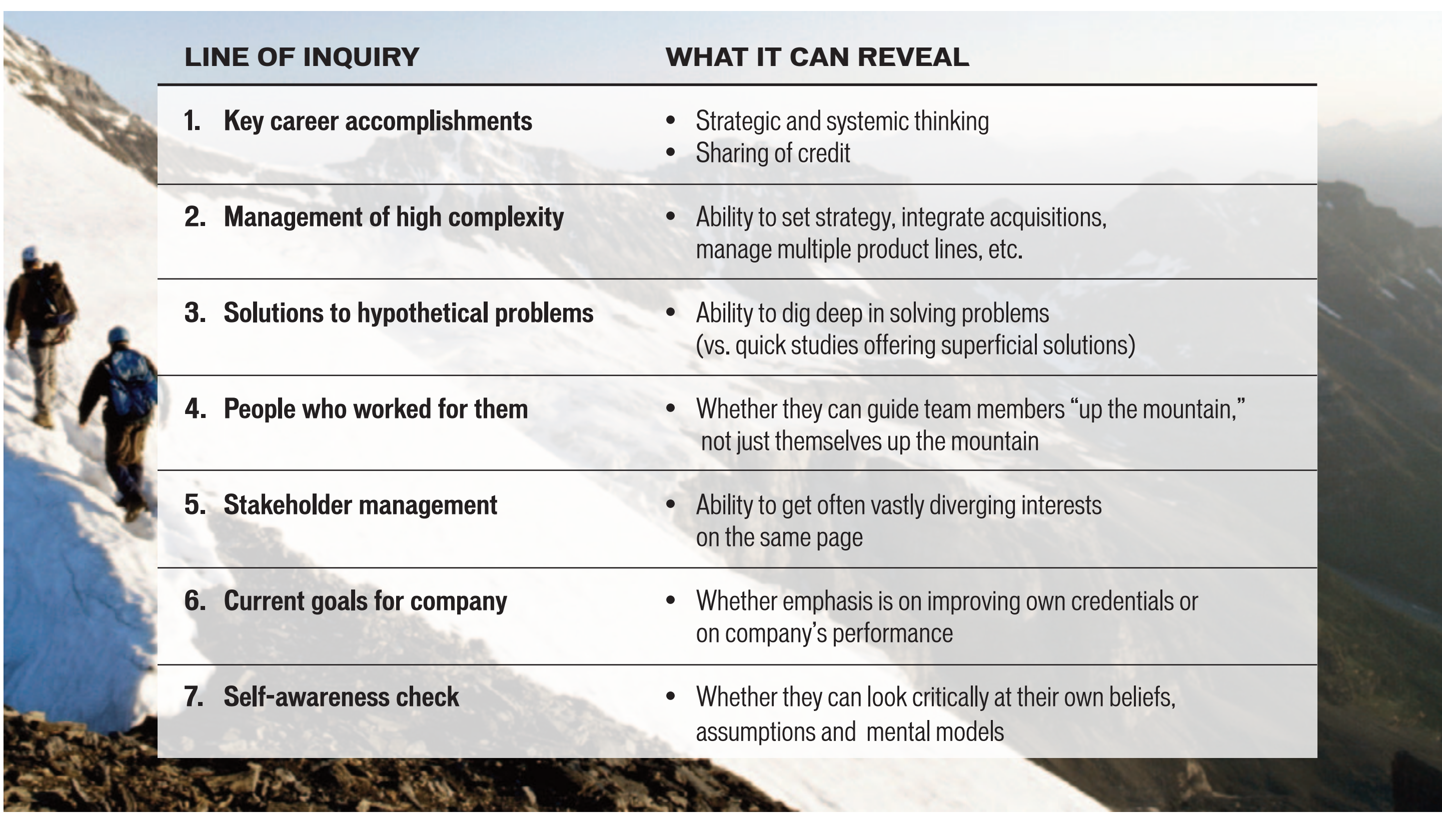
How to Determine Whether a CEO Has the Skills

As we indicated earlier, the three most important traits of CEOs at PE-owned companies are not always easy to recognize. This is especially the case when a PE firm must position itself as an attractive buyer for a company. In those cases, the time pressure to close a deal, and the reluctance to ask potentially awkward questions, make a thorough CEO assessment even more difficult. It's grossly unrealistic to unleash an army of psychologists with a battery of psychometric tools in the due diligence phase.

To ensure CEO quality before or after an acquisition, PE firms that pursue seven lines of inquiry can shed considerable light on whether the candidate has what it takes (see Figure 3):

Figure 3:

Seven Lines of Inquiry in CEO Interviews



LINE OF INQUIRY	WHAT IT CAN REVEAL
1. Key career accomplishments	• Strategic and systemic thinking • Sharing of credit
2. Management of high complexity	• Ability to set strategy, integrate acquisitions, manage multiple product lines, etc.
3. Solutions to hypothetical problems	• Ability to dig deep in solving problems (vs. quick studies offering superficial solutions)
4. People who worked for them	• Whether they can guide team members "up the mountain," not just themselves up the mountain
5. Stakeholder management	• Ability to get often vastly diverging interests on the same page
6. Current goals for company	• Whether emphasis is on improving own credentials or on company's performance
7. Self-awareness check	• Whether they can look critically at their own beliefs, assumptions and mental models

- ***Exploring key accomplishments in their careers.*** A number of questions will expose how well CEOs think strategically and systemically, the importance they attach to gaining alignment and commitment to a strategy, and their history of developing people. Asking a CEO about his 3-5 greatest career accomplishments can be very revealing. How much of the success do they ascribe to a good strategy vs. thinking through the "systems" aspects of that strategy and putting the pieces in place? How much did they talk (if at all) about how they convinced key stakeholders to agree to the strategy, and how they gained that commitment? How much of their success do they attribute to their personal contributions vs. influence they provided that enabled others to exceed their own capacity? When a CEO speaks of his accomplishments through a purely personal lens minimizing the achievements of others and teamwork, it is a big red flag. Viewing a CEO's experiences through these lenses is almost always highly revealing. They enable a PE firm to probe far below the surface of CEO resumes, which typically give superficial explanations about how they took a firm from X to Y dollars in revenue or market share.

- ***Discerning their ability to manage high complexity.*** Some CEO jobs at PE-owned firms are more complex than others. For example, the CEO job is less complex when the investor or portfolio manager is driving the strategy and the CEO is essentially the COO. Even when the CEO is asked to devise the strategy, his job may be less complex if the business model is simple – e.g., one core product and one market segment. But the CEOs who have functioned more as COOs or have run less complex businesses may not be ready for jobs with more strategic and complex responsibilities. They may not be able to set the strategy, integrate acquisitions, deal with multiple product lines, and handle other elements. Hearing how they'd deal with such complexities can reveal whether they'd be overwhelmed by them.

- ***Looking at how they would solve tangible hypothetical problems.*** This is about posing a thorny potential problem that they may be asked to handle. The key is to make it tangible enough that it sparks their best thinking. Observing the degree to which they inquire more about the problem vs. respond quickly with a solution will illuminate their capacity for systems thinking. Do they follow with a line of inquiry rather than answers (a good sign)? Or do they respond with a formulaic answer (a bad sign)?

The key is to then look for the degree to which they inquire more about the problem vs. responding quickly with a solution.

- ***Listen below the "storyline" when they talk about the people who worked for them.*** The aim is to understand how much loyalty they've generated over the years in talented executives who could follow them. Who would they say are the most talented people they've met in their careers? Would those people join them in a new company, and if not, why? (For example, did they have a falling out?) The CEO who has a hard time pointing to the most talented people he's worked with may believe his career success was mostly about him … a red flag. The CEO who acknowledges others but doesn't think they would work for him again may also prove troublesome. To put it succinctly, these kinds of CEOs have generated little loyalty. In continuing the mountain climbing analogy, those CEOs are not likely to care about getting their team up the mountain. CEOs' views on past employees can also shed insights on whether these leaders can make tough decisions about replacing under-performing team members. Sometimes even the most loyal team members don't have what it takes for a PE firm to meet its ambitious growth targets, and must be replaced. The CEO must have the stomach for it. CEO candidates should be asked (when they have poor performers on their team) how they knew when it was time to replace them, and how they handled it. If it took too long, that's a bad sign. Look for evidence that a CEO can make the hard choices necessary to move the organization forward. Even better is a CEO who can make the hard choices in a timely manner and keep a respectful relationship past the change.

The CEO who has a hard time pointing to the most talented people he's worked with may believe his career success was mostly about him ... a red flag.

- ***Asking how they manage multiple stakeholders.*** CEOs of PE-owned firms must have a proven ability to manage multiple stakeholders. It can be very revealing to hear how the CEO managed multiple owners in the past without compromising the strategy or causing disharmony. Ask the CEO or CEO candidate to tell a story about how she navigated the often-choppy waters of employees, leaders, investors and owners – especially how she influenced those stakeholders aligned on the strategy. Every CEO of a PE-backed company must deal skillfully with multiple stakeholders – sometimes multiple owners and investors. It is important to know about the last time the CEO or CEO candidate had to respond to the demands of several owners who she thought might compromise company growth. How did the CEO resolve the conflict? Did the CEO have the credibility and clarity to reframe the assumptions and defend it with the board? Is the CEO able to differentiate when "going along to get along" will negatively or positively affect a sound strategy? You should also be looking to see if the CEO or CEO candidate has the resolve and maturity to do the right thing and absorb the heat from the board, without turning the heat on their team.

- ***Understanding their current goals for the company.*** If the CEO is in place at a firm you've just acquired, you can discern much about her leadership skills from the way she describes her goals. Is she exclusively focused on achieving her equity payout, or does she balance this with a focus on developing key leaders so they can dramatically improve the firm's performance? A great leader is one who believes they must be the servant who makes things happen for others on their team – not the center of attention and adulation. This isn't to say that a dose of narcissism is bad in a CEO. In fact, a little narcissism – say 25 points on a 100-point scale – helps high-performing CEOs confidently ask their people to follow their lead. But highly narcissistic CEOs become a huge problem because everything is about serving their (often insatiable) needs. Using a rock group analogy, the best CEOs at PE-owned companies can get people to dance to their tune as the bass player, not as the lead singer who needs to be front and center at all times.

- ***Understanding their self-awareness.*** Everyone operates with a mental model of how the world works. But PE firms need CEOs who have self-awareness, emotional intelligence and the discipline to reframe their perspectives when the situation warrants. They not only understand their own mental model, but also are able to alter it when new facts come into play. To determine whether a CEO continually refines their mental model, ask about their past failures. CEOs who offer a simple explanation of blame, external forces or inexperience are not likely to revise their mental model. In contrast, if they admit to failure and acknowledge their role, and can articulate their personal growth path from the lesson, they are likely to be able to evolve their mental models.

PE firms need CEOs who have self-awareness, emotional intelligence and the discipline to reframe their perspectives when the situation warrants.

In interviewing these CEOs (or CEO candidates) and their teams, make a single person accountable for gathering and consolidating insight on these questions from members of the diligence team or the board. This human capital-focused partner should operate alongside the team, scanning for financial, operational, competitive and other insights about the business. It's difficult for people who are focused on gleaning details about the business to also simultaneously zero in on the CEO as a leader. What's more, the human capital expert needs to be deeply familiar with the PE firm's culture, way of operating, and deal thesis. The rest of the deal team doing the interviews should then debrief and share their opinions about the CEO or candidate for the job.

Getting the Right CEOs On Board: More Important Going Forward

In our research on companies with less than $2 billion in revenue – those owned by PE firms and others – we have found the three key CEO leadership traits explained in this paper are often missing at many PE-owned companies. That's a problem. While all companies need CEOs who can motivate, develop and coach their teams up the proverbial mountain, those owned by private equity firms need it even more.

Why are such leaders harder to find in PE-backed companies? It could be that such CEO assessments are perceived to slow the deal-making process down. In reality, screening a CEO can be done in as little as 6-8 weeks, starting on Day 1: the first discussion with a target acquisition.

Because the CEO running a PE-owned firm will have a major impact on its success, such assessments need to be made before or just after the close. Dozens of PE firms have told us they waited too long to replace a troublesome CEO running a portfolio company. None lamented that they rushed to judgment and replaced the CEO too soon.

In fact, one PE company told us it allowed the wrong CEO to run one of its businesses for a full five years. It believed the business was so unique that the CEO was the only person who understood how to run it. After the fifth year of lackluster growth, the PE firm replaced the CEO, and the new one turned it around rapidly. The PE firm admitted to us that had it installed the right CEO from the start, it would have made a much bigger return when it sold the firm.

Knowing whether you have that CEO right from the very start of owning a firm can significantly impact an acquisition's ability to fulfill its promises.

Knowing whether you have that CEO right from the very start of owning a firm can significantly impact an acquisition's ability to fulfill its promises. As Carlyle Group managing director David Rubenstein once said, "Private equity firms need to recognize that their ultimate, long-term success is dependent not just on raising large sums or achieving high rates of return, but rather on the skill with which individuals are recruited, retained, trained, compensated, promoted and (in appropriate situations) transitioned or retired." [7]

In short, PE firms must pay close attention to the CEOs who run their portfolio companies. If they focus on the right attributes and choose carefully, they will greatly increase the odds their portfolio companies meet or exceed their expectations.

[7] "Human Capital in Private Equity," p. 11., published by Private Equity International London.
http://financeforentrepreneurs.com/wp-content/uploads/2015/10/HumanCapitalinPrivateEquityMercer.pdf

About FMG Leading

FMG Leading is a human capital strategy firm that partners with visionary leaders and investors who are committed to transforming the healthcare industry in America. Working at the intersection of humanity and high performance, the advisors at FMG Leading partner with clients to design integrated development strategies that accelerate growth, build enterprise value, and create industry-leading results.

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Throughout his professional career, Dr. Matt Brubaker has partnered with investors, boards, and CEOs to build high-performing organizations. His advisory work, especially in Private Equity, focuses on growth strategy, senior team alignment, and enterprise-wide change initiatives. A recognized thought leader on the subject of human capital strategy, Dr. Brubaker's work has been featured in numerous management publications including: Harvard Business Review, Forbes, The Wall Street Journal, Chief Executive, Fast Company, and Private Equity International. Dr. Brubaker earned his Master of Arts degree in Dispute Resolution at the University of Massachusetts, and his Doctor of Education in Organizational Change (Ed.D.) degree from Pepperdine University. He serves as an Operating Partner at WindRose Health Investors, a New York-based private equity firm, and also sits on the boards of JM Search, Traditions Behavioral Health, and Big Sky Bravery.

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