Why PE Firms Need Human Capital Strategies to Accelerate Value Creation

When Portfolio Company Leaders are Strongly Aligned with a Growth Plan and Galvanized to Implement It, Higher Returns Can Follow

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FMG LEADING®

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EXECUTIVE SUMMARY

PRIVATE EQUITY IS BOOMING. In many sectors, the cost of acquiring companies is at record multiples, and thus the pressure to turn them around quickly and profitably is more intense than ever. But in response, many PE firms have not deviated much from the standard three-part playbook for managing their acquisitions: financial leverage, operational restructuring, and investments in growth (especially bringing in new talent at the top of the organization).

From our years of advising PE firms in the third area, we have found too many rely almost exclusively on top-grading senior talent with A players and aligning their monetary incentives (a lucrative exit) with that of the general partner. Their belief is that those should be enough to push the strategy forward. Unfortunately, they often do not.

In the worst cases, they result in a new top management team that isn't fully aligned on the growth strategy, that operates in silos, and thus doesn't work productively enough to solve cross-functional challenges. These often are the sources of the greatest opportunities to accelerate economic value. The new team of A players work diligently in their silos. However, they don't work together strongly enough on opportunities to increase demand and create efficient supply that requires truly unified efforts. Therefore, although there is plenty of activity, there is little actual progress toward value creation. This, in turn, can amplify conflicts and dysfunctions that slow down or derail the growth strategy.

We believe the key leadership team challenge for today's PE-owned companies is no longer just about hiring new talent at the top and giving them strong financial incentives to execute the growth strategy. That will always be crucial. But with today's demands for more aggressive growth strategies to generate sufficient returns, PE firms need something more. They need to get the leadership of the companies they buy – both new and existing management team – to understand the growth strategy deeply, support it wholeheartedly, work effectively to refine it if necessary, and execute it with passion and excellence.

But creating such a great top team requires not just a growth strategy for the business; it also demands a strategy to align and engage its people. We refer to this as a human capital strategy. To greatly increase the odds of getting the returns they expect, PE firms must devise human capital strategies at the onset of their acquisitions. From helping create a number of such strategies, we explain how to do so.

We also speak with Nick Orum, President of Gryphon Investors, about their approach to human capital strategy and how it accelerates returns across their portfolio of investments.

UNPRECEDENTED PRESSURE IN THE PE MARKET

This is the tale of how a private equity firm quickly assembled an all-star team to run of one of its portfolio companies and how it led to a near financial disaster. Earlier this decade, the PE firm purchased a health care services company and set it down a path of rapid growth. Or at least it thought. The PE firm quickly replaced every member of the existing top team except for one, who soon departed as well.

Their high-ticket replacements were all-stars. Each came with excellent credentials from other industries, but with little experience in the business of their new employer. Nonetheless, the PE firm started buying similar companies for the team to integrate and expand its footprint.

Typical PE playbook, right?

But not long after getting comfortable in their sparkling new offices, the top team had to deal with a quality crisis in the hospitals that delivered the firm's services. It was a shock to the new executive team, which had been out of touch with the field quality problems. Regulators soon swooped in, forcing the PE parent firm to bring a new CEO to turn things around rapidly.

Does this story sound familiar – the rapid replacement of an acquisition target's top management with A players who are new to each other, and who must get behind the turnaround strategy and gel as a team in little time? If it does, it's not surprising. We've seen it play out dozens of times in many a PE firm portfolio.

"PE firms have been under tremendous pressure this decade to boost the returns on their portfolio companies."

It's understandable, too. PE firms have been under tremendous pressure this decade to boost the returns on their portfolio companies. The much higher prices they must pay for acquisitions means those companies must command higher prices upon exit. And getting a higher price, of course, requires accelerating their growth in the years under PE ownership.

The statistics on the PE industry show how acute these pressures are. Bain Capital's 2019 Global Private Equity Report paints a picture of a frenetic sellers' market for attractive firms. The number of transactions has stayed "stubbornly flat," the Bain report said, between 3,000 and 4,000 deals a year since the beginning of this decade. "For [general partners], finding the right asset at the right price was the biggest constraint on doing deals in 2018." And the biggest challenge for PE buyers in 2018 was high transaction multiples.[1]

The prices at which PE firms must buy companies for their investment portfolios (expressed as a multiple of earnings before interest, taxes, depreciation and amortization) are at record highs, according to PitchBook.[2] Between 2010 and 2018, the median multiple of U.S. PE buyouts has risen from eight to more than 12 times EBITDA (see Exhibit 1). Median hold times this decade – five years – are significantly longer than those last decade before the global financial crisis (when they were less than four years), with that extra year often meaning another round of investment and losses.

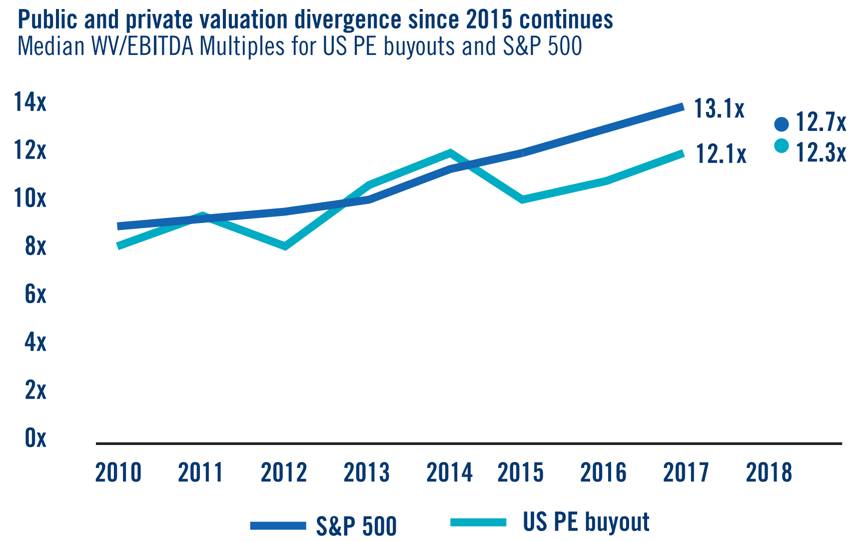
1 Bain's 2019 Global Private Equity Report. https://www.bain.com/insights/year-in-review-global-private-equity-report-2019/

2 PitchBook, a Morningstar service. https://files.pitchbook.com/website/files/pdf/PitchBook_2019_Private_Equity_Outlook.pdf

“The economics of private equity this decade put a premium on the top management teams at their portfolio companies to get behind a solid growth strategy and gel far faster as a team.”

RISING PRICES OF U.S. PRIVATE EQUITY DEALS

Exhibit 1:



Note:The S&P 500 multiple is calculated using the aggregate values of the underlying companies, whereas the PE buyout multiple is the median value

Source: PitchBook
**As of November 30, 2018*

All of this has had a profound effect on how PE firms manage acquisitions. Our deep experience with the third piece of the playbook suggests that most PEs need to reevaluate it. (See sidebar.)

The economics of private equity this decade put a premium on the top management teams at their portfolio companies to get behind a solid growth strategy and gel far faster as a team. A solid growth strategy and A players to execute it is no longer enough, as we will explain.

Leadership in a PE 4.0 World

In their 2015 book *Private Equity 4.0: Reinventing Value Creation,* three authors described four industry business models for private equity since the 1940s[3]:

- **PE 1.0:** from 1946 to the 1980s, a time in which PE firms used the junk bond markets to buy and split apart large conglomerates.
- **PE 2.0:** from the 1980s to 2000, a time in which PE firms made operational improvements in their portfolio companies through technology and other means.
- **PE 3.0:** from 2000 to 2008-09, a period in which PE firms introduced practices that generate profitable revenue growth.
- **PE 4.0:** from 2009 to present day, this has been about value creation via operational and profitable revenue growth initiatives.

We believe human capital strategies are now an indispensible part of PE 4.0. For portfolio companies to thrive amidst higher acquisition prices and compressed timeframes to generate higher returns on them, the previous playbooks are grossly incomplete. Relationship engineering is now a vital part of the modern-day PE playbook.

3 Benoit Leleux, Hans van Swaay, and Esmeralda Megally, “Private Equity 4.0: Reinventing Value Creation” (John Wiley & Sons, 2015).

WHAT PE-OWNED FIRMS NEED NOW: A HUMAN CAPITAL STRATEGY

Given the economics of their markets, PE firms not only need more aggressive growth strategies for the firms they purchase; they need "human capital" strategies to make sure employees at those firms (from top management on down) are fully behind and able to execute those growth strategies.

A human capital strategy is a rigorous plan about how leaders will get the people in their portfolio companies aligned on the growth strategy and capable of executing it according to plan. To be sure, this may require adding A players to the team. But it will demand much more, including a management team that is deeply in sync with the growth strategy and works exceedingly well together to execute it.

Think of it this way. If the first part of the traditional PE turnaround playbook is around financial engineering and the second part is on operational engineering, you could consider a revamped third part of the playbook to be about relationship engineering – i.e., helping leaders at the portfolio company to create great working relationships with one another and the board, and in a highly positive working relationship with the growth plan itself. By this, we mean having portfolio company leaders who deeply understand and believe in the growth strategy, and know exactly what they must do, both individually and collectively, to make it work.

Once leaders are aligned this way, they then need to get other managers and employees in crucial roles on board as well. By the way, many of those roles are not likely to be at the top of the organization. In a manufacturing firm, they could be plant managers. In a hotel chain, they could be the front desk personnel. In a health care services company, they could be managers running daily operations of its service centers.

Without a human capital strategy, engineering a strong relationship among the key players and with the firm's strategy will not at all be easy to achieve. This is especially the case today, given that PE growth plans must be more ambitious to generate the expected returns on acquisitions made at higher price-earnings multiples. In this kind of environment, any of the following conditions will threaten even the best-crafted PE growth strategy:

- Functional silos that focus marketing, sales, product development, supply chain, and other executives on improving their silos. The greatest opportunities to create value are usually cross-functional.
- Tense relationships between the investors and the leadership team that develop when the latter group views board requests for change as being forced upon them. In a distinct minority of cases, this can create adversarial relationships between portfolio company leadership and the board at times in which they need an especially productive and respectful working relationship.
- Leadership team members (new and old) who aren't used to the pressures of private equity ownership – of needing to make concerted change rapidly without upsetting the healthy human dynamics that keep people from splintering and losing trust.

> “The right human capital strategy gets the board, company leaders, and 1-2 layers of management below working in lockstep to understand a high-level investment thesis and turn it into a robust growth strategy that leaves few questions unanswered.”

By the way, the need today for a human capital strategy that supplements a growth strategy is particularly true for larger PE acquisitions. “As deals and funds get bigger, [PE] firms need to understand that a playbook for a $20 billion acquisition is not a simple scale-up of the playbook they use to unlock value at a $2 billion company,” said Hugh MacArthur, the leader of Bain & Co.’s global PE practice. “Megadeals require a mega-investment in due diligence and the skills needed to choreograph change on a massive scale,” including complex cultural change programs.[4]

With these challenges in mind, we offer a three-step approach to developing an effective human capital strategy:

1. Creating an intentional onboarding process to translate the investment thesis into an actionable growth strategy;
2. Assessing the firm’s people capabilities and limitations; and
3. Executing and monitoring the human capital strategy to make sure it is working.

Let’s dive deeply into each one.

A New Onboarding Process: Getting Portfolio Company Leaders Fully Behind the Growth Strategy

Most onboarding activities we’ve seen over 30 years at PE-owned companies are haphazard, financially focused, and conflate growth targets with strategy. Bringing in and orienting the new members of a management team is the most opportune time to set the right human capital strategy.

And the right human capital strategy gets the board, company leaders, and 1-2 layers of management below working in lockstep to understand a high-level investment thesis and turn it into a robust growth strategy that leaves few questions unanswered.

Thus, the first step of creating your human capital strategy is intentionally designing your portfolio company onboarding process. The new process should be in part about building high-functioning relationships between investors and the management team soon after the acquisition is made. That is the relationship engineering part of human capital strategy.

One of the most important relationships to intentionally engineer is between top leadership and the board – i.e., the ownership representatives and other advisors. We call it getting them on the same side of the table – not on opposite sides that demarcate “us” from “them.”

But the onboarding process must go beyond the board and top management. It must also use a participative process to clarify the growth strategy so that leadership at multiple levels can a) intimately understand it, b) challenge and then embrace it (which should be a better or deeper plan than the original), and c) thoroughly know what they must do to help achieve it.

This plan must also enable management to differentiate from the many potential priorities that often emerge during a turnaround, and select the few that will create substantial value during the life of the investment. We have seen portfolio companies pancake under

4 Hugh MacArthur, Bain & Co. article in PE Hub, “Private multiples are ascendant. Is this the new normal?” March 21, 2019. https://www.pehub.com/2019/03/private-multiples-are-ascendant-is-this-the-new-normal/#

the weight of a myriad of initiatives – all rooted in best practice – without truly understanding the few that will generate the greatest value. A to-do list of 15 to 20 "mandates" – all of equal importance in the minds of leaders and the board – is likely to result in initiative overload.

Getting the Board and the Leadership Team on the *Same Side of the Table*

One of the many advantages that private equity firms have over public companies is the board directors of their portfolio companies. The boards are constituted at the portfolio company level – rather than at the highest level of a public company that owns many subsidiaries. That gives them a governance edge. "Since board activities focus on only one business unit, they can effectively surface, grasp, and debate the critical strategic, organizational, and operational issues it faces," said the authors of a 2016 McKinsey article.[5]

In addition, when those directors have a substantive equity stake in the portfolio, it can further focus their attention on making the portfolio company successful. The same holds true of the leadership team. Having a big future pay date can motivate tremendous work efforts.

Yet the boards of PE-owned companies can also become intimidating – especially when the business is grossly underperforming. At times like this, a PE-owned company's board can feel like a firing squad to leadership. Board members, eager to see their own big pay day, are often quick to micromanage problems they don't fully understand. But even if they don't start issuing mandates, they can suggest ideas in ways that spawn resistance rather than buy-in by a team that already feels the pressure to perform.

This is understandable. As savvy investors, PE firms have learned how to focus pressure on areas of the business with the greatest potential to create value. As such, board directors often have heated conversations with senior managers who miss their goals.

However, the most effective boards don't want to be viewed as intimidating. They want to be seen as influential advisors – directors to be tapped when they possess invaluable expertise that could make a difference in the business.

We call boards and leadership teams that operate this way as being on "the same side of the table." When they can reach this place, any friction between the board and company leaders is much more likely to generate positive and concerted action.

This requires board directors who can balance their sense of urgency – i.e., not letting the incessant ticking of the clock of the hold period affect their interactions with leaders – with a sense of empathy. It means having directors whose first instinct is to help, not to fire.

5 Matt Fitzpatrick, Karl Kellner, and Ron Williams, "What private-equity strategy planners can teach public companies," McKinsey, October 2016. https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/what-private-equity-strategy-planners-can-teach-public-companies

"Leading companies have defined their missions in ways that make it easy to find and keep valued employees."

The onboarding process is instrumental in establishing the norms of how people will communicate with one another during the period in which the company is owned by the PE firm. It will also instruct them on how disagreements are heard and resolved. It should set the cultural tone for what is ahead: a strong and productive working relationship from the start that gets only stronger and more productive over the PE firm's hold period.

When we say the top team must work exceptionally well together, we don't mean that they need to agree with each other constantly. In fact, when we see a top team that isn't exchanging conflicting views, we know it is not likely to be effective – especially in the pressurized environment of a PE-owned company. Unwillingness to voice opposition can block debates and thus better decisions on crucial issues. The best-performing executive team members at PE-owned companies often disagree with one another, sometimes even vehemently. We encourage them to disagree and work out their disagreements. However, their disagreements are constructive and devoid of personal attacks that can foster private grudges.

But the onboarding process is also crucial in creating alignment among leaders around the growth strategy. Strategic alignment is thus a critical output of onboarding. What do we mean by strategic alignment? We define it as the extent to which all leaders (and, by the way, not just those at the top) share a consistent view about their company's growth strategy – how success in achieving that will be measured, and the critical few priorities required to achieve that success.

Moreover, this degree of strategic alignment requires a dynamic management model and process to ensure these priorities can be translated into the activities of each employee. At the end of the day, the goal here is not just to get to the goal, but to get there quickly.

When strategic alignment is tenuous, a growth strategy's success will likely be in jeopardy. If such alignment is extremely weak, the strategy is at high risk of failing at some point – even if current financial indicators don't indicate it. The reason is that leaders will be sidetracked with conflicting priorities, organizational politics, intense internal competition for resources, and other people problems. These will slow down the strategy's execution – new marketing campaigns to boost leads, cost-cutting moves such as office consolidation, and the smooth integration of acquisitions.

Assessing People Capabilities and Limitations

So now you have a leadership team that is totally in sync on what they must do over the next 5-7 years (the typical hold time of a PE firm acquisition). The next step in creating a strong human capital strategy involves evaluating people (especially the current set of leaders), and their ability to change and work within the new culture that will support the growth strategy.

Before we dive into that, a word of caution. PE firms can spend inordinate amounts of time and money to get all the elements of a great human capital strategy in place: highly talented leaders, significant education and training of them and others in the organization, a massive cultural change initiative, and more. We advise clients not to do it all. Instead, we tell them to spend their human capital money judiciously. You don't need to invest

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Gryphon Investors' Approach to Human Capital Strategy:
A Q&A with President Nick Orum

GRYPHON INVESTORS is a private equity firm focused on middle market investment opportunities. Based in San Francisco, the firm has managed more than $4.8 billion of equity investments and capital since 1995.

Nick Orum is president of Gryphon and serves on the boards of portfolio companies CORA Health Services, ECG Management Consultants, OB Hospitalist Group, Smile Brands, Water's Edge Dermatology, and LEARN Behavioral.

FMG Leading: Gryphon has invested in numerous companies for nearly 25 years now. How do you evaluate the human capital aspects of a potential investment during the diligence phase?

Orum: We do it in a couple of ways. We have a group of a dozen people who help us assess and develop human capital plans for the companies in which we invest. The diligence process itself takes two tracks. One person is responsible for an organizational development assessment.

The OD person is looking at the senior leadership team, the quality of their integration, and the next level of management. We survey the entire organization and then hold a series of discussions and debriefs with the senior leadership team to get a much more informed point of view on the state of affairs in the company.

In parallel, we have a person who focuses on the human resource aspect of due diligence. That includes benefits, the nature and structure of incentive compensation, and other aspects of the reward system. The HR person also looks at a company's recruiting, retention and talent development processes.

FMG Leading: How does a human capital strategy fit within your larger toolkit for creating value in your portfolio companies?

Orum: It's the foundation of our most important efforts to build value in a company. In the middle market in particular, and in more asset-intensive businesses in the industrial and consumer sectors, so much of an investor's ability to improve the trajectory of a company depends upon having the right human capital strategy in place.

This includes the senior leadership team – how it's constituted, how effective it is, how well team members collaborate – and the longer-range plan for developing high-potential people, as well as the succession plan.

We do a fair amount of incremental diligence during and just after the deal closes. It informs how we develop our human capital strategy.

FMG Leading: How critical is a Chief Human Resources Officer in relation to a portfolio company's ability to execute on a human capital strategy?

Orum: A quality HR organization led by the right person is indispensable, and in many of our new portfolio companies the CHRO is a critical part of the strategic team. Yet other middle-market companies don't have a CHRO on day one. We look at where the company is in its lifecycle, its financial wherewithal, and the particular challenges for its management team.

Sometimes an organization either just can't afford a CHRO, or it has other priorities and can't bring someone on board right away. While we look at each company individually, generally our preference is to have them invest in a CHRO.

FMG Leading: What are the three most common human capital challenges you encounter with newly acquired portfolio companies?

Orum: The first is coaching the senior leadership people as individuals and as a team. The second is identifying and developing future top managers among high-potential professionals, and thinking through the gaps in their current organization if you move them up. Our human capital team will often help companies develop a leadership academy or similar program to accomplish this. It can not only fulfill its primary objective – developing leaders – it's also a fantastic recruiting and retention tool.

And third, we look at the total reward system in the company, but we do it carefully. One of the worst things that a PE firm can do, particularly with sales and marketing professionals, is to immediately overhaul a company's compensation system. Still, in most cases we do see opportunities for improvement – sometimes just incremental but in other cases bigger changes that better align people at all levels of an organization.

FMG Leading: Does Gryphon's focus on human capital dynamics differentiate you when fundraising and does it serve as an advantage in attracting potential acquisitions?

Orum: I believe our human capital approach is well-received among institutional investors because it's frequently different than what they see at other PE firms.

And it's well-received by the owners and operators of the companies we invest in. Their companies typically are market leaders with unrealized opportunities. They are often limited by their ability to recruit and retain professionals at different levels of the company.

We believe companies with more sophisticated human capital strategies and development tools have a high comfort level with Gryphon as a partner. If they're already working on the human capital issues that we see, they are more likely to be aligned with the growth plans we create with them.

FMG Leading: How do you measure the return on investment in human capital strategy throughout your portfolio?

Orum: We do many things that help create value within our companies: strategic planning, developing specific business-building initiatives, providing resources from our own in-house operations experts and working with exclusive executive partners.

That makes it difficult to trace back how much improvement is due to the human capital investment alone. What I can say is that human capital is the grease that makes the entire machine work, and it has had a really pronounced impact on how the companies we invest in perform versus their peers. Often our companies will, at sale, appear to get premium value. We truly believe this reflects the investments we've made in the depth, quality and cohesiveness of the senior leadership team.

FMG Leading: Many PE companies' human capital strategies are focused almost entirely on hiring "A" players. Comment on the effectiveness of this approach alone?

Orum: An "A" player at one company might not be an "A" player at another. It all depends on whether that person's skills fit what the company needs. An effective human capital strategy will help you clearly define those needs in light of your business plan. If the company must go through a pretty significant transformational change around its business model and how it goes to market, it will need a very specific set of skills. But other important considerations are whether an individual's management style complements the rest of the leadership team, and what gets done to help the team work together most effectively.

Some of our best-performing companies are led by people who might not meet everyone's definition of an "A" player. They're successful because they have the right capabilities and style for that situation – and they work incredibly well with their team and have built a highly collaborative culture.

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equally in all the people and culture needs of your portfolio companies – only the ones with the greatest potential to impact your financial and operational goals between the time you buy and sell your companies. The best investors we've worked with have a targeted plan to add value, and are just as clear on areas they will leave for the next sponsor to engage and add value.

Consider, for a moment, just the action to improve the quality of the leadership team. Replacing the entire team with A players may be overkill. Decide where you truly need A players, and where you don't. We've seen PE firms with stellar portfolio company turnarounds decide not to replace certain capable but B quality members of the top team because of their limited impact on company success. (That also frees up money to secure the A players who are needed.)

But whether or not someone is an A player (or whether you're interviewing an A player for a top role), they need to be assessed on a dimension that we call "change agility." By this, we mean their ability to quickly gain new knowledge, skills, and working relationships and yet remain productive. Those who are poor in change agility are not likely to work well in your portfolio companies. They carry significant limitations in an organization that must break from many practices of the past, make good and fast decisions, and execute them quickly and effectively. They will hold you down. And the more they occupy a key position, the greater the anchor they will become.

Another dimension on which to evaluate talent is cultural fit. Companies typically acquired by PE firms need some adjustments to their culture – the values, beliefs and behaviors they've exhibited for years. Most likely, some pieces of their culture will need to be revisited or reemphasized (if long forgotten) to make a strategy for rapid and profitable growth work. The question for leadership will be this: will present and future leaders in the company possess the skills to navigate the cultural changes necessary to make a rapid and profitable turnaround of its business?

To many PE firms, this may sound like foreign territory. But be advised that several successful PE firms are operating with a highly sophisticated human capital playbook. One is Vista Equity, which manages $31 billion in buyout, credit and hedge funds. The San Francisco-based firm, run by founder Robert Smith, has bought more than 200 software companies since 2010. He has accelerated their growth and sold many of them for big gains. (One them was marketing automation software firm Marketo, which Vista Equity bought in 2016 for $1.8 billion and sold to Adobe in 2018 for $4.8 billion.[6]) Vista has a 100-person consulting team that helps its software companies improve their operations. But it also requires all employees and potential hires to take an hour-long test for social, technical, analytical, and leadership skills. In hiring 6,000 people in 2017, the company conducted 850,000 tests.[7]

Vista Equity's success may make it sound like a major investment in human capital evaluation, training, and development is necessary today. But, again, we warn against moving on all the fronts mentioned and doing way too much. Not every human capital investment will generate outsized returns.

6 Forbes, Sept. 21, 2018 article. https://www.forbes.com/sites/nathanvardi/2018/09/21/billionaire-robert-smiths-vista-equity-makes-3-billion-selling-marketo/#7fbab1031d33

7 Forbes, March 6, 2018. https://www.forbes.com/sites/nathanvardi/2018/03/06/richer-than-oprah-how-the-nations-wealthiest-african-american-conquered-tech-and-wall-street/#101d86123584

“We believe the key elements of strategic alignment can be measured just like a PE-owned company’s performance can be measured.”

Executing and Monitoring the Human Capital Strategy

So the onboarding process will enable the leadership team to flesh out the growth strategy at a deep, and thus, actionable level. The assessment of people, their capabilities, their fit in the new culture, and what needs to be addressed (and not addressed) will be the outcome of the second step.

But then that human capital assessment will need (like the growth strategy) to be distilled into a plan, one that covers how the human capital needs are to be addressed throughout the hold time of an acquired company. And, of course, your human capital strategy will need to be executed. Your chief HR officer can play an important role here, working in concert with the CEO and other leadership team members.

But much can happen to the growth plan, and the human capital plan, between year 1 and sell date. The strong alignment of the top management team can begin to soften. The acute pressures of a turnaround can force operational or financial decisions to change. And yet the leadership team, the board, and the rest of the company must still be able to work in a unified and positive manner if the investment goals are to be achieved.

The demands on a leadership team to turn around a struggling acquisition or place a well-performing one on a higher growth path can be tremendous. They can make working at a private equity-owned company stressful for all its executives – even for teams that at the outset are highly aligned to the growth strategy, highly skilled, and great working as a unified team.

The demands of growth and occasional market setbacks in years 2, 3, 4, etc., can make team members wonder if the strategy is indeed sound. That, in turn, runs the risk of unraveling the strong alignment that was there at the beginning.

So what can a CEO and the board to do make sure their human capital strategy doesn’t unravel? We believe the key elements of strategic alignment can be measured just like a PE-owned company’s financial performance can be measured. Here are some examples of that, as well as suggestions on what to do:

- **Executive team alignment to the strategy:** Does every top team member continue to believe that the “winning” strategy is still a winning strategy? Determining this can be done by holding sessions for top teams to “clear the air” – to get their differences and concerns on the table about the viability of the strategy. At one of our clients, such a meeting turned very emotional, but ultimately helped end growing animosity between the top marketing and operation executives.
- **Executive team “fit”:** In a healthy team, there are bound to be conflicts because decisions require the collision of viewpoints. Sometimes these conflicts can turn nasty. This is where it can be hugely helpful for team members to better understand each other’s personalities, and how they can unwittingly create personal friction. Get everyone in the room and work so that everyone understands the nuances of each other’s personalities and how they make decisions. In other instances, setting team norms about how to work out differences can go a long way. One is this: “If I have a problem with another executive’s decision or performance, I will first come face to face with that person and discuss it, rather than go behind him.” Such measures can go a long way toward reducing ill will on the team.

- **Board/management conflicts:** Inevitably there will be disagreements between the investors who worry about whether their investment is going in the right direction and the management team they chose to generate the return. Skilled facilitators can optimize meetings between board members and company leaders so they operate more as peers who solve issues rather than as adversaries in a hierarchical relationship. (See page 7 sidebar on building a healthy working relationship between the investor and the portfolio company management team.)

All to say, the key to achieving a solid growth or turnaround strategy is having a highly effective human capital strategy – one that gets the right people in place, makes sure they're in sync on the strategy, and that they're working very productively to make it happen.

But just as a management team can veer off a solid growth strategy over the time it is to be implemented, so can it veer off a solid human capital strategy. It is up to a PE company's owners, its CEO and CHRO to make sure the indicators we've mentioned above stay positive throughout its ownership.

OVERCOMING FOUR BIG BARRIERS TO IMPLEMENTING A HUMAN CAPITAL STRATEGY

In our experience, PE firms face four big challenges in creating and adopting such human capital strategies: lack of awareness of the problem, intense time pressures, mistrust between PE investors and leaders of the acquired company, and the expense. Let's look at each one.

What Alignment Problem?

Many leaders, both at the PE firm and the acquired firm, may incorrectly assume that the top team is already aligned to the growth strategy. Aligned incentives have been one of the hallmarks of the private equity business for decades, but there is more to alignment than making sure everyone is chasing the same carrot. We've seen time and again the leadership team of a PE-owned company assemble around a conference table, sit through a two-hour presentation on the growth strategy by the CEO, and nod their heads throughout the session with few questions or pushback. Many CEOs would conclude from that, "They get it and they buy into it." The work of strategic alignment is done, right?

Not so fast. You can't determine the degree to which a leadership team is truly aligned with a new strategy at this point. Not until you delve far deeper into how the overarching plan fits with the functional plans will you know how much the leaders have bought into the strategy. The more they try to flesh out their part of the strategy – the marketing plan, the sales plan, the production plan, and what not – the greater the chances they will see some cracks in the overall plan that they believe are unrealistic for them to implement.

The best leadership teams not only agree with the overall financial goals, they also buy into the specific goals they must achieve.

“The cost of hiring the wrong person, or more importantly, falling short of company growth targets and thus ultimate deal value on exit, will be exponentially more expensive than making an investment in doing it right at the outset.”

No Time for This

For a PE investor, the deliberation time to evaluate an acquisition's existing talent may seem like a luxury it can't afford. Traditionally, PE firms have been too eager to call in talented outsiders right away, thinking that this quick fix will jolt the company out of its rut and increase value more quickly. PE firms tend to have a transactional culture, accustomed to sizing up people quickly like they size up companies to be acquired. We've heard PE companies say, “Money is no object. We need the best [fill in the blank] executive we can get.”

We argue, however, that PE firms need to evaluate people more deliberately to achieve strong alignment to a growth strategy. They also must take the time to build strong alignment. Such rigor in sizing up human capital and getting people to understand and buy into a growth strategy can actually accelerate its execution. The reason is that aligned and motivated leaders will be far more committed to getting things done and better at working with each other.

Mistrust Between PE Board Members and Management is Unavoidable

Wariness between the PE firm and the key managers at the acquired company can be inevitable. The new owners and long time veterans each can have their own agendas and power dynamics, and some gamesmanship and mistrust are to be expected. This can be especially true with “second level” executives and those with deep subject matter expertise. Candor is often lacking early in the game between investors and portfolio firm leaders, with pleasantries covering up deeper misalignment and distrust.

To overcome this barrier requires what we call “getting the PE firm and management team on the same side of the table,” not as opposing forces. This enables directors to act not just as overseers for owners but also as a genuine leadership advisory board. (See sidebar.)

We Can't Afford It

PE firms often need outside help in evaluating current and potential leadership team members – and gauging their alignment to strategy long after the acquisition date. But, of course, this costs money. Private equity investors are rightly scrupulous about cash flow. They frequently look at these types of investments as “over the top” – until, of course, a portfolio company's financial performance has seriously deteriorated. (By then, it's often too late). But the price of hiring A players who don't work out, or of strategies that aren't implemented well, can be much more substantial.

The cost of hiring the wrong person, or more importantly, falling short of company growth targets and thus ultimate deal value on exit, will be exponentially more expensive than making an investment in doing it right at the outset.

A NEW APPROACH TO PORTFOLIO COMPANY LEADERSHIP

As acquisition targets increasingly have more buyers that want to pursue them, it will keep increasing the need for PE companies to get higher returns from their investments. A big and relatively untapped lever for many PE companies is how they manage the leadership challenges of the firms they acquire.

PE companies that have done this have taken a more enlightened and effective approach to selecting and helping the leaders of their portfolio firms, and they are reaping greater financial rewards. They realize their human capital strategies are just as important as their growth strategies.

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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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With over two decades of leadership and advisory experience in global consulting and other professional services firms, Richard has built deep expertise in helping companies grow and generate value for their owners. His broad capabilities include building organizational and financial structures, strategy formulation and valuation assessment, and growing equity value in preparation for successful exit. Richard brings strategic focus and clarity to organizations, establishing clear roadmaps for success and aligning corporate objectives with vision. His coaching of senior leadership focuses on enhancing the customer experience, ensuring operational effectiveness and maximizing shareholder return.

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MaryCay brings a wealth of Professional Services experience, having held senior leadership positions with both Thomson Reuters and Westlaw prior to joining FMG Leading. In addition to her oversight of FMG Leading's Professional Services practice, MaryCay also serves as an executive coach, weaving a unique blend of pragmatic business savvy with neuroscience in a way that ignites executives and their teams. Her approach envisions an inspiring future and unlocks the passion and potential within the organization through a blend of customized tools, workshops, retreats, and coaching.

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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