WHAT IT TAKES TO LEAD

Challenges for the new private equity CEO

Division presidents of large, multinational companies almost unanimously aspire to CEO roles. These executives often see private equity as a compelling career path, complete with autonomy, the opportunity to prove their leadership and a chance to create significant value and wealth. Private equity firms are attracted to the leadership, training and track record of these executives, but typically view untested CEOs with skepticism. How, then, do we match up the "supply" with the "demand" for this talent, and more specifically, how can the "readiness" of portfolio company CEO candidates be determined?

To further explore the concept of first-time CEO readiness in a private equity environment, we spoke with experienced portfolio company CEOs and private equity partners about the key success factors. While firms have different strategies and philosophies about what works and what doesn't, we found common ground on several broad themes:

- Doing more with less
- Investing in the right team — early
- Working with the board
- Finding the right CFO

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Doing more with less

Executives with leadership experience at large companies can be attractive candidates for private equity because of the depth of their industry and customer knowledge, leadership training and understanding of core business and branding principles, all of which are transferable to a portfolio company CEO role. Despite these apparent strengths, excelling as the president of a $2 billion division of a public company does not automatically prepare an executive for the range of financial, business and talent issues inherent in running a $250 million portfolio company.

"The CEO has to be the visionary, the one who has the vision for how to expand the business, and is the primary business developer for the company, capabilities not all division leaders have had to develop," said David Moross, chairman and CEO of Falconhead Capital. In addition to driving the strategic plans for the business, the CEO must motivate the organization to achieve short-term results. The CEO needs to wear bifocals, striking the right balance between disciplined cash management to meet today's goals and making progress on the priorities that will build long-term value for the business, said Bill Toler, former CEO of AdvancePierre Foods. "You have to make Friday's payroll while you're reinventing the future."

> *"The CEO has to be the visionary . . . the primary business developer for the company."*
>
> – David Moross,
> Falconhead Capital

Executives from a corporate background also have to adjust to a different pace and set of expectations than they may have been used to in previous leadership roles. The division head who had to focus on achieving 2 percent or 3 percent growth while managing costs in his last role suddenly faces the expectation that he will double the size of the business in three to five years. Achieving those objectives requires a sense of urgency and entrepreneurship and the ability to simultaneously juggle a diverse set of priorities.

"There are four or five important initiatives in play at once. It's not only a question of making the budget; it's making a key acquisition happen, making strategic decisions to change the trajectory of the business, hiring key people in critical new development areas, and rebuilding the organization and the culture to be more effective. It is a very different rhythm of life than making sure you deliver the numbers to the CEO's office of a big public company," said Tim Palmer, managing director of Charlesbank Capital Partners.

> *"The pace is intense. The most successful leaders are the ones that are just always on; it's part of the game."*
>
> – Tim Palmer,
> Charlesbank Capital

Given the risks of hiring a first-time portfolio company CEO and the urgency in getting the company quickly on track, what gives investors confidence that a candidate can make the transition?

In addition to an impressive track record of driving growth, private equity partners say they look for tolerance for change, especially experience moving from a "big" environment to a "small" environment, where results had to be achieved without extensive resources. Autonomy in previous business settings, including broad functional responsibility, as well as a willingness to take risks throughout his or her career also are indicators of the ability to transition.

> *"In big companies, there's a whole machine that works whether you're there or not. In private equity, the CEO is critical to making the company run; you're not surrounded by a machine. The CEO needs to have the confidence and bias for taking calculated risks."*
>
> – Jane Miller, CEO, Charter Baking

Another valued trait is the confidence to run the business as if it is his or her own company, said Keith Miller, a partner with Goode Partners. "The CEO needs to understand that he's here to run the business as though it's his own. We're here as guardrails. We have no interest in running the company, but want to provide the necessary resources where they may be lacking, even if that means helping to identify deficiencies."

Investing in the right team — early

Success in private equity requires a small, talented and highly focused team supporting the CEO, and building the right team early in the investment lifecycle is a lesson many experienced private equity CEOs said they learned after under-hiring for a fast-growth company.

"The depth and quality of people, processes and systems is always different when you move to a smaller private equity company from a bigger corporate environment. Understanding that and making the changes necessary to elevate talent and processes is critical to long-term success," said Toler. AdvancePierre, for example, was formed through a roll-up of several smaller companies; legacy executives who might thrive in a stand-alone business may not have the skills to manage it as it grows rapidly by acquisition. "The processes, people and skills that made each of these small companies very successful aren't the ones that will enable a $2 billion company to operate effectively."

Paul Nardone, an operating partner with Sherbrooke Capital who successfully scaled and sold three private equity portfolio companies to strategic buyers, said he learned from experience to prioritize hiring executives sophisticated enough to manage a rapidly growing business. "I initially thought too frugally and too narrowly about the kinds of people that I recruited for my management team; I was thinking like a boot-strap entrepreneur, trying to stretch directors into VPs, and I learned a lesson. Some just couldn't keep pace with the business, and some didn't meet the requirements of our private equity investor," he said. "You certainly have to think big and think aggressively when a private equity group is involved in your business, because that's what they want you to do, and you need people who can be successful in each stage of the business."

> *"Get the management team in place early so you have the braintrust building the business with you over the whole five-year horizon. You don't have time for 'B' players in the first few years."*
>
> – Bob Caulk, Operating Partner and former CEO of Spectrum Brands, a THLee portfolio company

Be aggressive in stepping up the quality of talent in advance of growth, and be willing to over-hire for critical roles based on the intended end game for the investment, experienced CEOs recommend. "We have a strategic and tactical plan for every one of our portfolio companies that gets developed while we're going through the due diligence process. We have an operating-centric approach at the partner level, so the plan is developed by the actual partners who will work directly with the entrepreneur or family in whose business we are investing. That plan is critical for determining whether the company has the people necessary to tactically carry out the strategy," said Keith Miller.

Like the CEO, executives in a portfolio company have to be willing to be "doers" and not just leaders. "When you have limited resources, you have to make sure you're hiring complementary and supplementary skills to the team; not duplicative," said Jane Miller, CEO of Charter Baking. "You need people to actually roll up their sleeves and do the work."

Working with the board

How to work with and leverage the board of directors was the most universal (and emphatic) theme discussed among CEOs and private equity partners. While they may have interacted with boards in prior roles, reporting to and, more specifically, working with a private equity board requires the development of an entirely new set of "muscles" for most first-time CEOs.

The most obvious new dynamic is that a private equity company's board typically consists of financial sponsors (i.e., owners), and one to three additional outside directors with relevant operating experience in the best case scenario. The observation made by several financial sponsors is that, either through lack of confidence or over-confidence, first-time CEOs felt the need to bring fully developed plans and presentations to the board — rather than engaging directors on key strategic and operational issues.

> *"The board and the investor group want a dialogue, not a deck."*
> – Bob Caulk

The best CEOs are comfortable with a give-and-take with the board and investors, and treat them as partners in the business.

"They want to hear about things early, and they want to hear about them often. That was the key to success with all of my investors. People really appreciate when they think you're getting out way ahead of something and giving them an opportunity to weigh in," said Nardone. "Too many people approach working with private equity investors as managing information and want to release information in a polished board environment. I approached it that way myself the first time and approached it very differently the next two times. I just concluded that this is a true partnership and I'm going to leverage these folks to make all of our jobs a little bit easier. That has proven to be much more successful."

A clearly articulated strategic plan helps build and maintain alignment between the CEO and the investors. This plan, alternatively referred to as a strategic roadmap or value creation plan, was universally discussed across all of our interviews, and was described as helping to provide a "True North" for where the CEO and board want to take the business. Nardone talked about working with his board to think ahead and figure out what, specifically, they want to be able to say in their presentation to strategic buyers at the end of the investment horizon — and, with that end in mind, develop a roadmap to get to that desired outcome.

The cadence and content of communication between a CEO and board varied, but generally speaking in addition to standard weekly calls and quarterly reporting and meetings, several CEOs reported having near-daily conversations with the lead sponsor on topics ranging from M&A, cash flow, business performance and longer-term capital expenditures.

> *"The best CEOs create a regular and active communication pattern with investors. They can talk to various members of the board, but we also like to have a key point of contact for the CEO."*
> – Tim Palmer

"It requires more confidence rather than less to be that open with the board. You want to engage the board in strategy, that's really where the board wants engagement. You want to engage them in organization and people. Acquisitions are important for most of them. My advice is to be transparent, be early and have an informed point of view about the action plan," said Bob Caulk, operating partner and former CEO of Spectrum Brands.

Investors expect the CEO to map out a calendar of topics to be reviewed at board meetings, well in

Five things CEOs wished they knew before their first portfolio company role

Understand how private equity works. The fundamentals of how a fund raises money, its inner workings and hierarchy, and its politics all can affect how the firm interacts with your business. Are the partners distracted by other deal activity? Is there another portfolio company in trouble that might change the way the firm works with your business? Also, understand the deal structure and the implications of the structure. How much has the firm already invested in the business? How much capital is left for acquisitions or other capital spending? What's the approval process for gaining access to those funds?

Understand how the private equity sponsor will interact with the business. Experienced CEOs said working with private equity is much easier when you know the players in the firm and how they interact with the company: who does the work inside the firm, who's paying attention on conference calls, who to call in advance of a board meeting and who to follow up with after the meeting.

The depth and quality of people is almost always different. Recognize and address gaps in capabilities and processes early on, based on the strategy and exit plan for the business.

Manage expectations. Don't be overly optimistic about the time frame for turning around the business. Expect that not everything will go as planned. As one CEO cautioned, "If you say it's going to take three to five years to turn around the business, and it gets done in three-and-a-half years, you're a hero. If you say it's going to take two or three years, and you get it done in three-and-a-half, you're in trouble."

It's OK to say you don't have all the answers. Most first-time portfolio company CEOs are reluctant to admit that they don't have the solution to every problem, but CEOs who have been through the process say they learned to engage the board on the toughest challenges. Seeking advice and ideas from the board when challenges arise often can result in surprising and successful solutions.

Five things PE investors look for in CEOs

> **Imagination and vision**
But also the ability to balance vision with short-term results

> **Self-confidence and conviction**
But also humility

> **Ability to think and plan**
But also a bias toward calculated risk

> **Work ethic; flexibility**
Multitasking; dealing with ambiguity

> **Self-starter**
Highly autonomous operating experiences (as proxy for CEO role)

advance. These topics should match the cycles of the business — strategic planning, operating planning, budget-setting; be mindful of deadlines and anticipate what the board will want to talk about.

Experienced portfolio company CEOs say first-time CEOs benefit from having a formal or informal mentor on the board, especially for the first year or two. The mentor can be the operating partner or another director with whom the CEO has some chemistry, but ideally the individual is someone who has a broad point of view on the investor side as well as operating knowledge and skills.

Finding the right CFO

The portfolio company CFO has an important and multifaceted role, serving as a partner to and proxy for the CEO and a bridge from the business to the private equity firm. The CFO has to speak the language of the investors and be aligned completely with the CEO. While the specific capabilities a company needs in its CFO will vary depending on the strengths, weaknesses, size and complexity of the business, a portfolio company CFO has to have exceptional technical finance skills, a willingness to dive into the details and strong communication skills.

"You want someone with high intellectual capacity. You want the kind of CFO who is able to articulate better than anybody, including possibly the CEO, the drivers of the business and how the business is doing," said Palmer. "You want a strategic business partner who understands the business at an instinctive level; that's very valuable for a CEO."

Caulk, who has been on both the management and sponsor sides of private equity investments, agreed. "The CFO is probably the most important position other than the CEO. The CFO has to have the CEO's back because there is a lot that happens that the CEO may not see, feel or touch, both inside the company and with the private equity investors. The CEO needs a CFO who is completely open and transparent with him or her and who not only understands the numbers but can be part of the strategic brain trust."

Financial sponsors look to the CFO of portfolio companies to be the key conduit of information to the private equity firm. Analysts at the firm talk to the CFO all the time; they have to know the numbers inside and out. Sometimes public bonds are used to finance the company, so CFOs also have to know how to deal with public investors. In short, the CFO has to have the confidence of the CEO and the private equity firm.

However strong the CFO, most private equity firms expect the CEO to have a firm grasp on all of the financial matters of the business as well; and it can be a red flag for investors if the CEO appears to be relying too heavily on the CFO for the financial details.

Conclusion

First-time portfolio company CEOs, particularly those who have spent their careers in the corporate world, can potentially get a slower start with their first private equity assignment if they are not aware of and focused on important differences in leadership and communication requirements. Managing in a high-intensity environment with fewer human and financial resources than they are used to requires "muscles" that are not necessarily developed in a corporate setting. First-time CEOs also must get comfortable with the financial sponsor as a partner in the business. Firms that understand the potential pitfalls and provide the necessary support will be in a better position to help first-timers through these challenges.

About Spencer Stuart

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