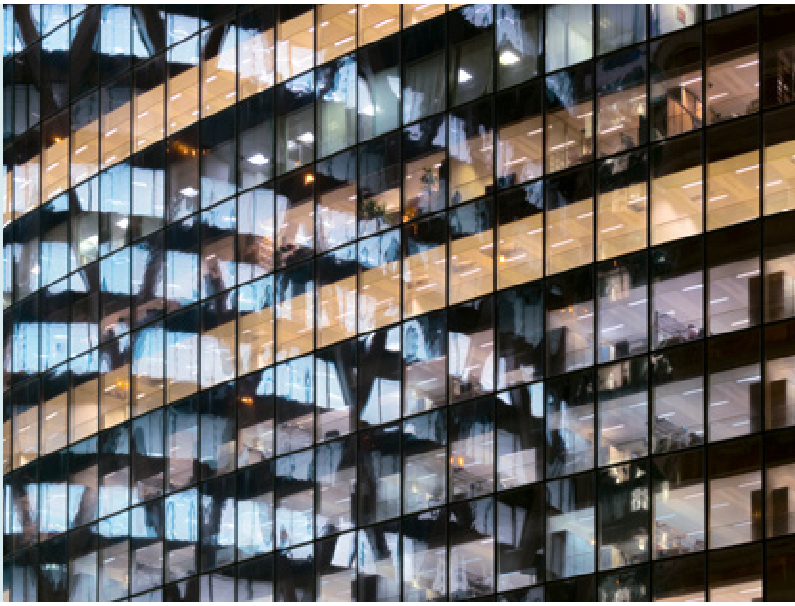
Six Human Capital Pitfalls for Private Equity to Avoid in Pre-Deal Diligence and Post-Close Planning



The diligence process is a critical period for private equity (PE) firms as they assess the merits of an investment, compete to win a deal and build trust with their future management team. While strategy, operations and financial levers are standard elements of this phase, human capital is often overlooked — even as management is recognized as perhaps the key success factor for deals.

Talent diligence that goes beyond gut instinct or cursory review has become critical, if not required, for PE firms. With that in mind, below we consider six common human capital pitfalls that negatively impact PE deals — and how to avoid them.

Pitfall 1: Failing to conduct sufficient management due diligence

PE firms invest significant time assessing a target company's business, growth prospects and marketplace. Yet management often receives less scrutiny — perhaps out of habit or because quantifying its value is harder. Private investors increasingly recognize that "what" they are acquiring depends largely on the "who." A deep, unbiased understanding of management talent is critical to any new investment.

Pitfall 2: Moving too slowly to link talent with the change agenda

Talent evaluation pre-deal is often too simplistic. It's not just about whether the management team is "good" or "bad," but rather whether it's the right team for achieving your operating agenda. Context matters; the operating environment, strategy, team and ownership dynamics may differ from the past. Failing to evaluate talent against your value creation plan (VCP) could come back to haunt you months — or years — into ownership.

Pitfall 3: Over-indexing on the CEO

Much has been written on the CEO's link to value creation. Yet experienced asset owners and talent managers understand the importance of team dynamics and how top teams can drive or create the environment for accelerated performance. When making new investments, it's important to determine the critical roles beyond CEO, the expectations for each, who holds those positions, and whether or not they can accelerate the VCP.

Pitfall 4: Getting blinded by stellar pre-deal advisers

It's understandable why pre-deal advisers are often among the first considered for management and board roles post-acquisition. However, what makes them attractive options — proximity, availability and their role in the diligence process — does not necessarily mean they have the right experience or capabilities post-close. For this reason, it's important to have independent hiring processes that separate pre-close necessities from post-close decision-making.

Pitfall 5: Allowing the talent agenda to become a source of tension

Even when aligned on business objectives, owners and management can get tangled on the talent agenda. Sponsors may fear being seen as heavy-handed, management may feel threatened, or the courtship process might not allow for quick talent changes beyond the most obvious. However, the development of a holistic talent agenda as a standard part of any process can help defuse this tension. A programmatic approach to human capital, like Spencer Stuart's Human Capital Program (HCP), can quickly align and energize management around ownership expectations, build trust and increase speed to value.

Pitfall 6: Lack of leadership accountability for the human capital program

Few portfolio company operators have HR business partners who have driven strategic, enterprise-wide human capital transformation in the time period PE owners expect. Furthermore, most PE stakeholders don't know enough to assume the role for HR or lack the bandwidth and time. As a result, the best human capital programs are often the result of CEOs who prioritize the talent agenda or rely on outside expertise. Regardless of approach, even the best-planned talent agenda will fall short without program management and accountability for execution.

Conclusion

Developing a targeted talent agenda for every investment, whether through an HCP or another process, can ensure that human capital drives value creation pre-deal and beyond. To achieve this, we advise the following best practices:

» Have a process to gain management insights pre-deal

» Link perspective on current talent to future plans, not just past performance

» Focus on critical top team members, not just the CEO

» Link pre-deal talent with post-close needs through unbiased process

» Use the talent agenda to align ownership and management

» Take a programmatic approach to human capital

Human capital strategy demands the same diligence and planning that finance and business strategy receive. Firms that fully embrace this principle will have the upper hand in an ever-more competitive PE landscape and uncertain marketplace.

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