Leadership Alpha in Private Equity

An analysis of private equity firms' interaction with and optimisation of portfolio company leadership

November 2022

Executive Summary

Leadership is widely acknowledged as the most important internal determinant of a firm's performance.

This also holds true for Private Equity (PE), where the calibre of portfolio company leadership is cited as the number one reason for deal success[1].

> **"Portfolio leadership quality can make the difference between 2x and 4x returns."**
>
> **Operating Partner**
> Global PE Firm

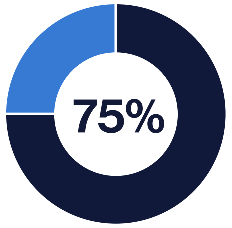
Whilst it is very difficult to directly quantify the impact on financial value, or indeed isolate the contribution made by leadership from broader operational improvements, 94% of General Partners (GPs) responding to our survey considered portfolio leadership as "very important" and believed it contributed an average of 53% towards investment returns[2].

Yet, despite this overwhelmingly positive sentiment towards the value of leadership, the evidence from our research shows a profound gap between the importance that PE firms attach to leadership and the time, resources and money they dedicate to optimising it – a paradox for an industry that is performance-driven by definition. In this gap lies a considerable source of untapped advantage for those firms that are willing to invest in an area that has traditionally been highly subjective and time-consuming. In addition, considering the key role of leadership as a value driver for EBITDA growth, the importance of portfolio company leadership is set to become increasingly relevant during a downturn and rising interest rate environment, as GPs seek to highlight their ability to generate operational alpha over merely relying on valuation multiples or leverage.

During our study, we interviewed 25 leading PE firms and PE recruitment specialists to explore the main trends and innovations relating to the optimisation of portfolio company leadership. Given the intrinsic link between leadership practices and overall value creation models, our research also explores the latter with a particular focus on the point of interaction between GPs and their portfolio companies.

No. 1
Contributor to returns

> **"Leadership is the single biggest contributor to returns, yet the area we do the least diligence on."**
>
> **Chairman**
> Global PE Firm



> **"75% of the deals that go wrong do so because we backed the wrong management team."**
>
> **Managing Partner**
> UK Mid-market Fund

As a result, we provide insights on:

1. Why there is a gap between the perceived importance of leadership and the efforts dedicated to it
2. What influences a fund's approach to optimising their portfolio leadership
3. How approaches to both leadership and broader value creation are evolving
4. Where the greatest opportunity lies to drive competitive advantage

Why is there a gap?

- Whilst PE value creation models have evolved, the approach to assessing and optimising leadership has remained largely unchanged
- Reasons for this include conflicting priorities, cynicism towards qualitative data, ambiguous ROI and a reluctance to change what has worked in the past
- Difficulties in quantifying the financial impact attributed to leadership has created ambivalence towards efforts to improve it against other more quantifiable measures

What influences funds' approach to portfolio leadership?

- DNA of founding partners, firm culture and mission
- Investment strategy, organisation design and remuneration
- Bifurcation between AUM and performance-based (carry) models
- Relative sophistication of value creation effort and approach to leadership optimisation

How are value creation approaches evolving, and which is best?

- Leading models tend to be either involved or systematic (or both)
- Successful models are deliberately designed and clearly linked to investment thesis and strategy
- Focus is turning to scalability, portfolio synergies, monitoring and cost/benefit attribution

Where is the greatest opportunity?

- The interaction between GPs and their portfolio companies is often inefficient and lacks codification
- Interventions are commonly reactive, costly and time-consuming
- Technology and tools can help address issues, but industry investment and adoption is mostly in its infancy
- Future focus is on codifying value creation playbooks and automating performance dashboards to enable scalability

NOTE: For the purpose of this paper 'leadership' refers to the effectiveness of portfolio company CEOs and their executive teams. It should also be noted that as participants are predominantly based in Europe and APAC, the views expressed are inherently skewed towards practices and trends in these regions.

1. Source: "A Left-Brained Approach to Portfolio Company Talent Decisions" by Bain (2021)
2. Source: The findings are based on insights from Teneo's survey and interviews with representatives of 25 leading PE firms and specialist PE recruiters. In most cases, participants were either the founder/managing partner or a member of the senior leadership team

Why is There a Gap Between Importance and Effort?

There are several reasons why the effort and investment in optimising portfolio company leadership lag behind its perceived importance.

To understand the current landscape, it is first worth recapping the context, background and evolution of the PE industry, as these significantly influence the current ways of working.

Since its beginnings in the 1960s, PE has evolved enormously. Evidence suggests that prior to the Global Financial Crisis of 2008, much of the industry's performance was generated from multiple expansion or financial leverage. Therefore, whilst the calibre of portfolio company leadership teams has always been an important part of the investment equation, it was not necessarily the primary ingredient to the successful execution of the investment case.

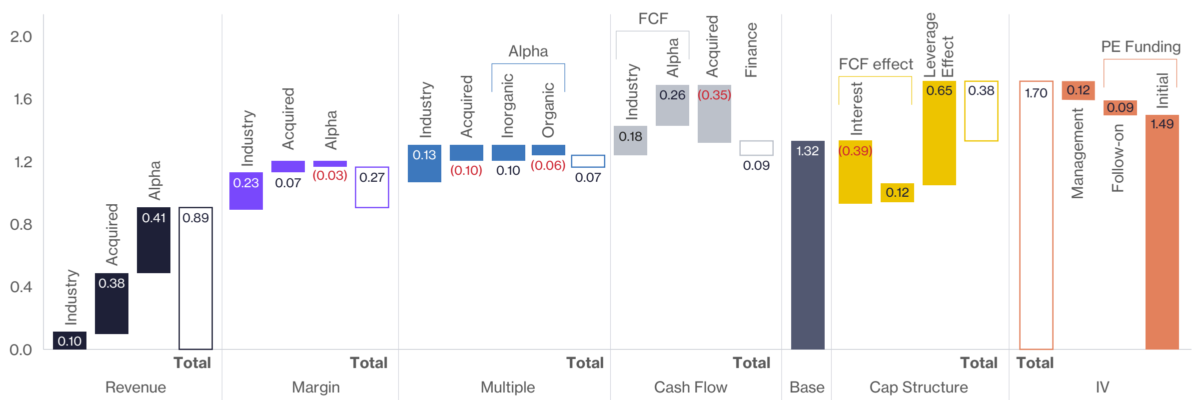
Today, value creation looks very different. PE firms now need to demonstrate value creation interventions across a broader range of investment strategies. In parallel, the companies in which they invest are

> **"The quantification of leadership impact is one of the most under researched areas of academia."**
>
> **Dr. Elizabeth Moore**
> The University of Law Business School

Value creation 1.0 – Conventional framework[3]

EBITDA Impact + **MULTIPLE Impact** + **NET DEBT Impact** = **VALUE Creation**

Value creation 2.0 – Value creation drivers framework[3]



3. Source: "Value creation 2.0" by INSEAD & Duff and Phelps (2016) and "Private equity performance in financial crises - A theoretical perspective" by Copenhagen Business School (2020)

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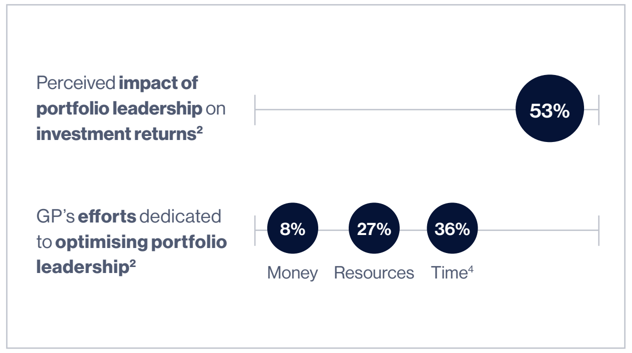


increasingly from technology and service driven sectors[5].

The general movement towards investing in higher multiple industries means that the capability of management to drive growth and deliver operational effectiveness has become a much more important part of the value creation equation. However, despite increased efforts to evaluate and deconstruct the sources of GPs' value creation, the widespread adoption of more granular frameworks is still in its infancy. In addition, the ability to isolate and quantify the financial impact of leadership does not yet seem possible.

PE's evolution has also coincided with a period of unprecedented capital inflows and success in the industry. Consequently, it appears that many PE firms have not felt the need to update their legacy ways of working or invest in the latest leadership-related tools and capabilities. **"If it isn't broken, don't fix it[6]."** Similarly, whilst some Limited Partners (LPs) have very sophisticated evaluation models and data sets, participants shared that their scrutiny on GPs' value-add has been more muted due to the exceptional recent returns. **"Everyone talks about value creation, but in reality there is no better story than a good multiple[6]."**

Attitudes are changing, however. Virtually all the funds we spoke with identified gaps in their existing efforts around people, leadership due diligence and the way in which they interact and intervene with portfolio companies.

Why is there a gap between perceived importance and effort?[6]

- "It is too subjective and hard to quantify... other things end up taking precedence."
- "We face pushback internally and have limited access to management during due diligence."
- "There is a delicate balance between monitoring and empowering."
- "Ours is an apprenticeship industry, where leadership is assumed to be either inherent or learned 'on the job' ... and hence does not need a concerted effort."
- "As an industry, we have done a fairly poor job conducting leadership assessments in a systematic way. We still largely rely on, 'I really like the guy.'"

> **"Three or four years ago, the impact of leadership on value was much lower... Today, performance is so much more than financial value. Leadership has an enormous impact on critical value drivers like reputation, DE&I, culture and engagement of regulators and other stakeholders."**
>
> **Senior Managing Director**
> Global Infrastructure Fund

4. Note: The amount of time dedicated to portfolio leadership is likely a reflection of the seniority of survey participants, with more junior team members typically spending relatively less time

5. Source: Pitchbook (2022)

6. Source: Insights and quotes from study participants (Teneo, 2022)

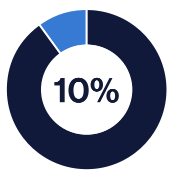
What Influences a Fund's Approach to Leadership?

Our analysis found a strong correlation between the relative effort applied to optimising portfolio company leadership and the investment in overall operational value creation. We highlight below some key influences upon this.

The culture and DNA of most PE firms is still heavily influenced by their founding partners. Whilst many of the early pioneers are now approaching retirement, they are often still present and have a tremendous influence on the organisation: how it's run and where the emphasis is placed. This is particularly relevant now, as many of these founders are considering their legacy, succession and the next chapter for their firms, including decisions around selling, merging or listing.

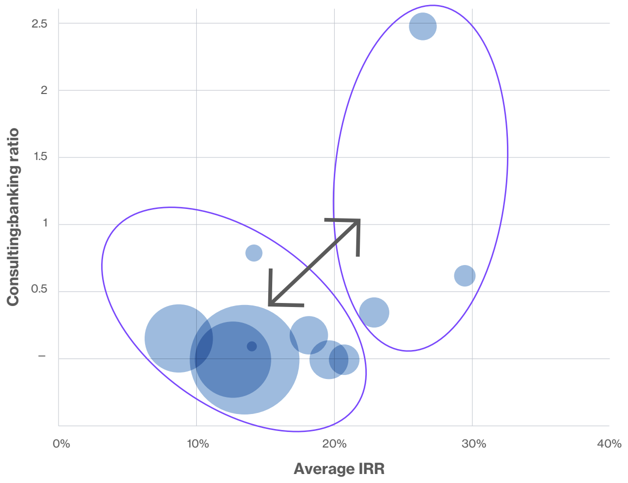
> **"The biggest worry for the industry is the shift from carry to AUM. High prices are wiping out returns, and only 30-40% of all funds go into carry."**
>
> **Managing Partner**
> European Mid-market Fund

The above factors seem to be creating a bifurcation in the industry between firms pursuing AUM growth (and related fees from multi-strategy platforms) versus the 'traditional' PE firm that primarily focuses on beating performance hurdle rates to achieve carried interest incentivisation.



The majority of concerted leadership efforts occur during the first 10% of the investment period[2]

DNA vs. AUM vs. IRR analysis[7]



The size of the nodes is indicative of AUM

Our research explored the background of founders and C-suites of 14 of the world's leading PE firms and found the following:

- Firms with founders from a predominant investment banking background appeared to lean towards AUM growth and were therefore more deal-oriented.
- Firms with a higher proportion of founders from a consulting background were often smaller, with a strong focus on performance and consistently achieving higher returns. Two of these firms stood out for applying the most effort and investment into operational value creation and had the highest average IRR[8].
- Our research suggests that where a firm sits on this spectrum has wide-ranging implications across their culture, structure, resourcing and remuneration philosophy. It also appears to determine how much effort is applied to the investment process compared to the level of support applied to portfolio companies after a deal completes. As an example, only 25% of participants deemed leadership efforts to be 'most important' during post-deal execution, and none considered it 'most important' during exit preparation. When one considers that these periods constitute the vast majority (>90%)[2] of the holding period[9], this highlights a significant opportunity for PE firms to have a greater impact.
- We also found the relationship between the deal and operating teams particularly intriguing and a key indicator of where a firm sits on this spectrum. When operating professionals exist, they are often perceived as 'second-class citizens' in deal-oriented cultures. As a result, there is less focus on operational value creation and a decreased willingness to engage (and invest) in leadership optimisation efforts.

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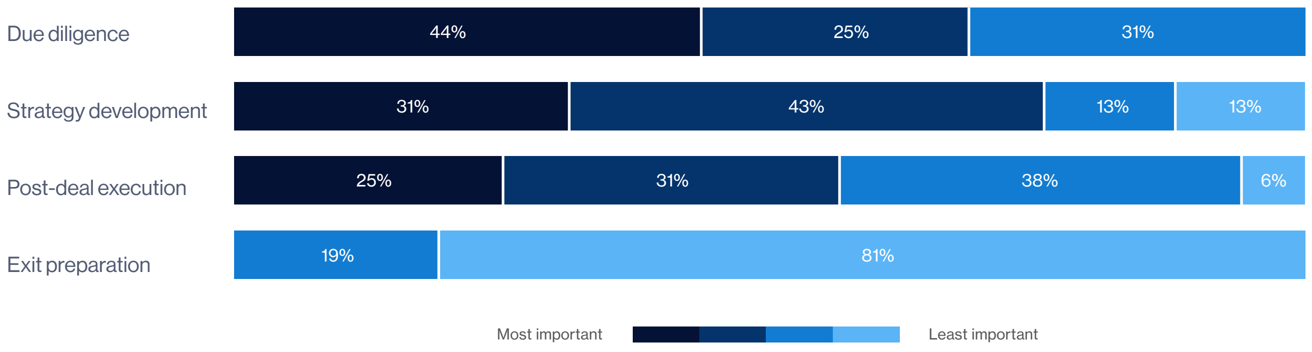
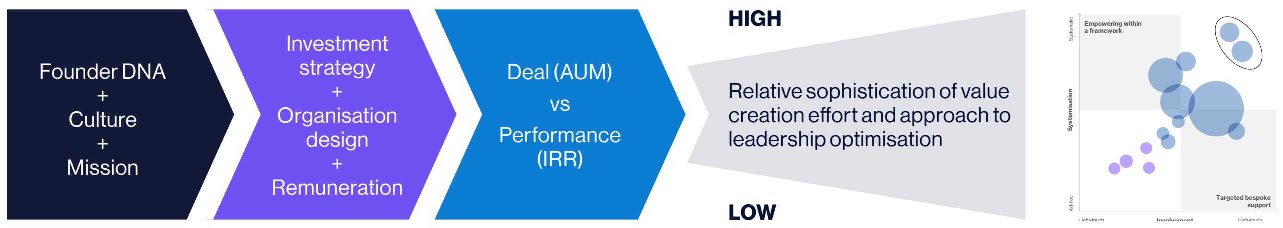
GP leadership efforts by investment stages[2]





7. Note: The findings are based on an analysis of the professional backgrounds of key executives at 14 PE firms (eight global firms and six of the major Asian firms). AUM data is based on various public sources. For IRR source see footnote 8

8. Note: The IRR calculations are based on average of reported IRR figures for 2010-2019 (source: Pitchbook, data as of June 2022)

9. Note: Based on an average holding period of 5.9 years between 2005 to 2020 (source: EY annual report on the performance of portfolio companies, 2021)

How Are Value Creation Models Evolving, and Which is Best?

Whilst there is a spectrum of value creation models, the best are deliberately designed to be either systematic or involved – or both.

Whist there is a wide spectrum of sophistication between value creation models, those undertaken by market leaders have many shared traits and are constantly adapted, with a particular focus on better balancing impact, cost-efficiency and scalability.

Our research evaluated the models adopted by a number of leading firms based on two key parameters: the level of **fund involvement** and the level of **systemisation**.

Successful models happen by deliberate design, not chance

The level of fund involvement

(High vs light touch)
How directly involved are fund teams in portfolio companies' value creation plans and interventions?

The level of systemisation

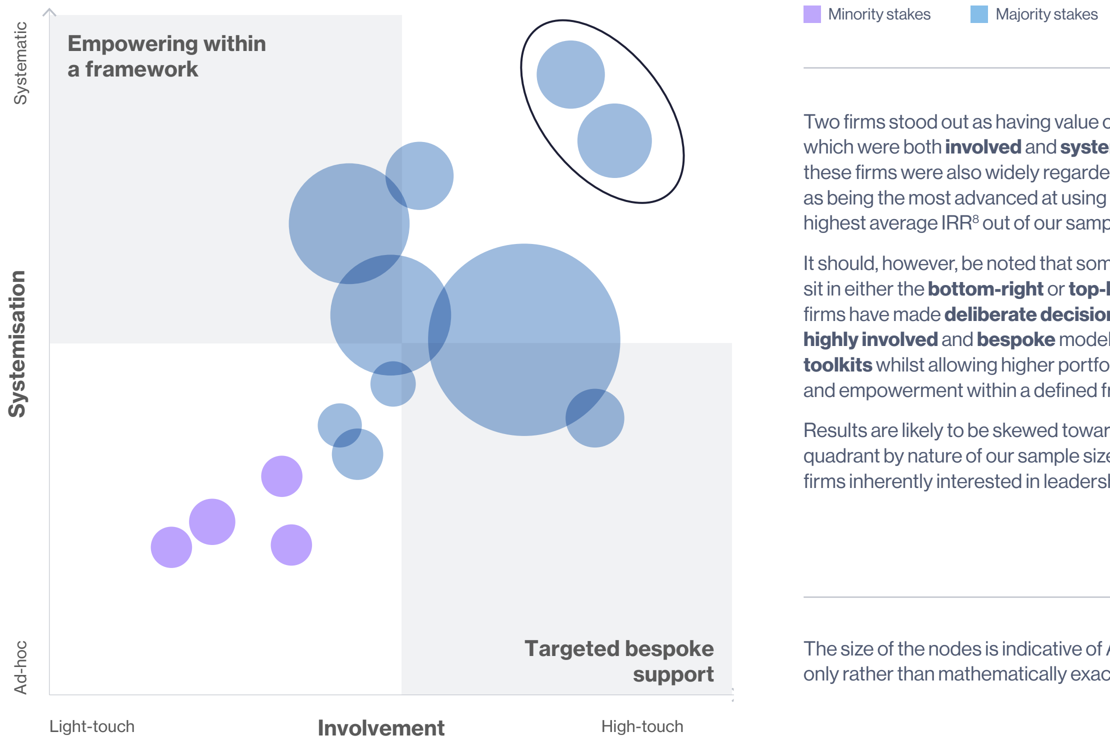
(Systematic vs ad-hoc)
Is the fund's value creation approach and playbook applied across all portfolio companies in a systematic manner?

The dynamic between deal and operational professionals was highlighted several times in our interviews. All participants agreed that the primary responsibility for deal performance fell under either the deal partner (69%) or the investment committee (31%); operating partners were considered to have secondary responsibility for deal performance. Responses were more varied when it came to responsibility over portfolio company leadership. Whilst most participants (81%) still believed primary responsibility fell with either the deal partner or the investment committee, an increasing number (56%) selected 'operating' or 'talent' partners as being either 'most' or 'second-most' responsible for portfolio leadership teams. Anecdotally, participants shared that operating and talent partners' responsibility over portfolio leadership increased during the hold period of the deal, as they are generally seen as being the closest to management. This led to a potential ambiguity about who owns the relationship with portfolio company leadership at various points during the investment cycle. Indeed, despite the acknowledged importance and association between leadership and performance, this delineation (or lack thereof) was an area that was often under-designed.

To counteract this, funds have been increasingly hiring dedicated talent partners as part of operations teams. Historically, much of this work was outsourced to recruitment firms. Whilst some respondents reflected a negative perception associated with using generalist HR professionals, those that had hired talent partners with sufficient credibility at the board and CEO level conveyed their immediate value and ability to improve this point of interaction.

Another observation was that for some large multinational GPs, there was a natural tension between the design and cost allocation model of industry-specific support versus the housing of more generalist, industry-agnostic capabilities such as ESG, technology, procurement, talent, supply chain, brand and marketing. More broadly, a useful proxy for overall sophistication was an exploration of how effective GPs were at increasing value through portfolio company synergies and ecosystems. Again, there was a broad spectrum

in how this was achieved, but the best examples included proactive sharing of knowledge, rotating and 'repurposing' staff and hosting functional networking opportunities to identify and encourage commercial partnerships. The isolated measurement of this component was, however, largely non-existent. This, therefore, provides another opportunity for GPs to demonstrate this ability and quantify impact.



Two firms stood out as having value creation approaches which were both **involved** and **systematic.** Interestingly, these firms were also widely regarded by other participants as being the most advanced at using data and had the highest average IRR[9] out of our sample.

It should, however, be noted that some very successful firms sit in either the **bottom-right** or **top-left** quadrants. These firms have made **deliberate decisions** to favour either a **highly involved** and **bespoke** model or to apply **systematic toolkits** whilst allowing higher portfolio company **autonomy** and empowerment within a defined framework.

Results are likely to be skewed towards the top right quadrant by nature of our sample size and the inclusion of firms inherently interested in leadership and value creation.

The size of the nodes is indicative of AUM. This is illustrative only rather than mathematically exact[10]

Value creation 3.0	**Market leaders are increasingly focused on maximising value through portfolio synergies and ecosystems.**

10. Source: Pitchbook (data as of June 2022)

Where is the Opportunity for Greatest Improvement?

The research highlighted several opportunities for improvement which, if combined, can have a considerable impact on performance and provide a more credible and data-backed articulation of a fund's value-add credentials.

This, in turn, could become a key competitive differentiator, impacting brand reputation and the ability to raise capital. An obvious opportunity for improvement is in the measurement and replacement of CEOs. Participants reported an estimated average of 6.5 months before taking any action against underperforming leadership. Consequently, participants noted that it took approximately 24 months (34% of the average industry hold period) between noticing the first signs of underperformance and a full return to productivity. Interestingly, the responses highlighted that larger GPs are generally slower to act compared to smaller funds.

Performance intervention: ~24 months to return to productivity after first warning signs of underperformance

Month 0
First warning signs of under-performance

Month 6.5
Avg time PE firms take to decide to intervene with PortCo CEO[6]

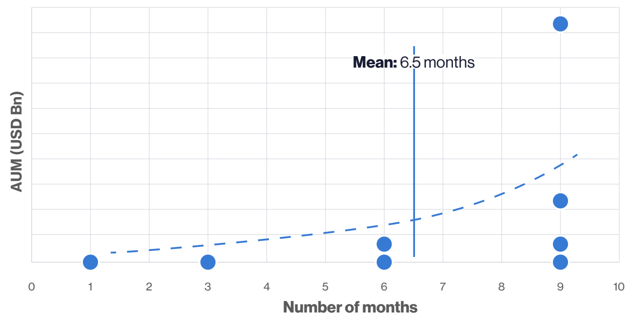
Month 12
Avg time PE firms take to identify new candidate(s)[6]

Month 18
Avg time taken for new CEO to be onboarded[6]

Month 24
Avg time to return to desired productivity[6]

Indeed, much of the opportunity appears to lie in improving the efficiency at the point of interaction between funds and their portfolio companies. This is especially true as it relates to the management and monitoring of portfolio company CEOs and their respective teams. We found large variability here, with a general lack of codification in respect to each firm's intervention strategy. The above statistics highlight the obvious opportunity for improvement, but also suggest that some firms simply do not try to replace their CEOs. Instead, they believed the time, expense and effort of doing so do not justify the means. **"We rarely change CEOs. It takes too long, so after the initial selection, we leave them to it. Fortunately, our under-performers are overshadowed by the majority of firms that are successful[6]."**

After the first performance warning signs, how quickly do PE firms intervene to commence the CEO replacement process?[2]



The fund-portfolio company interaction raises two key questions:

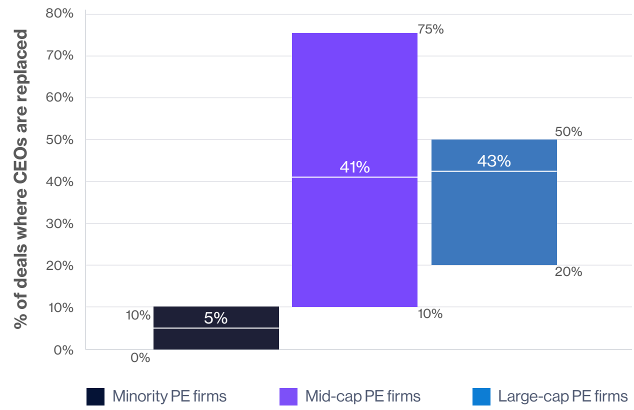
- **Firstly, what are the processes and metrics used to monitor the performance of portfolio companies and their CEOs?**

  Our results highlighted that 80% of funds rely solely on financial or retrospective data, often presenting multi-month delays. In most cases, this data is collected manually through spreadsheets, which raises the opportunity to automate performance dashboards. This should also allow for the capture of a broader range of organisational data points that, in time, can become lead indicators of financial performance. These types of tools are now commonly used in public companies, as increasing reporting scrutiny is driving a rapid adoption of alternative data for the capture and disclosure of ESG, DE&I and other non-financial credentials.

- **Secondly, to what extent is changing the CEO (and their leadership team) a definitive part of the GP's investment case and strategy?**

  For minority stake investment firms, this was clearly a less pressing focus as their ability to change the CEO is greatly reduced. Conversely, large-cap GPs reported the highest mean figure, changing CEOs in 43% of investments on average, with a range of 20%-50%. The other group was represented by mid-cap, buy-out GPs. This group illustrated the broadest range, changing CEOs in 10%-75% of their investments, which, whilst showing a lower mean, intuitively reflected the broader spectrum of strategies and investment styles categorised by this group.

How often do you replace portfolio company CEOs[2]?



What Can PE Firms Do to Improve?

Considering such an opportunity, how serious are PE firms about improving in these areas?

There was a broad acceptance that the investment in, and adoption of, various technologies and tools can help address several issues highlighted by our research and can be achieved without significant investment.

However, despite such acceptance, the commitment and appetite to invest in these areas remain underwhelming:

75% 75% of participants suggested that they are not fully effective at using technology (and for the most part are not planning to change this).

25% Only 25% are planning significant or very significant investment over the next 12 months.

Interestingly, most of the funds planning significant or very significant investments are those already perceived by others as market leaders.

Internal status to drive change

These results highlight part of the challenge faced by individuals within PE firms who preside over this area. This was especially apparent in firms with more deal-orientated cultures, where more internal engagement is required to change legacy ways of working. Similarly, whilst individuals need to build internal credibility to drive such changes, they also needed to establish a cost-value allocation model that was acceptable to investee companies and fund leadership.

In summary, we conclude that the following three components are required to design a high-impact, cost-effective value creation model that is capable of servicing an ever-growing portfolio in a scalable manner:

- **Codifying the value creation approach** into a structured and cohesive playbook, underpinned by clear intervention criteria and supported by functional expertise, technology, tools and methodologies.
- **Developing automated performance dashboards** to track, monitor and provide better visibility through a range of leading performance indicators across key organisational dimensions, both financial and non-financial.
- **Measuring and quantifying operations teams' impact** in order to fairly apportion cost/benefit and quantify their value-add to funds and other stakeholders.

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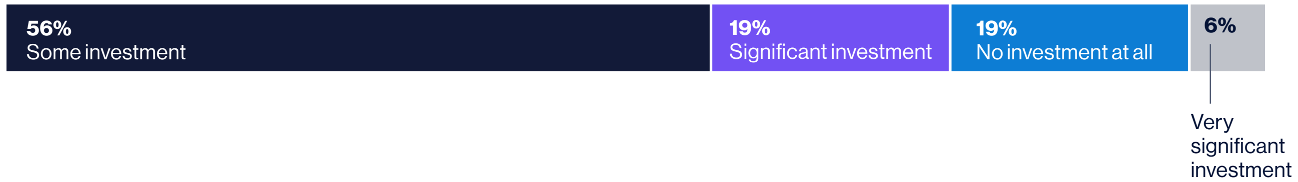
How effective are you at using data and technology to objectively inform your activities and decisions around portfolio company leadership[2]?

To what extent are you investing (or planning to invest in the next 12 months) in the use of data and technology to inform portfolio company leadership activities and decisions[2]?



Examples of tools and technologies providing powerful leadership and organisational insights

Organisational network analysis

Leverages meta data to identify informal socio-technical organisational networks and information flows

- Cultural diagnostic
- Organisation design
- Change agents
- Passive/active leaders
- Risk management
- Succession planning

Key person diligence

AI-based tools delivering powerful and fully customisable individual and team assessments based on public data

- Personality profiling
- Team analysis
- Sales effectiveness
- Digital footprint
- Engagement style
- Industry networks

Big data and NLP

Combines big data and Natural Language Processing (NLP) to provide powerful organisational insights

- Consumer sentiment
- Employee engagement
- Lead indicators
- Business intelligence
- Media sentiment
- Social listening

There are a range of emerging technologies which have the potential to be applied to leadership and people activities. Many, however, remain in their infancy and present complex data privacy questions. Whilst these technologies are already widely used by military and state authorities, their application in the private sector is yet unclear. They present a method by which funds can point to objectivity and data to support judgments which have been historically subjective.

These tools will likely become a complement to, rather than a substitute for, human judgment and experience.

Teneo

Authors

Josh Lewsey
CEO, Financial Advisory, APAC
Josh.Lewsey@teneo.com

Anthony Vasey
COO, Financial Advisory, APAC
Anthony.Vasey@teneo.com

Claudia Polli
Managing Director, Financial Advisory, APAC
Claudia.Polli@teneo.com

Contributors

Sue O'Brien OBE
Executive Chair, People Advisory, UK & Vice Chair, Teneo
Sue.Obrien@teneo.com

Peter Callas
Senior Managing Director, Financial Advisory, UK
Peter.Callas@teneo.com

Jarek Golebiowski
Senior Managing Director, Financial Advisory, UK
Jarek.Golebiowski@teneo.com

In collaboration with The University of Law Business School

Prof. Marco Mongiello
Pro Vice-Chancellor, The University of Law Business School
Marco.Mongiello@law.ac.uk

Dr. Elizabeth R. Moore
Head of Leadership, The University of Law Business School
Elizabeth.Moore@law.ac.uk

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