Middle Market Methods™

Value Creating Solutions in Private Equity

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The Most Difficult Type of Deal Diligence

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Introduction

The pre-close potential portfolio company courtship in private equity includes the omnipresent deal team question: “Will this leadership team successfully execute the investment thesis?” The merit of this question is self-evident. Making money is easier with the “right” people in charge of the portfolio company. There are many ways to interpret “right.” Several methodologies are available to deal teams for answers. The most useful answers are not derived from background checks despite their inherent value. Overt pursuit of more valuable leadership diligence by platooning an industrial psychologist tends to be eschewed out of concern for spooking the sellers. Absent a non-invasive alternative, important diligence goes unaddressed. However, there may be unexplored alternatives. This article will frame one of those alternatives.

For What Are We Looking?

The primary curiosity is about the leadership team, beginning with the CEO. Leadership sets the tone for expectations within the company, as well as how actions manifest into results. Specifically, the objective is behavioral proclivities. Behavioral analysis may seem best left to the clinically trained. In some instances, that may be appropriate. However, our practical life experiences have made us more attuned than we may recognize. In his book, *Start with Why: How Great Leaders Inspire Everyone to Take Action*, Simon Sinek addressed this phenomenon in non-verbal limbic brain terms: what feels right versus wrong. Perhaps all we need is a framing tool for guidance. Leonard Goldberg’s five factor model, a/k/a the Big Five, is such a tool. Consider below each of the five behavioral traits of the model.

> *The five factor behavioral model is a validated framework.*

Openness to Experience

The openness to experience behavioral trait reflects receptivity to something that may alter a person's worldview—even if such appears to defy conventional wisdom. There have been times in world history when this trait got people into trouble, e.g., Galileo's heliocentric argument for the solar system. Openness is a desirable leadership trait that hedges against myopia and groupthink. Openness correlates positively with change-agency required to embrace the risk of change to become more competitive. George Bernard Shaw perhaps describes such leaders best: "You see things; and you [ask] 'Why?' But I dream things that never were; and I [ask] 'Why not?'"

Sample question for revealing openness: "What is the most dramatic change you adopted that defined the company's success?"

Conscientiousness

The root word of conscientiousness is conscience. The definition may be easier to visualize by comparing conscientiousness with its opposite: sociopathy. Sociopaths act without conscience; they have no regard for the impact of their decisions on others. Therefore, conscientious people are Golden Rule people. They comport themselves the same irrespective of whether people are watching. Conscientious leaders live their values. Of course, this requires knowing what a leader's values are for juxtaposition with observation.

Sample question for revealing conscientiousness: "What is the toughest personnel decision you ever had to make?"

Extroversion

The extroversion behavioral trait for the model may be misleading upon first impression. Whereas openness and conscientiousness are "good," one might infer that extroversion is also "good." Actually, both extroverts and introverts may be "good." The population ratio for extroverts to introverts is 2:1, respectively. Perhaps a better way to consider the point is EQ, or emotionally intelligence. Leaders with good EQ possess a self-awareness that includes adjusting their approach to more effectively engage others. The hazard to avoid is "projection," which entails requiring others to be the same as we are.

Sample question for revealing EQ: "How does your hiring process determine cultural fits?"

Agreeableness

Corporate folklore is punctuated by a story about Alfred T. Sloan, former General Motors CEO, after whom one of his alma maters, MIT, named its management school. Sloan would not indulge a meeting sans decisioning arguments, i.e., opinions defended by facts. Sloan insisted on constructive critique. Sloan's technique was the antidote to what Daniel Kahneman described as confirmation bias, i.e., the boss only absorbing input that agrees with his/her conclusions. Agreeableness is negatively correlated with effective leadership. The question is whether a leader may disagree without being disagreeable. Domineering leaders do not effectively mine the benefit of the intellectual horsepower within their teams. Indeed, domineering actions stifle such into eventual extinction.

Sample question for revealing agreeableness: "How are strategic decisions made?"

<u>Neuroticism</u>

Neuroticism refers to one's reaction to stress. There are two types of stress. Eustress is inspirational. Athletes who enjoy the fulfillment of competition personify eustress. The combination of adrenaline and endorphins produce a natural high. Distress is the opposite, resulting in unhealthy manifestations, e.g., depression. Robert R. Blake, Anne Adams McCanse, and Jane Srygley Mouton's research argued two leadership styles: the one we aspire to be and the one to which we default to under duress. The question is the line of demarcation.

Sample question for revealing neuroticism: "When do you know it is time to go fishing?"

How Do We Find That for Which We Looking?

The questions for the Big Five traits above only scratch the surface. A more holistic and valuable approach is next presented relative to the business model. The deal team not only wants to know how the business model works, but also how well it could scale. Part of the answer regards the skillsets and empowerment of the functional leaders in the company. To wit, the functional leaders of the company bear the leadership "fingerprints" of the CEO. The deal team may learn more—and more valuable—insights from the functional leaders than from the CEO.

Since the initial audience is with the CEO, the deal team should start by asking the CEO to describe the business model by its high-level functions. A generic example might include: product development, marketing, sales, customer service, procurement, manufacturing, shipping, accounting, IT, and HR. Next, the deal team should ask who leads each of those functions. This may or may not mirror the organizational chart shared by the intermediary. Upon learning the identities of those functional leaders, the deal team should ask if they could visit with each.

Five factor model insights may be gleaned from the CEO's direct reports.

The pivot point has arrived! This is a “moment of truth.” How will the CEO react and what does it mean? For the sake of argument, let’s remove from consideration that the CEO may deny access to keep from spooking his/her team. Indeed, this happens. However, the issue is sometimes defused by positioning the inquiries as value-creation consultancy—something plausible and at least partially correct.

Scenario 1: The Chaperone

One scenario “bookend” is that visits are chaperoned by the CEO. The worst version of the scenario is the deal team directing the question to the functional leader and the CEO answering it for them. A slightly less extreme possibility is the functional leader making eye contact—or some other cue—whose objective is determining whether the functional leader may safely answer the question without reprisal.

The deal team is left to decipher not only what they were told, but more importantly, what they learned in context. One possibility is that the CEO directs instead of empowers. This is a common occurrence. The practical governance mechanism for many founding entrepreneurs is control. This model does not scale for at least one practical reason: growth will overwhelm the CEO’s bandwidth. Another manifestation could be indisposition due to illness, possibly catalyzed by stress. If the deal team proceeds with the transaction through closure, they should be completely cognizant of the need for coaching and/or succession planning to avert value-creation obstacles.

Scenario 2: Complete Transparency

The best scenario “bookend” is the CEO responding that he/she has already advised his/her team that they will be interviewed by people with whom they might consider a strategic relationship to aggressively capitalize on growth opportunities. Accordingly, the deal team is free to make direct contact with functional leaders as they wish in any order they prefer, but with the caveat that they be respectful of the functional leaders’ time. The deal team is likely impressed by internal communication, trust, and empowerment.

Scenario 3: Between the Bookends

The more realistic encounter scenarios with functional leaders lie somewhere between the bookends. This does not change what the deal team desires to know. Rather, the dynamic frames the obstacles between the deal team and functional leaders for the information the deal team desires to obtain. Absent direct access to functional leaders, the deal team may creatively approximate at least some of their objectives with diligences vendors. This may or may not be part of the official statements of work for those vendors.

The Functional Interview Objectives

Some simple questions and their rationale are itemized below for consideration in profiling the company culture and leadership dynamic.

What are the responsibilities of your functional area?

This is a scoping question. A clear functional objective precludes resource diminution by non-value-added and/or unaligned work.

How does your functional area enable and/or create value for the company and its customers?

This is a signal of strategic alignment and perspective. The answer is a litmus test for any published or verbalized mission, vision, purpose, strategic intent, priorities, and/or goals.

How does your functional area know it has work to do?

Business model functions may have internal and/or external vendors. Is the functional leader and his/her team clear on this? In well-designed business models, the function has line of sight and time expectations on work signals. Moreover, technology design may enable these signals.

How do you know when the responsibilities of your functional area are completed?

Analogous to work signals for vendors, a function has internal and/or external customers. Does the functional leader know what is expected from his/her customers?

What tools do you use to manage your functional area?

This is both a manual and automated tool question. If the business model lacks a good system, the deal team will likely have to make a substantial investment to support growth.

How does your functional area know when it has done a good job?

The answer reveals aspects of process metrics and performance management. Ideally, the functional leader knows what to expect by doing a “good” job without being told.

How does your functional area know when you have to ask for permission to do something?

This is a span of control question. For example, the operational leader in manufacturing might respond that he/she has to abide a capital budgeting process for a new piece of machinery. However, maintenance and repair may be autonomous.

Upon contemplating growth, what are your biggest concerns for your functional area?

The is a “thinker” question. Does the leader engage his/her ecosystem proactively or reactively? The answer may also yield a bottleneck well ahead of occurrence. Common answers include people and capital. A “people” answer may be a reflection of inefficient processes, difficulty in recruiting labor, and/or protracted onboarding.

Closing the Loop

The functional interviews provide solid diligence on robust scalability—or lack thereof—for the business model. However, the exercise doubles as a report card on the CEO for how well he/she has prepared the team for growth. In simple, yet practical terms, the data gleaned from the functional interviews will shed light on (i) the CEO, (ii) the individual functional leaders, and (iii) the dynamic between and among company leadership on all five behavioral traits. More importantly, the deal team will have valuable insights for that important question posed at the advent of this article: “Will this leadership team successfully execute the investment thesis?” By inference, the underlying question is: “Are these the right people with whom it will be easy to make money?”

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Middle Market Methods™ offers a value-creation toolbox of cultural, growth, and productivity solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother investment hold period, resulting in higher exit multiples. Additionally, deal team time is liberated from operational surprises to invest in new transactions.