Questions that Matter to Value-Creation

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Introduction

Private equity sponsors whose investment aspirations emphasize shorter hold periods must promptly commence post-close value-creation initiatives. Attempting too many simultaneous value-creation endeavors may overwhelm portfolio company teams who are recovering from transaction fatigue while concurrently contending with their normal responsibilities. An initial sortie of "vital few" initiatives should be rationalized amid the "worthy many" opportunities. Moreover, the private equity sponsor may amplify expeditious results by complementing portfolio company leadership's execution skillsets and/or capacity. The celebrated completion of a complex deliverable may be succeeded by launching another initiative. Such iterative value-creation among triaged priorities enjoys vindication via a rewarding investment exit.

Prioritizing the "vital few" among the "worthy many" opportunities is an integral element of value-creation.

Initial post-close value-creation opportunities and priorities may be identified as a byproduct of both solicitation dialogue with founding owners (i.e., sellers) and vendor diligence under the letter of intent (e.g., quality of earnings). Like any other sale in any other context, seller stakeholders' dialogue is inherently biased to project latent potential over scalability impediments. Even so, some prudently crafted questions posed to sellers may yield thoughtful responses to potential buyers. Indeed, Albert Einstein promoted the virtue of critical thinking questions over anecdotal answers. Einstein had faith in scientific method to validate "right" answers.

Pursuit of meaningful answers to the prudent questions should be stewarded by the emotional intelligence of the interviewer. Daniel Goleman enumerated five characteristics of emotional intelligence, also known as EQ: (i) self-awareness, (ii) composure, (iii) motivation, (iv) empathy, and (v) relationship management. Crafting candidates for antecedent "right" questions and navigating the response labyrinth for useful insights are the subject of this value-creation installment.

What Will Be Your Corporate Legacy?

Commencing with a legacy question is a “vision” thing, i.e., begin with the end in mind. Altruism is an admirable leadership trait. How might this be revealed? My favorite version of legacy question is “What do you want on your corporate tombstone?” (It plays better in person than in prose.) Mortality is both inevitable and definitive. Amid my odyssey of supporting entrepreneurs, I have learned the practicality of the “corporate” adjective. Absent that modifier, respondents may answer from a personal perspective instead of a corporate perspective. Admittedly, “personal” and “corporate” versions may conflate. However, the question should seek to distinguish between the two as the personal version may be “too personal” to probe. There is an argument in support of the point.

One of the most successful sponsor clients I have ever served posed a deliberately ambiguous version of the question. While the initial seller responses commonly reflected non-financial altruism, my client observed that the “real” motivation migrated to financial aspirations concurrent with negotiating the purchase agreement. His strategy was practical: remind the seller of their platitudes as a negotiation tactic. However, the seller infrequently capitulated. Even so, my client was not deterred from his routine. Rather, he better understood his potential investment partner.

The objective of the first critical thinking question begins with the end in mind.

Why focus on the corporate emphasis over the personal emphasis? Private equity firms brandishing a bullpen of immediately deployable value-creation resources may provide the sculpting tools through which the corporate tombstone is carved. Wielding the core competencies required to resolve the most prominent scalability obstacles for the sellers’ companies represent an economic argument more aligned with the sellers’ economic objectives. Sellers may be more favorably disposed to the allure of the “second bite of the apple” argument when the roadmap is clean and tangible—not nebulously esoteric.

The tombstone question is also an anchor question for a pivot.

What Keeps You Up at Night?

Contextually, the next question, “What keeps you up at night?”, is understood as business-related when preceded by the tombstone question. The question should not be posed until rapport is comfortably established because a candid response requires respondent vulnerability. Otherwise, the response value is suspect. Hence, the opportunity for a potentially revealing answer may be unfortunately forfeited.

The predominant governance mechanism for founding entrepreneurs is control. The boss—being the point of convergence for all major decisions—may have plenty to ponder. Accordingly, the odds are high that something is front of mind even if it does not necessarily disturb his/her slumber. What should the interviewer hope to learn? The answers should map to some combination of growth, process, and people. In other words:

- what is the source of growth,
- how will growth be digested, and
- who will steward the growth?

Two scenarios should be considered. First, the interviewer may elect to pose follow-up questions for a deeper comprehension of any response. Second, the interviewer may pose a follow-up question to understand why nothing was mentioned for omissions among the three. The encounter should be entirely Socratic, i.e., open-ended questions designed to invite the respondent to do most of the talking. Moreover, the interviewer should be careful about breaking the silence of pregnant pause. Indeed, the respondent may be wrestling with word choice to convey their thoughts cogently.

What Are the Implications of Rapid Growth?

The title of this section is euphemistic. The operative version of the question is “Could you run the business the same way tomorrow morning if it were three times as big?” I am careful about hyperbole. I have never experienced a “yes” response. More often than not, the “no” response is punctuated with emotion—and followed by a hint of regret over the spontaneous eruption. The interviewer of the entrepreneurial boss may have both an opportunity to diffuse the tension and position their value-creation support. Savvy sponsors should pursue what popped in the respondent’s consciousness because it is likely a material impediment to growth. To the point, the issue should be understood for corrective and/or preventative attention. Again, an equity sponsor with a retinue of resources may draw from a well of analogous challenges and reservoir of successful outcomes.

Rapid growth can produce challenges that result in sleepless nights.

One might correctly deduce that the rapid growth question is a corollary of the insomnia question. Why, then, risk redundancy? First, consider the scenario that the rapid growth question response is an exacerbation of the sleeplessness question, which may indicate degree of severity. Second, consider that the response to the rapid growth question has no connection with the insomnia question. To wit, the rapid growth answer is not yet a catalyst of nightmarish slumber but may be destined to get there. As with the second question, Socratic method is an enabler.

Now What?

Digesting a trove of input benefits from categorization. Two suggestions are offered. One borrows from the Six Sigma SIOPC tool, an acronym that stands for suppliers, inputs, processes, outputs, and customers. SIPOC is a high-level process map for understanding the basic value chain of a business model, or subset thereof. For purpose of analysis for the three questions, prune the bookends to accomplish inputs, process, and outputs. (See Figure 1.)

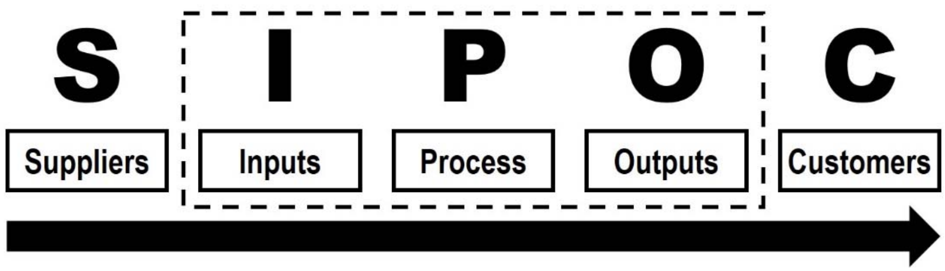

Figure 1: Inputs, process, and output subsets of the Six Sigma SIPOC.

Sponsors tend to be focused on EBITDA—an output. The interview process is likely to produce seller feedback skewed toward inputs and processes. The directionally correct perspective for the sponsor is addressing the input and process issues that will produce the desired EBITDA output. By example, sufficiency of skilled labor could be an input issue, while production quality may be a process impediment.

Another suggestion is the fishbone diagram created by Kaoru Ishikawa to profile potential root causes to a problem. The “problem,” or challenge, per this article is post-close value-creation. The root cause categories are machines, methods, materials, measures, mother nature, and people. (See Figure 2.) The interviewer may seek a more granular understanding on some responses by posing judicious “Why?” probes.

Using both the SIPOC and fishbone diagram has merit. In the spirt of Vilfredo Pareto’s research, an 80/20 grouping is likely. In other words, 80 percent of the impediments to post-close value-creation will be anchored in 20 percent of what the interviewer learns from the respondent.

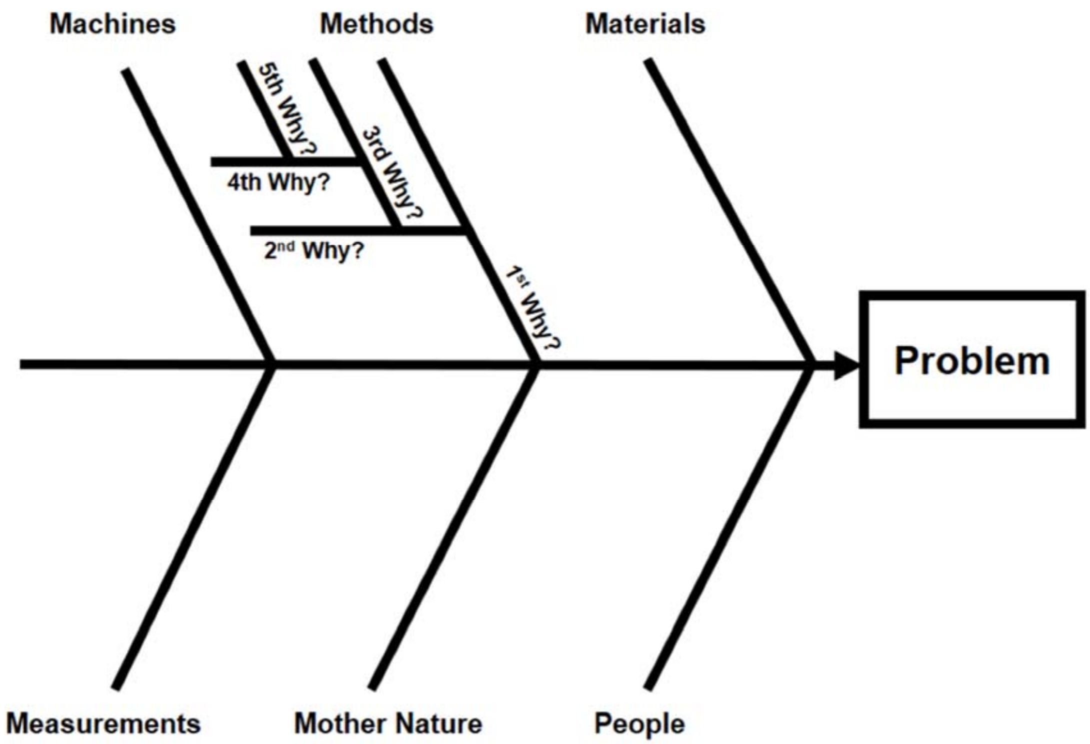

Figure 2: Fishbone diagram.

Suppose the interviewer discovered a threat to the investment thesis. How, then, does the investment professional transform such knowledge into mutual, differentiable benefit? The answer is how the sponsor partners with the seller to address issues to create value. Let's revisit the growth, process, and people categories for a deeper dive.

Growth

Growth is an obvious driver for value-creation. It may be both organic and acquisitive. Organic growth may be driven by penetration (i.e., share of wallet), expansion (i.e., share of market), and new product development (i.e., new markets). What are the existing capabilities for each? A common deficiency in organic endeavors is salesmanship. In the universe of sales professionals, only about a tenth are trained in sales technique. This means that opportunities may be missed and/or margins forfeited. Indeed, failure to establish the value-proposition with prospects and customers may result in capitulating on price, i.e., margin erosion via commoditization.

Rapid growth will reveal the degree of robustness for the core business model processes.

Acquisitive growth is common in private equity. Indeed, buying may be the more economically rational alternative to building. Experience in acquisition integration is uncommon in the lower middle market. Integrations are highly complex project management exercises. Execution amid task dependencies is problematic. Developing integration as an acculturated core competency may be desirable. Equity sponsors brandishing this expertise may easily differentiate.

Process

Existing processes should not be assumed to be "good." Waste and inefficiencies abound. The value chain must continually validate itself with quality and timeliness which minimize variation for customers. Robust scalability is supposed to produce higher margins through better asset utilization. Enabling good processes with technology is pathway to productivity.

Regarding the relationship between technology and process, the lower middle market tends to get this backwards. Companies commonly implement new systems before scrutinizing their processes. The result may be only making poor processes more efficient—not making great processes more productive. Another prudent point is that good processes should be foundational to the RFI (request for information) and RFQ (request for quote) steps for technology vendor vetting. Again, sponsors who wield this collective wizardry are priceless potential partners to sellers.

People

Talent is a prerequisite of value-creation, i.e., minds over matters. Growth will drive demand for known and new skillset capacity. An "employer of choice" must exert an institutionalized approach for recruiting, onboarding, developing, and motivating its talent pool.

Skilled people are integral to both growth and productivity.

Talent recruitment is analogous to product marketing. Employers need to understand channels for reaching likely candidates. Moreover, proactive recruitment ahead of need is highly advisable to avoid settling in a pinch. This is especially critical in a low unemployment economy.

Organizational architecture must reconcile the talent pool with the value chain processes. Indeed, the modern workforce seeks fulfillment in complement to compensation. Employers need to position their talent to produce profitable results, reward the success, and retain the tribal knowledge. No one reconciles a talent pool with a value-creation strategy better than Coach Mike Krzyzewski at Duke. Each year, Coach K recruits the best available basketball talent, then designs offensive and defensive schemes which enable his players to differentiate. Five national championships speak for themselves.

Let’s pursue the coaching point from a different angle. The portfolio company head coach is the CEO. Is he/she motivated and/or may he/she be mentored to scale? If not, succession may be the only viable alternative. Orderly succession is among the most delicate of lower middle market private equity endeavors. Seasoned emotional intelligence is a prerequisite sponsor skill.

Conclusion: The Sponsors’ Opportunity

No company is completely prepared for its future—even if company leadership had a crystal ball to predict its ecosystem dynamic. Not only are some variables beyond control, but they may not even exist when the investment is consummated.

Stated simply, the alchemy that propelled the portfolio company to its first recapitalization is not necessarily the same algorithm for achieving a successful exit. Sponsors with resources primed for immediate deployment to address growth, process, and people challenges possess a compelling value proposition. Sponsors with measurable results therefrom maintain a more compelling value-creation credibility.

Limited partners have latched onto the hedge of equity sponsors with a demonstrable strategy and resource repository to support portfolio companies in overcoming inevitable growth obstacles. Institutional investors in private equity funds are increasingly making these capabilities/results a precondition of commitment to the sponsor’s fund. Among the benefits for sponsors is easier fund raising made possible by readily substantiating how they predictably create value.

Asking the right questions leads to win-win value-creation opportunities. A track record of expeditiously capitalizing on value-creating opportunities builds brand equity. Everyone wins. The seller may be more disposed to the “second bite of the apple” proposition. The gratified limited partner may look favorably on a larger commitment in the next fund. The sponsor’s carry is more substantive. And to think it all began by asking the right questions.

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Middle Market Methods™ offers a value-creation toolbox of growth, productivity, and cultural 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.