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Private Equity Learning Cultures: Post Mortems and Deliberate Practice

By John A. Lanier

Albert Einstein quipped that the definition of insanity is doing the same thing over and over again and expecting different results. Are some private equity firms guilty of this by forfeiting an effective learning opportunity?

World-class businesses espouse learning cultures that strive to continually improve each aspect of the workflow. In private equity the analogy would span from origination, through the hold period, to exit. Good private equity learning cultures examine not only what they did “right” on a transaction, but also what they wish they had done differently. The pros tell us we learn more from our mistakes than our successes.

Harvard Business School pioneered the case study methodology for learning. Indeed, Harvard alums are strongly represented in the private equity industry. Many firms espouse case study principles for interviewing candidates—typically associates—to join the firm. The ritual includes financial modeling. This is an excellent vetting process for joining a firm. How come, then, the case study principles lay fallow thereafter for seasoning talent within the ranks?

> *Learning cultures continually improve each aspect of the business model workflow.*

One of the lines I share during my private equity firm seminars is that private equity is the last campus in America on which hazing is a time-honored tradition without danger of extinction. The line evokes predictable guffaws, largely because an “outsider” has the temerity to pronounce the obvious.

Private equity is a bastion of agency theory. Carry points in a good investment’s exit salve a lot of hazing wounds. However, agency theory portends what Dave Logan, John King, and Halee Fisher-Wright dub “level three tribes” in their book, *Tribal Leadership: Leveraging Natural Groups to Build a Thriving Organization*. The mantra for members of level three tribes is “I’m great.” Moreover, the undertone of this mantra is “And you’re not!” Thus, we may ask whether agency theory has turned firm members into mercenaries and cannibals. Clearly, agency theory inhibits teamwork.

By contrast, Logan, et al. describes a “level four tribe” distinguished by the esprit de corps of “We’re great!”—a team oriented focus that competes outwardly, not inwardly.

These teams understand that it is better to be a reserve special teams lineman for the Packers than the starting quarterback for the Steelers. (Note: Cheese Heads won Super Bowl XLV at the expense Big Ben's Steelers.)

Corelius A. De Kluyver and John A. Pearce write that effective learning cultures possess five key traits: (i) encourage systems thinking, (ii) foster a shared vision, (iii) challenge existing mental models, (iv) promote team learning, and (v) cultivate skill development. Learning cultures unfortunately appear to be the exception instead of the rule among private equity firms. Learning after joining the firm may be more Darwinian than nurturing, and more threatening than enlightening. Moreover, those who survive despite the hazing sometimes punch out to start their own firms. Ironically, the hazing tends to "pay forward" in the new venue. Deal professional turnover in firms has catalyzed succession planning challenges that limited partners are forcing firms to address as a condition of fund raising.

Several motivational models are useful to examining a learning culture and the unintended consequences of its absence. Frederick Herzberg's hygienic and motivating factors are particularly poignant to the topic. Hygienic factors do not motivate, but can de-motivate by their absence. Hygienic factors include firm policies and administration, supervision, interpersonal relations, working conditions, compensation, status, and security.

Many are drawn to private equity by the allure of big bucks. Even so, the research says that compensation as a sole motivator has diminishing returns. This is where Herzberg's motivating factors become relevant. Motivators include achievement and its recognition, the nature of responsibilities and commensurate authority, career-pathing, and personal development. Note how the motivating factors cluster near the apex of Abraham Maslow's hierarchy of needs, e.g., self-esteem and self-actualization. Furthermore, Herzberg's motivators jibe with characteristics of Logan et al.'s level four tribes.

Hygienic factors de-motivate by their absence. Motivators need to be calibrated in context.

The private equity deal pipeline has a trove of learning opportunities. Mostly, they come in won and lost deal analysis. Upon broaching the subject with firm managers, I rarely recall these leaders eschewing post mortems on deals. Some even make token efforts to start them. However, few institutionalize the process. This is a tragedy, but why?

Geoff Colvin's book, *Talent is Overrated*, identifies "deliberate practice" as key to superlative performance. Colvin adds that deliberate practice should be applied to something important for which we are not very good. Moreover, Colvin imparts that deliberate practice is a major time commitment. Effective deliberate practice includes immediate feedback mechanisms. In addition to substantiating his hypotheses with ample academic research, Colvin cites deliberate practitioners like Jerry Rice, Tiger Woods, and Mozart.

Colvin's book imparts a significant gotcha called the "10 year rule." Essentially, breakthrough performance on critical skills tends to require a decade of deliberate practice! How does this reconcile with an industry that thinks in terms of quarters? Simple. Start now or the deal professional will hit the 10 year milestone in his or her next firm.

Deliberate practice takes about 10 years to be differentiable.

Assuming the deal post mortem idea is gaining some traction in this argument, the next question is how does the firm institutionalize a learning culture? The following model features simplicity.

1. Establish trigger mechanisms for conducting post mortems.

Two are suggested. First, at the same time each month, e.g., first Mondays, review all definitively lost deals from the Indication of Interest or Letter of Intent stages. Second, review all won deals within a week of final close.

2. Have a simple, codified format.

Try answering two questions. The first question is "What three new things learned from this deal should be institutionalized for the benefit of all deals?" The second question is the converse of the first question: "What three things learned should be avoided in all future deals?"

3. Require each member of the deal team to prepare their two responses in #2 independent of each other.

No two people perceive things exactly alike. Avoid groupthink responses.

4. Require universal firm participation.

Leaders need to lead by modeling desired behaviors. When the boss plays hooky, the process gets subverted. Walk the talk! This is one of the primary root causes of most failures to establish good post mortems.

5. Establish and honor ground rules.

Mistakes are painful. They are also great learning opportunities. However, no one is going to volunteer for public evisceration. Again, leaders need to lead by focusing on issues—not personal attacks. The post mortem "personality" is another major root cause for failure to institutionalize a good process.

Facilitation best practices come in handy here. First, publish behavioral ground rules on the wall. Second, establish a sufficiently painful fine for violations, e.g., $100 per incident for senior partners and $50 for junior partners. Remember, fines are per incident. Third, identify a worthy charity such as Habitat for Humanity. Fourth, give the fines from each session to Habitat. If the firm is going about this the right way, Habitat will enjoy some initial excitement before wondering why the donations are tapering off. This is not a criticism of Habitat, but rather a compliment to a good post mortem process.

Post script: Consider applying fines to preparation (#2) and attendance.

6. Document the discoveries.

A cumulative spreadsheet is advisable. Furthermore, comments should be categorized by type to make the Excel auto filters handier. Save the file to an easily accessible shared drive. Even better, make sure everyone has a desktop hyperlink to the file.

7. Analyze the data.

On a quarterly basis, the managing partner responsible for training and development modules (Oops, I'll write about this opportunity in another installment) should review the database. Patterns may emerge from the database for applying deliberate practice opportunities.

Post mortems align with learning cultures.

On an annual basis, revisit the post mortem process itself. The process intended to drive improvement should also be subject to improvement.

In summary, George Santayana reminds us "Those who cannot remember the past are condemned to repeat it." Instead of repeating bad history, private equity firms have an opportunity to learn from experiences via institutionalized post mortems and accomplish improvement with deliberate practice. Consequently, the firm may make history—the kind with superlative exit multiples that make competitors salivate with envy and LPs line up for the next fund raising.

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Middle Market Methods™ offers a new investment transition best practices seminar for private equity firms. The premise is that the best practice adoption correlates with a smoother ride during the hold period and higher exit multiples; additionally, deal team time is liberated from operational surprises to invest in deal origination.