Middle Market Methods™

Value Creating Solutions in Private Equity

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The Legacy Effect

By John A. Lanier

Introduction

The easiest way to make money is put the right people in charge and turn them loose to create value. But what about the strategy? In *Winning*, Jack Welch presented an argument that the right people will make sure that the strategy is correct. So, exactly who are the right people? Private equity investment is attracted to entrepreneurs who successfully exploit a business model. This does not necessarily mean that someone invented the next Google. Rather, they may have configured a differentiable delivery mechanism. Both instances abide by Michael Porter's strategic model: product differentiation, cost leadership, or keen focus on either, i.e., specialization. But these value creating wizards typically sell controlling interest in the first bite of the apple, and punch out entirely on the second bite. Moreover, these leaders may not possess the skillsets conducive to scaling the business model commensurate with the investment thesis. The leadership style that attracted the private equity investment is not necessarily the leadership style that assures a successful exit, i.e., that which got us "here" may not get us "there." Deal teams have their work cut out for them to execute moves on the chessboard for the typical three to five year hold period. What should the leadership legacy roadmap look like?

The right leaders will assure that the right strategy is in place.

Diligence

Confucius counseled, "Choose a job you love, and you will never have to work a day in your life." Are job lovers or indentured servants running the portfolio company? For the same reason that acquisition integration commences during diligence—irrespective of the probability for deal consummation, succession planning must start in diligence. The process starts with leadership diligence—arguably the trickiest of all diligence. Basically, deal teams have to conduct such diligence discretely because overt approaches might kill the deal. The big question is "How does the place really run when the visitors go home?"

How might the answer to the big question be approximated? A practical approach begins with identifying key components of the business model and the “owners” of those processes. The ability to talk with them lends insights. First, how does business model functional ownership jibe with the organization chart? Second, do the diligence representatives have unsupervised access to those people, or does the boss babysit them? If a proctor is present, what does the body language, i.e., the non-verbal communication, reveal? Does the recipient of the diligence question look to the overlord for signals about how to answer? The decision tree of possibilities is robust and complex. The objective is discovering whether the environment is dictatorial or delegated. The answers telescope what awaits the deal team and board post-close. Depending on the answers, the deal team may punt.

Deal teams should be sober to particular hazards in navigating this type of diligence: anchoring and confirmation biases. Research abounds on both topics. Anchoring bias is a type of benchmarking against which all subsequent data points are compared. Humans are especially vulnerable to this type of bias in the absence of comparative context. Confirmation bias regards our tendency to latch onto confirming data points and fend off conflicting ones. This is why first impressions are so important. The emotional rollercoaster of transactions can amplify anchoring and confirmation hazards in the form of closure bias, which compels us to overlook troublesome leadership signals at the prospect.

The Talent Pipeline

Eleanor Roosevelt said, “A good leader inspires people to have confidence in the leader; a great leader inspires people to have confidence in themselves." The simple fact of most middle market investments is that succession C-level leadership is predominantly recruited externally because a talent pipeline was not part of the value creation modus operandi of the sellers. Deal teams are pretty good at such recruitment. However, they also typically miss a major strategic necessity: building a talent pipeline so that the company may safely rely less on external recruitment going forward. The point opens Pandora’s box.

Implement a simple model to get started and build on those successes.

Middle market companies tend to have underdeveloped human resources disciplines. The red flag is where HR is parked in the org chart. If HR is configured under the CFO, the perspective on employees is more likely that of expense instead of asset. Concurrently, performance management systems may not exist or are inadequate. Moreover, there is only about a one in ten chance that hiring managers in the typical middle market company have any type of recruitment or management training.

Let’s examine a Spartan model that addresses the problem. First, return to the major components of the business model. Identify the three major technical and behavioral competencies of leadership for that function. What is the difference between this type of competency profile and a job description? Most job descriptions include hubris, some of which is legally necessary. By contrast, the profile’s objective is leadership practicality.

How does the incumbent compare with those three requirements in each category? Discovering gaps is expected. Addressing those gaps with coaching and development is good leadership. Eschewing a solution is dereliction of duty. Essentially, blowing this off is setting up the manager to fail. Even if external recruiting becomes necessary, these profiles are beneficial for establishing a strike zone for the recruiter.

Second, what happens if the process owner is abducted by extraterrestrials? Are protégé options in the wings, or will the company resort to a reactive mad scramble to fill the post from external sources? Even if external recruitment is successful, it is likely to be both protracted and expensive. Moreover, the process does not end when the new hire arrives on the scene. Cultural assimilation typically takes months. Peter Drucker reminds us that "culture eats strategy for breakfast." Consequently, it is purely delusional to think a new hire will be optimally effective on the first day.

Third, how does the company approach entry level talent? This is one of the most overlooked value-creating engines in the middle market. A good strategy abides by marketing principles and develops recruitment channels. When managers adequately profile the type of talent they seek, e.g., technical and behavioral competencies, the next question is where the prospects hang out. Not only should these channels be identified, they should be engaged proactively. A great rhetorical question is "Why proactively?" Two simple answers prevail. For openers, better decisions are made when managers are not pressured to settle. Additionally, options make for better decisions. Being proactively visible in the channels with potential hires is a great way to brand the company. By starting with good talent, the odds are higher that leadership positions may be promoted from within. World class companies do this for many reasons, not the least of which is that it reduces execution risk and opportunity cost. Performance is de facto interviewing for next level opportunities. Companies may easily promote diversity by emphasizing such on the front end of the talent pool.

Identify recruitment channels and proactively recruit to brand the company.

Middle Market Methods devised Legacy Axes (see Figure 1 below) to guide leaders in developing recruitment channels. The tool was inspired by arguments in Clayton Christensen, Eric Roth, and Scott Anthony's book, *Seeing What's Next: Using Theories of Innovation to Predict Industry Change*. T-shaped attributes are preferred for positions that entail vague rules of engagement and pronounced complexity, i.e., the northwest quadrant. T-shaped professionals are people described by Tom Kelley and Jonathan Littman in *The Art of Innovation: Lessons in Creativity from IDEO, America's Leading Design Firm* as broad perspectives with deep knowledge on select topics.

Summary

Peter Drucker observed:

> An organization that is not capable of perpetuating itself has failed. An organization therefore has to provide today the [professionals] who can run it

> tomorrow. . . . An organization which just perpetuates today's level . . . has lost the capacity to adapt. And since the one and only thing certain in human affairs is change, it will not be capable of survival in a changed tomorrow.

The most sublime compliment afforded an executive is that the place runs smoothly without him or her. Such is the essence of the legacy effect. The antithesis of the legacy effect is that the place—or a key function within the place—cannot run without the boss. This is a risk the deal team and board must promptly address because it poses a material threat to enterprise value and exit scenarios. Left to their own devices, portfolio companies suffering succession deficiencies are unlikely to fix them. Indeed, they may not actually know how, or want to if they did. The research on this type of change management is discouraging—and approximates the 80/20 principle. Less than a quarter of people change their ingrained personal habits; consequently, three quarters of the leadership ranks will struggle with the traits required by the investment thesis.

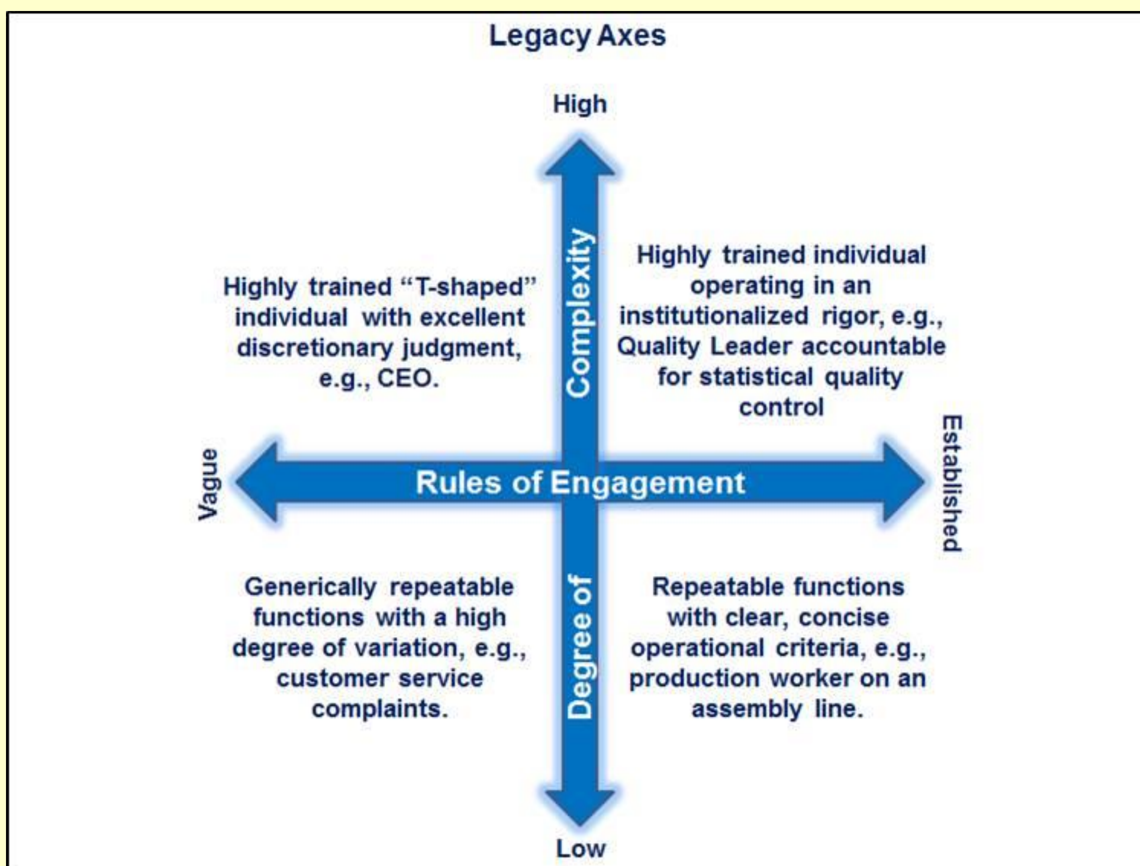

Figure 1: Legacy axes.

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