The Top 3 Reasons PE-backed CEOs Fail

By Alan Foster & BJ Wright

The sad irony of the PE industry is that while it catches a lot of flak in the media for slashing and burning people and being too tough, in reality most PE investors wait two years too long to upgrade a CEO. So they (and their investors) are paying the price twice: their public image is poor no matter what and they lose a key opportunity for maximizing returns.

Most experienced GPs will say that getting the right CEO in every portfolio company is critical. Many have conducted internal analysis that conclusively proves it. They tell their LPs that their approach to helping management teams to create value is distinctive. Yet behind closed doors they lament that their actions do not drive the results that they want. In fact, they will confide that they are not always on the front foot with CEO changes or have the language or approach to convince CEOs that they will help deal with talent in a systematic way.

Over the last 20 years, we have worked with >200 private equity and alternative investment funds in both pre- and post-close situations, representing roughly half of our business as a firm. We recently collaborated with Professor Steve Kaplan at the University of Chicago, whose team coded over 3000 of our CEO and C-suite SmartAssessments®. Each assessment was an in-depth, one-on-one, five-hour interview that generated hundreds of data points per leader, enabling us to compile the largest database and study of its kind. We analysed millions of data points to understand the most common risks across >850 private equity CEO candidates whom we have assessed over the last ten years.

So what did we find? Most CEO candidates considered by private equity firms exhibit at least one of three common risks that seriously damage investor returns.

First, CEOs do not build the right team fast enough, costing their PE sponsor hundreds of millions of pounds in lost opportunities and mistakes. A hefty forty-three percent of CEO candidates we met had a repeated pattern of either hiring poorly or not removing underperformers quickly enough. Some executives make painful hiring mistakes early in their career and learn from their mistakes. But many do not. Executives who have grown up at well-run companies are often the most complacent and least appreciate the importance and urgency of hiring well. After all, a high-functioning HR department did this work for them in the past. Often it is a lack of skill (most have never been taught how to hire) or will (they fear confrontation or prefer a warm body in the seat). Yet the best CEOs will quickly evaluate the hand that they have been dealt and move quickly to course correct on mis-hires. One successful CEO we worked with sat down every quarter with a pencil and blank sheet of paper. He sketched out his leadership team as if he could only have 80% of his existing team. This prompted him to get out ahead of changes. If you do not have an understanding of how a potential CEO has built past teams and what process he/she uses beyond gut instinct, then you are flying blind and leaving value on the table.

Second, CEOs frequently struggle to set clear and correct priorities that reflect the investors' deal thesis, leading to confusion and wasted efforts. This shows up in more than one-third of CEO candidates. One reason is the CEO's instinct to push too much onto the business – often dozens of initiatives destined to distract the organisation. We have found the more successful and seasoned the CEO, the fewer priorities they are comfortable having. It is also critical to ensure there is not a mismatch between the CEO's playbook and the business requirements. We recently worked with a PE investor in an industrial company seeking steady organic growth, but they inherited an incumbent CEO with a career pursuing aggressive M&A. After 15 months of miscommunication and frustration on all sides, they parted ways. This mis-hire hurt their IRR and was knowable ahead of time. We often support GPs when they realize the importance of investing more time and deploying proven approaches to understand how their CEO is going to set strategic priorities and drive financial results.

Finally, CEOs are often unprepared for the high expectations PE investors have with respect to understanding the business financials. About 20% of candidates simply lack the financial acumen required in a leveraged environment. Often, this is because the CEO comes from an environment where their role involved managing a P&L, but not a full business. Other times, the CEO candidate is being considered because of expertise in a functional area other than finance, which may be critical to the success of the portfolio company, but under representative of the breadth of skills required to partner with a PE-backed board. In most cases, you can mitigate the risk with the right CFO/Finance Director, assuming the leader has both the self-awareness and ability to hire an A player who can complement this gap.

Over the last few years, private equity funds have begun to question their approaches to evaluating and holding accountable the CEOs at the helm of their most important investments. Embracing change is hard, however, and deal partners are cautious about anything that may disrupt their working relationships with their CEOs. With LPs increasingly paying attention and demanding results, more innovative (and prudent) firms are finding better ways to select and work with the leaders they know will determine their investment success. As a PE investor, evaluating talent with the same systematic rigor you use to assess every other aspect of the business will help you make significantly more money with fewer headaches.

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