Heidrick & Struggles

PRIVATE EQUITY PRACTICE
HEIDRICK CONSULTING

PRIVATE EQUITY FOCUS: **BUILDING PORTFOLIO COMPANIES' TALENT ADVANTAGE FOR THE DOWNTURN**

When preparing for volatility, private equity firms should not forget to assess whether their portfolio company leadership teams have the right capabilities to weather the storm.

Whether the United Kingdom and major markets in Europe have technically entered a recession is a debate for economists. What is certain is that these markets and others are becoming increasingly volatile amid fears of Brexit's aftermath one way or another, ongoing trade tensions between China and the United States, and the ever-present uncertainties of the fast-paced modern economy. While a global downturn isn't necessarily on the horizon, it would be wise to make prudent preparations.

Most private equity (PE) firms are taking necessary steps in safeguarding their portfolios—for instance, by combing portfolio companies for deadwood that should be jettisoned or for non-core operations that could be quickly divested. They are examining and testing balance sheets to ensure their financials are strong enough to withstand any shock. However, few, if any, are scrutinizing the leadership teams in their portfolio companies with the same rigor. For the same reasons they are testing whether the capital structure of a portfolio company will sustain an economic downturn, PE partners should also assess whether a company's management team has what it takes to weather—and potentially capitalize on—a down cycle.

Just as a country needs different leadership during times of peace and prosperity as opposed to war and crisis, different sets of management skills are needed during a downturn compared with those necessary during the benign economic conditions of the past decade. In a downturn, corporate leaders must be more agile and even fearless as conditions change rapidly and operational and strategic options can narrow. With the right leadership capabilities, companies can not only survive a downturn but also take advantage of the opportunities that can quickly emerge, and disappear, during troubled times.

Upheaval in the United Kingdom: A preview of potential impact on deals

A general downturn would, of course, have a significant effect on PE activity, and pragmatic PE partners are already taking precautions. The United Kingdom, where confusion surrounding Brexit is leading to greater uncertainty, offers a preview of changes that are likely. For example, financial data company PitchBook has reported that between 2015 and 2016 (the year the Brexit referendum passed), the value of PE investing in the United Kingdom from investors based in the European Union fell by more than half, from €22 billion to €10 billion. After a spike in 2017, deal value dropped to €14 billion in 2018 amid confusion over Brexit's fate.[1]

Furthermore, the *Financial Times* has reported that annual PE investment growth rates in Germany and France between 2015 and 2018 were double that seen in the United Kingdom, based on volume. Even Italy and the Netherlands showed faster growth rates than the United Kingdom. During the same period, the United Kingdom's share of EU-based PE investment also fell about five percentage points, while many other European countries enjoyed an increased share.[2]

If these trends take hold in Europe more broadly, or around the world, PE partners will have less and less time to take necessary precautions across all areas of their portfolios, and deploying the right leadership to help portfolio companies survive and thrive through a downturn will only get harder.

€22 billion

▼

€10 billion

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1 Leah Hodgson, "No-deal means no deals? How Brexit could impact UK private equity," PitchBook, January 14, 2019, pitchbook.com.
2 Javier Espinoza, "The Brexit effect: Private equity firms shun UK for Europe," *Financial Times*, May 11, 2019, ft.com.

Reviewing talent as a downturn looms

In reviewing talent to prepare for a downturn, our experience and research suggest several areas PE partners should examine that are crucial to ensuring that the leadership teams at portfolio companies are ready. It's also crucial that, throughout these companies, they apply the same level of rigor to these assessments as they do to their financial ones.

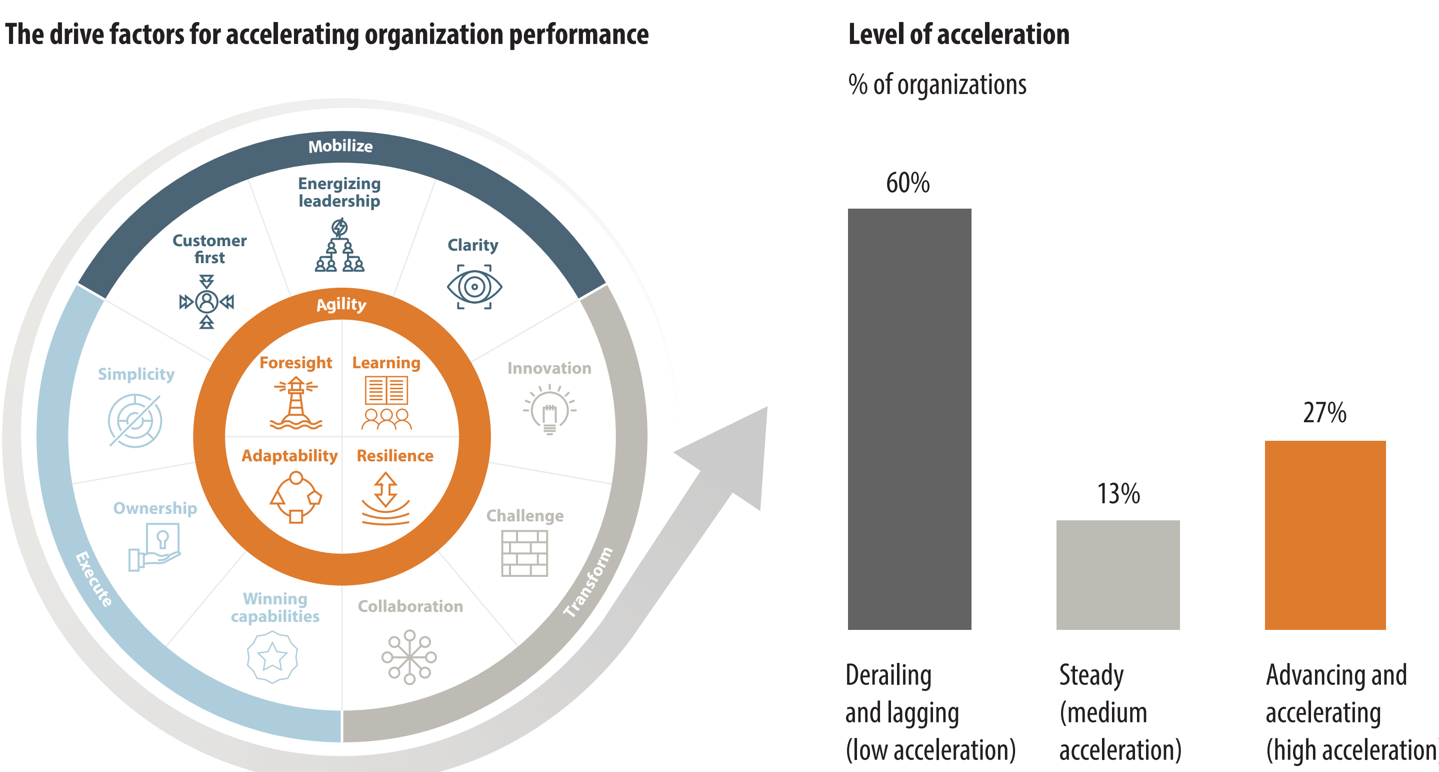
The right skills in the right roles

Partners should understand that different capabilities are needed to guide a company during turbulent periods. Heidrick & Struggles research has demonstrated that, at any time, crucial skills for senior leaders include agility, foresight, and flexible thinking. These are vital to a company's ability to mobilize, execute, and transform with agility—what we call META.[3] And, in a downturn, leaders must be prepared to move even more quickly as situations change or opportunities develop. The ability to take risks and move swiftly past any failures will also be critical. Yet our research also shows that most leaders struggle with these skills even in the best of times (Figure 1).

PE partners should assess the senior leaders of their portfolio companies against these criteria, with an emphasis on capabilities that would increase in importance during a downturn. Assessing executives' own perceptions of their strengths, along with their teams' perceptions, is an important first step. (A sample META assessment is shown in Figure 2). As with any team- or organization-

3 This analysis was first described in *Accelerating Performance: How Organizations Can Mobilize, Execute, and Transform with Agility* by Colin Price and Sharon Toye (Wiley & Sons, 2017). Additional information can be found on heidrick.com.

Figure 1: **Less than a third of companies excel at mobilizing, executing, and transforming with agility.**



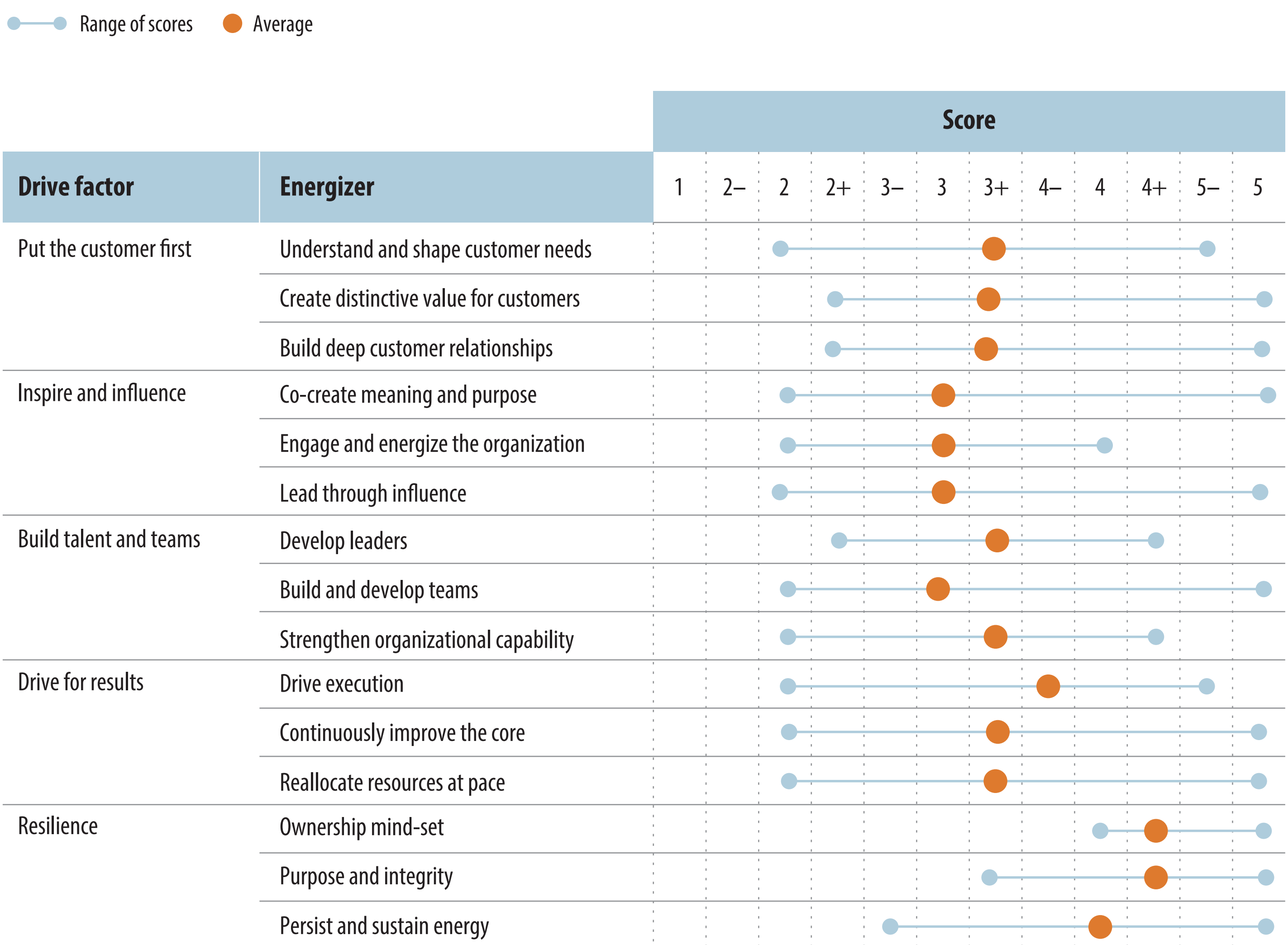
wide performance evaluation, this process can create tension, but transparency, clear communication, and a common language around the objectives can help ensure that organizations, and the participating leaders themselves, see it as constructive.[4]

The assessment is likely to reveal capability gaps that should be addressed immediately, while there is still time to bring these new skills into the organization smoothly and before competition for them becomes more intense. Some, of course, can be developed through internal coaching and training. However, many companies will also want to look outside their existing talent pool to fill any remaining gaps.

The case of one beverage company based in Europe illustrates the kind of close examination of a management team that is needed to adapt to changing circumstances. The company was founded as a local producer and soon began selling its products in its own and other retail outlets. Success came surprisingly quickly, and, within a few years, the company was operating outlets and production sites in more than a dozen countries. To assess its leaders' capabilities in this new environment, the company conducted rigorous internal interviews and developed external benchmarks, with a particular focus on leaders' ability to mobilize, execute, and transform with agility. Careful communication and ongoing conversations with senior managers were critical during this process to keep tensions as low as possible.

4 See Andrew LeSueur, Krishnan Rajagopalan, and Sharon Sands, "Navigating top talent decisions for mergers and acquisitions," Heidrick & Struggles, August 20, 2019, heidrick.com.

Figure 2: **This sample META assessment shows a team's scores on competence in key areas.**



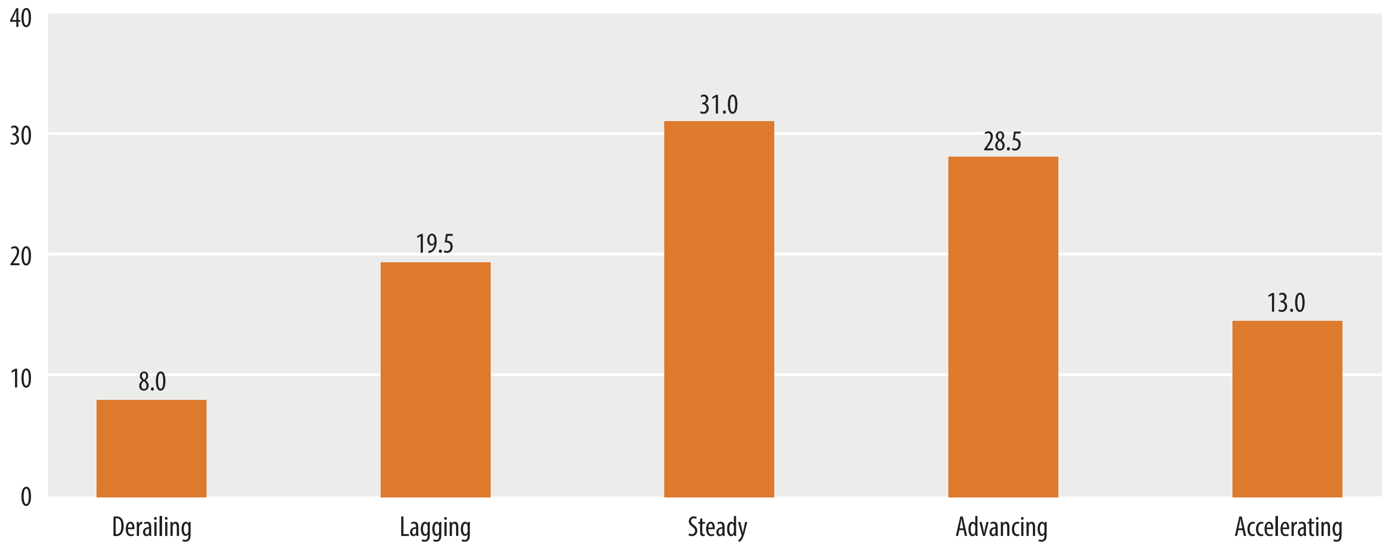
At the end of this examination, it was clear that several specific changes were needed. A few people were brought in from outside the company for senior positions in marketing, commercial, and international functions; roughly the same number were reassigned to roles related to product innovation and special projects; and one manager left on good terms.

Working together with a common approach

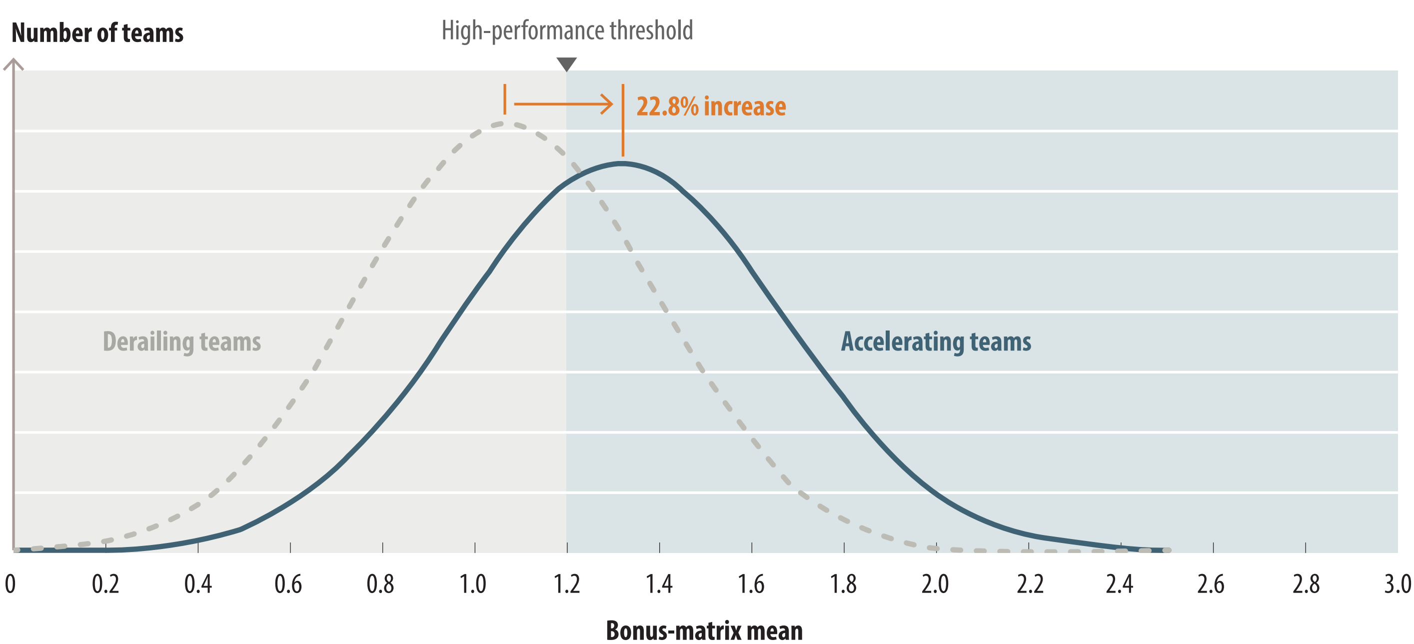
Senior team alignment is essential in any business environment. Our research shows that, among 3,000 teams we studied, senior teams with the strongest ability to mobilize, execute, and transform with agility had a 22.8% higher economic impact, on average, than other teams. In other words, they reduced costs more quickly, went to market more effectively, and launched products or services more smoothly (Figure 3).

Figure 3: **Most teams aren't accelerating . . .**

n = 1,118



. . . but accelerating teams make a lot more money.



During a downturn, senior team coherence is critical. Troubled business environments engender fear, internal competition, and siloed behaviors as executives fret over protecting their turf—and, more specifically, their jobs—during the maelstrom. To ensure the best fit as a whole, most PE firms will also want to assess how well the leaders of a portfolio company work together as a team, both in terms of specific skill sets and knowledge and in terms of leadership capabilities.

Yet top teams that work together well are rare. Our research has shown that 12% of senior teams are in the bottom quintile of team performance, compared with 6% of teams below the director level (Figure 4).

For some companies, the efforts to ensure the top management team is aligned and can deliver in changing times begin before the deal is completed. For example, one PE firm was pursuing a deal for a media group. As general negotiations were underway, the PE firm began an evaluation of the assets, focusing first on the leadership team's overall alignment. Developing a shared internal vision of the future was seen as an essential step before embarking on changes in governance, performance management, behaviors, and culture that would be needed to form a newly independent company. An executive at another PE firm noted: "We like to create a shared starting point, a common language, because it takes away the personal bias and arguments—particularly in tough times—so that we can focus our resources and efforts in the right areas."

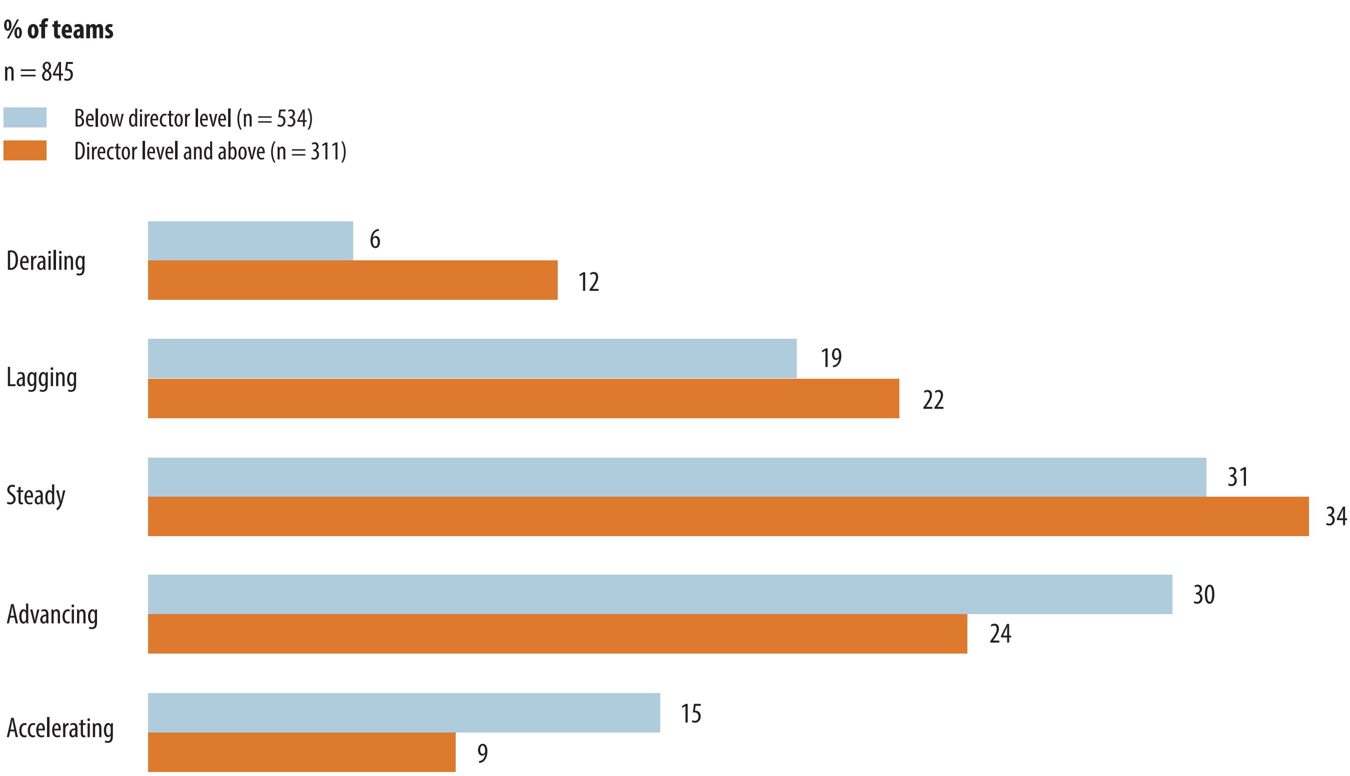
The value of alignment, of course, is not confined to the top team. A shared understanding of the challenges ahead and a shared purpose throughout an organization is crucial for optimal results.

Our research has shown that as companies seek to accelerate performance, people at organizations that are better at setting a strong, clear purpose also say their organizations' performance is 2.5 times better than people at organizations that lag at purpose. This is because purpose creates alignment throughout the entire organization and enables informed decision making to accelerate performance.

Yet even in good times, creating a shared, resilient culture can be a particular challenge for PE-owned companies, as the new owners seek to connect effectively with the portfolio company and staff worry over potential changes, real or imagined. The fear triggered by a downturn only makes things worse. An aligned senior team—committed to change and to engaging the workforce toward its new purpose—will make a significant difference.[5]

5 For more on the power of resilient cultures and culture change, see, for example, Chad Carr and Scott Snyder, "Building a digital culture," Heidrick & Struggles, June 4, 2019, heidrick.com.

Figure 4: **Team performance is worse at the top.**



Note: Numbers do not sum to 100%, because of rounding.

Accelerating the whole organization through disruption

Once PE firms are satisfied that they have the right leaders in place, working well together, those leaders can turn their attention to ensuring that each portfolio company as a whole is prepared to thrive through any coming volatility. One important step is for portfolio-company leaders to apply the same rigorous, constructive assessments throughout their organizations, so the right people are in the right places, working well together at every level.

Some PE firms also provide development programs for their portfolio companies. These training programs not only build capabilities through targeted workshops but also provide a forum for skills assessment and help create a network that spans the PE firm's portfolio. PE partners can draw on such networks to encourage innovation and beneficial disruption. In addition, PE partners can benefit from maintaining some centralized attention to senior talent over time, assessing both individual companies and those companies taken together.

As PE firms fortify their portfolios to weather any coming storms, neglecting to ensure that portfolio companies have leaders ready for the tough times ahead is likely to undermine their other efforts.

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