



Insights from The Clarion Institute Successfully Handling the Transition to Private Equity Ownership

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The Emergence of Private Equity

Private Equity (PE) has become a driving force in the business landscape. The financial resources available to PE firms have enabled them to do record deals over the past year and there is every indication this trend will continue. Financial services veteran John Bogle sees it as “a shift from traditional owner’s capitalism to a new form of manager’s capitalism.”

PE deals are done for many reasons, but most deals fall into one of two categories: restructuring or growth. The first type is aligned around financial engineering, where assets are restructured for greater value, typically with a near term plan to sell the entity off in pieces. We call the other type of deal “growth enablers.” In these transactions, management is unleashed to pursue a different growth and value creation path than would be possible in public companies that face quarter-to-quarter earnings pressures.

A good portion of the activity we are now seeing features these growth-enabling strategies. While there is talk in the press about “going private” to get out from under the burdens of Sarbanes-Oxley, this reasoning is not on the minds of executives we talk to. Since most plan to re-enter the public markets within 4 to 5 years, they intend to maintain rigorous reporting standards regardless of their temporary private status. The focus for these executives is the ability to pursue aggressive growth opportunities over a longer time horizon than public ownership typically tolerates.

For example, one client currently enjoys a unique platform for global expansion that combines on-the-ground physical presence and complementary online delivery of services. While their industry is becoming increasingly crowded with new entrants, none is as well positioned to establish global brand recogni-

tion. Now is the opportune time to invest and expand quickly across several regional fronts simultaneously. The support of a PE investor will allow this organization to move forward with its ambitious plans.

Fortunately, both the PE investor and the organization’s senior leadership understand that the bold growth investments required in today’s fast-paced, global competitive markets often penalize share price because conservative, short term investors view the strategies as less attractive, riskier, long term plays.

Recognizing how quickly competitive advantage is gained and lost these days, companies with meaningful competitive differentiation see an important side benefit to PE financing. Because of less burdensome reporting requirements, they can hold innovative strategic moves a little closer to the vest, keeping their strategy confidential long enough to get established before competitors try to follow along.

Challenges in the Transition

Even with strong financial and strategic alignment, leadership teams moving in (or out) of private equity ownership face a number of challenges along the way. We’ll look at a few common ones.

Transition Distraction

Given that all parties are in support of the growth enabling objectives of the deal, there is great incentive to make the transition as smooth as possible. The last thing anyone wants is to shift leadership focus from growth to the deal mechanics, but it’s hard to avoid devoting some significant time to transition issues. Beyond that, there is a “getting to know you” phase that needs to be anticipated

and properly managed to minimize loss of productivity.

Clarity and Communication

Unfortunately, lack of clarity and communication around role expectations, decision-making processes, etc., often impedes performance and speed of execution. One client we followed through PE ownership and sale went through periods of time marked by lack of clarity around strategic intent. The executive team could not get clarity on whether the investor group was positioning them for imminent resale or was ready to invest more aggressively in the next phase of growth opportunities. Strategic paralysis ensued. When roles and objectives are not clear, the confusion can unwittingly create passivity on the senior team.

Turnover and Executive Uncertainty

In recent times, with the disturbing increase of CEO and C-Suite executive turnover, more emphasis is given to effective “on-boarding” to diminish lost productivity around executive turnover. It is much the same with PE transactions, where there is a two-way “on-boarding” process, as both executives and PE owners size up new expectations and roles for each other.

Typically PE investors are buying leadership talent as part of the deal, but who that covers is often not apparent to those who are not directly involved in making the deal. PE firms and the top leadership team must be very sensitive to the impact that the change of ownership will have on the senior team. Is everyone staying? For how long? Is there uncertainty about who is in and who is not? Executives who do not know their fate are likely to be seeking other opportunities, and may leave just when you need them most.

Stay-On Incentives

When properly designed, executive incentives can create laser focus for the senior team, but we have also seen it create dissident fractures. In one client organization, the executive packages intended to incent the senior team to stay

on inadvertently created counter-productive motivations. A very small subset of executives agreed to continue on short term more because of the highly attractive stay-on bonus than because of an all-out commitment to the new long term company direction. Consequently, there was not clear alignment between individual, team and company exit strategies, which impacted decision making criteria and time horizons. While it should not have been a surprise, cohesiveness around company goals, confidence, transparency within the team, and trust all diminished accordingly. To make matters worse, the lack of cohesiveness at the senior team level inevitably trickles down to create confusion in much of the rest of the organization.

PE Owner Involvement

Another area to clarify is just how involved PE owners expect to be. Dealing with PE owners is different from dealing with boards of directors in publicly held companies, and the leadership team needs to manage this difference. On the one hand, CEOs are sometimes surprised at how active PE owners are, and how deeply into the business details they wish to get, sometimes reaching far down into the organization. The typical protocol of respecting lines of reporting relationships in publicly-held corporations may be ignored by PE owners who will seek answers from whomever they please. Employees feel obligated to respond but can be confused about how to do so.

On the other hand, lack of sufficient involvement from PE firms at the higher, strategic level can be equally confusing. Trying to open up a more direct and candid communication around possible strategic initiatives, one CEO actively engaged those PE investors with relevant industry knowledge by including them early on in strategic planning sessions for two-way dialogue. His purpose was to benefit from their broader industry experience but also to gauge their appetite for expansion into new ventures. Afterwards, it proved difficult to interpret their lack of follow up and engagement in the process going forward, threatening the ability of the senior management team to move decisively.

Most PE owners are expecting to buy an intact, high performing senior team, and are not looking to be experts at organizational and infrastructure issues, or leadership team talent development. In fact, they are often impatient with any such issues. The CEO and the senior team must find ways to work through organizational challenges, with or without PE owners involvement or support.

There is an important lesson to be learned here: PE investment firms do not always seem to realize the impact of their ownership status on their companies' leadership teams, and they need to manage themselves more effectively to make their investments more successful. But who is going to deliver that message? Typically the burden of figuring out owner-executive working relationships is entirely one way: left up to the CEO and the top management team. Again, managing an equity owner is different from managing a board member. Plan to devote time and effort to this task.

The Pressure Is On

CEOs of acquired, now privately-held companies have a lot on their plates. This is especially true when companies are bought for their growth potential. CEOs, challenged to grow faster and make bigger bets, may need to change their own risk profile and that of their teams. Further, aggressive growth requires rapid acquisition of resources and promotion of talent into higher levels of management responsibility with wider delegation – a different operating style. Larger infrastructure size also means a greater need for processes and standardization not previously required by the smaller company. And stretching for growth also means thinking more about leading edge innovation and the organizational climate to make it happen. Growth is invigorating, but can also be messy. When the investment horizon of a PE firm is to have your company ready to sell at much higher value in 3 to 5 years, all of this must happen in very short order. The pressure is on.

Where to Start – The Leadership Team

Clearly, each situation is unique. However, our experience with clients indicates that often both the company's leadership systems and its operating models go through a significant, sometimes unanticipated, transformation. The carrot is that if the transition is done well, it can lead to significant value creation. The question is how best to approach the opportunities and challenges PE ownership provides.

Whether the shift in ownership is the result of purchase by a PE firm or buyout by senior management, this is a critical juncture for the senior team to step back and reassess the leadership fundamentals: what they expect from themselves, what the business needs, and how they govern. If there are impediments to senior team effectiveness, this is the time to address them; PE investors expect them to have their house in order. Stepping in as a high performing team lays the foundation for a swift, efficient ownership transition.

New strategic imperatives that often come with private equity also necessitate reassessment of the business operating model: strategic differentiation, organizational structures, and fundamental behavior and cultural systems. Chances are there will be significant adjustments required in a few areas that are more than "change as usual." Ownership transition provides a platform to make those tougher changes that may previously have gone unaddressed. This approach will bring success to the new ownership assimilation and adjustment process.

For example, an organization that has previously built success doing one thing well may need to create a new mindset of opportunity and creativity. Another organization may have to cut through old turf barriers to quickly and efficiently reallocate resources based on new strategic imperatives and investment criteria. These types of actions challenge senior leadership to march in a uniform direction while still remaining agile and responsive to the emerging opportunities that are sought to propel new growth.

A Closing Thought

Our experience advising senior leaders navigating the transitions in and out of PE ownership has led us to have a strong view on the appropriate approach to the work. We encourage leaders to step back and do a thoughtful review of both senior leadership expectations and the operating model of the business.

It is also very important for the organization that senior leadership is “at the helm.” As

new owners, PE investors typically bring intensity and new ideas to the table, but it is unlikely that they have the desire or leadership capacity to run the business from the inside. The dialogue with PE owners must challenge the status quo but not leadership’s authority. When this holistic collaborative approach is employed, we have seen powerful results to the benefit of all: customers, leadership, employees, and the private equity firm alike.

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