KILBERRY

MERGERMARKET

Industry Research Report

A View from Both Sides

How PE firms and sellers can form wise partnerships

Methodology

Kilberry commissioned a survey of 50 private equity industry executives – 25 managing directors at PE firms and 25 members of management teams at portfolio companies – to learn about their methods of assessing and partnering with each other. The PE respondents were divided regionally among firms based in New York (80%) and Toronto (20%), and the portfolio companies are (or were previously) owned by PE firms in the two cities. Only mid-market PE firms were eligible for participation.

The following key is used throughout the report to differentiate between the survey respondents.


PE investors


Portfolio companies

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Introduction:

The management intangibles

The private equity industry has entered a new era. After decades in which financial buyers could choose from an abundance of targets and implement time-tested strategies to improve them, buyouts have become more challenging. More investment dollars than ever before are in private equity (PE) – collectively, the industry had US$2.4 trillion in assets under management in 2016[1] – and fund timelines have been getting longer, indicating an increased difficulty to achieve growth targets.[2] For PE firms, this means that a more nuanced approach is often needed.

One key area of potential growth for PE investors is to find companies with stellar management teams – and avoid targets with teams that are incompatible with their goals. At the same time, management teams need to understand whether an investor will make a good fit for their culture and working style. As a result, a thorough two-way due diligence is critical for the parties to understand whether the match is right and, on the buyer side, to make sure the target's management team can meet expectations.

It should be said that management due diligence is one of the least-understood parts of M&A targeting. PE executives tend to focus more on financial and operational diligence, and sellers do not always know what to expect from the process.

In order to better understand the characteristics that PE investors look for in a target's management team, as well as the qualities that management teams look for in their PE investors, we conducted a study of both sides. The results reveal that PE investors consider the quality of a target's management team as nearly equal in importance with the quality of the company's product and operations, and that both parties put a high priority on personality fit and communication styles.

Both sides also judged management assessments to be a largely positive experience. PE investors said that methods such as external evaluations and background checks were highly predictive of a team's future success, indicating that there is a well-functioning approach to this challenging aspect of PE targeting.

Flash points did appear between the two sides, however. The main points of tension revolved around day-to-day control of the business: many portfolio company managers argued that their PE owners exercised too much oversight, while investors said they valued executives who accepted their input. These results indicate that the two sides may not always get to know each other sufficiently in the negotiation phase.

Key findings from the study include:

- On average, PE investors think that quality of management at a target company contributes 31%

1 https://d3k9pt3r5jsyv9.cloudfront.net/docs/newsletters/pe/Preqin-Private-Equity-and-Venture-Capital-Spotlight-March-2017.pdf

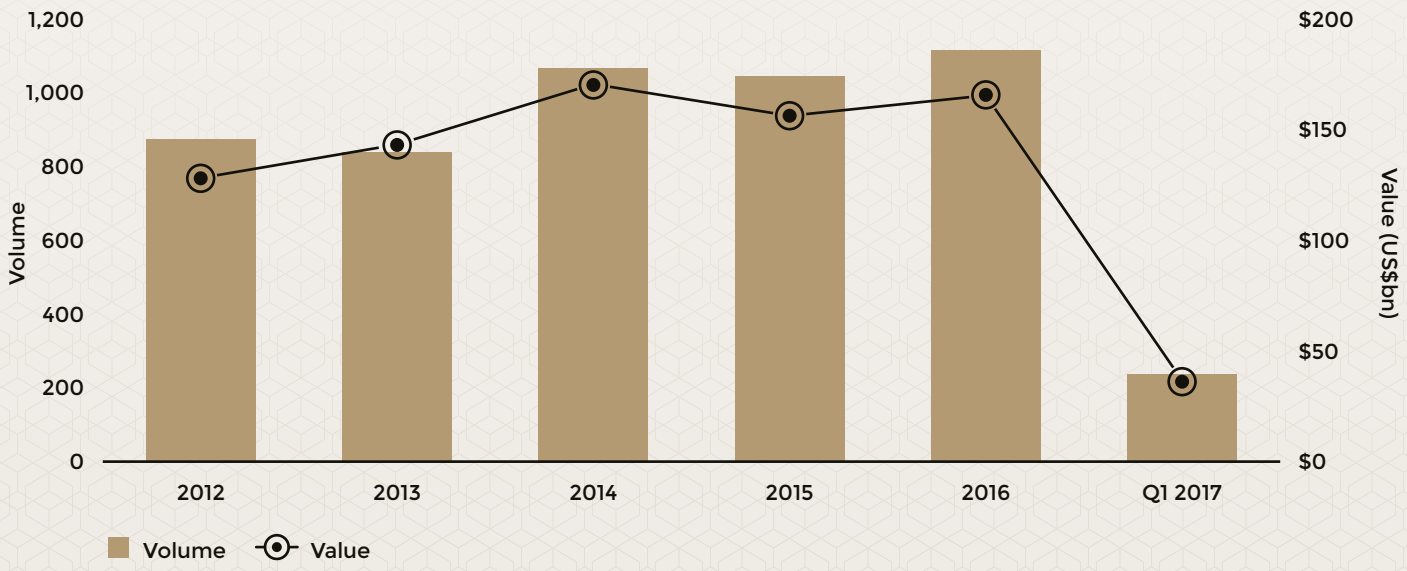
2 http://mergermarketgroup.com/wp-content/uploads/2016/12/Pepper-Hamilton-Report_PE_Lifecycle_Final-LR_updated.pdf

to the success of a deal, while they said the company's operating model/ fundamentals contributes 37% and the product 32%.

- When evaluating a management team, PE investors value a direct, transparent communication style (20% named this as the most important quality) and managers who are easy to work and get along with (12%). Portfolio company executives said they valued the same qualities in a PE investor in almost equal measure (16% and 12%, respectively).
- The greatest number of PE investors (44%) said that external assessments were the most important formal method for evaluating a target company's management team.
- More than a quarter (28%) of portfolio company executives said their PE owners were too involved in managing the business, while nearly a quarter (24%) of PE investors said the greatest challenge they encountered with management teams was their reluctance to cede control of day-to-day management.

The first chapter of the report focuses on the targeting and due diligence phase of a PE deal. The second chapter looks at issues the two sides face during the hold period.

North American private equity M&A activity, 2012 - Q1 2017



Chapter 1:

Assessing the fit

The targeting phase of a private equity deal is a whirlwind of activity. It can be challenging to conduct thorough and impartial due diligence on all aspects of the other party – especially when both sides already view the deal positively. What's more, evaluating the management team at a target company, or the PE deal team on the seller side, is one the least-understood phases of the process.

It is a common adage that the most important part of a business is its people. But perhaps PE investors are simply not as concerned about the quality of the management team as they are about a target's product and operations?

According to our study, this is not the case. When asked about the contribution that each of these three parts of a business makes to the success of a deal – its management team's capability, operating model/fundamentals, and product or service offering – on average, PE investors rated them as almost equal in importance. Specifically, they valued the contribution of the management team at 31%, the product at 32%, and the operating model at 37% of success.

A managing director at a New York-based PE firm with five current investments explained that all three aspects are critical to a well-functioning business. "The management is as important as the operations and the services a company is offering," the MD said. "The skills of management can determine how the company grows, so they are very crucial for the development of a company. The operating model, on the other hand, can always be changed."

Despite this result, some investors are reluctant to spend an equal amount of time assessing a target's management team as they do studying the other two elements. If the three aspects are equally weighted, then a PE firm's time and emphasis should coincide with that, said Dr. Katherine Alexander, a principal at Kilberry. "Where you do see PE firms focused is the first two – the product and the operational model. The people side, on the other hand, often gets forgotten."

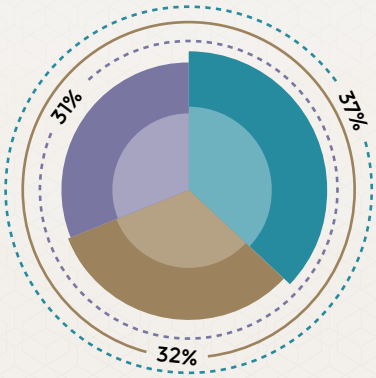
Bottom line: Fundamentals, product, and quality of management each account for about 1/3 of success in PE. Make sure your focus in due diligence reflects this balance.

Building a blueprint

PE investors can be quite blunt about what they're looking for in a target's management team. "It is important that the business management is open to input from the investors," said a partner at a New York-based firm focused on the business services and industrials sectors. "Any resistance from management will slow down growth and will not allow the PE investors to help grow the business."

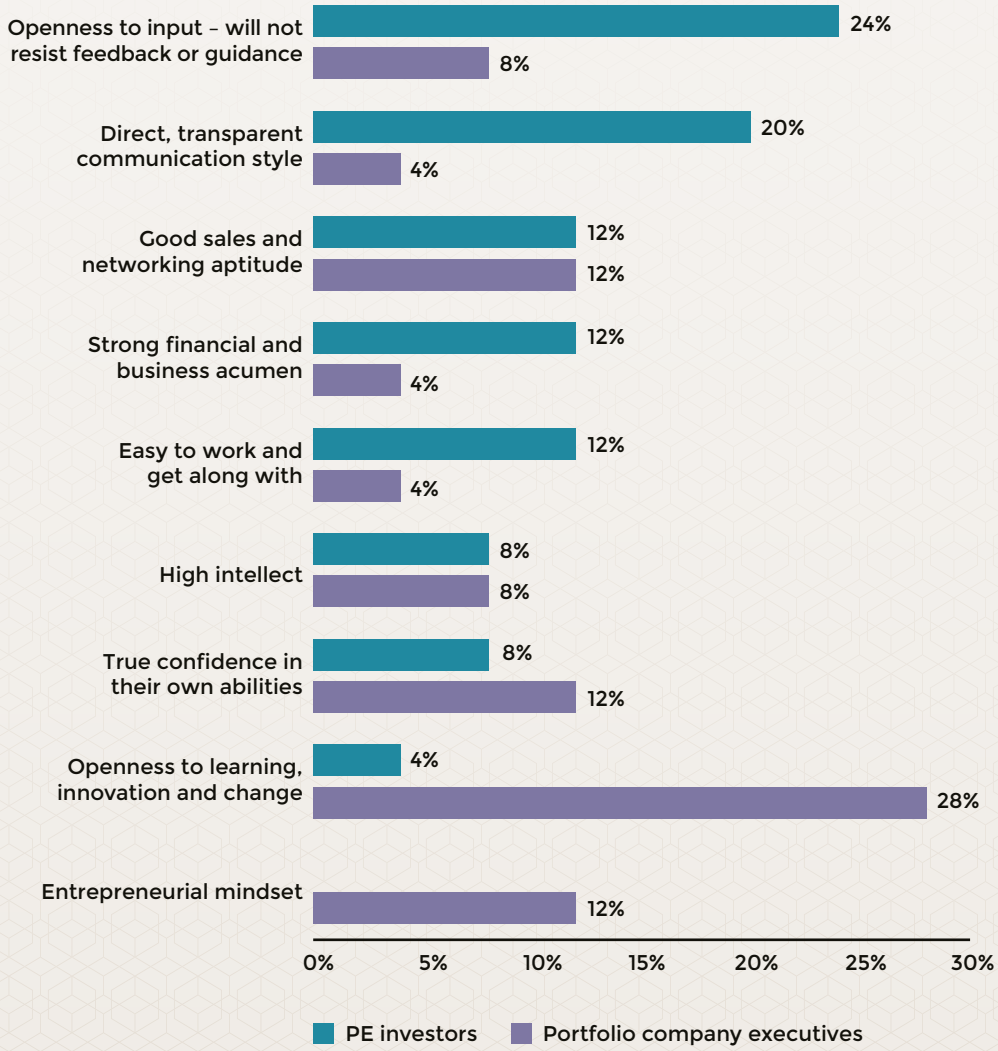
This stands in contrast to the views of many portfolio company executives. They often put greater stock in a different kind of openness – toward learning, innovation, and change. "Entrepreneurs should focus on changing trends," said the CFO of a PE-owned hotel management firm in the US Southwest. "Their inclination toward innovation and learning will help them make the right decisions to be successful."

PE investors What is the contribution of each of the following to the success of a private equity deal? (% for each totaling 100% - chart displays average totals given by respondents)



- Operating model/ fundamentals
- Product or service offering
- Management team capability

What is the most important characteristic of a successful entrepreneurial leader/CEO?*



*PE investors were asked the following question: "When deciding to do a deal, what is the most important quality you look for in a management team?"

A broader divergence of opinions can be seen when it comes to the qualities that PE investors and management team members think define a good CEO or entrepreneurial leader. PE investors value a direct, transparent communication style (20%), as well as people who are easy to work with (12%), have a strong financial acumen (12%) and a good sales and networking ability (12%). On the portfolio company side, executives agree that good sales aptitude is important (12%) but otherwise rank the attributes of true confidence in one's own abilities (12%) and an entrepreneurial mindset (12%) as being more valuable.

There are two key takeaways from these results. First, PE investors focus on personality traits of management team members – their top priority is to have managers with whom they can get along easily and who listen to their advice. Executives at target companies and portfolio businesses should bear this in mind when working with their PE owners or bidders. And second, PE investors should be aware that management teams often value different qualities in a CEO than they do. This underlines the importance for the PE side to create a blueprint for leadership before evaluating the target's team.

"When a private equity firm is looking at a deal, they typically start with a well-researched growth strategy," said Dr. Richard Davis, CEO of Kilberry. "The business is evaluated against this strategy, but the people aren't. When evaluating people, we think it's critical to start with the investment thesis, determine the requirements to execute this thesis (based on internal and external factors), and formulate a leadership blueprint. Then you can assess the team against that blueprint."

In other words, both sides may be making invalid assumptions about what the other party values in a business leader. Make sure you are clear about what you're seeking before embarking on the process.

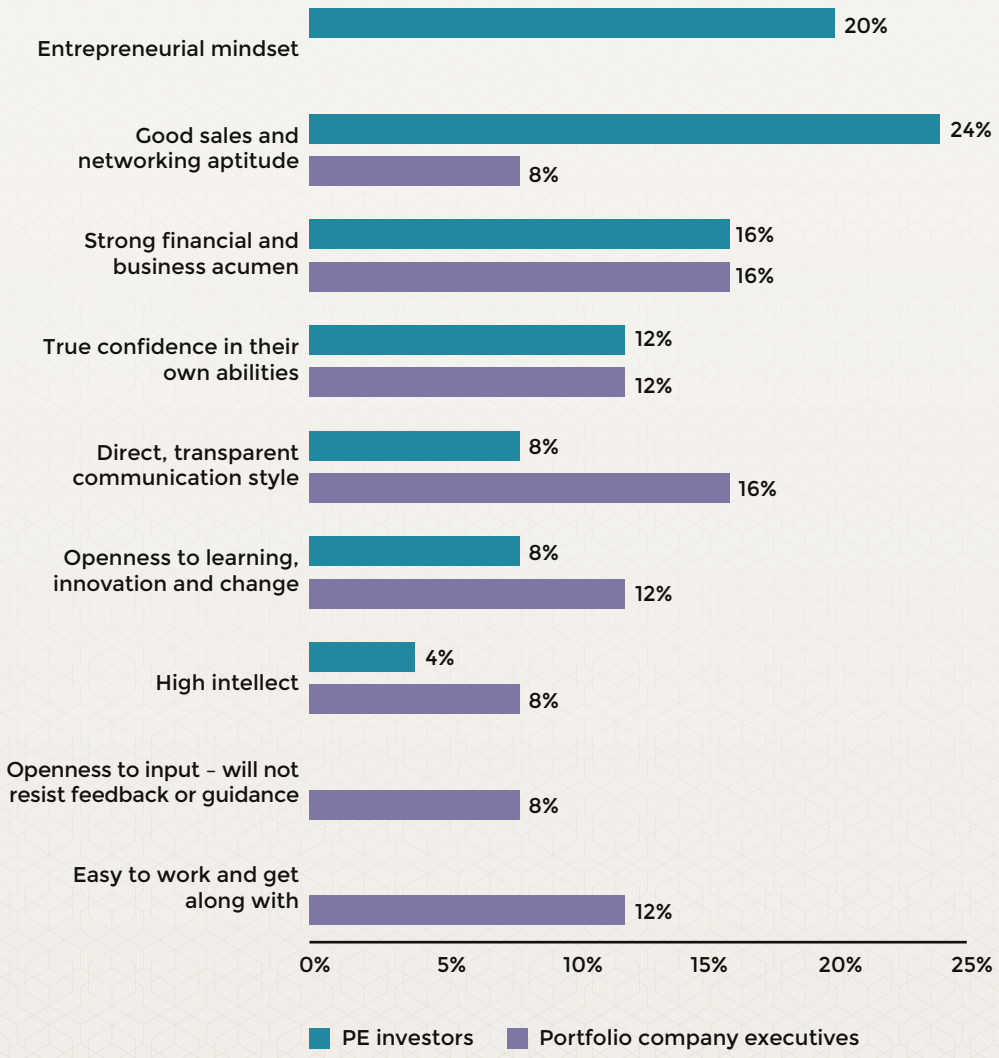
Bottom line: Investors, you may be looking for the wrong attributes. Build a blueprint for leadership before evaluating a CEO.

Profile of a PE investor

Perhaps fittingly, portfolio company executives value many of the same attributes in a PE investor as PE investors value in a management team member. At the top of the list are strong financial skills and a direct communication style. "We looked for a PE company that understood our needs and would be easy to work with," said the CEO of a Canadian marine services operator. "We wanted to partner with a company that would be able to help us create value and at the same time had a good understanding of how our business works. Business acumen is very important to us and we wanted a company that had a strong sense of business and finance."

On the opposite side, most PE investors think that a good sales and networking aptitude (24%) and an entrepreneurial mindset (20%) define a successful private equity professional. "A PE investor should be able to interact and network well, and they should be able to create strong networks that they can tap into when needed," said a partner at a New York-based PE firm focused on the financial sector. Both sides should keep this divide in mind during the targeting phase.

What is the most important characteristic of a successful PE investor?*



*Portfolio company executives were asked the following question: "What is the most important characteristic you looked for in your private equity investors?"

Bottom line: Investors, you should know that sellers are looking for different things in you than you may think. Show that you are easy to work with and have a direct, transparent style (along with being financially savvy).

Case study

Merging competitors

For a PE firm, combining two competitors is a major challenge. The investors need to pick the right person to lead the combined entity, and a new culture must be created that suits both sides. Kilberry helped one PE client through this complex process.

A leading mid-market private equity firm engaged Kilberry to help with a highly complex transaction: purchasing a majority stake in two competitive companies at the same time. The merged entity, an industrial supplies company, would be the largest of its kind in North America. The investors wanted Kilberry to help them answer two key questions: First, does the management team have the capabilities to execute the investment thesis? And second, how can they bring the two companies under one umbrella and ensure that they work well together?

One challenging aspect of the deal related to the vastly different cultures of the two target companies. Some of the differences could be traced to geographic and language barriers. More glaringly, one company was dramatically more entrepreneurial, whereas the other was steadier and more risk-averse. The investors also wantedto know how the head of one of the companies would perform as CEO of the merged entity. The PE firm had reason to believe the deal could end in disaster without careful planning.

To start, Kilberry assessed nine individuals on the two teams. The goal was to understand the personalities and capabilities of the various team members; what they brought to the table and what that meant in terms of the viability of the deal; and finally, how the two teams could come together, either by managing their differences or creating a new culture going forward.

After assessing these leaders, Kilberry gave the green light for the deal, determining that management had a good balance of experience, capability, and growth opportunity. There was value to be created. Kilberry gave key leaders advice on how they could adapt to the new environment, and insight into the ways the other side functioned. Kilberry also gave the new CEO key advice to help him understand aspects of his own leadership that would impact his abilityto be successful under these circumstances.

The PE client was extremely pleased with both the insights and recommendations that came out of the process. Through Kilberry's assessment process, the true value of management was understood and they put on the table issues that were present on the two sides but were difficult to talk about. The result was a clear roadmap on what they needed to do to be successful and alignment around how they needed to lead going forward.

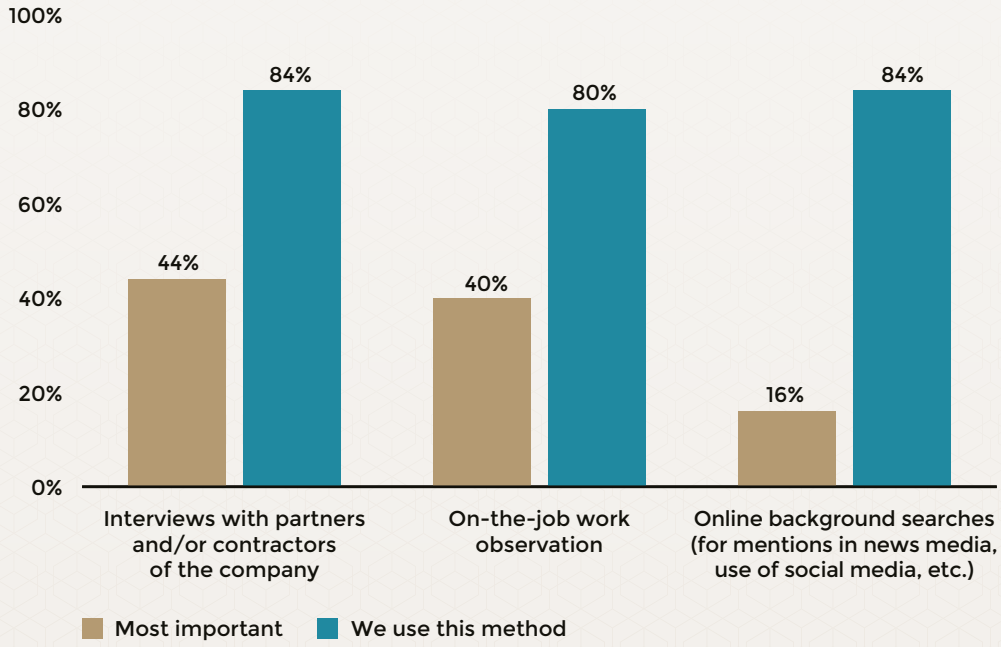
The investors wanted Kilberry to help them answer two key questions: First, does the management team have the capabilities to execute the investment thesis? And second, how can they bring the two companies under one umbrella and ensure that they work well together?

Assessing the assessment methods
PE investors use an array of tools to help them understand a target's management team during due diligence. Some are more effective than others. In our survey, respondents said they prioritize interviews with contractors and/or partners of a company (44% called this the most important informal method) and external assessments by psychologists or consultants (44% called this the most important formal method).

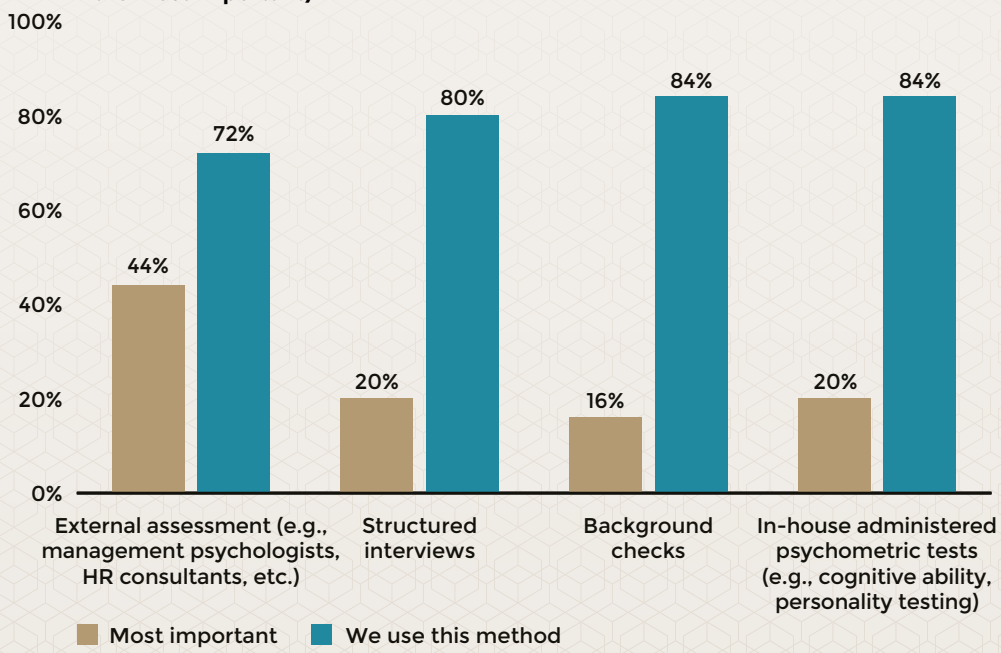
When asked which methods are most predictive of a management team's future success, an equal proportion of PE investors named external assessments (20%) and background checks (20%). The fewest number of respondents held esteem for the informal methods of on-the-job work observation (8%) and online searches (4%).

One managing partner at a Canadian PE firm that has operated for more than 15 years said external evaluations and background checks allowed them to dig deeply into a team's abilities. "We hire consultants to help us analyze the members of the team closely so that we can have a thorough understanding of how they think," the partner said. "Carrying out a background check is important as well to understand if members of the

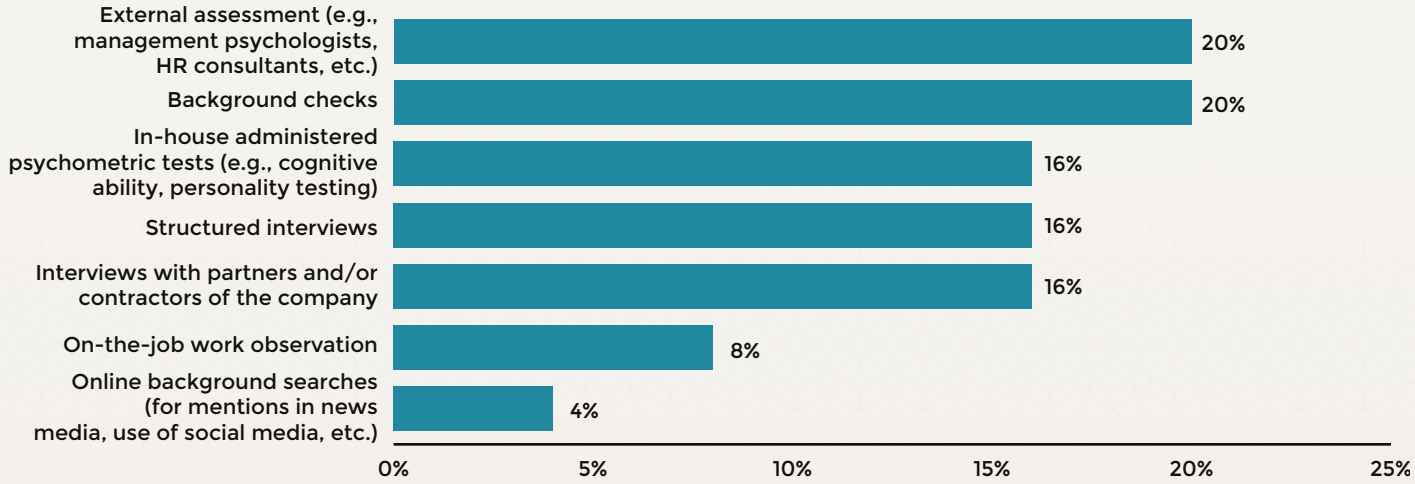
PE investors What informal methods do you use to assess the management teams at acquisition targets? (Select all that apply and the most important)



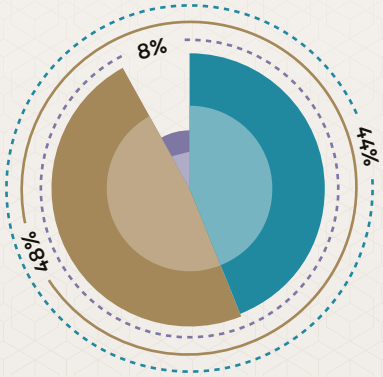
PE investors Besides the previous methods, what formal methods do you use to assess the management teams at acquisition targets? (Select all that apply and the most important)



PE investors Which method do you think is the most predictive in assessing a target's management team?



PE investors In the deals you have done over your career, how closely has an external assessment of management (i.e., by a management psychologist, HR consultant, etc) aligned with what you see later?



- Very closely aligned
- Somewhat closely aligned
- Fluctuated significantly from deal to deal

team have been involved in any fraudulent activities or if they have failed in any large projects before."

One key reason that external assessments can be effective is that they bring an objective party into the process who is not distracted by the pursuit of the deal. An apt analogy is buying a house, according to Kilberry CEO Dr. Richard Davis: Just as in PE targeting, you see a lot of options and it can take a long time to find one that checks off all your requirements. But when you do, the excitement can make it difficult to conduct the proper diligence without overpaying.

"We see ourselves as the home inspector," said Dr. Davis. "We're an objective third-party who can stop the excitement of the buy, do a timeout and say, 'Let's lift the carpet and look behind the wallpaper. Let's see what's going on here underneath the surface. Also, based on this, how should these issues affect the value of the house, and what can be done to raise that value if you buy it?'"

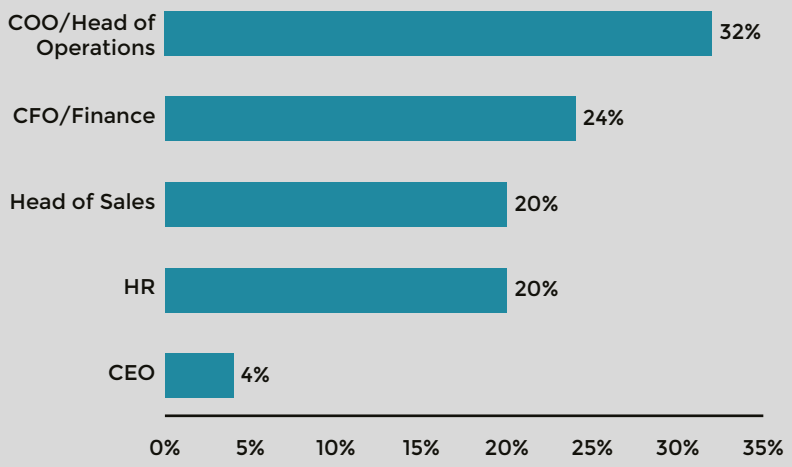
These assessments are only valuable, however, if they prove to be accurate. And indeed, the vast majority of PE investors who have used external assessments said the results aligned very closely (44%) or somewhat closely (48%) with what they saw later, while 8% said the alignment had fluctuated significantly from deal to deal. No one said the assessments did not align at all with their later experiences.

A partner at a New York-based PE firm with 14 companies in its portfolio said the evaluations they carried out had proven highly accurate.

"All our assessments have been precise and on target," the PE partner said. "The analysis of management skill sets and abilities has helped us make strategic responsibility allocations more effective, and we have benefited significantly as we focused on opening up the management teams' hidden talents."

Bottom line: External assessments are accurate and predictive of future behavior. Use them to your advantage.

PE investors When you look at management teams, which of the following functions most often lacks the needed skills or capabilities at the time of investment?



Weak links

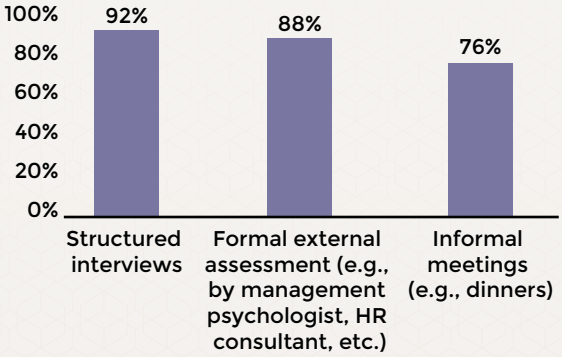
The skills of different management members are considerably different depending on the company, especially in the mid-market. Our survey indicates that executives in two positions especially can be lacking: COO/head of operations (32% said the person in this function most often lacked the necessary skills) and CFO (24% said the same about the person in this job).

Investors said they could best leverage their own abilities in these areas to improve performance at portfolio companies. Unlike the position of CEO, which is often held by the company founder, who may possess the main vision behind the business, the COO and CFO can benefit from having broader work experience.

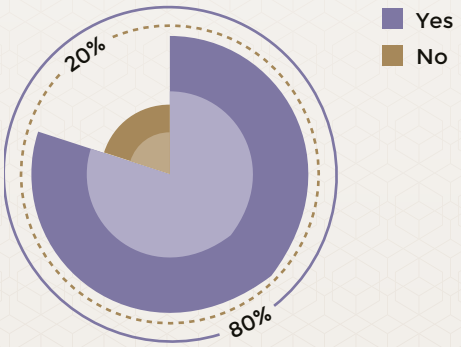
"Operational improvements are the most important to successfully drive business growth," said a partner at a New York-based PE firm with investments in the consumer, media and marketing segments. "The COO is not always able to apply constructive ideas to change their business outlook. Therefore, we consider bringing in our own management expertise to this functional area in order to improve performance."

Bottom line: COO and CFO are the least qualified at the time of a deal. Make sure you have a handful of highly qualified executives on-deck to serve as replacements.

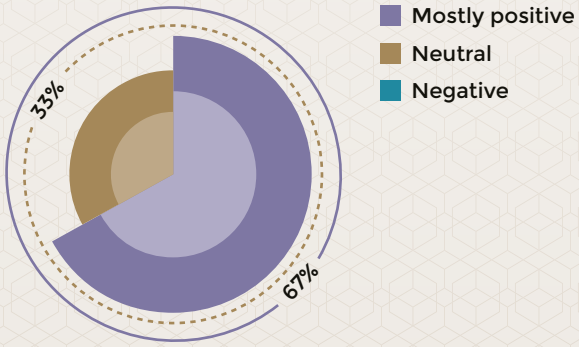
Portfolio companies **How did the private equity buyers get to know you prior to the deal? (Select all that apply)**



Portfolio companies **Was that sufficient in them getting to know you?**



Portfolio companies **If you did a formal assessment, how did you find the experience?**



Interviewing for capital
Executives at portfolio companies said that structured interviews and formal assessments were the most common methods used by buyers to get to know them; about nine in ten respondents said they underwent them. And eight in ten executives said these methods, together with informal meetings such as dinners, were sufficient for the investors to get to know them.

Most notably, two-thirds (67%) of the management team members who underwent a formal assessment said they found the experience to be mostly positive and one-third (33%) judged it to be neutral, while no one said they had a negative experience. Yet some PE buyers don't use external assessments – indeed, 28% of PE investors said they don't employ the method (see page 11) – because they think the evaluations introduce friction to the relationship being forged with the seller. These results indicate the opposite – that sellers mostly view them positively.

"The formal assessment was done merely to understand both the strengths and weaknesses of our internal operating team, and the results helped us identify areas of focus that needed change or development," said the CFO of a Latin American import-export company. "New strategy implementations were discussed and overall it helped us improve our collaborative efforts in making the business a success."

Another participant in the study, the finance director at a retail equipment manufacturer, said the process helped both sides to understand their work cultures better, putting them on the same page for collaboration later on.

The experience of an assessment is also shaped to a large degree by the philosophy of the team carrying it out. If the process is designed to be beneficial to both sides, the interviewer can gain the trust of both parties and properly assess their compatibility. "What we always find is that the sellers find the experience to be insight-building," said Dr. Davis of Kilberry. "It's a two-way due diligence conversation – they're understanding themselves and the private equity buyer. We take the approach that it should be a positive experience for the person being assessed."

Bottom line: Sellers are not scared off by external assessments. Instead, they find them to be positive, insight-building experiences.

Case study

Walking away from a deal

Abandoning an acquisition – especially after substantial due diligence has been done – is never easy. However, if a target cannot fulfill a buyer's investment thesis, walking away is the right thing to do. Kilberry helped one PE firm come to this difficult decision.

An established mid-market private equity firm asked Kilberry to help assess a target in the US professional service industry. The company had a strong business model and the plan was to grow through rapid geographic expansion and key acquisitions in the targeted regions. This strategy made sense on paper – the balance sheet was good and the model worked. However, they had to make sure that the management team was equipped for the task.

The investors hired Kilberry to assess the company's founder/CEO, who was an industry veteran, and the COO/CFO, a business school graduate and the primary operator. One of the main tasks was determining whether the CEO had the ability to fulfill their growth strategy. He needed to be a natural business developer and a good all-around salesperson – the PE firm's leadership blueprint required someone who could identify target acquisitions, influence owners to sell, and otherwise be the face of the company to the public.

After evaluating the two executives, Kilberry recommended that the PE firm not do this deal. Kilberry assessed that the CEO's personality and leadership style were inconsistent with the ability to scale the business and that he was going to be a difficult partner for the PE firm. The CEO was hard-headed and a poor sales leader. His style would be a total mismatch for the PE firm's deal team. Critically, while he had developed a good business at a small scale, the success of the company was tied closely to him (i.e., they were really investing in him) and he was not a good investment. As a result, the deal would have been a mistake waiting to happen.

The PE firm took Kilberry's advice and reluctantly walked away from the deal. While they had already put substantial resources into due diligence, and were hoping it would be a more positive outcome, most of the information Kilberry provided was not surprising to members of the deal team – they had felt something was amiss but weren't able to put it into words. So, despite the fact that they needed to pass on the deal after pouring so much energy into it, they were relieved in the end, because Kilberry helped them dodge a bullet.

Kilberry also managed the sellers very carefully in the process. They were extremely disappointed with the result and wanted to know why the deal had fallen through. Kilberry reviewed some of the feedback with them, gave them advice on who might be good partners for them in the future, and provided advice to the CEO on how he might think about leading going forward.

The CEO was hard-headed and a poor sales leader. His style would be a total mismatch for the PE firm's deal team. Critically, while he had developed a good business at a small scale, the success of the company was tied closely to him and he was not a good investment.

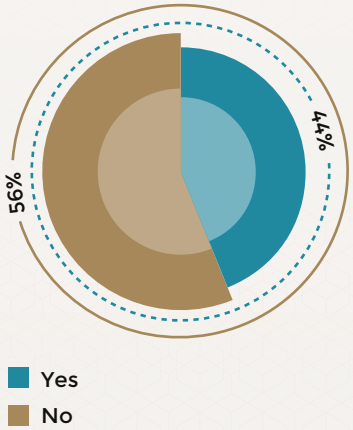
Walking away
One possible outcome of the diligence process is finding out that a company's management team doesn't have the qualities necessary to make the deal worthwhile. Close to half of PE investors (44%) said they had walked away from a deal during exclusivity, with the top reasons being an insufficient drive or motivation to grow on the part of the team (27%) and poor leadership skills demonstrated by management (27%).

A managing director at a New York-based PE firm focused on industrials explained candidly that they saw a lack of drive in the managers at one recent target. "Looking back at the performance of the management team, we realized they were not very motivated to work," he said. "We did not feel they would be in a position to get us the returns we would need in the future."

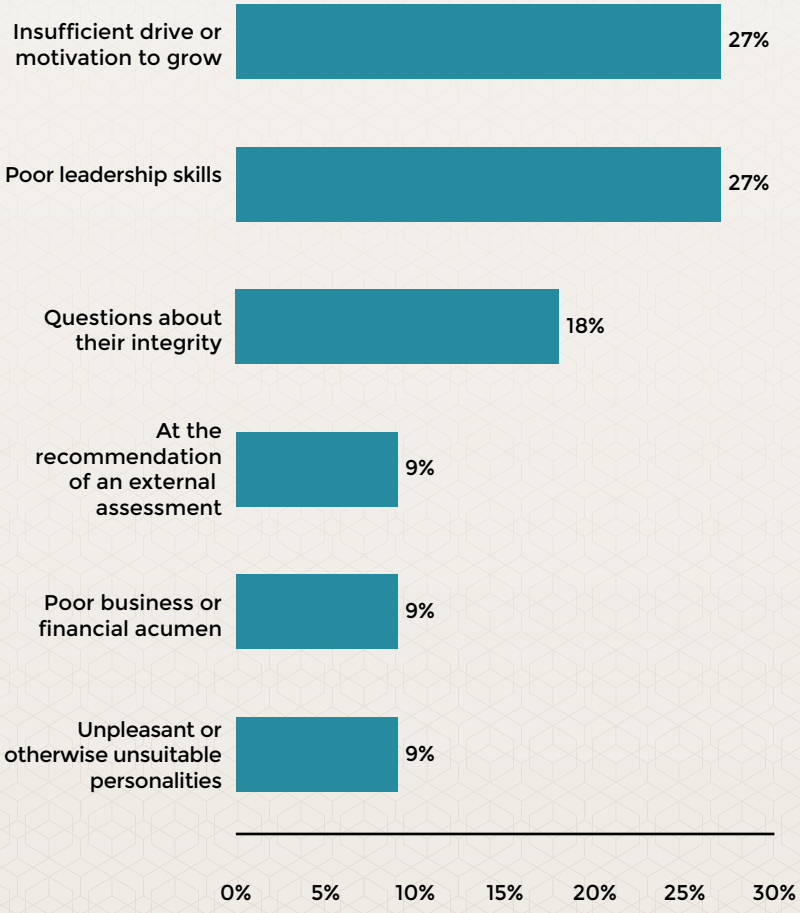
In another case, a PE investor said they doubted the team's ability to manage large amounts of capital. "We did not feel they were very good at doing business, and we also got a recommendation from an external source that helped us make our decision."

A similar percentage of management team members (36%) said they had walked away from deals due to issues with the PE team. Those who had rejected deals put more

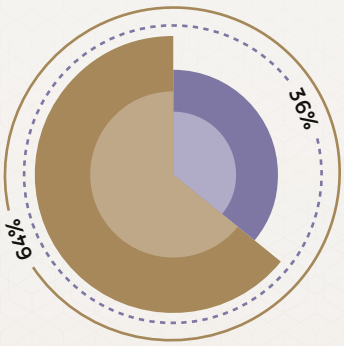
PE investors Have you ever walked away from a deal during exclusivity due to issues with the target's management team?



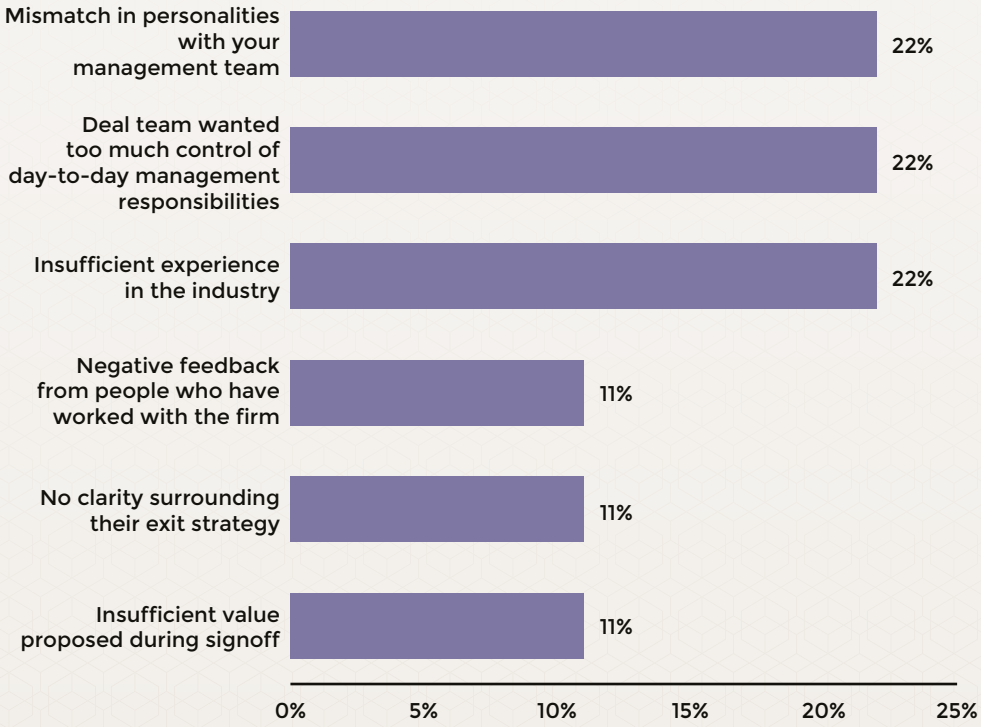
PE investors If you have walked away from a deal (or deals) due to issues with the management team, what was the most important reason for doing so?



Portfolio companies **Have you ever walked away from a deal with a private equity firm due to issues with the deal team?**



Portfolio companies **If yes, what was the most important reason for doing so?**



emphasis on mismatches in personality and a desire on the part of investors for too much day-to-day control of the company.

"We considered a deal that we did not go through with because the PE company's management wanted to make all decisions in the company, small and large, and this would have interfered with our growth," said the CEO of a Canadian transport firm. "It would not have allowed us to make changes as we wanted or develop our strategies as we saw fit."

The importance of personality to portfolio companies makes it critical for PE investors to approach the subject seriously, according to Kilberry principal Dr. Katherine Alexander. The first step for each side should be to conduct a self-examination. Only after understanding the culture and working style of one's own team can they determine whether they will make a good match with a particular target and/or PE firm.

"We see firms with very different cultures," said Dr. Alexander. "Ultimately, the two sides are in the deal for the same reason, but you see some PE firms that expect more from their targets and are more hands-on, for example. Those kinds of nuances really matter."

Bottom line: Both PE investors and sellers agree that personality factors are critical, and sufficient to walk away from a deal if they are not right.

Chapter 2:

Expectations vs. post-deal reality

In the current private equity environment, it can be highly challenging to find a good partner given the competition and price multiples. But after you complete a deal comes the even more difficult part: building a fruitful relationship between your teams that drives business growth.

This chapter examines the most common benefits each side seeks in a PE partnership when it comes to management, and the most significant challenges they experience as well. Taking advantage of the opportunities available and addressing the inherent difficulties can make the difference between a spectacular rate of growth and a deal that fizzles out.

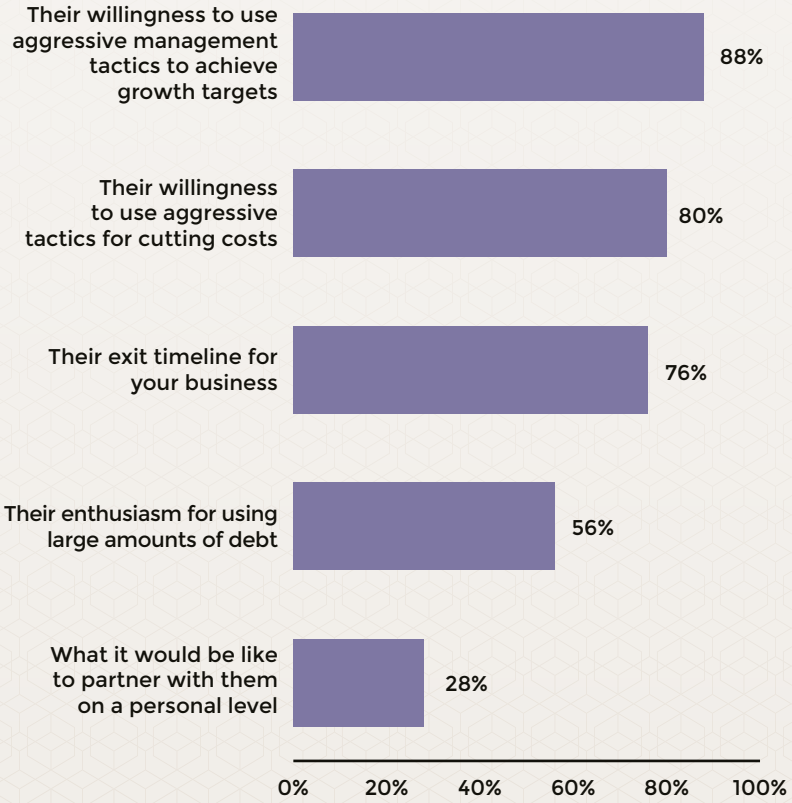
For potential PE targets, it can be difficult to find out what it's like to be owned by a PE firm before a deal is done. In our study, company executives said they wish they had known more about their investors' willingness to use aggressive management tactics to achieve growth (88%) and cut costs (80%), as well as more information on their exit timelines (76%).

One participant in our study, the CFO of an industrial manufacturer in the US South, said he wished they had known more about the PE firm's plan to cut costs because it affected a sensitive area for any business – their personnel. "Their aggressive cost-cutting tactics put significant pressures on management, and we wished we had known this before being sold," the CFO said.

"Downsizing is a major step and these strategies are harsh on our management team and employees, who have served our business loyally for years."

This attitude reflects a major theme expressed by some management teams in our study: they would like their PE investors to focus more

Portfolio companies **Which aspects of private equity firms do you wish you knew more about before being sold to one? (Select all that apply)**



on developing strategy and less on day-to-day control of the business. More than one-fourth (28%) of executives said their investors had been "highly involved" in managing the company and this same 28% said the involvement was "too much."

The CEO of a waste management firm said their PE owner's role in overseeing the business was excessive. "We could do without them interfering in every step," the CEO said. "Because of their involvement, management has not been able to run the company the way we see fit and make critical decisions."

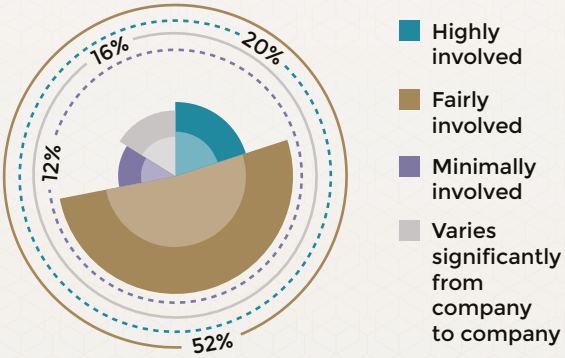
At the same time, nearly a third of company managers (32%) said the most important thing they were looking for in a PE investor was an active partner to help manage and grow the business. Almost one quarter (24%) said they wanted a more diverse range of viewpoints, experience and knowledge, and 20% said they sought connections to a portfolio of synergistic businesses.

"The PE firm's confidence in us has resulted in fruitful outcomes that will help our business grow in new industrial sectors and international markets," said the CEO of a company that operates a customer rewards platform. "Our technological innovations have rapidly caught on in the market and we are actively targeting more businesses and clients that could benefit from our technology."

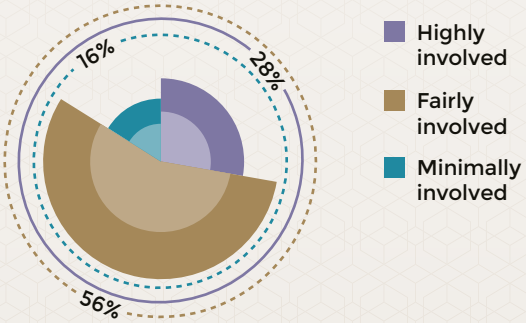
The best way to avoid conflicts over decision-making is to set ground rules for the relationship very early on, said Dr. Alexander of Kilberry. To do this, the two sides should start by learning about each other in the negotiation phase and be clear with one another about their goals and desires in the partnership. Then, the two sides should hold regular check-ins over the course of the ownership period to understand what is working well and what isn't.

Bottom line: No surprise, PE investors – your CEOs want you to be either less involved or as involved as you are now. Keep that in mind as you build your partnership.

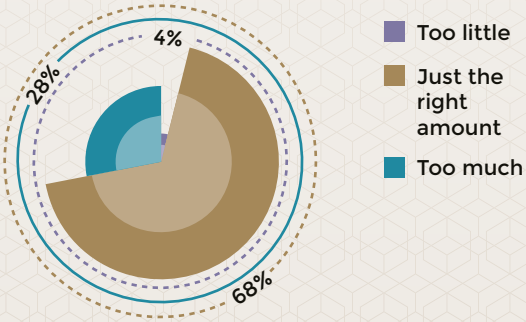
PE investors How involved are you in managing your portfolio companies?



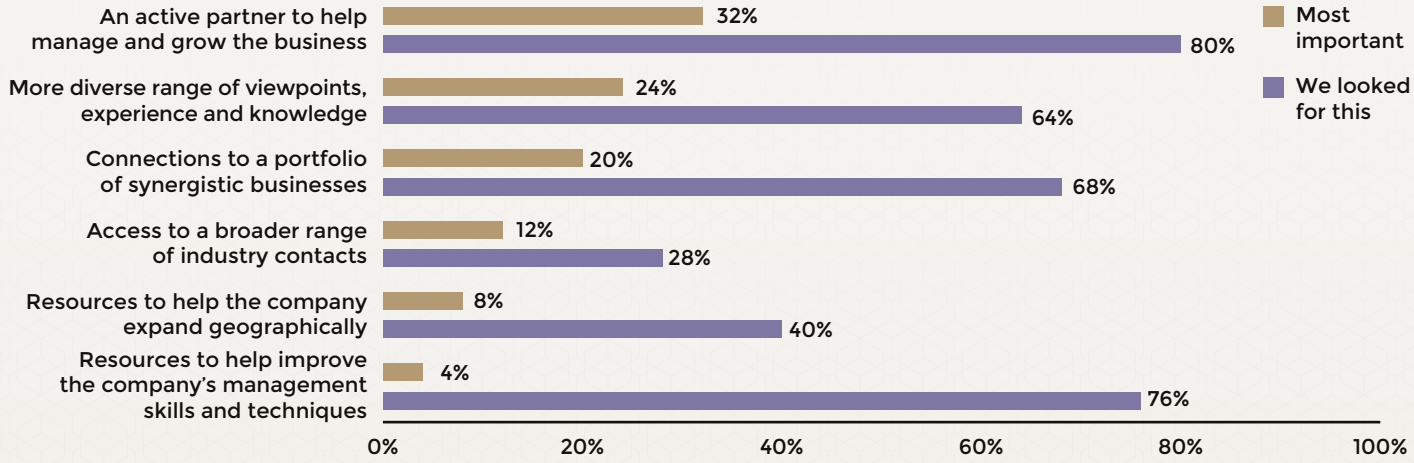
Portfolio companies How involved has your private equity owner been in managing the company?



Portfolio companies How would you rate this level of involvement?



Portfolio companies **Aside from capital, what were you looking for when evaluating potential private equity buyers? (Select all that apply and the most important)**



Case study

Assessing a succession plan

Kilberry helped a PE firm assess an acquisition target's CEO-to-be.

A private equity firm needed help addressing a common but delicate issue: how to ensure a smooth CEO succession at a target company. The investors hired Kilberry to assess the current CEO of the target, a manufacturer based in Canada, and his presumed successor, the company's president. The CEO was also the company's founder and, like any founder, he was reluctant to relinquish control completely, despite being ready to move into a new role.

A second challenge was determining whether the current president – the CEO's presumed successor – could carry out the PE firm's investment thesis. The company had a successful product but the public hadn't heard of it and there were opportunities to increase efficiencies. So, the thesis focused on enhanced marketing, operational efficiencies, and expanding into new geographies. This meant that the new CEO had to be a real entrepreneurial leader. The current president was already the company's head of sales. The question was: Could he elevate his game and, at the same time, step into the CEO role as a growth-oriented, entrepreneurial leader?

Kilberry assessed the two individuals to understand their attributes and capabilities. Based on insights generated from the assessments, Kilberry determined that the management team indeed possessed the necessary capabilities to execute their strategic objectives. The current CEO was somewhat difficult to work with, but he was prepared to reduce his role in the company. And the current president was a sales-oriented leader with entrepreneurial DNA, exactly what the PE firm needed.

As an additional assignment, the PE firm asked Kilberry to gain further context into the company and support the CEO post-deal. They met with 10 other members of the leadership team and developed the basis for a lasting advisory relationship with them. As a result, Kilberry did follow-up "pulse checks" every six to twelve months to coach the current president as he transitioned into the CEO role.

Sought-after synergies
The needs of different businesses can vary widely, but our study indicated that investors and company executives generally agree on the main benefits of their partnership. In particular, they both place a premium on improved management techniques and processes – 40% of managers said this was the most important benefit they gained and 24% of PE investors named it most vital. Both sides also lauded the value of having connections to synergistic businesses (16% of managers named it as most important and 32% of investors said the same).

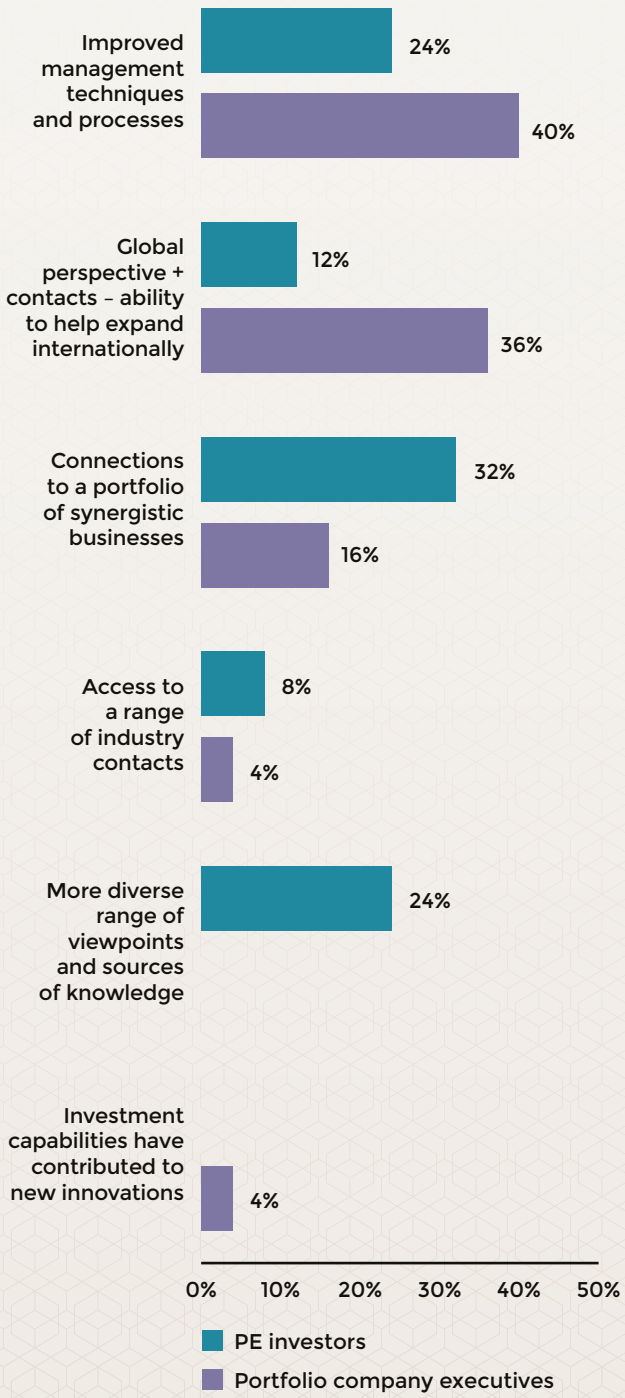
In recent years, PE firms have begun more actively forging ties between the companies they own. "We have increased our focus on certain industries to benefit from the strategic connections we can create," said a managing director at a Connecticut-based PE firm focused on the manufacturing and specialty consumer sectors. "This has helped us greatly. We provide our businesses with opportunities to merge with suitable partners to bring more efficiency and thus help save on operational costs. It can also be helpful in expanding into new markets."

It is noteworthy that "improved management techniques" was the top benefit cited by company executives, despite the fact that a significant minority said they think their PE owners play too large a role in management. This indicates that, in many cases, they are looking for guidance and skill-building but will resist a heavy hand.

Another point of emphasis for executives is the desire to gain from their PE investors' global perspective and contacts. More than a third (36%) of our participants named this as the key benefit they gain from their partnership. "Our PE owner's portfolio stretches across geographies, giving them more experience and insights in expanding internationally," said the CFO of an industrial engineering firm in the US South. "Through their network, we have resolved our supplier concerns and have started to work with more efficient and effective suppliers from across the globe. We have also been able to tap new markets that will significantly benefit our overall performance."

Bottom line: You both generally agree on where you can add value. Make sure you do!

What has been the most important benefit of your partnership with the portfolio company/PE firm?



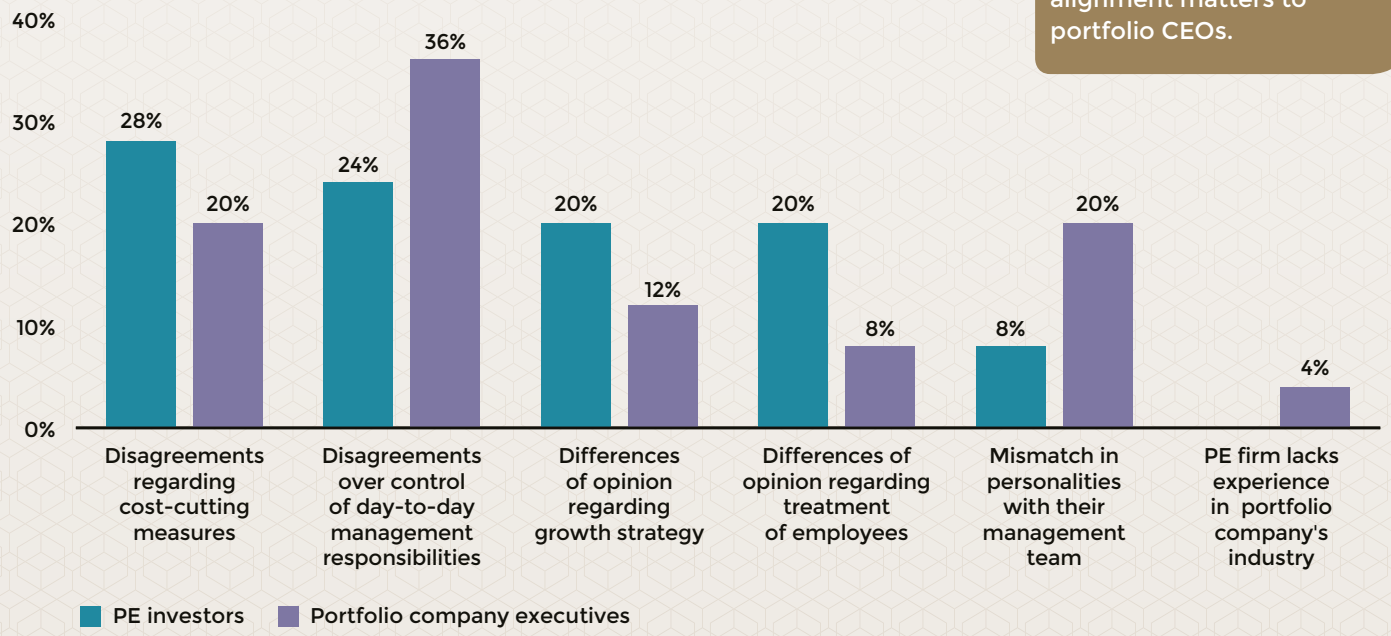
Pain points
Investors and executives also agree on the challenges each face most: differences of opinion regarding cost-cutting measures and day-to-day control of management. About half of each side said they confronted these two difficulties most commonly in their partnership.

"Some business leaders are hesitant to give up control of their company and focus on remaining an integral part of it," said a partner at a PE firm that has invested more than US$7bn over a 30-year period. "Their inflexible nature hampers our strategies to some extent, as they resist changing day-to-day activities. This can be a major challenge in growing the business."

The tensions that can arise underline the importance of establishing whether the fit is right between buyer and seller during targeting. Indeed, the clash of styles can occasionally lead to an irreparable rift between the two sides. "We were not able to fully understand the ability of the team to work under new management," said a managing director at a New York-based PE firm currently investing out of a US$2bn fund. "Because of this, there was a lot of miscommunication and resentment between the teams. We also overestimated the skills of the team and had felt their business would be able to grow well, but over a period of time we realized they were not as skilled as we had originally thought."

Another issue for managers is potential mismatches with the PE team in terms of personality. The CFO of a labor staffing company described the difficulties this led to: "The buyer's team and our teams differed greatly when it came to personalities and this led to a lot of miscommunication and skirmishes in the company. These took a long time to settle."

What has been the biggest challenge in your partnership with the portfolio company/PE firm?



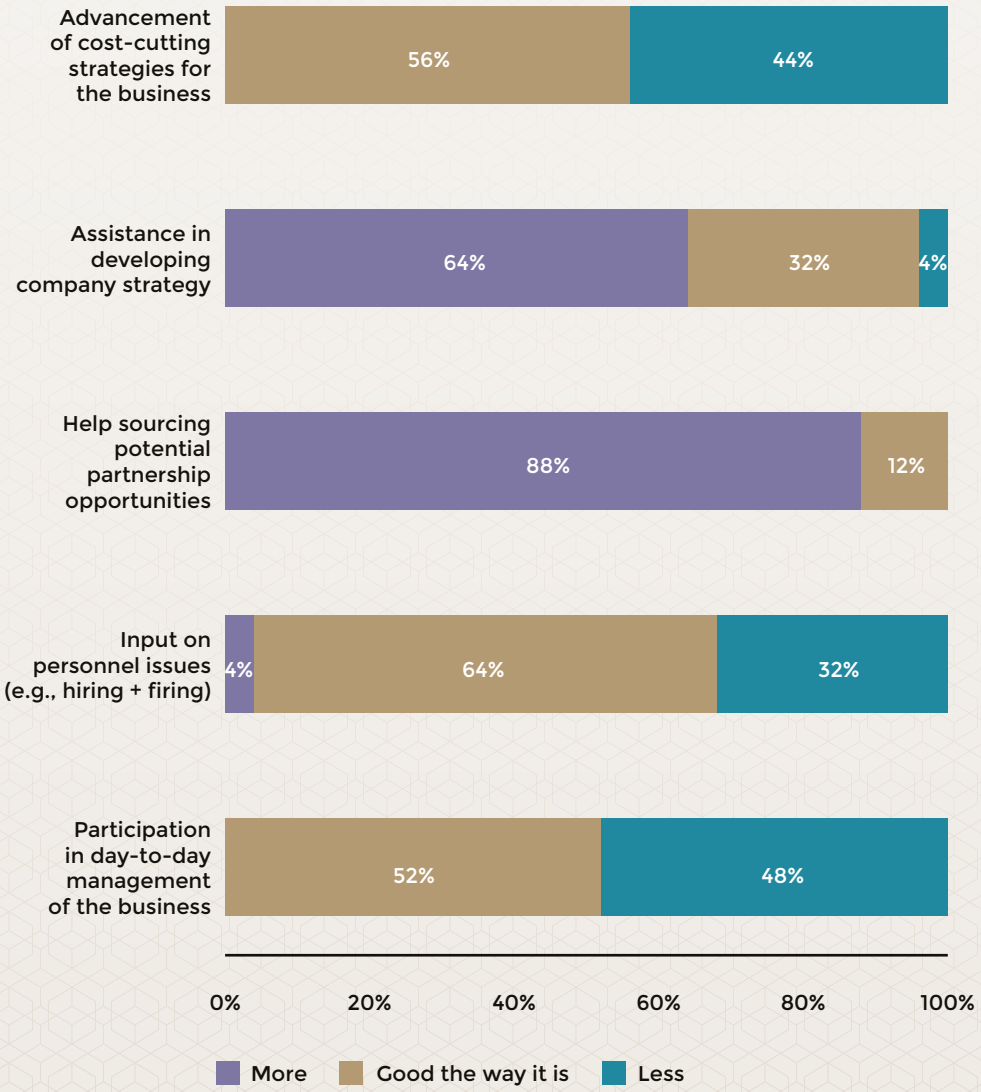
Bottom line: Personality alignment matters to portfolio CEOs.

The Goldilocks question
Two areas stand out for executive teams when it comes to things they'd like more of from their PE owners: help in sourcing potential partnership opportunities (88% said they want more of this) and assistance in developing strategy (64% said they want more of this). "We feel our PE company could work with us to develop our strategies and goals more – we do not feel they do enough and need to work more closely with us," said the CEO of an oil & gas exploration equipment manufacturer. "We also need to network better and do not feel our PE investors are introducing us to the right networks. We need to develop stronger networks to exploit the market and grow."

As seen previously, a larger proportion of managers would like their investors to be less involved in day-to-day control of the business (48%), in pushing cost-cutting strategies (44%), and in giving input on personnel issues (32%). "Leaving management responsibilities to the managers is important," said the CFO of a property investment firm. "It keeps the hierarchy intact, and the management teams can guide their employees in a more personalized manner."

Bottom line: You can be most helpful to your CEOs by helping to source partnership opportunities and guiding strategy. Leave the day-to-day to them – especially personnel decisions and cost containment.

Portfolio companies **Please indicate whether you would like to receive more or less of the following actions from your private equity owner, or if the current level is satisfactory**



Conclusion:

Making the right choice

In the current market environment, it has become more difficult than perhaps ever before to achieve a consistent yield on investment. As the performance of many asset classes becomes more volatile, private equity has remained among the most reliable.[3] The PE industry is evolving quickly, but it appears set to retain its position of prominence for years to come.

PE investors must be vigilant, however, to maintain the rates of return that they and their LPs have grown accustomed to. This means conducting deeper due diligence on targets and paying closer attention to areas of potential risk and opportunity, including the quality of management teams.

For sellers, the prevalence of PE investors means that ample exit opportunities are available for well-run and profitable companies. Being aware of a buyer's priorities can help you find the right situation for your firm and avoid an incompatible partner.

As you navigate due diligence or begin your collaboration with a PE firm or portfolio company, keep these three points in mind:

- A company's management team contributes roughly the same amount to the success of a deal as its product and operating model. Make sure you devote adequate resources to this aspect as a result.

- Personality and communication style are vitally important to both sides of a PE deal. If the fit is not right, the relationship can turn sour and significantly hamper prospects for growth.

- Tensions over day-to-day management responsibilities are common in PE relationships. Confirm that you're on the same page with the other party before finalizing a deal, and check in with each other regularly after a deal goes through.

Please contact Kilberry if you'd like to learn more about this research report or if you'd like to discuss the management due diligence process in your next deal.

3 https://split-decisions.readz.com/chapter-1

About Kilberry

Kilberry is a firm of Management Psychologists who provide executive assessment and development services to Investors, CEOs and Key Corporate Leaders. Using psychological insight and business experience, we help companies create value by choosing the right executives, backing the best management teams, developing extraordinary leadership, navigating through periods of leadership transition, and identifying hidden intangible assets.

Kilberry has offices in Toronto and New York, and serves clients across the globe in a wide range of industries.

Kilberry's Private Equity Practice
Using our pre-deal management due diligence process, we help private equity firms understand more precisely who they are investing in and whether they have the ability to execute the investment thesis. We "lift the hood" on management teams in order to capture their true capabilities, key attributes, and underlying motivators, ultimately as a means to drive the value creation process. Our clients have a deep and accurate understanding of who they are getting and also how to best partner with them post-deal. We work with top PE firms in the mid-market space across Canada and the United States.

For further information about this report or on our Private Equity expertise, please contact:

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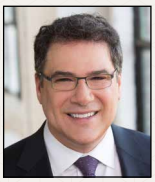

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