EXECUTIVE INSIGHT

What It Takes to Succeed in Private Equity

An Overview for Portfolio Company CEOs and Their Teams

WHAT WE THINK

While listed companies have traditionally provided superb training grounds for general managers and future business leaders and are a natural pool of talent for private equity, ultimately a significant number who have thrived in listed companies fail in private equity portfolio firms.

So, our assumed models of “what looks good” may not always fit private equity. It is not the same as the joint stock world, legally or culturally. There are certain broad traits that research suggests are important for private equity leaders.

What Are the Private Equity Challenges?

Most private equity firms have high levels of debt and require constant attention to cash flow, spending, debt repayment, and financial targets so companies can achieve their exit in two to five years. There is always the issue of the owner’s sale and exit, which almost never exists in most public company environments. The overriding requirement is to manage and pay down debt in reasonable time frames.

Private equity requires CEOs and their teams to be aggressive in making radical restructurings and changes in trying to run and fix companies. In doing this, they need to operate with a speed and rigor often uncharacteristic of public organizations. The private equity firm is focused on fewer goals and a defined endgame frequently outlined in financial terms.

Portfolio companies typically have fewer human and financial resources than corporate counterparts. Private equity CEOs typically need to have a broader grasp of business functions and need to be able to make decisions that might be delegated in public companies.

Private equity stakes for CEOs and top teams are generally illiquid and long term—different than the conventional equity incentives of corporate stock options that vest annually. Longer-term and inherent illiquidity associated with private equity deals requires CEOs and their top teams to be able to plan and make decisions over three- to five-year periods. They must be wholly adapted to medium-term value creation.

Despite the pressure for results, CEOs and top teams of private equity firms do not have to contend with the panoply of reporting requirements of public companies. Freed of analysts’ quarterly reporting demands and the glare of publicity, they can take a longer-term view of affairs and maybe cut some corners.

"The mission of the buyout board from the first day to the last is the creation of long-term value...it cannot manage quarter to quarter...that misses the point philosophically...the plan is to build value over time...you have to think about things differently...you have to be patient...." [1]

Summary Characteristics of Private Equity Culture

- Highly leveraged—unwavering attention to cash and debt
- Defined endgame in three to five years
- Fewer and more focused goals
- Less bureaucracy to navigate
- Fewer internal functional resources to work with
- Upgraded financial opportunity for achieving successful exit
- Focus on concrete longer-term objectives

Traits of Successful Private Equity CEOs and Top Team Members

Sector Experience

Each business is normally guided by a leader who has specialized knowledge of the particular industry.

Financial Acumen

Because of the debt burden, private equity CEOs must possess real financial knowledge and expertise. They must know how to manage high debt and reduce costs. They need to be totally focused on capital management and debt reduction. Real financial savvy is key. Financial strategies command most attention. This requires more than just being numerate or able to read and manipulate the (corporate) P&L. Private equity firms have added new, more complex measuring sticks to business.

Functional Breadth

As well as specialized sector knowledge, portfolio CEOs typically have broad experience of every function, particularly product development, supply chain, sales, marketing, and finance: they are generalists. Behaviorally, they excel at prioritizing, allocating resources, and resolving conflict over goals. They have to create and run streamlined businesses, so they have to adapt to the relative lack of resources and be flexible enough to run lean.

Ruthless Decisiveness

Private equity CEOs need to have a ruthless decisiveness that functional and public company executives often lack. They have to be quick to make tough, important commercial and financial choices.

"The rate of change that private equity forces on portfolio companies is something most public companies are not comfortable with." [2]

CEOs have to operate with a strong sense of urgency and decisiveness in making choices. Typical failures of struggling portfolio leaders are the inabilities to remove inadequate executives and to cut overhead *fast enough.*

"It was these essential responsibilities that most corporate boards had found daunting, if not impossible, to fulfill until desperation and the example of the buyout showed them how." [3]

Risk Orientation

Private equity CEOs have to be comfortable with high risk and uncertainties. The system in private equity favors risk taking. Management can earn huge payouts if turnarounds succeed. At public companies that seek to deliver steady returns to shareholders, executives are often rewarded for playing it safe. Private equity CEOs have to provide entrepreneurial leadership and pursue drastic change.

Private equity CEOs and their teams typically lead substantially autonomous businesses in heavily decentralized organizational structures. They have to be able to select, motivate, and mobilize small, tight top teams to deliver clearly defined commercial results in strict adherence to investors' time frames. At the same time, they have to forge effective board-level partnerships with frequently intrusive, hands-on, financially astute owners. They have to be autonomous yet collaborative when it matters.

Summary

The leaders of private equity portfolio companies are arguably a special breed. They lead takeover targets to higher levels of operating returns as compared with their corporate owners. They are usually:

- Best in class in their functional specialism
- Financially savvy
- Long-term thinkers
- Ruthlessly decisive
- Risk takers
- Psychologically able to shoulder the burden of high debt and to initiate and pursue drastic change to pay it down fast

References

[1,3] Baker, G. and Smith, G. (1998). *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value,* 101–105.

[2] Sorkin, A. (2007, September 23). Is Private Equity Giving Hertz a Boost? *The New York Times*. Retrieved from www.nytimes.com

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