CEOs and Private Equity: Don't Become A Statistic!

By Robert Rough and Bernard Carrico

An Alix Partners survey found private equity groups (PEGs) replace 58% of CEOs within two years of buying a company and 73% of CEOs during their ownership period. This is a terrible outcome for both the CEO and for the private equity group. How can it be avoided? There are important takeaways for both private equity groups and owner/CEOs of lower middle market companies selling controlling interest to a financial buyer.

Companies acquiring smaller companies usually purchase 100% of a target's equity but few PEGs do because lower middle market companies (valued between $10 million and $50 million) are often dependent on the CEO, usually the majority owner, for success. PEGs usually buy 60% to 80% of the company. This provides the buyer with management continuity and reduced risk inherent in replacing the owner. This strategy provides the owner liquidity, asset diversification and "another bite at the apple" when the financial buyer resells the company in 3 to 7 years.

Most literature addresses preparing a company for sale and the sale process. Little focuses on the period of PEG ownership. Owner/CEOs focus on price and transaction terms but do not properly research the new partner/boss they will be working with for the next few years. Private equity groups, so happy to have landed a transaction in today's hyper-competitive market, miss or overlook warning signs. Technology and the way transactions are worked nowadays compound the problem. The sad result is that many partnerships fall apart, leaving both parties frustrated and potentially destroying company value.

A successful post-transaction partnership requires up front planning, understanding the differences among PEGs, and performing due diligence throughout the process rather than just at the end.

Potential buyers list. The process starts during the goal setting sessions with the investment banker (IB). Good IBs make it their business to know many PEGs and their operating style. Using the owner's goals for their post transaction role, for their company and its employees, the IB assembles a potential partner list. Some may be less well known to the banker but have a strong interest in the industry, others may be well known and worked with the IB in the past. The owner and banker together refine the list before the marketing phase begins. The banker will use knowledge of the chosen firms to tailor the marketing documents, pitch and process accordingly. Private equity groups, for their part, must make sure investment bankers understand their investment criteria and, just as important, their culture and how they work with portfolio companies.

Due diligence. Owners and the IB develop questions for PEGs. These questions are raised during the process as the PEGs perform their due diligence. Some question areas are best handled by the owner alone, some by the owner and banker together and some are best addressed by the banker one on one with a senior representative of the PEG. Choosing an IB who knows how PEGs operate after the transaction makes a big difference in the quality of the questions generated and response interpretation. General question areas follow, specific questions differ with the situation and are beyond the scope of this article.

1. *What are their goals?* Knowing the PEG's goals and how they will be achieved help the owner project how much change will be needed. Knowledge of PEG *modus operandi* is critical in probing this area. In the survey 78% of PEGs listed "pace of change" as the biggest source of conflict with CEOs. Learn what that really means.
2. *What is the exit?* PEGs have exit plans up front which should be explored.
3. *How will performance targets be set?* PEGs are results driven. Their goals and how that translates into performance targets are critical. Not surprisingly, this is the second biggest area of conflict.
4. *What are the firm's communication expectations and style?* PEGs differ in their reporting requirements, meeting or contact frequency and availability expectations. For example, 31% of CEOs wanted scheduled monthly meetings as standard contact while that was acceptable to only 3% of PEGs. 14% of CEOs expected to be available 24/7 while 33% of PEGs hold that expectation.
5. *What does the PEG offer other than capital?* Know the role the PEG will play in different situations and in different areas of the company.

6. *Post transaction contact person or team?* Some PEGs separate transaction teams from portfolio management teams. Specific questions will get this answer but also knowledge about how the PEG operates that could have a substantial impact on the CEO after the transaction closes.
7. *What is the firm's track record?* The transaction community jokes that all PEGs are in the upper quartile of performance. Getting specific details on this can be difficult and requires careful interrogation.
8. *Will the team be enjoyable to work with?* Owners spend a lot of time with PEG partners, especially if company performance lags expectations. Do they respect you, your achievements, management team, and treat you like a partner during the transaction process? In the modern world, technology reduces face to face time. A good banker finds ways to increase time spent with each other.

Private equity groups usually perform legal (criminal) and financial due diligence on potential management partners. Some may perform research into the CEOs prior employment beyond confirming dates, etc. but not many. Did the CEO really achieve the results claimed? What outside factors were present that helped? Were other management team members really responsible for the hard work that led to the success? What is the CEO like when adversity strikes? What is his/her work style and ethic?

References. This critical step is often done too late. Sellers shouldn't wait until a single PEG has been selected. Start making calls when the field has narrowed based on indications of interest.

1. *Contact current CEOs, exited company CEOs, and fired CEOs.* Unlikely a PEG will provide this complete list but the response might be enlightening.
2. *Test PEG answers to questions with the references.* Understand PEG behavior under different circumstances.
3. *Develop independent references.* The banker should try to provide useful sources of information beyond what the PEG offers.

Few private equity groups have the opportunity to speak with former employees, former partners and others who might provide insight into working with the CEO. Conversations with vendors and suppliers focus on making sure nothing will disrupt the business relationship or areas such as customer service, product quality, etc. It is difficult to ask about the personality or working with the CEO. More and more, PEGs are using tools liked LinkedIn to network with people who have worked with the CEO and can offer insight.

Technology and the Deal Process

Too many transactions are closed nowadays with the PEG and the CEO/management team not knowing each other. I have anecdotally heard as little as four to six hours spent face to face before closing! Two suggested remedies: Change the way you handle data rooms and document negotiation

Data Rooms: Data rooms used to be just that, a conference room at the company filled with boxes of contracts, corporate documents and other due diligence items. PEGs would send people in to go through the data room for two or more days depending on the size and complexity of the deal. It was a pain in the neck. During that time, however, PEG personnel would eat meals with various members of management, get to see the company "in action" rather than all dressed up for the management meeting, and get to know staff personnel as they got questions answered, made copies, got coffee, etc. With virtual data rooms, this is gone.

Document Negotiation: In earlier days, the buyer's lawyers would draft the main documents, send them to the seller's counsel and then both sides would convene in a conference room to hash out at least the main issues. In addition to avoiding the endless emailing back and forth of "how about this, how about that" comments, each side got to see how the other side negotiates. My private equity firm once walked away from a deal during negotiations in large part because of how the CEO acted while negotiating some difficult issues. How do you learn that over email?

Going back to the days of true data rooms may not be possible but spending more time with potential partners is. As for negotiating documents in person? Try it. As a bonus, it will also speed up the document negotiation process.

Nothing guarantees a good outcome but these steps should greatly improve the odds. And yes, it is a lot of work. Just keep in mind that closing the deal isn't the end of the story, it's the beginning.

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Sources: AlixPartners web site. *Annual private equity survey: replacing a portfolio company CEO comes at a high cost.* https://www.alixpartners.com/insights-impact/annual-private-equity-survey-replacing-a-portfolio-company-ceo-comes-at-a-high-cost/