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Human Capital in Private Equity

A mergermarket and RHR International research report





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Methodology

In November 2006, RHR International commissioned Remark, the market research division of Mergermarket, to carry out a global research project concerning the human capital and management issues encountered by private equity firms throughout their fund cycle.

The aim of the research is to provide an insight into what investors look for in prospective management teams, how they assess talent within their portfolio companies and their own funds, and how they expect human capital issues to develop for private equity in the future.

Remark interviewed over 100 senior private equity practitioners in the US and Europe by telephone in December 2006 and January 2007, with all respondents guaranteed anonymity.

Foreword

The past year saw an unprecedented amount of private equity coverage in the global business press.

Barely a day has gone by without yet another deal being struck between a private equity firm – or increasingly consortiums of firms – securing the ownership of attractive companies. Many of these target companies are no longer the fledgling or flailing type; indeed, ever-growing private equity firms are increasingly using consortium vehicles to target some of the world's biggest and most famous companies and brands.

Private-equity firms already own a growing stable of the world's most famous companies – Hertz, Neiman Marcus and Toys “R” Us, among others. Last year saw nine of the ten largest buyouts in US history. Furthermore in recent months there has been a flurry of private equity firms pitching for some of the UK's biggest household brands. In both the US and UK, private equity has moved beyond mid caps and into the big league of listed companies. In short, almost nothing appears out of reach of the private equity backed buyout.

What is becoming increasingly apparent is the stakes are high and appear to be getting higher. But what is often not appreciated is that in the midst of all this frenzy, there are some interesting dynamics and differences that are inherent within and around the private equity firm and the deals it strikes.

For some years, RHR International has been watching this with ever-growing interest, both from inside and outside our private equity clients. What we have been observing are fundamental differences in the way private equity firms are resourced and run, and equally in the way they approach and assess their next targets. But this is mainly anecdotal evidence. As psychologists, we wanted to delve further into some of these hypotheses and test them through more formalised research. Armed with more conclusive evidence of what is actually backing and driving these burgeoning deals, we hope to better understand the types of people, dynamics and associated practices of private equity firms for our clients. Our intentions for this are three-fold: to better inform the industry, serve our clients and ultimately, help to make them even more effective in the management of their companies – both within their portfolios and their own.

We are very excited to bring you the findings of our research, Human Capital in Private Equity.

RHR International Company

Executive Summary

- Over two thirds of respondents (69%) believe that poor company performance is either very often or always attributable to management issues.
- Respondents were divided over whether management changes are implemented quickly and effectively enough. 37% believe they make such changes quickly, however, factors such as incumbent management and 'egos' were noted by respondents as impediments to quick and effective change.
- Respondents identified two primary difficulties to conducting a management assessment. 43% of respondents cited the limited time private equity practitioners get with the management of a prospective portfolio company while 22% acknowledged the unreliability and unsuitability of the reference/track record assessment method for gauging future performance.
- Respondents were keen to demonstrate that private equity firms are moving beyond a more instinctive approach when it comes to picking talent.
- Respondents use a combination of methods when assessing the management and leadership qualities in a company pre acquisition. Carrying out tests and assessments whether they be internal (70%) or external (26%) were cited by the majority of respondents as well as taking references (59%).
- When assessing the management teams of a potential portfolio company, respondents noted that current and past performance is taken into account in addition to finding a team that collectively performs well. This implies less attention is given to scalability and future performance.
- The vast majority of respondents (85%) are at a company which regularly assesses the performance and development of management teams. This mostly (59%) takes the form of annual or quarterly assessments and (360 degree) reviews. However, many of these respondents noted that reviews do not take place at Partner level or above.
- Given the increased competition in private equity, over a third of respondents see reorganisation and management assessment occurring very often post deal.
- With private equity continuing to develop in both size and scope, 54% of respondents believe that the management of the private equity firm will become more institutional in culture, which will bring a need for greater professionalism, structure, specialism and operational excellence.

Survey Findings

The Acquisition Process

1. How do you look at management and leadership qualities in potential acquisition companies?

- Respondents appear to use a combination of methods when assessing management and leadership qualities pre acquisition. This mostly involves extensive interviewing and carrying out internal (70%) and external tests (26%) and assessments, as well as taking references (59%).
- On the one hand respondents continually underline the role of the reference system and the importance of 'personal opinion' in light of interviews conducted with management:

"[We get to know them] through feeling and human appreciation. Of course we look at their achievement, how people who have worked with them speak of them. We build a picture like that, and if all the impressions we get are convergent and build a coherent picture then it is generally the right picture."

- Furthermore, with some respondents, opinions on management are built up during the course of the due diligence, and then backed up later.
- On the other hand, respondents were keen to demonstrate that private equity firms are moving beyond this more instinctive approach when it comes to picking talent. Various mentioned are benchmarking, psychometric tests (individual and team), character assessments, and skills, emotion and intelligence tests.
- A subset of these respondents (26% overall) use external people to aid this assessment, including headhunters and HR consultants.

The issue for private equity is whether the intuitive and instinctive approach to selection it seems to prefer will guarantee success as deals get bigger and the stakes higher. We are finding more and more private equity investors are concluding it is not.

Dr. Robert Irving, London office

2. What difficulties do you encounter in assessing/judging the management team?

- There appear to be two primary difficulties faced in management assessment: the limited time private equity practitioners get with prospective portfolio company management (43%); and the unreliability and unsuitability of the reference/track record assessment method for gauging future performance (22%).
- The former is a symptom of an ever increasingly competitive auction process, while the latter demonstrates a flaw in the human capital strategy of many investors. Indeed, with the limited access to management a clearly foreseeable obstacle, it is perhaps surprising that many respondents rely so heavily on the subjectivity of a reference system that "does not distinguish good managers from bad", and of a track record analysis that does not necessarily indicate future performance.
- In fact for 13% of our respondents, there is an acceptance or frustration that the process is not a science:
"Standard procedures in assessment don't exist [for private equity]; the validity of findings is subject to question; and you never know how those assessments will change afterwards: it's like a forecast."
- As well as the limited time factor in auctions, a handful of respondents also highlight the danger of putting off management teams with too much human capital due diligence. As one European investor noted: "If you go in too forcefully it can sometime influence your likelihood of winning the deal."

It is a sellers market and winning the auction is the clear priority. Yet there is a need to mitigate investment risk on the management team. The main requirement is to enhance the quality of referencing and assessment. Some firms get it on the table early that they will formally assess the management team at the point of the deal being struck and that this is a core value in the way they do business.

Dr. Paul Ofman, New York office

Survey Findings

3. What improvements could be made to the way you currently assess/judge your management teams?

- Over a fifth of respondents felt not much in the way of improvements can be made to their existing processes, in spite of current flaws. These well intentioned but rather laissez faire attitudes are perhaps best summed up by the following respondents;

“Nothing specific is needed; just general improvements to existing methods.”

“You just have to trust your gut feelings; you can only learn from things after they happen.”

- For a further fifth, the solution lies in dealing - or rather coping - with the time and references issues. In other words, most respondents focus on making the best of a less than optimal structure:

“Getting to know them [management] before the deal actually is a deal. We are spending increasing amounts of time meeting good managers.”

“I should have more access to truly independent references. It’s not easy to find the right people to talk about someone, and this is the key.”

- However, for almost 25% of respondents, the greatest improvements should be made by engaging external assessment people and techniques, and performing more in-depth or systematic tests.

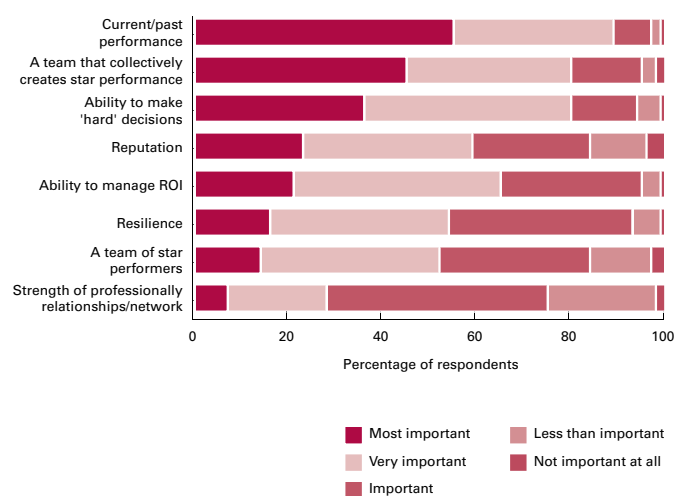
“The industry needs to professionalise itself: more external; more structured; more templates.”

- For some respondents, however, the skill of good private equity investment lies in the ability to judge management attributes. Some are also sceptical of blanket management due diligence: “it’s horses for courses”, summed up one respondent.

If external providers are to be used to assess management teams it is essential they really understand what drives success in the private equity business scenario and can add real value in their judgments about people. The profile of success in private equity is not the same as in corporate life.

Dr. Ed Ryterband, New York office

4. When you look at the “management assets” of a potential portfolio company, what are the most important things you focus on/look for?



- The current and past performance of management teams is the most important factor identified by our respondents when assessing management teams of a potential portfolio company. Finding a team that will collectively perform well is also ranked highly, as is the ability to make hard decisions.
- Ideal management teams are not necessarily those that come with strong professional relationships or networks, nor need they individually be particularly star performers.

Private equity should be less about the past performance of a management team and more about whether it is scaleable. That is, can its members adapt to meet the demands of the investor for higher performance in relatively short time scales?

Dr. David Astorino, Philadelphia office

Post-Deal

5. In what ways do you ensure and assess that senior management deliver on strategy/trajectory post-deal?

- For the majority of respondents (64%) management is closely monitored, given defined performance indicators, targets, objectives, budgets, incentive schemes or business plans. This is deemed the best way to ensure management are on the same trajectory as investors, and to assess the qualities of those teams.
- A further 15% use regular reviews and assessments to gauge performance, some of whom noted the role of the chairman to mediate.
- Finally, 20% simply highlight the benefit for spending more time with investee companies:

“Spending a lot of time with them; form a close relationship with them; and use a combination of formal and informal tools.”

6. Are there any common characteristics that you believe inherently exist in management teams that fail post-deal?

- Although no clear attribute is mentioned by respondents overall, what was talked about mostly was an inability to execute. Respondents variously highlighted lack of leadership, differing objectives, bad communication, poor delegating skills, no flexibility, and over-optimism.
- But no single ingredient of failure is identified, and indeed nearly a fifth of respondents agree that “each deal and each group is different.”

Our clients emphasise that time needs to be devoted to establishing a solid platform off which growth initiatives can be launched. This requires a range of initiatives including assessing the management team, determining the organisation structure, improving financial reporting and other systems and reviewing performance and evaluation systems. Only then can attention be turned towards strategic initiatives.

Dr. John Del Monaco, Boston office

7. How often is lack of performance due to management issues?

- For over two thirds (69%) of respondents management issues are either very often or almost always the reason behind poor performance.
“Poor management is always the problem, as the very best management can even turn rotten businesses into good ones.”
- Only a fifth of respondents cite other sources of poor performance, with a large proportion of these pointing to market forces as the primary contributor.
- Whether this is accurate or not, the fact remains that given the importance of management to the success of an investee company's performance, the majority of respondents appear less inclined to invest in or explore significant alternative management assessment methods.

8. Given the increased competition in private equity, how often do you find that management assessment and reorganisation is occurring post-deal?

- Over a third of respondents see reorganisation and management assessment occurring very often (more than 50% of cases) post deal.
- This appears to be a hallmark of a private equity market which requires success within a limited timescale (“we are not patient: if someone needs to be replaced, we do it quickly”) and one which necessarily requires tweaks to be made to investments:

“Reorganisation is an ongoing process in every deal: there is constant assessment. It's absolutely critical.”

“It [reorganisation] happens more often than we would like; the current climate means there is often not enough time to assess management beforehand, with a greater focus on the actual business and money.”

Our research echoes the findings of SJ Berwin's research in 2003¹ that poor management quality was the principal cause of deal failure across European private equity.

Dr. Robert Irving, London office

¹ The Human Capital Equation – 2003, published by mergermarket

Survey Findings

- However, a third note that change rarely occurs or confidently assert that they only chose companies with a proven management.
- Some further interesting observations from respondents are that management changes are much more prevalent now than two or three years ago: “it’s happening more often than in the past, and much sooner within the cycle”.
- In addition, some respondents noted that an increase in secondary buyouts mean funds are taking less of a gamble on management ability, but need to focus more on maintaining these management teams’ interest and incentivisation.

9. Do you feel that you make management changes quickly and effectively enough? What, if any thing gets in the way?

- Respondents are almost evenly divided over whether change is implemented quickly enough. On the one hand, 37% assert that they make management changes quickly. Reluctant incumbent management and ‘egos’ are noted as getting in the way of implementing these changes. There also appears to be caution determining these major changes:

“There is a tendency to hesitate. We always need to ensure it’s the right decision as it’s a large upheaval. We also need to be humane in the treatment of the outgoing team.”

- Rather candidly 40% admit that changes are not made quickly or effectively enough. Respondents are reluctant to disrupt the business (“We tend to give people the benefit of the doubt for a little too long.”), to highlight their initial mistakes, and to enter possibly lengthy legal battles. Finally one US respondent highlighted an issue that becomes more important in light of the increased competition amongst funds to perform well:

“We’re not as quick as we should. Clearly poor performance makes changing management easy. It is the average performers where we are slow to act.”

If the assessment of the people and the organisation is wrong or late, the investor will run the risk of funding growth initiatives with an organisation and people that are basically unfit for purpose, which ultimately leads to confusion and failure.

Dr. Grant Levitan, Chicago office

10. In anticipating a liquidity event (merger, IPO; secondary buyout), what, if any, management preparation do you perform pre-exit?

- A quarter of respondents prepare their management teams for exit through training, coaching and assessment. This might involve preparing them for communicating with the press or investors, for presentations to potential buyers, and exposing them to investment bankers and non-executive directors. As one US respondent noted:

“We aim for open and honest communication, and integrate them into the process. We all want no surprises, and also its practical as buyers ultimately need to do their due diligence.”

- Just under a fifth of respondents highlighted their openness to change management pre-exit, in order to bring in the skill sets necessary to achieve the best price. Often this appears to involve bringing in a ‘City-friendly’ Chairman, beefing up with non-executives with public company experience, possibly de-risk the business by making the company less dependent on key directors and leaders.
- But equally a fifth of respondents highlighted the need to do nothing that disrupts the business, and “let management get on with running the company successfully”.

Good practice increasingly requires an independent assessment of management pre-exit in order to factor management capability into the balance sheet when exiting an investment.

Dr. Guy Beaudin, Toronto office

Your Own Company

11. Do you regularly assess the performance and development of your own (management) teams? How?

- Most respondents (85%) are at firms where some form of assessment takes place for internal teams. This mostly (59%) takes the form of annual or quarterly assessments and (360 degree) reviews. However, many of these respondents noted that reviews do not take place at Partner level or above.
- For 20% of respondents, performance assessment is almost purely financial: "Financial performance is unfortunately the only method to assess performance in our industry".
- Only 3% mention using training or mentoring methodologies as part of the internal development, and a further 3% use external assessors:

"We have a consultancy firm that also comes in to assess the team each year. Our goals are set, and we know what stage everyone is at by having everyone on the same page."

12. What different characteristics do you believe are required by a successful leader of a successful PE firm?

- For over half of our respondents, a successful leader within a private equity firm specifically needs to have a good combination of the key business skills. These include decision making, strategic thinking, vision, market and business insight; analytical and financial skills, negotiation skills, and the ability to act quickly and take risks.
- For nearly three quarters of respondents, however, private equity leadership is about personality and people management skills. They highlight the need to be flexible, creative, honest and confident, and the need to have integrity, empathy and charisma to motivate people with first class business skills.

"It is quite difficult; a good investor is not automatically a good leader. We have to be able to judge personalities for what they are. And also be able to stimulate intelligent people there is a need to be charismatic, and people in our teams are our equals in terms of capacity and sometimes better, but we need to be seen as leaders."

As private equity firms grow in size and sophistication, people leadership skills will become increasingly critical to their success.

However, this hits on the paradox that good investors don't necessarily make good leaders. Indeed, this may command two parallel career ladders to success within the private equity firm – one based on technical and another on leadership excellence.

Anna Bond-Gunning, London office

Survey Findings

13. How do you make sure you get and keep the best talent for your firm?

- Perhaps unsurprisingly for an industry so focused on financial performance, 62% of respondents notes that monetary incentivisation is the best way to retain talent in their firm.
- In addition, however, the industry as a whole is seen as being dynamic, diverse and different to the rest of financial services, and hence a good place to work and keep staff motivated:

“It’s about providing an all encompassing experience: interesting deal flow; larger deals; a good environment and quality financial packages.”

- This does, of course, still mean that companies are required to differentiate themselves from their competitors, and so 43% of respondents highlight the need to motivate staff with more responsibility, with interesting deal work, and with good working culture.

“People are involved in every part of the business, and aware of all transactions. It creates awareness and ownership for the entire team. By doing this, everyone is involved in everything: junior and seniors work together and learn from each other. It is the best kind of apprenticeship and knowledge transfer.”

- Although 18% mentioned having some formal form of mentoring and/or development programmes, respondents maintained that internal instruction is key to retention of the best staff:

“It’s about having a management that challenges and grows. Offering training internally and externally, and recognising people when they do a good job.”

14. Within a management context, how will tomorrow’s private equity firm be different from today’s?

- The largest share of respondents (40%) believes that the management of private equity firm will become “more operational, more specific and specialised” and “professional and more structured”.
- In particular operational and industry experience will become more important. As one respondent says:
“People management will become very important, more operational background (i.e. industry experience) and functional experience not just financial. Value adding and creation will become very important.”
- As one US respondent elaborated, there will be a need to “engage more specialists in each area and make sure people are more professional than today.”
- Otherwise, 14% of respondents feel the future will bring “larger or more international firms and more institutional cultures.” As one European respondent says:
“Private equity firms will be considerably bigger with greater resources. They will become more institutional in character. Investors will also drive for more stable structures, and private equity will need to offer this stability to be able to compete.”
- Otherwise, a further 14% of respondents believe that private equity management will not change greatly.

Bigger firms command not only more specialist investors, but increasingly, more formal and professional leadership of these specialists. Similarly, as the private equity industry falls under increasing scrutiny, sound governance and conduct will become key to private equity firms’ public success or failure.

Dr. Paul Winum, Atlanta office

Future Issues

15. What will be the same (or different) about the successful leader of a PE firm in the future?

- According to a fifth of respondents private equity leaders will need to become more operational, professional, specialised and managerial in the future as their companies develop in size and scope, while being less of a deal maker.

“They will still need to motivate intelligent people, but they’ll need a broad understanding of different sectors and geographies, and to deal with highly emotional individuals and operational dynamics.”

- Furthermore, a fifth point to the need for a better balance of internal and external motivation and communication skills. Respondents highlighted the additional skills that will be needed when expanding overseas, and when private equity firms are exposed at a governmental or public level. One respondent went further by adding that the future will be

“...less identified by individuals. In twenty years it will not be about one man, as it can be now, but more of a team. It’ll be more like a bank and a franchise. There will therefore be a different skill base needed: more focussed, political, administrative and bureaucratic. All of this is due to buyout firms growing so big, and the ever increasing effect of regulatory issues and public scrutiny.”

About RHR International



RHR International is an international firm of management psychologists that has advised companies on leadership and organisational effectiveness for over 60 years. This includes work within the private equity sector. Working with business leaders, RHR consultants offer a powerful combination of the behavioral sciences and business acumen to achieve results for our clients. Our range of services specific to private equity includes:

- Due diligence management assessments and organisational assessments of target companies
- Post-deal, in-depth audits of CEO and management teams to highlight strengths and gaps, to ensure the right talent is in the right role
- On-going coaching for development of portfolio company management
- Facilitating management relationships with the Board

Private equity firms use RHR International's services throughout the complete deal life cycle – from due diligence, close, and post deal to preparing the portfolio company for sale or IPO. At each stage, the analysis and methodology is tailored to the outstanding issues and the sensitivity of the situation. During due diligence, the need is for speed and discretion in working alongside the deal team to gather and analyse critical data on the target company's management team. Immediately after the deal, there is a window of opportunity to dive deeper into understanding the strengths and gaps in the leadership team and the organization. With this information, decisions can be made on how to best use the leadership assets currently in the company and whether to hire external talent immediately if required.

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