Another one bites the dust

by **Andros Payne**

Why the half-life of private equity-backed chief executives is dropping and what can be done about it.

Changing the senior executive is a big and often risky step for sponsors. Losing one to two years in a seven year investment cycle hurts, and the uncertainty of whether the new leader will be better than the last gives pause for thought. Decisions are not taken lightly, but sponsors are reaching for the eject button ever more often. The trend is clear – senior executives are getting paid more and staying less.

In a recent report, Strategy& finds that global CEO turnover recently peaked at 14.3 per cent, a significant increase on the 9.8 per cent turnover rate a decade ago. At the same time, pay continues to rise. Average CEO pay across S&P 500 companies reached $15.2m (€13.6m) in 2013. No risk, no fun.

What is behind the trend, and what can be done to improve longevity and returns?

Portfolio company senior executives are at the fulcrum of the capitalist system. They are sandwiched between ever more demanding pensioners in the US, Europe, Asia and their GP agents, increasingly demanding customers and independently minded knowledgeable workers. Senior executives are caught between a rock and a hard place, trying to hold it all together. This conundrum is raising the value of the few, the gifted CEOs who understand how to balance the varied and often conflicting expectations of diverse stakeholders, and leading to faster ejection of those who don't.

What is driving increased CEO turnover?

Collaboration with the private equity sponsor is something that most CEOs need to learn by trial and error. The level of transparency and partnership demanded by the general partner is often not something a senior executive is used to, especially if they previously ran a family business or corporate division. Sadly, our observation is that few buyout houses help new CEOs to adjust with a crash course in private equity governance. Although non-executive directors can help in building the bridge, most new CEOs have to learn the hard way.

Another reason is that the typical value growth phases of a buyout require a breadth of leadership skills and competencies that few senior executives can master within the holding period. Driving cost reductions and operational efficiency at the beginning of an investment requires completely different communication and decision-making processes than growing top-line revenues. A great restructuring CEO is usually a round peg in a square hole for managing growth.

Additionally, senior executives are confronted with the challenge of delivering stable, improving results despite an increasingly turbulent business environment. External market volatility and shocks are now a fact of life. Those executives who are not able to take bold decisions and implement measures at pace are quickly shown the door when the ground shifts.

Finally, on the supply side, the most talented employees, including managers and functional experts, those who drive value creation, are increasingly difficult to manage and align. The old industrial age levers of authoritarian control don't work. Those who are most critical for the adaptation process underlying value growth are at the same time the least dependent on the company and the most likely to leave if change is not managed well. CEOs must effect change, while keeping the talented prima donnas on board. Fluffy stuff like "emotional intelligence" becomes important.

What can new CEOs do to increase their longevity?

Geoff Scott, the successful serial buyout CEO of Uster Technologies, recently advised new executives to "get naked in the fishbowl with your sponsor", which may not be obvious to new leaders used to more limited transparency. However, opening your books and your organisation allows a more collaborative relationship with the sponsor, in which they can add value where they have competence. Norman Walker, senior advisor to TPG, has clear advice for new CEOs: "What you want is an open, transparent relationship built on trust. The key to openness is having conversations and seeing the sponsor as a supporter as opposed to somebody who is trying to get in your way."

However, there is a fine line. New CEOs must be in control and this must be apparent to the owner. Even though this may be clear in the management regulations, new buyout leadership teams may be unclear about the decision-making role of the sponsor in practice. Investors may also exert more control, especially if they have reservations about a management team. When the sponsor suggests an experienced leader to work closely with the CEO on an interim project, this can blur the line of accountability and often signals an impending departure. Wise buyout CEOs will take charge – ask for forgiveness, rather than permission.

New CEOs also need to adjust their risk profiles. The return demands of private equity investors, their limited holding periods and their ability to diversify risk across the portfolio means that they have a different risk profile than managers who spend their career in a company. A new buyout CEO needs to understand this critical difference from the beginning and the expectations that the higher risk appetite of the sponsor brings. Private equity-backed CEOs need to take calculated risks to grow value – no firm invests in the status quo.

Another trick for effectively managing the sponsor interface is to get explicit agreement not just on the objectives to be achieved in the value growth plan, but also the assumptions behind the goals. If the senior executive invests time to inform sponsors upfront on assumed boundary conditions to reach financial objectives, then discussions about why a target may have been missed are more constructive.

In summary, Walker of TPG notes the critical characteristics of the survivor CEO: "The perfect CEO is one who is striving for excellence rather than perfection. What it really comes down to is decisiveness. Effective leaders will align, engage and galvanise their organisations." For those with the right stuff, the rewards can be great.

Andros Payne is founder of management consultancy Humatica.

THE PERFECT CHIEF EXECUTIVE IS ONE WHO IS STRIVING FOR EXCELLENCE RATHER THAN PERFECTION

P8_RD12.03.15_Comment_PAYNE_v1gh.indd 8 06/03/2015 16:26