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WHITEPAPER

ORGANIZATIONAL EXCELLENCE – RIDING PRIVATE EQUITY'S THIRD WAVE OF VALUE GROWTH

April 2023

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SERIES INTRODUCTION

Why Organizational Excellence?

Private equity has become hyper-competitive. With abundant liquidity and highly structured processes, new levers to drive value growth and differentiation are needed. And higher inflation will only increase the pressure.

Humatica saw this wave coming and published 'The Third Wave' in 2015. Back then, we anticipated the rise in Organizational Effectiveness as a new and complex value creation lever. Our predictions seven years ago proved correct as evidenced by an increasing number of specialist "Talent Operating Partners" and greater focus on governance quality. But there is far further to go.

The risk-adjusted returns of private equity are starting to sputter compared to other alternatives. According to Bain & Co. liquid investments in the S&P500 yielded similar returns to US buyout funds over the last few years. After the first wave of financial engineering and the second wave of operational excellence, which are both now priced-in, General Partners (GPs) need new ways to create value and differentiate in the eyes of Limited Partners.

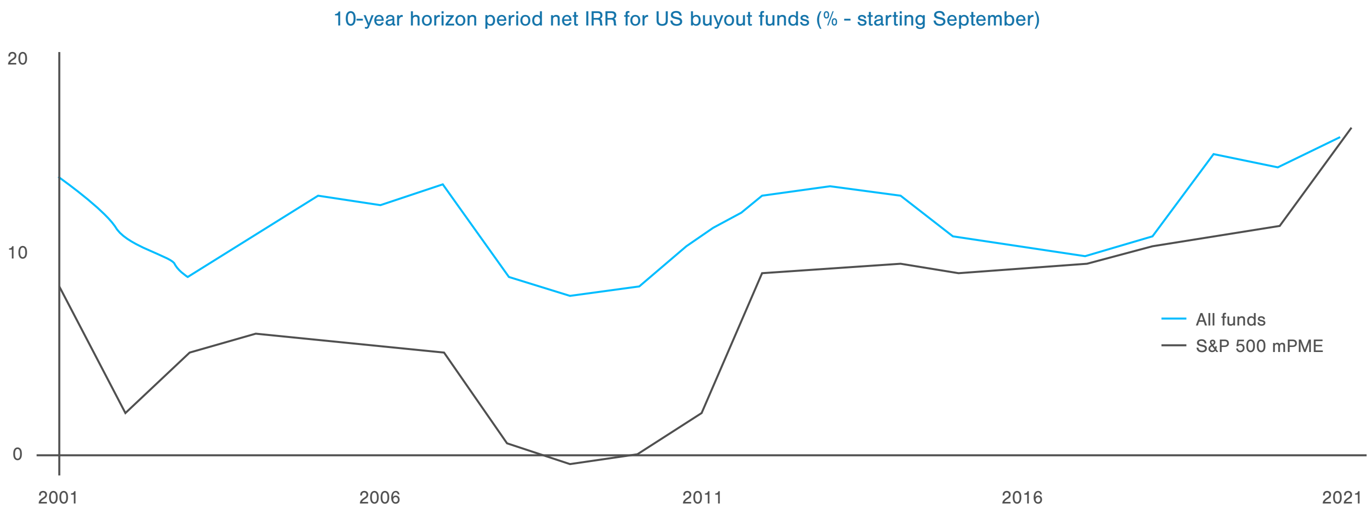

Figure 1 – Source: Bain & Company, Global Private Equity Report, 2022 – As of September 2021.

By focusing on Organizational Excellence, as the third and most complex lever, fund managers can accelerate operational excellence and sustained value growth in an increasingly turbulent market environment.

Organizational Excellence focuses on improving "soft" factors like culture, behaviors and management processes that sponsors are aware of, but struggle to properly address.

When asked what are the main drivers of deal success and failure, fund managers ranked soft-factors at the top. They include calibre and fit of the management team and alignment between the portfolio company and sponsor (Figure 2 & 3).

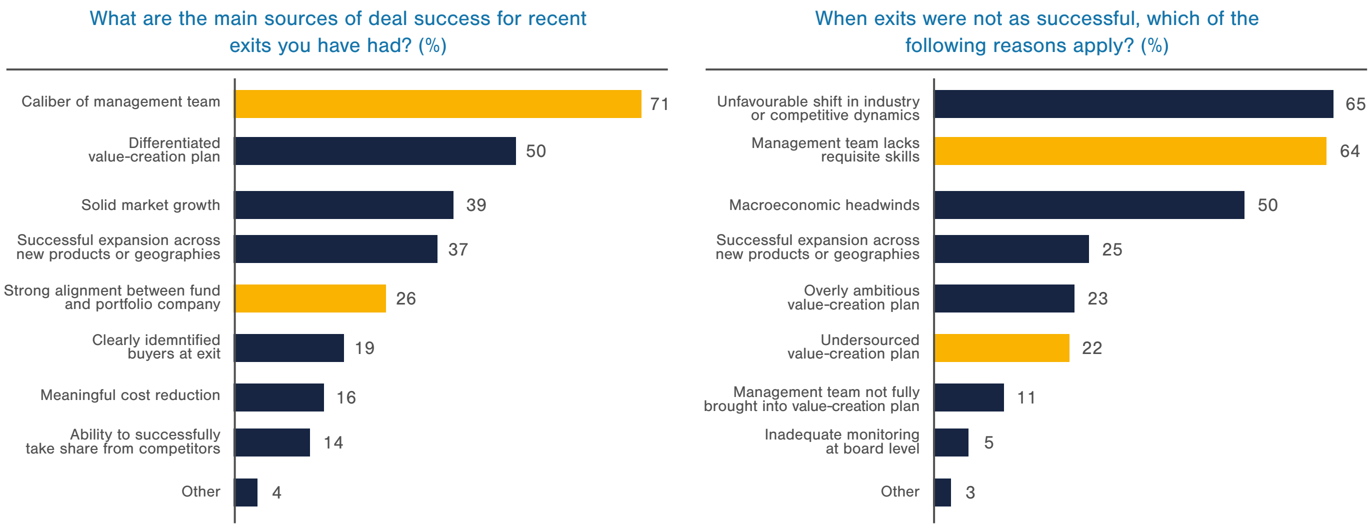

Figure 2 – Source: Bain & Company, Global Private Equity Report, 2021.

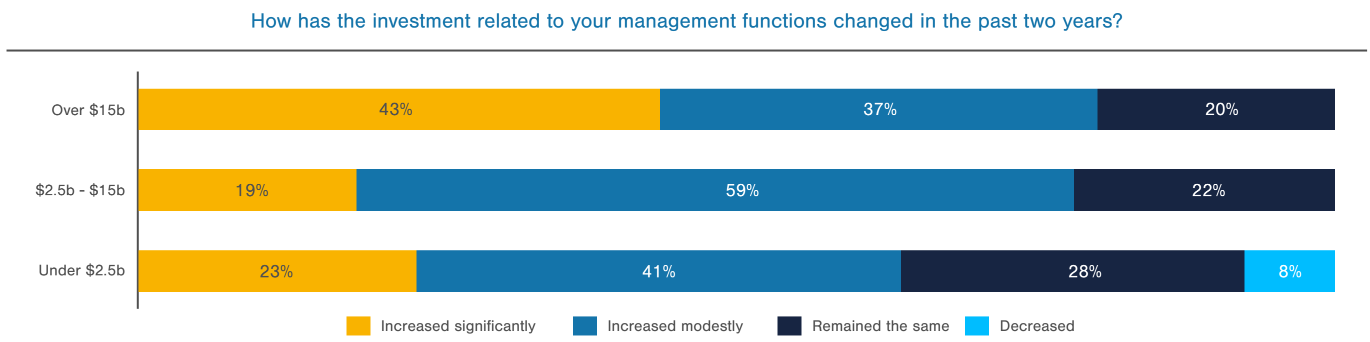

Figure 3 – Source: EY, Global Private Equity Survey, 2022.

As the realization that the organization and its collective ability to drive continuous adaptation are the ultimate source of sustainable value creating sinks in, more focus is turning to Organizational Excellence. A reliable leadership team, a good CEO, a high-performance culture, sound KPIs and mature management processes, a strong middle management bench, and a knowledgeable and capable workforce are all factors that differentiate between good and great investment returns. But, organizations are very complex, with many diverse and subtle drivers of performance. And, you are only as good as your weakest link. With a lack of codified management processes and best-practice behaviors, private equity sponsors are struggling to decipher how to address Organizational Excellence in a pragmatic way.

Our next series of articles, podcasts and webinars revisits our Third Wave Study findings to address four key elements to achieve Organizational Excellence:

- Leadership team excellence – It's not just the CEO
- Aligning and Activating middle management to drive change
- Codifying behaviours to decipher a performance culture
- Industrializing good leadership

We explore why these elements are critical for accelerating and de-risking full potential plan implementation. And, we provide pragmatic best practices that can be applied to tackle them.

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SECTION 1

Leadership Team Excellence: It’s not just the CEO

SECTION 1

LEADERSHIP TEAM EXCELLENCE: ITS'S NOT JUST THE CEO

The leadership team is a driving force for creating a high-performance culture and superior returns.

Contrary to conventional wisdom, getting the right CEO is not the most important organizational factor for success. The top concern is getting the right management team in place, including the right CEO.

Astute investors realize that the combined competence of the management team is greater than the sum of its individual members. It's one of the most powerful organizational factors that can "make or break" an investment. And, failure to act and make needed management changes early to enhance the team is the most common reason given for portfolio company under-performance (see Figure 1).

The way senior managers collaborate and augment individual strengths as a cohesive group is crucial for making good decisions and implementing the value creation plan at pace. Well-functioning leadership teams have a balanced set of skills and competencies to cover all the bases including strategic thinking, action-orientation, functional expertise, process know-how and sensitivity to people issues.

Has waiting too long to make management changes resulted in portfolio company underperformance within the last five years?

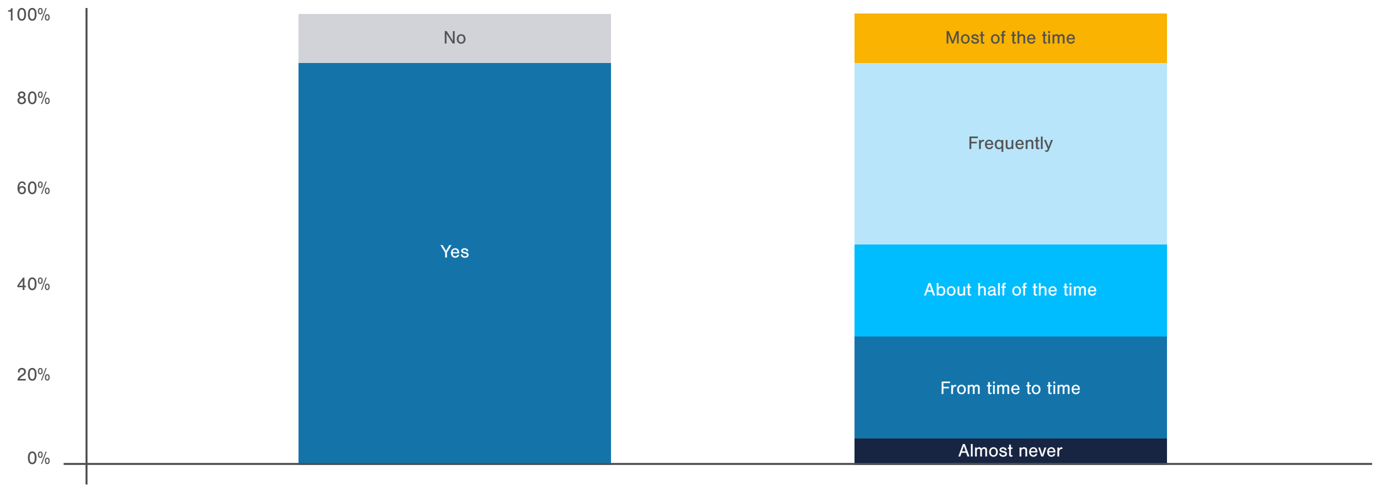

Figure 1 – Source: Bain & Company, Global Private Equity Report, 2021, Fund Manager responses

In particular, excellent management teams will bring institutional knowledge to establish best-practice management processes in all functions to enable mediocre managers to move from good to great performance. Diversity is also important in order to ensure no blind-spots in dynamic markets and growth cases where good decisions require connecting-the-dots from many different angles. Diversity also helps to ensure that different levers of influence can be applied to diverse cohorts and roles.

And the opposite case of a senior leadership team in conflict will leave the portfolio company dead in the water, without a compass and rudder.

Alignment of management team and private equity sponsor on value growth objectives and the governance are also critical prerequisites for success. It is puzzling how little time and effort is spent on explicitly aligning interests and mutual understanding between sponsors and management. A lot is left implicit. Getting fact-based transparency on the organization and management team in the first 100 days is a crucial foundation on which to develop trust and collaboration.

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SECTION 2

Best practice guide to assessing leadership teams

SECTION 2

BEST PRACTICE GUIDE TO ASSESSING LEADERSHIP TEAMS

While traditional leadership assessments can be seen as complex, subjective and even threatening exercises, there are other simpler approaches that sponsors can use to a get a fact-based understanding of leadership competencies.

Some of these best practices include:

ASK THE SAME QUESTION TO DIFFERENT LEADERS

A simple but very effective way to understand alignment and how the management team works is to ask the same question to different team members. This gives quick insights on whether information and opinions are shared, how communications works and whether or not the leadership team is aligned.

ASK FOR THE "WHY"

A good leadership team knows what the driving force behind their company is and how to use this "purpose" to motivate and energize the workforce. Leadership teams that are unclear about their company's purpose and/or values, and can't crisply articulate them or how they are translated in practice, fail to engage their workforces and create high performance organizations.

SURVEY THE ORGANIZATION

An anonymous employee survey capturing best practice leadership and management behaviors like Humatica's Altus, is an efficient way to get a fact-based benchmark on leadership team performance at all levels in one go. It is a great platform for delivering complete transparency as a basis for trust-building and collaboration between sponsors and management.

OBSERVE INTERACTIONS AND BODY LANGUAGE

Close observation of how the management team interacts during meetings is also a good barometer of excellence. Who is present in the meetings, who is not? Observe how the CEO interacts with and addresses his or her team. Gestures, eye contact, body language and behaviours often speak louder than a blue-chip CV or presentations.

TALK WITH CUSTOMERS & SUPPLIERS

The way customers and suppliers perceive the organisation is shaped by their interaction with senior managers. Do they have any interactions with the leadership team at all? The answer says a lot about how hands-on senior management is and how aligned they are when talking to external stakeholders.

"The way customers and suppliers perceive the organisation is shaped by their interaction with senior managers."

SECTION 3

Middle Management: Where the rubber hits the road

SECTION 3

MIDDLE MANAGEMENT: WHERE THE RUBBER HITS THE ROAD

Limiting assessments to the N-1 top-executives risks miscalculating the capacity of the portfolio company's organization to drive change.

Often overlooked, middle management is the critical link which translates the value creation plan into front-line actions. Winning hearts & minds and maintaining the trust of middle management is critical for any transformation process.

Gaps between management layers caused by differing incentives, poor communications or unclarity of goals can impair the cascading of actions down the organization and the escalation of emerging risks up during implementation – both of which slow execution of the value creation plan. In the worst case, hierarchical gaps are so large and trust so low that middle managers are passive-aggressive and silently boycott senior management and the PE sponsor.

In particular with mid-market buy-outs operating in niche markets, middle managers can have unique experience and subject-matter expertise which is indispensable and can't be easily replaced. When bench strength is thin, you have to fight the battle with the middle managers you have.

Middle managers often struggle most with the buy-out. They have little influence on setting value growth objectives, but must deliver on them.

And, org structure-, reporting line-, and leadership process-changes impact them more than other cohorts.

Finally, middle management performance and collaboration between levels in the organization are hard to assess due to their large numbers, a lack of fact-based transparency and objective KPIs. Performance at the N-2/3 levels is often a black box, even for senior executives.

Ensuring a strong and effective middle management that is aligned on the value creation goals is essential for translating the plan into action.

Middle managers often struggle most with the buy-out.

They have little influence on setting value growth objectives, but must deliver on them.

SECTION 4

Middle Management: How to “kick the tyres” before driving

SECTION 4

MIDDLE MANAGEMENT: HOW TO "KICK THE TYRES" BEFORE DRIVING

Humatica has pioneered analytical tools and methods to open the black box around middle management readiness and ensure smooth implementation of the value creation plan.

In particular, two key methods shed a hard-facts light on Middle Management's readiness for the next step in the value growth journey:

ASSESS MANAGEMENT PROCESS QUALITY USING A MATURITY MODEL FRAMEWORK

Utilizing a management process Maturity Model to conduct structured interviews on critical management processes for executing the value creation plan is a pragmatic and efficient way to assess middle management readiness. Maturity models come from the IT-world where they are used to classify the level of competence of programmers. They codify what good looks like at different levels of maturity.

The approach can be applied to management processes, which are otherwise not codified and left up to each manager to define as they see fit: A small independent shop likely manages field sales differently from a highly structured large corporate. A documented maturity model for management processes enables a pragmatic evaluation of the maturity level and readiness of middle managers in key functions.

To objectively assess management process maturity, it's instructive to ask simple questions about how middle managers lead their teams. How often do they meet? What do they discuss? Meeting agendas? KPIs? Do they note action items and follow-up? Are management processes being followed consistently across the organisation and best practice management behaviours shared?

There is not one right management process. However, the approach quickly identifies management processes that are clearly not mature enough to execute the value creation plan. This is where middle managers may simply not know what good looks like – a actionable reflection of their readiness level.

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ASSESS THE QUALITY OF DECISION-MAKING AND IMPLEMENTATION BEHAVIOURS IN EACH MANAGER'S TEAM

Humatica's Altus behavioural benchmarking tool and database can be used to measure the quality of behaviours and collaboration in each manager's area and between levels. In particular, the behaviours which drive the collective ability of a team to make good decisions and implement are critical for implementation of the value creation plan, and are driven primarily by the direct manager's leadership.

Benchmarking specific basic good governance behaviours like whether action-items are documented or followed-up on in a team is therefore revealing about the quality of mid-level leadership. And, by measuring specific team behaviors, identified outliers are translated into directly relevant improvement tips back to the team's manager. Altus is thereby an essential tool to identify bottlenecks in middle management and accelerate leadership development where the rubber hits the road.

The approach is also used to identify dysfunctional gaps between management hierarchical levels that hinder the effective flow of information and implementation, so that these can be addressed (see Figure 1).

By measuring specific team behaviors, identified outliers are translated into directly relevant improvement tips back to the team's manager.

Representative Altus Survey Scores

Question: Issues go unresolved in the company

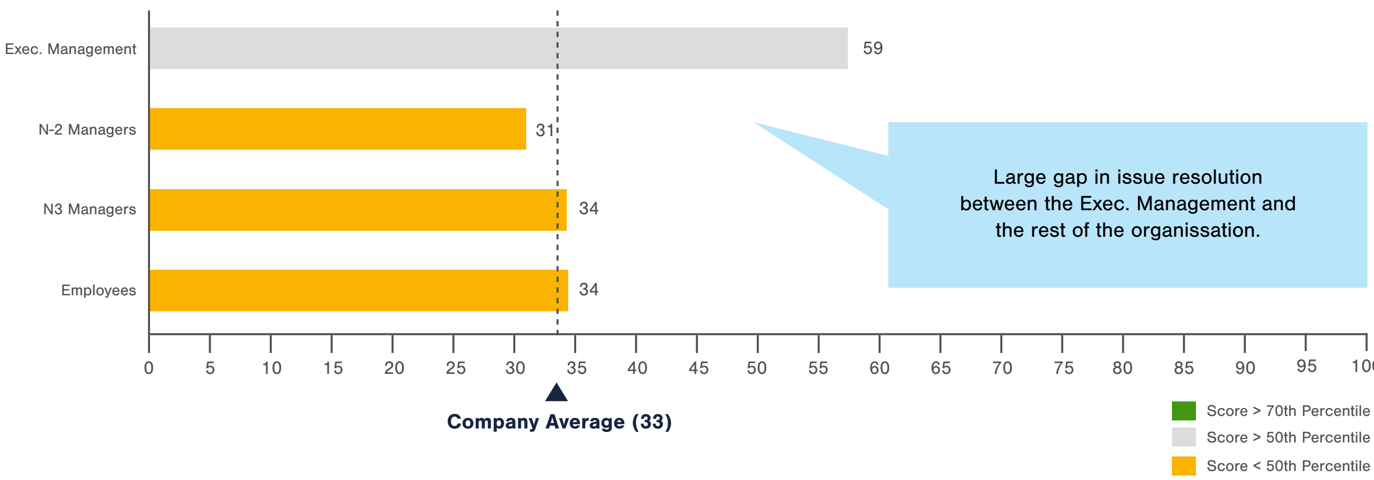

Figure 1 – Identifying hierarchical gaps in middle management

SECTION 5

Company Culture: How it drives value creation

SECTION 5

COMPANY CULTURE: HOW IT DRIVES VALUE CREATION

Corporate culture is a wonderfully fuzzy concept that is both liked and despised by investment professionals. They know culture is critically important, but don’t know how to measure and manage it.

PwC’s survey of private equity partners indicates that over half agree that cultural issues hamper value creation (Fig 1).

A good starting point is to define culture in the context of executing the value creation plan. For this purpose, we define culture as the set of unique and repeated organizational behaviors that drive the collective ability to make and implement decisions – that is, to adapt.

If action-items agreed in a meeting are neither documented nor followed-up on, this is characteristic of a non-committal culture with a lack of feedback and accountability.

A portfolio company’s culture will impact implementation of the investment strategy.

These, and similar behaviors make it hard to get things done and implement the value creation plan on time. And there are hundreds of other behaviors which collectively define a firm’s culture and drive its ability to implement change. Prior to Humatica, these behaviors and critical soft factors had escaped measurement and quantification. They were not codified and could therefore not be industrialized.

A portfolio company’s culture will impact implementation of the investment strategy. Even with an otherwise strong management team, value growth will be delayed if the culture is incapable of translating strategy into actions by making and implementing good decisions quickly at all levels and across functions. With a poor corporate culture, managers are pushing a string. On the contrary, an empowered, entrepreneurial, and result-oriented culture can transform a mediocre business to deliver outstanding growth and profits.

Did cultural issues hamper the realisation of value in deals?

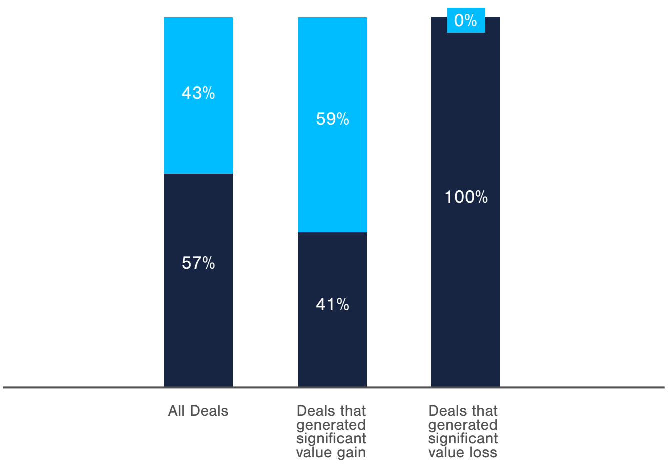

Figure 1 – Source: PwC, Creating value beyond the deal: private equity, 100 PE partners’ responses

> Transforming culture is neither easy nor fast, but it is doable. The starting point is to measure the specific behaviors which drive the collective ability to make and implement good decisions quickly.

Transforming culture is neither easy nor fast, but it is doable. The starting point is to measure the specific behaviors which drive the collective ability to make and implement good decisions quickly. This status-quo x-ray of the way the organization works is a catalyst for management to define specific culture changes that are needed in order to increase collective agility. It also generates employee buy-in and commitment for required changes.

Defining or augmenting a set of aspirational values and corresponding reference behaviors is another key step in the culture change process. Values provide a framework for managers and employees to calibrate their own, and other employee's behaviors. In particular, if they support trust-building, honesty and the free flow of information they will help to improve the quality of decisions and speed of implementation. Documenting, communicating, and living the values is one of leadership's most important contributions to shaping culture.

Management also needs to take actions which demonstrate and signal the agreed values and desired culture. This is particularly important for shaping the behavior of knowledge-workers, who don't respond well to a command & control leadership style. The CEO plays a uniquely important role for signaling as all eyes are on him/her. Publicly recognizing exemplary behaviors sends a powerful signal. And, sanctioning behaviors that jeopardize the values and/or a performance culture sends a clear signal on unacceptable behaviors. Leadership signaling for positive and negative outlier behaviors, drives accelerated culture change among the broad base of employees.

The best time to assess culture is immediately post-deal. This enables management to formulate and implement a behavioral change plan in time to get the benefits. By assessing the culture early, PE-sponsors understand how much time and effort are needed to shift the culture and realize value growth. Humatica's Align + Activate service, powered by the Altus behavioral benchmarking survey, are a catalyst to build consensus on cultural bottlenecks and how to resolve them.

SECTION 6

Company Culture: How to Assess it?

SECTION 6

COMPANY CULTURE: HOW TO ASSESS IT?

As much as a company with a good corporate culture can thrive even in difficult times, a firm with a dysfunctional culture can stumble in growing markets and thereby delay implementation of the value creation plan.

Assessing the aspects of culture which drive decision-making and implementation, enables PE-sponsors to understand how much time and effort is needed to activate the organization and accelerate full potential plan implementation.

Company culture assessment best practices include:

USE THE WEB

Company culture leaves a mark on everything it touches, especially on social media and ranking websites. The corporate website is full of information about the organization and a good place to start for understanding what is important for an organization and what not. How is the CEO ranked? What is the atmosphere at work? What is important during the recruiting process? The anonymous voices of employees can indeed be a powerful source of information on company culture.

LOOK AT HR PROCESSES

Assessing the maturity of HR processes is an excellent way to understand what value the company places on human capital and on the maturity of leadership processes. Do they have any leadership and development program? If yes, who are the participants and what are the goals? How are people hired? What competencies do they look for? How are people fired? Understanding the role and quality of HR processes is an important input to understanding corporate culture.

UTILIZE PLANT / OFFICE VISITS

Plant tours are guided, but nonetheless worth the time. During a visit, sponsors and senior executives have the opportunity to observe subtle but important behaviors. Are break-rooms and the common kitchen clean? Does each employee take personal responsibility? What are the signals from the body language? Do employees run away from the visiting group? Or, is there positive acknowledgement of the important role each employee plays? For the careful observer, the reaction of employees to visiting executives is very revealing about the culture.

LEVERAGE HISTORICAL EMPLOYEE SURVEYS

The results of anonymous engagement surveys can be helpful for understanding company culture in general, and what employees' key pain points and motivators are.

UTILIZE HUMATICA'S ALTUS BEHAVIOURAL BENCHMARKING SURVEY

The ultimate precise way to quantify a company's culture in the context of its ability to execute the value creation plan is to utilize Humatica's Altus employee survey to measure the quality of behaviours which drive the collective ability of teams and the organization to make and implement decisions. This approach allows a fast and pragmatic focus on measures which will specifically improve the fundamental capability of the organisation to implement change.

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SECTION 7

Good governance starts at the top, but it doesn't end there

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GOOD GOVERNANCE STARTS AT THE TOP, BUT IT DOESN'T END THERE

ESG and good Governance have become essential tools for sustainable value growth. But Governance in particular has proven elusive to measure.

That's a challenge because good governance is the foundation for competitive success, value growth, environmental sustainability and social responsibility.

The first step is to define what is meant by "Governance" in the private equity investment context. It as the quality of decision-making and management processes that drive good E, S and financial outcomes. Good governance enables firms to avoid errand decisions at all levels that increase risk (b), while taking advantage of market opportunities to boost a. With this pragmatic definition, it's possible to assess the drivers of good decision-making and governance.

In complex and dynamic business environments (like every buy-out faces today), good decision-making is driven by orchestrating the right interactions to drive superior collective pattern recognition among competent decision-makers. The number and experience level of decision-makers matters. Too many people, and decisions are slowed. And, if they don't possess relevant experience, then the quality of decisions will suffer. Business complexity also demands that a broad set of patterns (experiences) resides in the decision-making group. They need to collaboratively test alternatives from different perspectives before final agreement. This is the strong business case for diversity and inclusion in good governance.

Given the complexity of the topic and importance of board-level decisions, it's no surprise that funds are addressing governance top-down. Clearly, the composition and way a board interacts are critical for good decision-making.

But good governance does not end with the board. It permeates every level, function and location of the company. In a world where brand and enterprise value can be destroyed in an instant because of poor decision-making by a small group in a remote part of the business, governance on the front-line matters. Funds are starting to realize this and are beginning to measure the quality of behaviours which drive good decision-making and governance across their portfolios.

> "In a world where brand and enterprise value can be destroyed in an instant because of poor decision-making by a small group in a remote part of the business, governance on the front-line matters."

SECTION 8

Best practices in assessing governance quality

SECTION 8

BEST PRACTICES IN ASSESSING GOVERNANCE QUALITY

Assessing good governance is still in its infancy. The most common approaches are focused on interactions with the top-level board and senior executive.

The state of the art is starting to apply software tools and data analytics both at the board level and throughout portfolio companies.

AT THE BOARD LEVEL

Funds are spending more time to align the board composition up-front and monitor on-going governance excellence during the holding period. Beyond ensuring that the right mix of industry experience and diverse competencies are present in the board, some funds are investing in up-front team assessments to improve collaboration and the way board members interact.

There is more diversity in how funds are managing board governance during the holding period. The most structured have invested in customized on-line software tools to manage board documentation and provide a platform for continuous quality feedback. These tools can capture 360 feedback on every board member around each meeting. Did everyone contribute? Was the discussion hijacked?

Ongoing assessments are the foundation for periodic feedback discussions with each board member to ensure that their contribution is having the intended impact.

IN MIDDLE MANAGEMENT

Governance in middle management is assessed by looking at the quality of management processes in each functional area. Humatica utilizes a codified maturity model of documented best-practice management processes to assess the quality of governance. This can be done through structured interviews to understand management rhythms, management information, KPIs and feedback loops which dictate how decisions are made and implemented.

WITH FRONT-LINE EMPLOYEES

On-line tools like Humatica's Altus behavioral benchmarking survey can be used to measure the quality of interactions which drive the ability to make and implement decisions at all levels. Early-adopter funds have applied Altus across their portfolio to identify where behaviors are consistent with good governance and where outliers indicate risks in the way decisions are made and implemented. It's proven to be an efficient way to get early, fact-based transparency on at-risk teams and governance gaps. Transparency also provides a strong incentive for governance excellence at all levels in the portfolio company.

> On-line tools like Humatica's Altus behavioral benchmarking survey can be used to measure the quality of interactions which drive the ability to make and implement decisions at all levels.

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