THE IMPERFECT STORM: SELECTING TOP EXECUTIVES FOR TRANSFORMATIONAL INVESTMENTS IN PRIVATE EQUITY

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Dr. Alice Mann is an operating partner at Blue Wolf Capital Partners LLC. The Blue Wolf Capital Funds are a family of private funds which focus on transformational investments in middle market companies. For over 20 years, Dr. Mann has advised senior executives to build high-performing leadership teams, develop winning talent strategies, and design organizations that achieve outstanding performance results. As the firm's human capital leader, Dr. Mann drives Blue Wolf's human capital due diligence and works directly with the leadership of Blue Wolf's portfolio companies to develop their talent strategies and capabilities to deliver on their value creation plans.

At many organizations, boards and C-suite executives spend much of their time focusing on protecting their business model from outside influences. In the process, however, they may be overlooking a greater risk that is emerging from within – the impending shortage of C-suite talent that will be vital to drive value creation in the future.

A number of factors, ranging from demographics to increased market competition, are placing the possibility of filling CEO roles, in particular, that become vacant in the next 10 years at risk.

Imagine the following: you're the CEO for a company and you have to tell your board of directors that you've just under-delivered on EBITDA. No matter, next year's forecast looks much better, as you've recently executed a major acquisition that will position your company for growth and transformation. But, that transaction hasn't yet produced all of the cost savings that were forecast. You're confident that next year will.

Sound complicated? Now add in board members who disagree about your commercial strategy and what the business priorities should be for the next 12 months, much less the next quarter.

Successfully navigating this hypothetical board meeting calls for a particular type of CEO: a leader able to weather storms brought about by uncertainty, miscalculation, and misfortune. It's the kind of skillset that often proves invaluable in the context of private equity.

Leading Teams Through Transformational Investments

Private equity seeks opportunities to deliver substantial value in our messy, imperfect and highly complex world that others have either missed or lacked the risk tolerance to pursue. Building financial models and other analytical tools for approximating the uncertain realities of how a business, its people and industry will perform over time is integral to helping identify worthy investments. But beyond the numbers, the value of an investment is often dependent on a company's human capital; people with a particular mindset can make or break the profitability of a portfolio company.

As human capital operating partner at Blue Wolf Capital, a private equity firm in Manhattan, my job is to identify people who can lead teams through "transformational investments." These are investments that require several years of business transformation in order to prepare them for a sale to a strategic buyer at a premium multiple.

For example, a transformational investment could be a company that acquires its closest competitor only to require rapid innovation in its pricing strategy and software platforms to keep up with EBITDA projections. Or maybe it's a family founder-led company based in Texas in a developing industry that has invested handsomely in their facilities, but not at all in their systems, business processes, or talent. The people I look for to lead companies like this can't be faint of heart—they see these uncertain situations as exciting opportunities filled with promise.

But how do you select the successful leaders who will thrive in such an imperfect universe of opportunity? Not only do these leaders need to embrace challenges as opportunities within the companies they lead, but they must partner well with their private equity sponsors, adding another layer of complexity to company-wide relationships. We call people who fit this bill "imperfect leaders." And they're just who we're looking for.

Four Traits of Imperfect Leaders

These imperfect leaders recognize the chaotic world of transformational investments in private equity and can maximize value. I've also found that they tend to share four traits in common:

1) Imperfect leaders are comfortable making decisions and taking action with a sense of urgency and a laser focus on achieving results, because they are energized by uncertainties and complexities in business that others would find paralyzing.

In late 2013, Hologic was a leading manufacturer of diagnostic tools for cervical cancer and breast biopsy tools - but was still not producing strong returns. Former Stryker executive Stephen MacMillan was appointed as the new CEO to lead the company through a major transformation. The medical device industry is highly profitable but also one of the most uncertain. Nonetheless, MacMillan moved decisively. In his first 14 months, he top-graded his executive team, and the team increased the sales of a three-dimensional breast imaging machine made by the company that costs around $350,000. They drove up demand from hospitals for the technology by aggressively marketing three-dimensional scans directly to consumers, who then requested the scans from their doctors for them. MacMillan's urgent action dramatically improved the company's financial performance, with shares more than doubling in value over his first four years.

2) Imperfect leaders accept their own flaws and, by extension, the flaws and mistakes of their team members. As long as everyone can learn quickly from their mistakes and adapt their own behavior to fit the business situation, imperfect leaders press on.

Imperfect leaders have often faced their own limitations, whether through heart-stopping challenges, critical feedback from their co-workers, or company-wide hardships, but they have persevered nonetheless. In his bestselling business book, Principles, Ray Dalio, the founder of one of the largest hedge funds in the world, Bridgewater Associates, shares the origins of his unlikely success. His early years were scattered with failure. Intelligent, but a terrible student; fired from one of his first jobs for scandalous behavior.

To top it off, Dalio publicly predicted in 1982 that the economy was headed for a great depression. As history shows, he was dead wrong. But Dalio learned from this public mistake, understanding that getting it right required more listening and internalizing of the views of other smart people. Changing his behavior by taking the advice of those around him drastically changed his course, leading to the immense success he has achieved today.

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3) Imperfect leaders know that getting it right is more important than being right, so they surround themselves with smart team members who think differently than them. And they empower those people to openly disagree with them in pursuit of building a better company.

These CEOs are using essentially the same techniques to extract value from a risky business terrain that fact checkers and superforecasters use to extract facts in our "post-truth" world. In a Stanford experiment, 45 people were asked to evaluate the credibility of information on different websites. 10 were PhD historians, 10 were fact checkers and the rest were college students. The surprising result: PhDs didn't do any better than undergrads – and both did far worse than fact checkers.

The main reason for the fact checkers' higher performance was the practice of "reading laterally." They opened multiple tabs on their browser, evaluating the credibility of every site by going to another site — before even considering the site's content. Just like successful imperfect leaders, they were allergic to certainty and wanted to challenge every assumption.

4) Imperfect leaders are open-minded, transparent and collaborative about their decision-making in real time, leaving no surprises for their teams or their private equity sponsors. These leaders make excellent thought partners, because they are constantly seeking new and improved ways to run the business and lead their teams.

When Tony Hsieh founded Zappos, he created a radically transparent business model. Zappos' organizational chart is available in real-time online, allowing each of the company's 1,500 employees to view the purposes and accountabilities of every other employee. Browsable and updatable governance methods and policy updates are also accessible, allowing every employee to view and contribute to the ever-improving and evolving structure of the company. In his role, Hsieh compares himself to a mayor who doesn't tell his residents what to do or where to live but provides an infrastructure under which growth and innovation are allowed to thrive.

Unconventional Methods for Selecting Imperfect Leaders

So, how do you select for leaders that can navigate imperfect storms under changing conditions, quickly learn and adapt through trial and error, then go on to create high performing companies?

Just as I've discovered these four qualities of successful candidates, I've also found a major problem in the selection process. Despite the fact that Ray Dalio likely would have failed any conventional assessment tools for leadership selection, he is one of the top 100 billionaires in the world today. What gives?

Unfortunately, traditional executive assessment methods are not engineered to find imperfect leaders. Instead the industry seeks "ideal" candidates. What is an "executive scorecard" if not a description of the perfect state? What are "leadership competencies" if not a checklist for the profile of perfection? What is a "behavioral or cognitive assessment," if not a normative tool for quickly establishing whether a candidate's behavior and mental processing fits into an ideal range?

These conventional tools are important for establishing whether the candidate has a track record of high achievement and accomplishments that are relevant to the CEO assignment at hand. Does the candidate check the boxes on the industry knowledge and the technical and functional expertise they would need to excel at a specific leadership role? Are there any red or yellow flags in their leadership style and personality that would clash with the current team and company culture? Can they collaborate well and build a wide range of relationships with their team and their private equity partners?

The conventional talent assessment tools are critical for establishing a baseline of the level of experience, skills and temperament that a candidate must have to succeed in a particular role. All of this information provides important inputs to the selection process. But when it comes to selecting imperfect leaders, you can't stop there.

These tools alone won't give you all the indicators you need ahead of time to know why one founder CEO will successfully make the transition into a professional CEO in a PE-backed company and another won't. Or why one CEO can fill the shoes of his predecessor of forty-years despite having a completely opposite personality, but another with a more similar personality to his predecessor will fail miserably. A stellar candidate may pass all the conventional risk profile tests with flying colors, but still not have a clue about the rules for engaging effectively with diverse teams.

But you can look for other indicators for how a potential candidate will lead to get a glimpse around the corner of what a future partnership with them might be like. These are the indicators that often get missed in conventional assessment methods.

For example, informal reference calls with those in your network who have previously worked with the candidate can go a long way. You can do as many interviews with a candidate's previous customers as possible. You can be relentless about asking for feedback from the entire diligence team about everything from a management team's expertise to how they interact and communicate with external partners as well as the most junior members of the team. You can learn more about how they will treat their employees based on how they interact with your administrative assistant.

Often a potential candidate will tell you before the deal even closes with both their actions and their words what they want from a private equity sponsor. And whether that is to be left alone or have private equity partners set clear goals and expectations can make a huge difference to your alignment with them throughout the investment.

Much of the messiness (and the opportunity!) in private equity investments in transformational opportunities is created by highly imperfect human beings working together to generate large sums of money in a limited amount of time. It's a pressure cooker environment. And even with the most aligned and motivating incentives, such investments can involve many cooks in the kitchen working elbow-to-elbow together, often without a common recipe, and sometimes without all of the requisite techniques and tools. Private equity needs people with the right approach to creating value in imperfect situations. Not only must these leaders embrace business challenges as opportunities, but they need to lead and partner effectively with a whole slew of imperfect people.