Private Equity vs. Traditional CEO

By Michael K. Lorelli

A heads-up to directors: Sure, private equity and public company chief executives carry some of the same DNA and title, yet the operating and expectation differences can be huge—and capable of creating a fireball.

Shareholder vs. Shareholders

Not having the ongoing management of shareholders is a plus for the private equity (PE) CEO—no public earnings releases, analyst conference calls, important shareholder phone calls, preparation of fancy annual reports, and the like. The PE CEO enjoys the simplicity of one or a couple of shareholders—or does he? The PE firm has powerful and timely motives to succeed, creating a different set of pressures. I will disagree with every article that says PE companies are not under quarterly earnings pressure. In many cases, it's substituted with *monthly* EBITDA (Earnings Before Income, Taxes, Depreciation, and Amortization) pressures and loan covenants that sometimes require NASCAR-caliber skills to stay off the guardrails.

The PE shareholder is focused on three metrics: return on investment, cash-on-cash return, and hold period. Two of these three metrics place enormous emphasis on time. Public company long-term earnings-per-share (EPS) growth is not as time-sensitive as the bragging rights of a four-year hold period. The public company CEO has no hold period.

The result in some ways is perpetual. There is no hard cliff date, after which you've failed. This can (and does) lead to more financial intrusiveness into the PE CEO's daily life. It can be a plus, as the newly minted MBAs on the deal team are, after all, pretty good at this stuff and can carry much of the burden when it comes to areas such as renegotiating the loan or resetting covenants.

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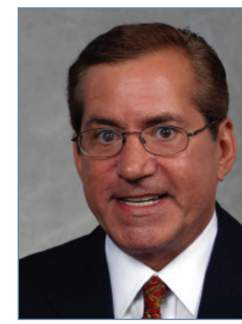
Private equity firms usually expect their CEO to be very heavily operationally focused, and in some ways to behave like a COO. That can be invigorating and fun for the right kind of CEO, particularly since the focus on EBITDA often doesn't afford the management layer of a COO at all—certainly a reality in small-cap companies. The PE CEO, therefore, needs to be totally comfortable and have the bandwidth to shoulder many responsibilities, even the mundane.

The flip side, particularly in the small-cap PE environment, is that it is truly "lonely at the top." Where do you go to confidentially kick the dog? My experience with PE deal teams is that the average IQ is about 160, so there is no shortage of mental stimulation. At one firm, I would book a half day in their office, often between board meetings and with a scant agenda, just to see where the conversation flowed. These were times when it was therapeutic to just let one's guard down and perhaps experience a few bonding moments.

PE CEOs of new companies have additional agenda items, such as the 100-Day Action Plan (how the deal thesis will be translated into an operational plan from the word "go"), and exit planning. Here is where the PE partners' contributions really shine. They have mastered the art of the 100-Day Action Plan and typically have tremendous resources to craft an Excel likelihood-versus-purchase multiple exit target matrix, with which the CEO can go and artfully cultivate relationships with the CEOs of potential next parents. Exit planning at a new company begins on day one.

PE deal teams nevertheless should be forewarned: Add value to your CEO or stay out of the way! There is a real difference between adding value and simply having your hand on the rudder. There's no faking it. The CEO's respect is earned. There is an art to constructive



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suggestions and engagement versus leading with your electoral votes.

PE CEO Candidates

A Top 5 PE firm has said that in 50 percent of its acquisitions there is an understanding that a new CEO will be recruited. Either the founder/owner/entrepreneur is cashing out or by mutual agreement, it is deemed that a different set of skills is needed for the next stage of the company. That same PE firm also said that by month nine, 50 percent of the CEOs are not standing. This redefines the expression "half-life of uranium."

This unfortunate result has lessons for the board involved in the selection process, for potential candidates as they boldly "opt in," for the recruiter who may want to notch another successful placement, and, of course, for the PE investor who at this stage may have tested his gymnastics to the limits with his limited partners. The time and money involved are significant: severance, recruitment fees, the onboarding of the second CEO, and so on. In the meantime, the hold period meter is ticking. A lost nine months because of the wrong CEO pick can seem like a lifetime—and to a PE firm, that *is* a lifetime.

The following characteristics best describe the PE CEO:

- "Jack be nimble, Jack be quick." The time pressures (hold period, etc.) of the PE environment put pressure on the stakeholders to change out the CEO much earlier if there are performance questions. Call it a faster trigger if you will, but those are the stakes. Management answers to their limited partners who are focused on returns. History suggests that Wall Street has more patience. Board members and recruiters would be well advised to err on the side of the candidate who both tolerates this immediacy and thrives on it.
- A Jack-of-all-trades skill set. She or he is indeed the chief cook, bottle washer, CEO, COO, Chief "Lended" Officer, and—given the scarcity of administrative assistants—may even have a trip to Staples on the to-do list.
- No corporate staff to write a strategic plan, and certainly no budget to commission assistance from a big-name consulting firm.
- The new PE portfolio company CEO had better cozy up and love the tight quarters shared with the deal team because they're in this foxhole together—and may even be sharing a pillow some nights.

It has been said by one recruiter that if you want a CEO candidate from a company like General Electric or PepsiCo, don't recruit an executive directly from GE or PepsiCo. Instead, find the executive who left one of the Fortune 50 companies to be the biggest fish in a smaller pond—only to fail, get kicked, fall in the streets, get rained on and shot at, and then picked themselves up, learned from the smaller company transformation, and successfully pulled themselves up by the bootstraps, and having been bruised, yes, by the experience, nevertheless learned the hard way to think and perform in an environment without all of the support systems.

To directors of PE firms, think about these observations from both sides of the fence. Some of these recruiting characteristics may have applicability to the search process for the new dawn of public companies, where Wall Street is becoming less and less patient.

After two tours of duty as a PepsiCo division president, I couldn't do what I do now without the skills I learned in that high-performance culture and environment. Yet I wouldn't trade my present day PE life for all the bitcoins in the world. The PE world offers truly unique and rewarding challenges, for both the portfolio company CEO, and its PE firm. The ideal next PE CEO candidate may be a blend of large company, smaller company, and PE experience. D