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Solving the "Problem Solved Problem:" Helping Private Equity Partners and Entrepreneurs Work Together to Build Great Businesses

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Ben Narasin and Michael Abbott have evidence that founders do a better job of raising money and generating shareholder value than "professional" CEOs. Replacing CEO/Founders can be expensive and create customer disruptions. And yet private equity (PE) partners find managing CEO/Founders so obnoxious, they often prefer avoid investing in first time entrepreneurs. Such a decision puts limitations on PE firms' addressable marketplace for investment. The inevitable law of supply & demand predicts upward pressure on PE buy-in costs. This article addresses ways that the turbulence of Founder/PE Partner relationships can be more effectively managed. Better management of the Founder/PE Partner relationship has strategic implications for capital raising, achieving the company exit strategy, and attraction/retention of key personnel. We examined five successful scenarios where CEO remained on the job three years or more after PE investment. Preliminary findings provide support for attribution theory: successful CEOs are more likely associated with PE partners who attribute Founder behavior to "state" conditions whereas unsuccessful CEOs are more likely associated with PE partners who attribute Founder behavior to "trait" conditions. Implications for successful CEO/PE Partner relations are discussed.

Ben Narasin of Triple Point Ventures and Michael Abbott of Kleiner Perkins Caufield & Byers (2015) examined 1.195 transactions between 1994 and 2014. These transactions involved IPOs or M&A exits. They gave the company "1" if the CEO was the founder or one of the founders and "0" the CEO was not.

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Founder CEOs raised more capital than professional managers and produced higher valuations. Value was defined as the difference between the company's valuation and the amount of capital raised. Their conclusion: founders generate more value. This article addresses CEO/Founders are "on boarded" when their reporting relationship changes from reporting to Founder Dominated Boards to reporting to Private Equity Dominated Boards The word "Board" is common to both entities. Very little else is common. Onboarding is a popular talent management tool to help manage risks associated with bringing new leaders into organizations. There are 334,000 references using the term in recent Google search. 76% of surveyed U.S. companies engage in a formal onboarding process for newly hired employees (Aberdeen Group, 2006). In the onboarding of Chief Executive Officers, however, there is little systematic research. This lack of research is not surprising. As a population, newly hired CEOs often pride themselves on their ability to "hit the ground running." Few CEOs request onboarding services at the time of hire. If it is offered, it is most likely rejected. (Sarros, 2007; Meyer, 2011). There is no published research on the subject, but most Private Equity (PE) Partners and Founder/CEOs report that things usually do go badly when Founder/CEOs accept private equity capital in return for PE control over the Board of Directors. Assuming that the Founder/CEO was one of the positive factors involved in the investment decision in the first place, helping Founder/CEOs successfully manage the transition from Founder Dominated Board to Private Equity Dominated Board should be of value to institutional investors, customers, employees, and vendors.

Method

To develop a framework for what "typical" is, we interviewed 14 private equity partners who were attending Boston chapter meetings of the Association for Corporate Growth, a national organization that serves as a resource for professionals involved in corporate transactions. These partners agreed to answer a set of open-ended questions. And all had at least five years of experience in the PE field. To determine how CEO/Founder onboarding takes place when things go well, we contrasted the general survey results with in-depth interviews with six pairs of CEO/Founders and their leading Private Equity Partners. Success was defined as the CEO/Founder remaining on the job for three+ years after the change from Founder Dominated Board to Private Equity Dominated board. Each person was asked similar questions in an open-ended format.

Results

In the general PE Partner survey, twelve (86%) stated that CEO/Founders they work with tend to remain as CEOs for two years or less after private equity investment. This reinforces the validity of using three+ years as an operational definition for success. Twelve (71%) of PE Partners attributed the departure to Founder "personality:" Founders become entrepreneurs because they like to operate with maximum personal freedom. PE members on Boards, on the other hand, have a fiduciary responsibility to institutional investors to see to it that portfolio companies are doing well. And for them that means getting involved in operational decisions like hiring/firing. This PE operational involvement is difficult for Founders to handle. They resent PE Partners' hands on the steering wheel. Two themes were most frequently mentioned by PE Partners when discussing the problems they had with Founders: "Smoke Gets in Y our Eyes" and "The 'Problem Solved' Problem."

"Smoke Gets in Your Eyes."

"Smoke Gets in Your Eyes" is a show tune written by American composer Jerome Kern and lyricist Otto Harbach for their 1933 musical Roberta. It became a classic Rock & Roll hit when recorded by the Platters In the context of Founder/CEO-PE Partner relations, "Smoke Gets In Your Eyes" refers to a common expectation that CEOs will "blow smoke" in PE Partners' faces in response to operational suggestions. "Smoke" refers to verbally saying, "yes" to a PE Partner "idea" and then doing nothing about it. Once "Smoke Gets in Your Eyes" this way, PE Partners find themselves on familiar ground knowing that they have a CEO they can't trust to execute. Once "Smoke Gets in Your Eyes," trust begins to vanish."

The 'Problem Solved' Problem"

A second category of Founder-CEO behavior revolves around informing the Board that there once was a problem but that the CEO has solved the problem. The CEO/Founder intention may be to provide examples to the Board of CEO effectiveness. But the PE Partner interpretation is that the CEO/Founder deliberately kept the Board uninformed about a problem that could impact shareholder value. What other issues exist that the Board is kept in the dark about? Once again, trust begins to erode. These two issues are so common among PE Partners they are actually predicted to happen.

And the attribution made is that it is the nature of the CEO/Founder's independent personality conflicting with the PE Partners' need for accountability to institutional investors. The most appropriate solution is to remove the Founder from the CEO role and find a CEO with prior private equity portfolio company experience. When Things Work Welln conversations with successful CEO-Founders, however, we found that the PE Partners were less likely to attribute CEO behavior to "personality." They were more likely to attribute the behavior to CEO/Founder difficulty of unlearning past behavioral habits of success that now may be counterproductive, given the nature of PE dominated Boards. PE Partners would take steps to help CEOs unlearn.

Smoke Gets in Your Eyes."

Entrepreneurs have the gift of being able to imagine a set of events that do not yet exist. They then take the steps to make that imagined event a reality. Social scientists call this behavior the Self Fulfilling Prophecy. (Downey et al, 1998). But that gift has a dark side when confronted with power shift at the Board level. Successful entrepreneurs often plunge ahead with their vision despite negative feedback. In successful situations, PE Partners expect their CEOs to mis-hear or fail to place the proper weight on PE Partners' "suggestions." A successful behavioral habit of staying focused on a vision despite negative comment is merely a behavioral habit that now must be unlearned. One CEO was encouraged to hire a General Counsel who had previous success in working with the lead director of the private equity firm that now dominated the CEO's Board. The partner and the CEO both agreed that this General Counsel would speak with every Board member between meetings to get a sense about how things were going. Three weeks before the Board meeting, the CEO and the General Counsel would sit down and plan for the Board meeting. Said the CEO, "I never walked into a board meeting not having an accurate understanding of Board issues with our business and issues with me. I would have distorted the information had the private equity partner spoken with me directly. I could listen less emotionally when the same information came from someone reporting to me."ne CEO received permission to place one person on the Board who was known as the personal friend of the CEO. This additional vote did not change the power structure of the Board but it did allow the PE Partner to use the friend as a back-channel communications tool.

In face-to-face communications between the Partner and the CEO, the Partner would use face-saving words like “suggest” and “advise.” But the CEOs friend was instructed to clearly inform the CEO that obedience was expected or the CEO would be fired.

“The ‘Problem Solved’ Problem”

Successful PE Partners would wait for the first instance of the “’Problem Solved’ Problem” as a way of unfreezing learned behavior. The CEO would be expecting to be complimented for solving a thorny problem. Instead the PE Partner would focus on how disappointed and angry the Partner was. If the CEO kept up this behavior, the CEO would be fired. The PE Partner would seize the stress of the moment to recommend specific structures be put in place to keep Board members informed about problems at the first sign of problems through phone calls and the monthly status reports. The PE Partner would then provide positive reinforcement by congratulating the CEO for reporting a significant problem to the Partner even if that problem has not yet been resolved.\

Theoretical Discussion

Attribution theory has proved to be a useful conceptual framework for the study of motivation. For example, Graham surveyed the contents of the JOURNAL OF EDUCATIONAL PSYCHOLOGY between 1979-1988 and found an average of 6.6 articles per year regarding attribution theory. She stated, “No other motivational conception has achieved this degree of visibility.” (1991). Attribution theory is the study of how observers and actors attribute the causes of behavior. Actors tend to give more weight to environmental factors that force them to behave the way they do (state attribution). And observers of actors tend to give more weight to enduring personality factors as a causal explanation (trait attribution). The difference is due to different levels of information each party has plus tendencies to rationalize behavior by distorting information (Taylor, 1983; Taylor & Fiske, 1978; Jones& Davis, 1965). The dynamic tension between state and trait attribution can often be seen in employees’ justification of behavior versus bosses’ reactions to those justifications.

The general sample of PE Partners tended to conform to attribution theory: PE Partners most frequently attributed CEO/Founder behavior to be "caused" by personality factors. The implication of this attribution is that personality is hard to change. It is easier to replace the CEO.

The attribution becomes a self fulfilling prophecy. In the sample of successful CEO/Founder transitions, however, the attribution was more likely to focus on state conditions: the difficulty for CEO/Founders to unlearn past behaviors that had contributed to past success. State attribution of behavior is a more optimistic conclusion, suggesting successful intervention is possible. Graham's article shows the power of attribution theory to help teachers be more effective in improving student learning: when teachers attribute poor student performance to "intelligence," teachers conclude not much can be done. And this is reflected in student performance. But when teachers attribute the same behavior to environmental factors, teachers are more likely to try creative ways of reaching students. This is also reflected in student performance. The present research has shown that these same ideas can apply in business settings when onboarding CEOs to the realities of power.

Implications for Practitioners

Onboarding is a popular tool in business but CEOs seldom request onboarding assistance. And yet it could be of value if offered. This study was a case where incumbents were keeping their jobs but the power structure had changed. CEOs derived benefit from onboarding interventions even in this narrowly defined situation. In a rapidly expanding business, it may be inevitable that most Founder/CEOs will be replaced. But if that replacement can be deferred for two or three years, there may be significant value for all stakeholders. E Partners want their portfolio companies to be successful but they are also incredibly busy. Many of the PE Partners we know are on seven Boards plus are managing time consuming transactions. They do not have the time to help CEO/Founders adjust to the new realities of power. And they may be the wrong interventionists anyway, since they are the new source of power. Successful PE Partners often employed third parties to act as a bridge. In one case it was a General Counsel who had special trust with botch the PE Partner and the CEO. In other cases it is the deliberate creation of a communications bridge between the PE Partner and the CEO through the management of Board memberships. Adding such a communications bridge to the Board might be a useful consideration.

Conclusions and Future Research Directions

This paper is a preliminary investigation about a rare but important issue in onboarding: CEO/Founders' jobs remain the same but the power structure changes.

As in any preliminary study, this research has limitations: small sample, a narrow geographic base focusing around the Boston, Massachusetts area, narrow industry focus that is heavily weighted with life science examples. Future research focusing in other areas of the United States and other countries would be welcomed.

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