AUGUST 2021

The Private Equity Sector Sees the Return of CEO Turnover

Dan Dunn

EXECUTIVE VICE PRESIDENT

After months of holding defensive positions amid a pandemic, many CEOs are taking the 2021 hiring boom as an opportunity to look for greener pastures. This is no less true in the private equity sector, where CEO turnover has long been an issue.

According to a 2018 survey by Alix Partners, 58% of private equity CEOs are replaced within two years of an investment. Over the lifetime of the private equity firm's holding of a company, CEO turnover jumps up to 73%.

When a private equity firm makes an investment, the clock starts ticking towards the eventual sale and hopeful profit that can be passed along to both the General and Limited Partners. What's most concerning to private equity firms is not only the turnover, but also the lost time spent recruiting and hiring a new CEO—not to mention the time required by new CEOs and senior management to assimilate themselves into an organization and begin implementing a new company vision.

Why CEO Turnover Remains High

For those in the private equity sector, the turnover rate of 58% in two years has a familiar explanation. When private equity firms purchase a family business, the new owners require the previous owner—who is usually the CEO as well—to stay on for a period of time to provide continuity in the business. Once that stay-period of roughly 1-2 years runs out, there is an agreement that the previous CEO will step down and the private equity firm will have the opportunity to choose their own replacement. Scenarios like this account for a large percentage of the 58% turnover.

The 73% turnover statistic is much more alarming and a cause for concern. The typical private equity purchase is held for 4-6 years. When you factor in a CEO replacement within that time-period, the ability for the private equity firm to attain desired returns and sell the business becomes much more difficult.

Strategic Hiring Can Lower CEO Turnover

The survey from Alix Partners brought up some valid issues, most notably the hiring and assessment process. When faced with choosing between the two, private equity firms prefer candidates with CEO experience rather than those with private equity backgrounds. In our experience, this preference makes a lot of sense, though there are some exceptions to keep in mind. The most important consideration is whether prior experience aligns with the position in question. Unfortunately, we often see private equity firms recruit executives from large academy companies to run their middle market business. While this sometimes works, the vast majority of such hires end with less-than-stellar results. There is a big difference, in so many ways, between running a division of a Fortune 500 company and managing a middle market private equity portfolio company. Talent is different, processes and systems are not as developed, and resources are often scarce. That's why an alignment between prior experience and the current role is essential.

Remove pandemic-related factors from the equation and you're left with four primary contributors to CEO turnover in private equity: lack of strategic direction, poor performance, poor communication, and lack of cultural fit. Pay special attention that last one, as a lack of cultural fit can cause or worsen the other three factors. With that in mind, how can private equity firms improve their chances of success by focusing more of their CEO assessment on cultural fit? Here are a few ideas we've found to have worked with our clients:

Step 1: Develop a Thorough Position Profile

Job descriptions are often generic, with details that could apply to a number of hypothetical roles. Many companies simply list major responsibilities of a job alongside a list of required skills and experiences. This seems like a prudent tactic, but it actually belies an important point: It is essential to recognize that in larger companies, *management* and *execution* are often relegated to separate roles; however, in a middle market business, the CEO is often responsible for both. The traditional levels of management don't exist in a middle market business—the talent is simply not there to delegate the work. Thus, a mere list of responsibilities in the job description isn't enough. It's important for candidates to know both what they will be responsible for and how involved they will need to be in getting it done. Equally important is for the private equity firm to be comfortable that the candidate understands and, ideally, can display examples of being in a similar situation.

Step 2: Clearly Define and Follow an Assessment Process

Lay out all necessary information regarding the interview process, including who needs to be involved and at what stage. Determine the competencies, skills, personal and professional traits required or desired, and discuss who will probe into a specific area. It's important to delegate responsibilities so that interviews are productive and provide relevant findings.

Begin with the end in mind: Conduct the final interview in a format that will reveal whether a candidate's professional and personal qualifications align with your needs; provide that candidate with the opportunity to understand the role and confirm if they are interested and motivated to take responsibility for the business.

Step 3: Don't Hire the Resume

All too often, we get calls from private equity firms that replaced a sitting CEO by picking a candidate with a seemingly impressive pedigree. The candidate's previous role was most likely with a large, reputable company within the industry. Whether it was a CEO or a Business Unit President, the private equity firm felt that they had hired someone from a prestigious organization who couldn't fail. As mentioned previously, however, this rarely works out, which is why those firms end up calling us for assistance.

Step 4: Seek Multiple Opinions and Feedback

References are important for more than just confirming experience and qualifications; they can also be used to solicit feedback on the personal traits, motivation, and best possible fit of the candidate. Speaking to people who know the candidate well can provide insights into the likelihood of fitting within the portfolio company.

Furthermore, trusted advisors to the private equity firm and portfolio company can assess a candidate's existing knowledge as it pertains to the firm. These advisors have a unique vantage point from which to assess the fit and performance potential of that candidate. Key people within the portfolio company may also be able to provide feedback on a candidate's potential cultural fit.

Finally, third-party assessment tools can provide insight into numerous candidate characteristics, including how they get things done and what attributes of leadership they possess, all of which contributes to a stronger assessment of cultural fit.

While there are no guaranteed steps to achieving 100% success in hiring, committing to an iterative process can improve upon past failures in identifying candidates with a high probability for success.

Post-COVID Strategy

As we get further from the worst days of the pandemic and normalcy returns, restless job seekers are finding a very friendly marketplace. Capable candidates are frequently seeing multiple offers, and companies are moving quickly to secure talent. This trend is likely to continue despite emerging COVID variants that are potentially halting return-to-work plans. Leaders must implement robust and efficient hiring processes and schedules because speed and efficiency are two of the key success factors in the current landscape. Besides staying on top of the quick-turn candidate market, this approach also ensures that candidates feel wanted and feel confident in their decision.