Getting strategic about human capital

Guest comment by **Matt Brubaker**

Investments in relationship engineering and other human capital strategies are generating greater returns for evangelist firms

While not generally known for being 'touchy-feely', private equity leaders today are becoming increasingly people-focused. Why? Because it's profitable.

High acquisition costs have created immense pressure as PE firms struggle to unlock sufficient value from their portfolio companies within compressed timeframes. The once reliable three-part playbook of financial leverage, operational restructuring and investment in growth has fallen short. Firms in the vanguard have overcome this challenge by adding a fourth prong to their approach: a human capital strategy.

Demystifying human capital strategy

PE firms are still learning about the levers they can move to align and engage the people within their portfolio companies to accelerate value creation. Such efforts, widely referred to as human capital strategy, are often mistakenly considered an offshoot of human resources or an area only worthy of piecemeal investment – a function to throw some money at and then move on to more critical priorities.

Too many PE firms have approached human capital strategy in this fashion, creating a self-reinforcing cycle of scepticism when poorly conceived, one-off approaches predictably fail to generate returns.

A portfolio company human capital strategy should be a comprehensive, diligent effort – devised in close collaboration with top leaders – that engages and aligns the board, portfolio company leaders and a layer or two of management below. Its goal is to ensure these parties deeply understand the growth strategy for the portfolio company, support it wholeheartedly, and are primed to execute it in lockstep, with passion and excellence, making adjustments as needed.

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This represents a major change for many PE leaders who traditionally found success meeting the human needs specific to their firm's investments with straightforward mathematical calculations. Previously, it was enough to bring in new, A-level talent and align monetary incentives such that leaders would be generously compensated upon a profitable exit.

But even the most motivated team leaders can, and often do, misunderstand priorities, focus on non-critical areas, operate in siloes and work at cross purposes. They thus fail to solve cross-functional challenges – often the greatest opportunities for accelerating economic value – and create delays that make it all but impossible to meet aggressively set targets.

A human capital strategy should employ a three-step process encompassing highly purposeful onboarding, sophisticated people assessment and ongoing monitoring and calibration. In so doing, PE firms can make certain their portfolio company leaders are strongly aligned with a growth plan and galvanised to implement it.

The most comprehensive human capital strategy today goes beyond instructing, assessing and motivating leaders, but further encompasses 'relationship engineering' – the intentional creation of productive professional relationships at and across levels of the organisation. Like financial engineering or operational engineering, relationship engineering represents a functional enhancement that serves the larger purpose of accelerating value creation.

Leadership in a PE 4.0 world

In their 2015 book *Private Equity 4.0: Reinventing Value Creation*, authors Benoit Leleux, Hans van Swaay and Esmeralda Megally described four industry business models for private equity since the 1940s.

- **PE 1.0:** from 1946 to the 1980s, a time in which PE firms used the junk bond markets to buy and split apart large conglomerates.

- **PE 2.0:** from the 1980s to 2000, a time in which PE firms made operational improvements in their portfolio companies through technology and other means.

- **PE 3.0:** from 2000 to 2008-09, a period in which PE firms introduced practices that generate profitable revenue growth.

- **PE 4.0:** from 2009 to present day, this has been about value creation via operational and profitable revenue growth initiatives.

We believe human capital strategies are now an indispensable part of PE 4.0. For portfolio companies to thrive amid higher acquisition prices and compressed timeframes to generate higher returns on them, the previous playbooks are grossly incomplete. Relationship engineering is now a vital part of the modern-day PE playbook.

Relationship engineering 101

Relationship engineering is one component of human capital strategy, but is among the most beneficial and difficult to get right. Done well, it establishes an early foundation of camaraderie and understanding, building trust among key personnel, even where a natural tension exists, and establishes norms for communication and protocols for how inevitable disagreements will be heard and resolved.

Most people understand that such positive relationships don't necessarily materialise on their own, especially in high-stakes business environments. It is far more common for dysfunction to take root and for organisations to normalise it, inadvertently accepting the accompanying productivity loss and missed opportunities.

The narrow distance between investors and management – compared to corporate boards overseeing numerous disparate subsidiaries – is illustrative. The close relationship is designed to provide a distinct governance advantage and primes a wider pool of experts to help solve portfolio company problems, empowering them to succeed where other business leaders might have failed.

However, this advantage is often wasted or thwarted because investors and management become adversarial. This happens for myriad reasons, such as portfolio company team members not being used to the pressures of private equity management and the speed at which change is required, or private equity leaders coming across as intimidating, especially when businesses underperform.

Relationship engineering makes it possible for difficult conversations to take place without upsetting the healthy human dynamics that keep people from splintering and losing trust. It breaks down barriers, getting PE firm and portfolio company leaders working at the same side of the table, such that empathy and mutual respect win out over intimidation, resistance and fear.

The result is that investors and management work in closer partnership, even amid disagreements and setbacks, to more quickly and constructively solve problems and meet goals. It also reduces turnover and creates a more pleasant work environment. The benefits of relationship engineering can also extend beyond board-management dynamics, helping sync portfolio company C-suites and the next few levels of management.

PE evangelists for human capital strategy

While relationship engineering and other human capital strategy components might sound outlandish to some, a growing number of evangelists have emerged. Vista Equity, which manages $31 billion in buyout, credit and hedge funds, has a 100-person consulting group that administers lengthy exams for all current and potential employees, measuring for social, technical, analytical and leadership skills, with six- to nine-month boot camps for new hires that provide big-picture insight on how the company makes money, how customers use its products, and best practices across company functions.

Alpine Investors, the software and services-focused firm, has changed its strategy such that it now recruits a CEO prior to identifying its next acquisition, allowing the new leader to participate in the due diligence process, thus putting talent first and foremost. Gryphon Investors tells us that human capital strategy is the foundation of their value creation toolkit.

Despite private equity's interest in human capital strategy trending upwards, many other firms remain resistant. They demonstrate an unwillingness to dedicate necessary time and resources to human capital issues, which they often dismiss or deem unavoidable.

These firms are entering an increasingly precarious landscape in which their competitors are more expediently solving the human-oriented challenges of their portfolio companies at the earliest possible opportunity. They thus risk creating significantly less value over the life of their investments, or the even more calamitous scenario of ill-fitting leadership and/or toxic professional relationships eroding their ability to generate a turnaround.

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