Privcap/ Video Series Briefing

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How to Optimize Human Capital in Your Portfolio Company

An executive summary of the Privcap thought-leadership series on human capital in portfolio companies

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How to Optimize Human Capital in Your Portfolio Company

Key Findings

1. *Good PE firms foster growth with an intelligent staffing strategy*
2. *A growth-stage company's founder may not be the right person to take to the next level*
3. *Human capital strategies should account for the "rule of one"*
4. *Often a founder needs to relinquish cherished roles to become a better CEO*
5. *Some founders are receptive to new staffing strategies, some are not*

The Panelists

Chris Capko
Vice President of Private Equity Strategy, ADP

Richard Relyea
Partner, Managing Director, 3i Group

Michael Thompson
Operating Partner, The Riverside Company

1 Good PE firms foster growth with an intelligent staffing strategy

Human capital is an important part of private equity—some might argue the most important part—especially when it comes to growth investing. Certainly growth companies have personnel needs that are more urgent than that of companies involved in late-stage buyouts or venture capital deals.

Good private equity firms understand this and devote a great deal of attention to installing human capital strategies that promote growth. This can be a delicate process. "It's always a tricky balance between investing for growth, putting in additional overhead costs, and allowing the business to pay for it," says Richard Relyea, a partner at 3i Group. "Often you're investing in a business ahead of growth, and you need to get the balance right so you're not overburdening the organizational structure."

PE firms also need to ensure that their company leaders understand which people are critical to the business and which people need to be replaced. They need leaders who are focused on value creation and growth and who will base staffing decisions on what's best for the company, not what's best for individual staff members.

"A lot of firms struggle to connect the dots between the management team and the team that's on the ground," points out Chris Capko, vice president of private equity strategy at ADP. "Are your people doing what they were hired to do? When we do an assessment, we often realize that 85 percent of back-office staff are spending their time doing things that are not strategic to the company."

Dialing Back the CEO

Michael Thompson
The Riverside Company

CEOs need to understand that if they take private equity to grow their business, changes will follow—for them and the company. The reality is that it's often necessary to add new talent to the organization, which means the CEO will have to relinquish some of his previous responsibilities and take on a more focused, strategic role.

"A lot of times you have a leader who started off as chief cook and bottle washer. He's out talking to customers as well as fulfilling orders," says Thompson. "Customers think, 'He's great. It's an awesome company.' But that may not be so good going forward, because at some point in time, you have to transition those relationships to other people prior to getting to the next sales cycle of the business." If the CEO is doing it all, the company is at risk if he suddenly decides to head for the beach or pursue a new venture. What's best for the CEO is not always best for customers, employees, and shareholders. And that's why everyone's interests need to be aligned if the company is to truly succeed, Thompson says.

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Mind the Gaps

Chris Capko
ADP

Private equity firms make many recommendations to their portfolio companies—everything from what type of enterprise software to implement to what third-party vendors to use. Capko says his firm conducts “portfolio-optimization projects” to identify gaps in the back office functions of portfolio companies. “It’s all about getting to that endgame and putting in place the infrastructure to do it.”

He recalls one company that had a significant number of gaps in its operations. He sat down with the CFO to discuss what needed to be done but quickly discovered that the CFO was resistant to making the needed changes. Capko had to impress on him the vital importance of filling those gaps, and the CFO ultimately—if reluctantly—executed on the plan.

Fast-forward a couple of years. The company had doubled its sales and was fielding acquisition offers. “The valuation went up to almost a billion dollars,” Capko says. “And at the end, we got feedback from the CFO telling us that if we hadn’t filled those gaps two years ago, we would have never gotten the multiple that we got when we sold.” That CFO also admitted that those changes went against his thinking, but looking back, he agreed they were absolutely necessary.

2 A growth-stage company's founder may not be the right person to take it to the next level

Founders are understandably attached to the companies they’ve run since day one. So it’s a delicate operation to ease out a founder if he’s not the best person to lead the company in its growth stage.

“One of the mechanisms to help you get aligned in terms of transitions in leadership is an agreement about a phasing out of that person’s role over time,” Relyea says. This could involve a period where that founder would be moving into a different role, such as on the board or as more of a pure investor.

“If you have a situation in which that works—where it’s right for the business and it’s an agreement you can reach—it’s amazing how much more aligned your decision-making tends to be about what resources are needed.” If a founder understands that his company—where he may still have a lot of capital at work— needs a new set of leaders in place, the conversation about his step to the side will be far easier. It will be less easy if he considers his new investors a temporary partner in his personal quest for success.

3 Human capital strategies should account for the “rule of one”

A small company usually has one person entering orders, one person doing accounts receivable, one or two people in customer service, a product-development person, an e-commerce manager, a buyer, and more. Investors must keep in mind that the company overall is only as good as the weakest link in this group.

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"A company may decide, 'Hey, we're going to have a product-development investment thesis,'" says Michael Thompson, an operating partner at The Riverside Company. "Then all of a sudden it gets derailed, because no one purchased some necessary part." So the company is only as good as the individual who drives that particular function. For human-capital management in portfolio companies, Riverside identifies the functions that are critical to drive what the firm's strategy is. "We may not install direct redundancy with multiple people, but we certainly make sure we have additional oversight in those key areas," Thompson adds.

4 Often a founder needs to relinquish cherished roles to become a better CEO

It pays to diagnose the founder's mindset before an investment, because odds are his role will change. "At least 80 percent of the time, we're trying to get the founder out of the functional discipline that they've been very adroit at," Thompson says. "And founders may struggle in that transition to bringing in talent, to letting go of some of the responsibility and decision-making."

When founders do struggle, sometimes dramatic actions have to be taken. Thompson recounts a specific example from the Riverside portfolio of a business that was sold based on that premise. "The CEO was outstanding as an innovator and product developer—but he really was never a CEO. His importance in this organization was embedded in product development. But we needed him to be a CEO, and we wanted to bring in somebody else on product development."

But Riverside knew that whoever they brought in would not be as good. So what did the firm do? "We transitioned that business to a strategic partner—not a financial partner—so they had some of those complementary resources," Thompson says. "That turned out to be a great result."

Transitioning to Ride Off Into the Sunset

Richard Relyea
3i Group

One of 3i's most successful investments in the last several years involved buying an industrial business from a husband-and-wife team whose son had taken over the company.

"Helping them to understand what we could do with the business under our ownership, in terms of the resources we could bring internationally and the appetite to invest in the business, caused them to want to not only choose us as the next owners of the business but to roll over a significant amount of their ownership in the business," Relyea says.

And because 3i had laid out a clear transition plan with the son, the firm was able to put in place the right management team at the right time for all stages of the company's growth. "The son stayed on as the CEO for the first several years, because he was the right person to take it from one point in the business' growth to the next point in the business' growth," says Relyea. And when it was time to step aside and ride off into the sunset, the son was also the right person to help 3i put in place the best CEO and leadership team for the next phase of the company's growth.

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5 Some founders are receptive to new staffing strategies, some are not

When a firm presents a founder with a plan to get to the next level, often the founder readily agrees... sometimes not so much.

Capko says he's seen implementing new strategies go different ways. "I've seen firms come in very strong and founders be very receptive to that approach, when GPs are really not looking for feedback, just looking for a receptive 'OK, that's great, we'll go with it.' I've also seen a strong game plan rolled out and then, once the GPs leave, the next day it's 'OK, we know they want to go in that direction, but we're still going to go this way.'"

He compares the strategy with a CEO to that of a manager of a successful baseball team. "What you do with a CEO, you sit down and say, 'What are you trying to do?' Some of them want to continue to create something great. Some say, 'I just want 3x my return on invested capital.'" ■

Expert Q&A

With Chris Capko
Vice President, Global Private Equity
ADP

Privcap: How do you work for private equity firms?

We developed a private equity program at ADP to specifically help private equity firms add value to their portfolio. We do that in a couple of different ways.

We start with working on their transactions. Then you move into the second lifecycle, how they manage their portfolio—we focus on portfolio-optimization projects that help their companies maximize human capital. Human capital management, or human capital in general, represents probably the largest expense for most companies.

But it's somewhat of an untapped market. No one's ever really been able to value human capital. It's been a soft cost. We've worked through a diagnostic tool to actually put a hard value on human capital and give firms a way to extract that value.

And when you look to firms that are going to exit an organization, we work with them to help professionalize their organizations before they put them up to bid. And that helps increase multiples and helps them sell it faster. ■

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