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PRIVATE EQUITY PRACTICE

Private equity: What do limited partners think of the talent within general partners?

In conversations with more than 50 limited partners around the world, we found that industry leaders expect to see general partners take an increasingly sophisticated and effective approach to their talent agendas.

In today's market of ever-increasing dry powder and high valuations, institutional investors (limited partners, or LPs) are increasingly scrutinizing their relationships with fund managers (general partners, or GPs), and talent remains at the core of most investment decisions. In a crowded environment, GPs face unprecedented scrutiny and increasing pressure to justify their fees and position their strategies and teams accurately. As interest rates and deal multiples continue to climb, it will only get harder for GPs to create value. And forward-looking LPs are increasingly aware of the critical role that talent assessment plays in their own investment strategies.

For the most part, GPs recognize that their business is relationship driven, but the degree to which they act on this insight varies. Some of this reluctance to act likely stems from a perception that LPs' opinions on talent run the gamut—but our research actually suggests otherwise. LPs are actively seeking evidence that GPs address fundamental issues such as leadership succession, the development of the next generation of talent, the maintenance of a healthy and entrepreneurial culture, and the transparency of decision making. In the past, LPs were willing to grant allowances to certain GPs on some issues such as transparency, but as LPs gain experience and sophistication, and as they commit more money to private equity, their views on GP talent become ever more important.

To learn more about what LPs are really thinking, and to help GPs strike the right balance between performance and building relationships, Heidrick & Struggles interviewed 52 executives from prominent LPs (chosen from the top 100 investors into private equity) to explore how they assess GPs when making investment decisions. We spoke with LPs across Europe, Asia, and North America, typically spending time with the lead investor into private equity and often the chief investment officer. Based on these insights, it is clear that GPs must do more to assess and portray their unique value proposition and differentiate their talent offerings.

LPs value performance data—but relationships increasingly triumph

A clear theme that emerged in our interviews was the increasing sophistication of LP assessments of GPs. Armed with more data than ever before, LPs can delve into highly rigorous analyses of performance data. "We have a template for due diligence, which has circa 100 data points, [that we use to] assess the underlying performance of the portfolio companies," said a leading UK LP.

However, there was wide recognition among the LPs that data and quantitative analysis represent just one component of the assessment process. "Performance data looks backwards," noted one LP. "It is what you see in the organization today and into the future that matters." LPs cited a range of qualitative factors—

including GP structure, processes, infrastructure, and, critically, talent—as the true differentiators in gaining that perspective. In addition to these assessments, nearly every LP talked about the importance of relationship building in their approach to investment decisions, noting the significant increase in co-investing.

"Relationships and referencing sit at the heart of what we do," said one of Europe's largest philanthropic investors. "Personal connections are where the value lies; we will reference across the markets to gain anecdotal and circumstantial insights. We do due diligence and build relationships with the partners of the firms we invest in but rarely probe any further."

The lead private-equity investor from one of the world's top 10 LPs clearly defined his function: "As a leader within this LP, my role is to shift colleagues from an early quantitative approach through to a qualitative relationship-based approach that assesses team dynamic, team constraint, and team decision processes. Our discussions with teams are for relationship insight, not data cross-referencing." As key trends in the marketplace continue to squeeze the margins on PE deals, this focus on relationships and qualitative assessments will only grow.

LP demand for co-investment is mounting

One key input into the growth of relationship-based investing is LPs' increased interest in co-investment. Indeed, the two are directly correlated: "LPs should be in the business of building long-term relationships and strategic partnerships, especially given the growth of co-investment," noted one LP.

The LPs we interviewed pointed out that stronger relationships through co-investment enable them to look beyond shortcomings in GP performance and focus on long-term relationships. "If we have an inherently positive view of the team and the strength of our relationship with them, then our desire to make long-term commitments and investments, as well as co-investment, can swing us in their favor in the case of marginal [negative] differences in performance compared to their competitors," explained one leading North American fund of funds LP.

Is there risk in concentrated relationships?

One LP commented, "We commit to somebody for 10 years, and after we commit, there is little we can do about it. Therefore we only go with people who are reliable, whom we trust, and who behave in the right way."

In addition to the initial work of relationship building, GPs must take care to nurture ongoing LP relationships—especially since most GPs have fewer and fewer of them. As the trend toward consolidation continues to gain momentum, LPs continue to place more emphasis on personal relationships even though they understand that their preference for certain GPs may lead to the exclusion of other, more qualified GPs that they know less well. In essence, many LPs are choosing the devil they know over the devil they don't.

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Indeed, closer and more emotional relationships between LPs and GPs can lead to significant subjectivity. The scale of financial investment leads to relationships that become "too big to fail"—LPs may overlook warning signs on performance, culture, or behavior just to validate their investment decisions—and that do not necessarily result in the best returns. We spoke with leading fund of funds investors and LPs at large North American institutions that are able to systematically switch their investors or teams from one significant GP relationship to another to avoid subjectivity and personal relationship bias. In this context, the size, resources, geographic proximity, and English-language skills of LP investment teams should not be underestimated.

Almost all investment decisions have talent at their core

Our conversations revealed several factors that LPs consider in assessing GP talent.

Leadership

LPs were nearly unanimous in their belief that GP leadership is a key differentiator in making investment decisions. As one LP put it, "The individuals on the team, firm leadership, and the depth of the bench of talent are very important. We do the appropriate work to check the strategy is backable, but without the people and extreme conviction in the team we cannot back them."

Some LPs mentioned that assessing leadership can be a difficult and subjective task—one even referred to successful leadership assessment as the "holy grail." Some LPs said they look closely at instances in which GPs found themselves in turmoil—and how they found their way out of it. "It is important that we can see the firm's ability to work through difficult periods or manage their way out of a challenge," said one LP. "We will scale back if we have wavering confidence in the leadership and their alignment—if there is a disconnect or disproportionate share of the economics motivating the main dealmakers." Others suggested that looking at the building blocks of the organization can provide enough insight: "Transparency, good governance, and alignment of interest from GPs, even during the good times, is refreshing and stand out when we see it. This is always driven by the GPs' leadership."

Succession and talent in development

In the minds of LPs, leadership evaluation is closely tied to succession. "In the best firms, you hardly notice succession—but we have withdrawn and will continue to withdraw from GPs on the basis of succession planning or departures or where we do not see new talent being actively hired," said one LP. Another noted, "We will actively consider not investing in the next fund if we do not see proper succession."

GPs must demonstrate to their investors that they have a viable succession plan in place. This is crucial for both the very senior levels of the firm and its pipeline of talent. The LPs expressed that they need to see evidence that talent is being actively recruited and developed with an emphasis on the long-term future of the firm: "We need to see and hear continuity and the passing on of knowledge within a GP if we are to continue investing," one Canadian LP explained. Another LP said: "We pay attention to HR processes within GPs, we are spending more time on this—the strength of a team and platform is based on people and whether they are going to stay and spend their careers with the firm. In an increasingly competitive labor market, this is becoming more important and we are hearing about it more from GPs proactively raising it with us."

A prominent European fund of fund LP summed it up quite simply: "On the three occasions when we have seen it go really wrong in 25 years, succession or generational change has been a key factor. A desire to cling to power is going to kill the franchise."

Culture and diversity

Several LPs cited firm culture as a key factor in their investment decisions. "We find the good firms are proactive in their discussions on culture; it is where you need to ask about culture that you should be worried," said one LP. Another noted, "We look for people who enjoy being at the firm. It is the best evidence of a team-based culture, and that is important to us." Or as another interviewee commented, "We are looking for people that really want to work together, not just earn together."

A leading European family office LP made a direct connection between culture and generational succession: "One of the best indicators of culture is how a firm pitches itself to its junior recruits and what career paths really look like, and how they operate. It means we can also assess their commitment to diversity, and this all ties into succession planning across the organization over three or four funds, and it really does influence whether we will increase or decrease our allocation."

LPs brought a wide array of perspectives on diversity, but there was general consensus that women and minorities are still underrepresented in GPs. LPs are highly focused on ensuring that the GPs they invest with are addressing this lack of diversity when recruiting, and they want evidence that diverse talent is progressing within the GP. They are also focused on diversity of talent within the portfolio companies controlled by GPs and think these companies should increasingly be held to the same standards as the public companies that LPs also invest in (through different teams and strategies). "We have been conducting a pilot on how many seats a GP nominates to portfolio company boards and what percentage of these have been women," said one LP. "Across our GPs, the percentages are clearly single figures."

Another explained, "We are spending more time thinking about gender diversity, not to the exclusion of other diverse attributes, but it is very important to us. We are very focused on it in our own organization. We are not at the stage where we expect it immediately of the GPs, but we do expect them to be thinking about it."

But the impetus for improved gender diversity is there. "You also have a challenge with 'identikit teams,'" said the European head of a leading global fund of funds. "If everyone is from the same background, what is the differentiator with their talent?"

Conclusion

LPs and GPs agree that talent is central to GPs' success. GPs regularly assess talent within an existing or potential portfolio company, as well as its culture and ability to accelerate performance under private-equity ownership. Rarely, however, do GPs apply the same level of scrutiny and rigor to their own organizations and talent.

We have seen more GPs appoint operating and, specifically, human-capital partners—senior team members whose remit is to make sure that talent and culture are aligned with the business objectives of portfolio companies. Indeed, the LPs we interviewed strongly supported the addition of a human-capital partner, particularly to GP operations teams composed of functional specialists. However, these roles rarely focus upon the GP itself.

Many LPs believe that "human capital at a GP is the remit and purpose of the managing partner," in the words of one. But sophisticated LPs are closely analyzing the approach GPs take to their portfolio companies. They expect to see a systematic, periodic evaluation of management teams that provides data to inform decisions and generate healthy returns. In turn, this analytical approach is beginning to inform their views on how GPs themselves recruit, develop, lead, and harness a diverse talent base.

In practice, a focus on relationships means a focus on talent. The LPs we interviewed agreed that many GPs would benefit from a third-party assessment of their talent and culture as they prepare for LP qualitative due diligence. Such an assessment would be more rigorous than an LP inquiry. It would help GPs not only to build better relationships with current and future LPs, but also to build better organizations with sustainable futures. In the words of the head of primary investing at one of the world's largest pension funds, "Returns are only as good as the people that are still there." And some GPs clearly have ample opportunity for improvement. "Everyone talks about investing time in growing talent, but most GPs are focused on 'now,'" lamented one LP, despite the fact that truly successful organizations depend upon long-term efforts to create a culture that values leadership, succession, future generation development, and diversity. ■

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