EightAdvisory

Trust: a major driver of value creation

Private Equity funds survey

May 2024

8 EIGHT INTERNATIONAL

Summary

Executive Summary

Eight Advisory surveyed a sample of Private Equity funds to analyse their views on the role of human capital in the performance of their investments. This qualitative field survey highlights the essential role of trust in the management team as a key success factor in the relationship between shareholders and business leaders.

Over the course of the year, we spent more than an hour face-to-face with managing partners, directors, account managers and shareholders from 11 different investment funds. We selected funds with an "interventionist" profile, as they are likely to take majority interests in SMEs.

> *Trust is a major factor: without it, no project can succeed.*
> Eric Tabarly

Deals are a highly financial subject, and seemingly the least "human" in the corporate world. Every transaction seems to be evaluated in terms of the company's potential growth trajectory and current and forecasted profitability. However, when asked about their investment criteria, two thirds of fund managers spontaneously emphasized the importance of human capital: *"Meeting and fitting in with the management team can lead to an offer. Or not…".**

When the human capital is discussed in greater detail, the word "trust" is repeatedly mentioned. While it is clear that trust alone is not enough, our survey results suggest that the choice between potential offers is based on this statement: does the fund team trust the current management team to deliver on the business plan? *"An average deal with a good management team can become an excellent operation, whereas a deal with an average team will never become a good one".**

Our research supports the hypothesis that trust is the most important non-financial factor when it comes to private equity investments, however by its nature it is difficult to measure and subjective based on personal relationships.

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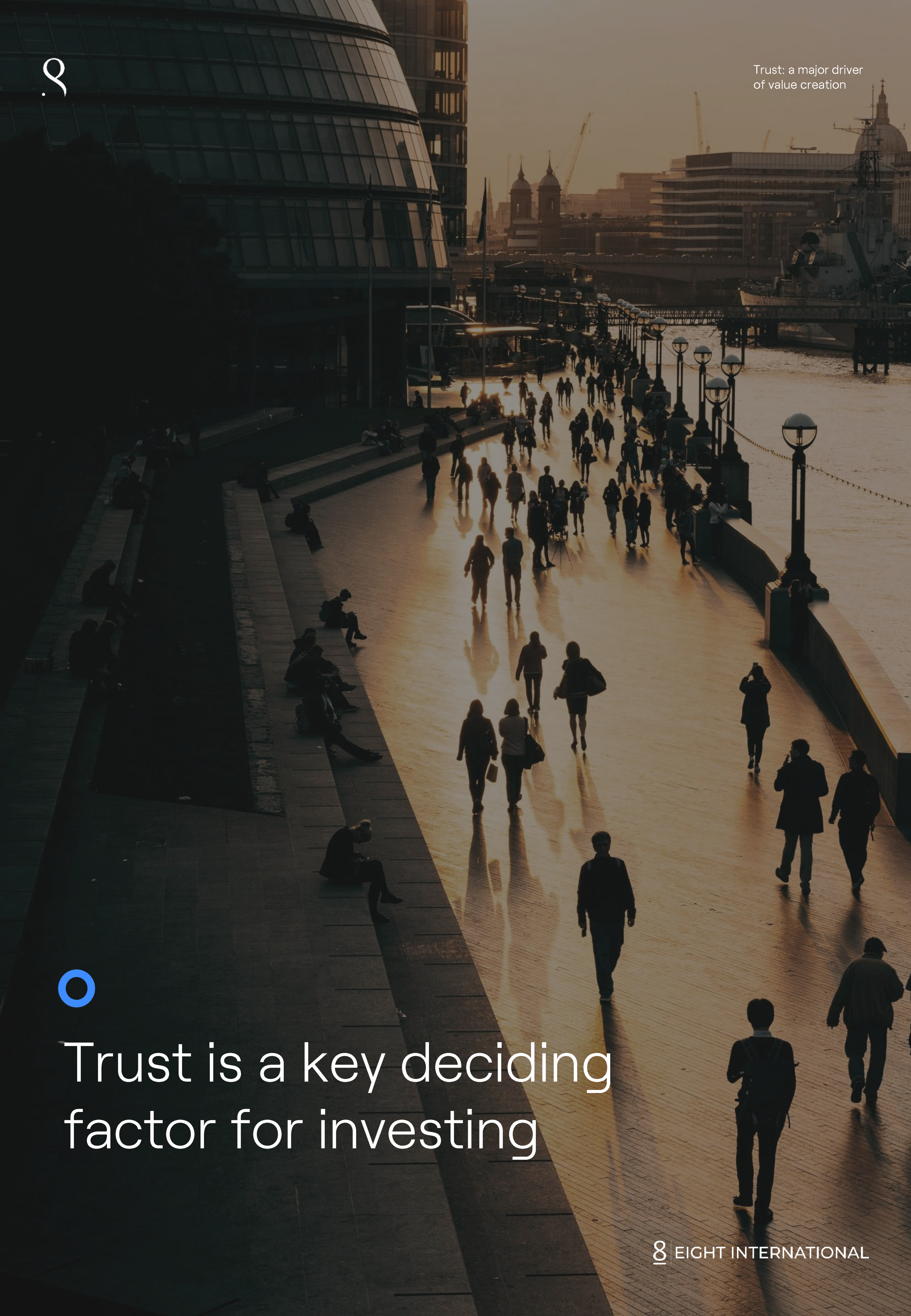
* Quotes in italics were taken directly from our interviews



Trust is a key deciding factor for investing

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A key success factor, yet still so difficult to measure ...

The common criticism of Private Equity is that they are only interested in the financial performance of their investments. This is a simplistic view. It is clear from our survey that human capital is a key factor, and that trust can sway the decision making to invest.

As we know, due diligence across a variety of areas are carried out to give funds a clear picture of a company's business, its operating and financial performances.

Unlike these seemingly more "tangible" areas, management competence, one of the cornerstones of trust, is not easily measurable. Numerous approaches with varying degrees of complexity allow us to assess the capabilities of management teams.

Some funds rely on intuition, while others have established routines that rely on external third parties. Finally, a few have put in place comprehensive procedures and sophisticated tools to help inform an objective opinion of the management team with whom they are considering a deal.

As a result, executive “assessments” and managerial due diligence are becoming increasingly common practices. The latter in particular provides us qualitative data to assess the management team performance. This enables an understanding of the company's current organization in the light of its history, and to identify development prospects and improvement areas.

We are seeing an increase in the popularity of these approaches, as Private Equity professionals are becoming more aware of the potential consequences in a misjudged opinion on a target’s management team..

Lack of trust in the management team does not give employees the opportunity to fully commit to achieving strategic objectives. Yet employee disengagement has a cost, estimated in 2018 by Gallup at nearly 100 billion euros in France (1).

... whose absence can be very damaging ...

When a fund doesn't trust the management team, a lot of time and energy is lost in confrontation and extra governance. The main sources of mistrust and tension between funds and management are a lack of interaction, communication and/or misaligned interests.

"People forget why they signed the pact, why they were aligned in the first place", reports one interviewee. If management and the fund are not aligned, vision and strategy can be interpreted depending on each person's experience and interests. This can lead to conflicting decisions and implementation of actions that are not adapted to the company's challenges.

When asked about the root causes of situations that have become complex and tense, one interviewee tells us that *"complicated situations are often due to a poor appreciation of the quality of management, linked to a lack of due diligence or too few interactions prior to the transaction".*

Conversely, a relationship based on mutual trust has many virtues.

Trust is a key deciding factor for investing

... trust can be a powerful value creation lever

The positive effects can be seen in the relationship between the fund and the managers, and between the managers and the teams.

Building trust between the fund and the management team enables a compounding of benefits:

- When the fund fully trusts the management team, and the latter feels it, we have seen that more initiatives are taken, teamwork is encouraged, and operational issues are prioritized appropriately.

- When, in turn, the management team trusts the investing fund, they are more likely to take its opinion into account when making decisions, to seek out the right expertise at the right time from its partner, and to move away from the vision of *"the "financial bad guy" to discover what the fund can bring to the table."*

This notion of mutual trust is particularly relevant in today's increasingly complex business environment. It can save significant time and energy for private equity professionals, knowing and trusting that the management team is in control. Similarly, when a management team has the support of the shareholders, it enables more focus to be placed on business operations and strategy, rather than wondering how to justify this or that decision.

At the same time, a relationship of trust between the management team and employees is essential for optimum performance, as it enables :

- greater commitment from employees, who through the intermediary of their manager, have a better understanding of, and support for, the fund's strategic objectives.

- a reduction in staff turnover and prevention of the risk of "quiet quitting", a phenomenon recently observed in companies.

- increased motivation. Psychologists such as Bart de Jong, Kurt Dirks and Nicole Gillespie have shown, through behavioral experiments and physiological data, how trust plays a part in motivating individuals to cooperate and strive towards common goals (2). Trust in one's manager, and in management more generally, has a significant influence on whether or not a person is willing to stay with a company, but also to go beyond his or her job description.

Taken to its logical conclusion, trust permeates interpersonal and team relationships, and also changes decision-making and governance methods. Buurtzorg, a homecare company, has based all its operating methods on principles founded on trust and delegation. Not only has the company experienced very strong business growth, but its impact on healthcare costs in the Netherlands has also been massive.

Trust enables teams to achieve their full potential, and generate the growth and performance expected from an acquisition. Why is it that this criterion, which is so important at the time of an investment and in the life of a company, is so little considered at the time of deals, and so little worked on within companies?

Sources: 1.) Marion Perroud, Challenges, June 20th , 2018; 2) Bart de Jong, Kurt Dirks and Nicole Gillespie, "Trust and Team Performance: A Meta-Analysis of Main Effects, Moderators and Covariates", Journal of Applied Psychology, April 2016

Understanding the complexity of trust to build it and maintain it

Understanding the complexity of trust to build it and maintain it

A multi-faceted concept...

In our view, this key factor is rarely emphasized by investors, as trust is often perceived as complex, difficult to define and constantly evolving. It is a dynamic asset that is built, tested and maintained.

- Trust is in fact the result of a complex process, as it is built up at different levels: as an individual or as a collective. It is shaped by each individual's personality and context.

  As contexts constantly evolve, the level of trust evolves in parallel, revealing its multiple dimensions: the same person can inspire more or less trust depending on his or her situation and the subjects to be dealt with.

- Trust is tested. Some people trust a priori, others a posteriori. In both cases, trust only endures if there is an alignment between the statement "I trust" and the actions demonstrated. It's the actions that will enable the other person to trust you. Or, rather the opposite, cause them to lose confidence.

- Confidence needs to be nurtured and maintained as a muscle. By respecting certain principles, sometimes applied without realizing it, trust can be established, maintained or improved.

The complexity that lies behind the development of trust explains why it is difficult to apprehend and measure during a deal.

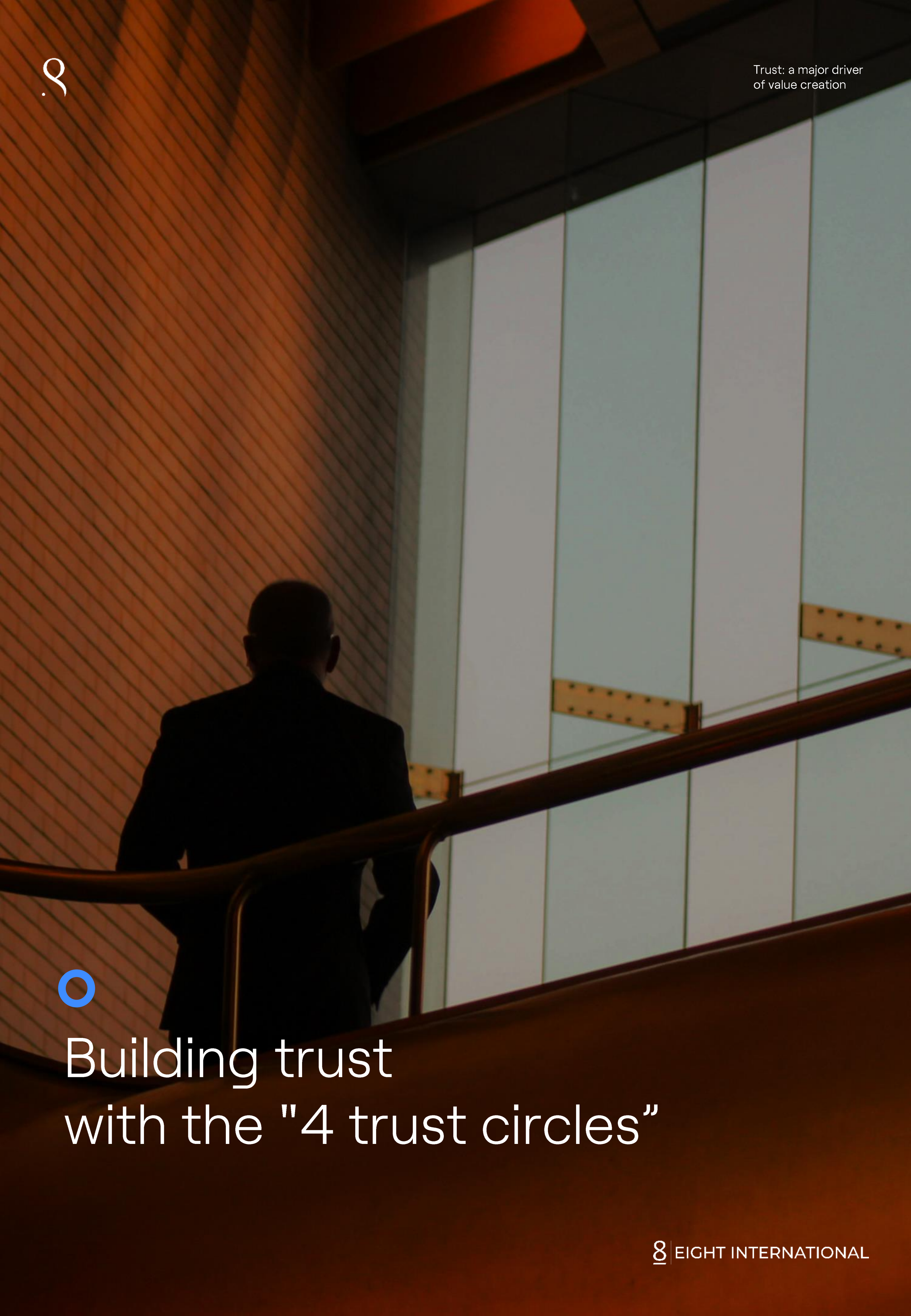
... that can be worked on concretely

These different facets are illustrated by concrete and documented use cases.

Thanks to its dynamic nature it can be worked on, nurtured and developed, as Best Buy CEO Hubert Joly testifies in his book “The heart of business", in which he explains how trust in his management team and employees was key to turning the group around. According to him, the three imperatives of a company are human, business and financial.

Convinced that he could save the company by mobilizing employees rather than seeking to reduce headcount and payroll, he placed particular emphasis on human energy production by remaining transparent about difficulties and encouraging vulnerability. Transparency and vulnerability are at the heart of his vision of trust and are part of the "4 trust circles" model developed by Eight Advisory.

Like Hubert Joly, we're also convinced that building trust is possible and, above all, essential to developing and improving a company's operational and financial performance. That's why we've developed this original model, which has been enriched and refined through our own experience.



Building trust with the "4 trust circles”

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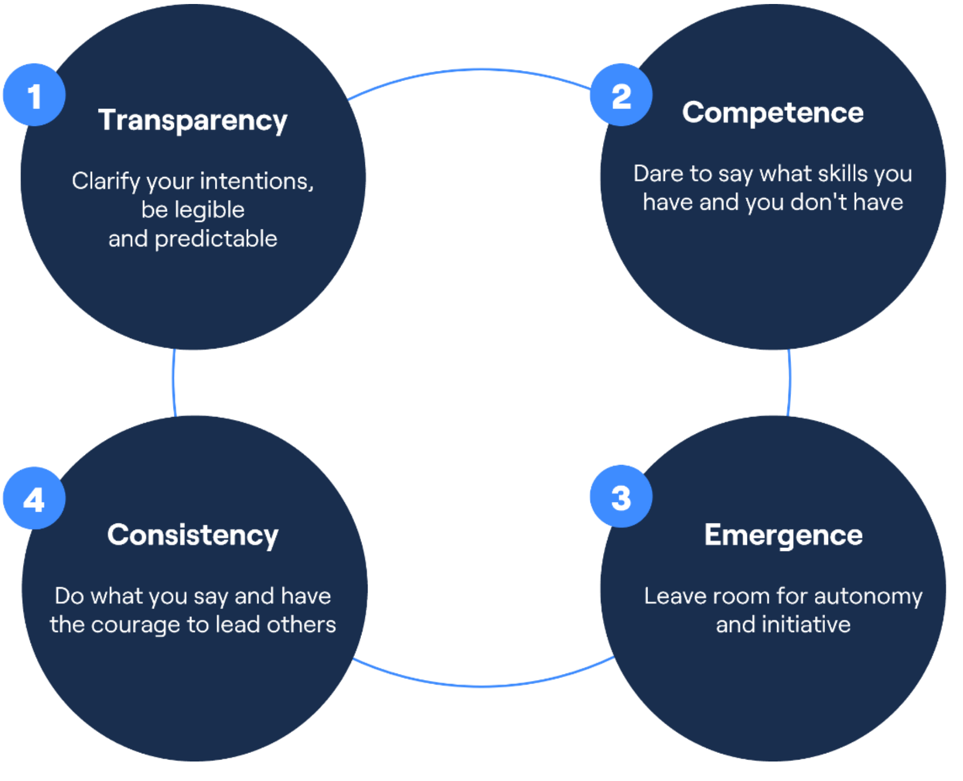
Building trust with the "4 trust circles”

Our "4 trust circles" model is designed to create and grow trust in very tangible ways within organizations, and in their relationships with stakeholders, including of course their shareholders.

Four circles to create and strengthen trust

Trust within management teams, or between shareholders and executives, is created and developed through four circles: transparency, competence, emergence and consistency.

These four circles help build healthy relationships that accelerate the generation of trust between individuals, teams and organizations.



Building trust with the "4 trust circles”

1 Transparency

Clarify your intentions, be legible and predictable

The first key to building mutual trust lies in an honest and open working environment. For a private equity fund, this means sharing its expectations with management, clarifying the reasons why this acquisition has taken place and not another. Managers need to understand both the fund's vision for their company's future and what is being proposed as a plan in order to be reassured and committed. Finally, there must be agreement on clear and explicit ground rules.

However, there is a nuance to transparency: not everything can be shared in real time with everyone. This is not an injunction to immediacy. In the pre-deal phase, for example, confidentiality applies. Similarly, it's important to think about the communication timing.

In our experience, up to 4 working sessions dedicated to transparency between the ExCom and buyers can be necessary to establish a healthy environment enabling collaboration and setup the foundations of a trusting relationship. This work, involving each member of the management team individually and collectively, helped to clarify the relations and working methods framework between the Group and the subsidiary, and to align them on the 3 /5-year vision.

2 Competence

Dare to say what skills you have and you don't have

Competencies reflect our ability to accomplish a mission and achieve a goal. It can be the case that managers do not fully understand how to achieve the fund's desired objective. A useful tool for building trust is to give the management team the freedom to express where their vulnerabilities and knowledge gaps. The fund can then suggest its own experts in support of the plan, recruit a person or implement any other actions to achieve objectives without compromising the new-found confidence.

In our experience we have seen that the management team can require significant coaching and development to formulate a 5-year strategic plan, shared by the operational teams, at the fund request. The first few weeks required a great deal of pedagogy, as the management was not operating within a framework that allowed them to admit that they didn't know how to implement the plan.

Building trust with the "4 trust circles”

“Emergence" means giving the management team the flexibility it needs to take ownership of the strategic project and facilitate its implementation. It also refers to a sense of "freedom within the framework“ that the management team can provide its employees during the project implementation, thus encouraging creativity and initiatives.

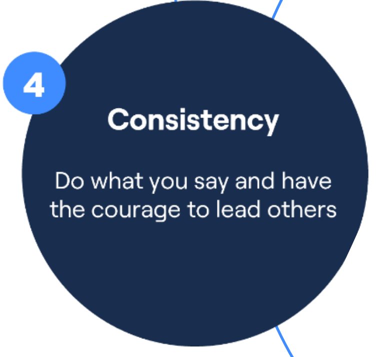
Autonomy can be seen as the driving force behind performance. It enables individuals to apply and develop their skills. Autonomy also fosters appropriation of the company's challenges.

The difficulty for the shareholder is to find the right balance between control, by setting a framework, and allowing autonomy within that framework. Defining the "size" of the framework encourages initiative, creativity and commitment, all of which boost performance.

An industrial company in the defense sector implemented a decentralized, empowering management system, which resulted in a strong cultural change. Managers were given the opportunity to experiment with new working methods in a "test" environment, aligned with the management principles they had co-created, before implementing them with their teams.

Consistency is first and foremost a principle applied to oneself, applying commitments made to all partners, management, employees and investors. High standards also means being able to react when trust is broken, in order to restore the balance.

There are a variety of responses in the event of a breach of trust, the most severe being to sever the relationship. Private equity funds are accustomed to taking strong decisions in the event of underperformance, even if this means parting with company management. It is essential to take into account this decision significant impact on the management team's trust in the fund. Explaining the decision in relation to shared objectives in full transparency helps to avoid a panic effect within the group and to turn it into a positive effect of continuity with commitments made.



Conclusions

Conclusions

Despite being difficult to assess and quantify, trust is the driving force behind a virtuous circle in group performance. A majority of the funds we interviewed outlined their regret towards complex and tense situations arising from a profound lack of mutual trust with management. The 4-circle trust model is an approach we have developed precisely to create this climate of trust.

The interdependence between the different circles of the trust model is obvious: we need to be demanding by making things clear, allow initiatives to emerge according to each person's skills, and constantly ensure that trust is maintained and developed within interpersonal relationships, within teams and in all actions carried out. Companies and funds can work on each of these components in parallel to foster the trust that generates human and ultimately financial performance. This is yet another opportunity to illustrate that funds have more than just the financial prism in mind, and they are committed to highlighting the human capital of the companies they promote and accelerate development for.

Thank you

We'd like to extend our warmest thanks to all those who took the time to answer our questions, helping us to advance our thinking on the subject of human capital and performance measurement.

Many thanks also to Léa Forest and Nicolas Bignon for their essential contribution to the writing of this article, which also owes a great deal to the exacting and benevolent proofreading of Christian Berling, Nicolas Cohen-Solal and Alexis Karklins Marchay. Our sincere thanks to them all.

Some of the funds that agreed to answer our questions:

Azulis capital

Triton

Sienna Investment Managers

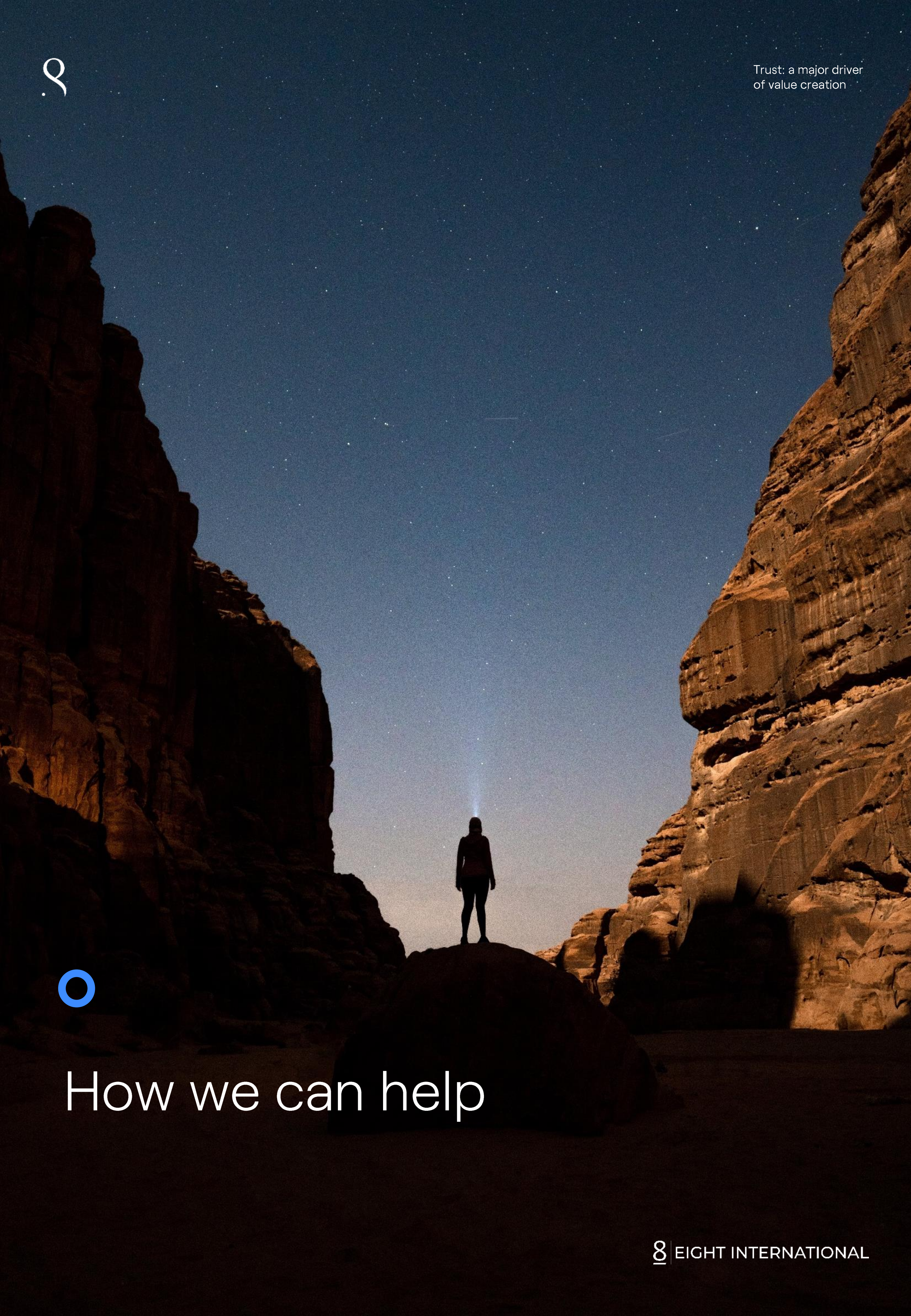
Bridgepoint

Latour Capital Operational Equity

Amiral Gestion Entrepreneurs Investis

Hivest Capital Partners

bpifrance



How we can help

How we can help

Eight Advisory is an integrated transaction, transformation and restructuring advisory firm with over 850 professionals, including over 100 partners, operating globally. We support clients in large cap and mid-market private equity investment communities, and management teams within corporates to navigate the complexities of a changing world: identifying, creating and realising value.

Founded in 2009

In 2009, experts with Arthur Andersen and Big Four backgrounds created Eight Advisory

Dynamically growing

Our team comprises +850 experts, including +100 partners

Built on the foundation of entrepreneurship, excellence and respect, our senior and experienced professionals deliver engagements in a hands-on, joined-up way. Our clients benefit from focused support which is value-driven, responsive and proactive and, with 15 offices across Europe and the US, we operate globally with a local feel.

Global reach

15 offices in France, the UK, Germany, Switzerland, Belgium, the Netherlands, Madrid and New York

Integrated approach

Working as One Team globally. Our DNA is a seamless combination of expertise.

We have built a one-stop shop for PE firms and their portfolio companies by combining all the different domains of expertises required throughout the investment life-cycle with our sector insights and our international geography. Our Private Equity Services help drive value creation from the identification of potential investments until the exit from the company.

Results oriented

We are providing the right technical expertise and a human approach to finding concrete solutions

Independent & trusted

Free from corporate finance or audit conflicts

Contact our People & Organisation experts and see how we can help you!

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