The Managers Are On Trial
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By **Carly Chynoweth**

INVESTORS ARE INCREASINGLY RUNNING THE DUE-DILIGENCE RULE OVER THEIR MANAGEMENT TEAMS AS WELL AS THEIR ACCOUNTS.

Watch out for the off-message manager

David McClelland is managing director of Carlton Strategy Advisors, a commercial due diligence firm. "My job is to take a view of the business's commercial strengths," he said. "I want to make sure it has a sensible strategy and that the management team is sharp enough to deliver it.

"Within two days of starting a project I interview the board. First I talk to them together, so that I can see the roles they play, how they interact and whether there is one dominant ego. Next, I spend at least an hour with each of them individually. There are a few particular warning signs. One of the biggest is when people are off-message. In other words, they start telling me the priorities of the business and they aren't the same as those in the strategy. I also worry if people are too focused on their own individual departments.

"If I pick up on any of these problems, I recommend the client calls in specialists to deal with them."

Securing investment used to be so simple. Get the financial and legal due diligence out of the way, go to lunch with the private equity firm or venture capitalist and — provided you didn't spray your peas all over the financier's expensive suit — you were good to go.

Today more and more investors are running the due-diligence rule over management teams as well as the accounts. Problems with management quickly feed into poor performance; resolving them after the deal is done can be time-consuming, distracting and detrimental to the investment.

John Glencross, chief executive of Calculus Capital, the private equity company, said: "Financial, legal and commercial diligence are all vital, but the people are probably the single most important factor with respect to return on investment.

"Far and away the strongest correlation with performance is whether the management team is up to the task of doing what they said they were going to."

People are probably the single most important factor with respect to return on investment Failing to conduct due diligence over the top brass may have costly and long-term consequences. "By the time you have disentangled the issues ... you have an underperforming investment and the time and cost of sorting it out," Glencross said.

Tim Worrall, a partner at Diligencia, the management due diligence consultancy, helps banks, private equity firms and venture capitalists to assess whether management teams have the skills, knowledge and experience needed to meet targets.

Usually he spends three or four hours interviewing each member of the board or the senior management team, though for a recent job he also assessed managers at the level below.

"The financial sponsor was concerned about the ages of some of the top team and wanted to be sure that things would keep running smoothly if some of the top team decided to retire," Worrall said.

He considers four things: does the management have a vision for the business; is there a plan that will get them there; can the team deliver that plan; and do managers know how to measure whether or not they're on track.

Worrall will also check that people fit their roles. "We are not overly reliant on psychometric testing but we do use some fairly simple profiling," he said. "A managing director or a CEO will have a very different profile from, say, a finance director. If not, we would probably have some concerns."

Investors will also need to be certain that individuals, particularly entrepreneurs who are used to making their own decisions, can work within formal business structures. "The client will want to know that the managers can work with the chairman whom the investor wants to bring in and that they can work within the governance structure," said Jana Klimecki, director of management due diligence at Tyler Mangan, the consultancy.

"For example, we worked on a project involving an entrepreneur who had never worked in an organisation other than his own. That's a risk because he suddenly had to adopt governance processes, go to meetings every week and tell people what he was doing. This is something that people can find very hard to deal with."

Glencross has walked away from at least three deals because the management teams were not up to scratch. "In one case, the feedback on one key individual was discouraging," he said. "In another, we felt that the team would not hold together. We felt tension dealing with them."

In most cases, however, consultants simply recommend changes that investors should make before proceeding with a deal. Mitch Titley, a partner at Gresham, the private equity firm, said: "Management due diligence points to cracks that we can heal before they become rifts." This may mean bringing in extra support, such as hiring a less senior manager to take over operational responsibilities, thus freeing a director to focus on strategy, or offering coaching to help improve particular skills.

"We also use [management diligence information] when selecting the chairman. For example, if the chief executive was very good operationally but not strategically, we would look for a very strategic chairman. If the finance director was weak we would seek a chairman with a strong finance background," Titley said.

The due diligence process may not end with the buyout or the investment. "Often investors structure [a deal] so that they have the power to restructure the management. Only about a third of finance directors make it through to exit, and sales guys are often replaced, too," Klimecki said.

Titley said bosses should not fear the diligence process: "We are not trying to find faults; we want to enhance the value of the business for everyone. This is about finding areas of the team that can be improved, not looking for weaknesses. It provides the chairman or CEO with an assessment of his or her own team.

"It's quite difficult to sell management due diligence to the management team initially, but often when they have had it, they really see the upside." If a team was very closed to the idea, he would question whether or not the company was the right one to invest in, Titley added.

David McClelland *is Director of Carlton Strategy Advisors Ltd. CSA is a commercial due diligence and business strategy consultancy, with clients across the Private Equity, Bank and Corporate sectors.*

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