Do you have the right CEO for your current business climate?

Some private equity firms make investments that span a variety of industries, while others may focus on one specific sector. Each sector has its own defined expansion and contraction periods, and a CEO who excels at managing their companies during one phase of the cycle may not be the best person for the job in a different cycle.

Global economic factors such as energy prices, geopolitics, industry maturation, obsolescence through disruptive business models as well as general microeconomic factors may dramatically change the original thesis used to make the initial investment and thereby challenge the leadership model of a portfolio company.

“There is no one current business climate/cycle for portfolio companies, as each is different,” stated Brent Williams, managing director and member of the Investment and Management committees of The Halifax Group. “Some are cyclical, some counter-cyclical and all with different drivers.”

Where some sectors blossom, others slump

Although the common belief is that periods of economic expansion are good for business across the board, this isn’t the case - and, conversely, not every company and industry suffers during tough times. In a white paper published as part of Fidelity Investments’ quarterly Leadership Series Compendium, the financial services company’s Asset Allocation Research Team broke down the different phases of the business cycle:

- Early cycle, a.k.a. the preliminary recession recovery phase
- Mid cycle, a.k.a. the momentum-gathering phase that culminates in peaking growth
- Late cycle, a.k.a. the pre-recession phase when profit margins deteriorate and growth rates stall
- Recession

The team went on to offer examples of industries that flourish and wane during each period:

- **Early cycle**: Interest-rate-sensitive industries such as the financial sector perform well, benefiting from increased borrowing. Meanwhile, IT and industrial areas tend to experience boosts in anticipation of economic recovery. The energy, telecommunication services and utilities industries typically lag in these circumstances. Expansion-minded, innovative CEOs thrive during the early cycle.
- **Mid cycle:** The IT sector performs best during this phase - particularly the software and hardware markets - thanks to companies’ increased willingness to make capital expenditures. The utilities and materials industries usually top the list of

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laggards. With business chugging along in the mid cycle, CEOs who refuse to rest on their laurels and instead look for ways to improve upon the current status quo can take their companies to the next level during this phase.

- **Late cycle:** In response to inflationary pressure buildup, the energy and materials sectors flourish, alongside health care. IT stocks, however, often take a dive. Pragmatic CEOs who do what it takes to ready their companies for the inevitable recession phase are extremely valuable during the late cycle.
- **Recession**: Industries that provide staples on which consumers are less likely to cut back tend to do best in a recession, such as health care, telecommunications and utilities. The technology and industrial industries are typically hardest hit, while the financial sector also experiences a downturn. This is the phase within which "wartime" leaders excel.

Companies in some sectors come into their own during recession conditions, while others blossom during the different phases of recovery.

What is the current business climate for a portfolio company?

Although enterprises may reach their peak performance during different points in the business life cycle according to which sector they belong to, it is still possible to make industry-agnostic assertions about today's corporate climate. In a word, it can be described as "positive."

"The economic environment has been very favorable over the past several years," said Tim Meyer, co-founder and managing partner at Angeles Equity Partners. "Those portfolio company CEOs [who] used the recession to strategically reposition their businesses are benefiting from the growth and expansion cycle that we are now experiencing, particularly in North America."

Peter Stein, managing partner at Trinity Hunt Partners, echoed Meyer's sentiments.

"For the most part, we are in a climate of expansion as most of our portfolio companies operate in industries outside of the oil patch," Stein stated. "Whether [our companies operate within the areas of] dog food, depositions or eating disorders, we are seeing continued demand for our services and expect this environment to continue for the next several years."

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Meanwhile, Dominic LaValle, managing director of the Private Equity Group at Sowell & Co., was more cautious in his assessment, describing a "generally 'stagflationary'" economy.

"In commoditized industries, it's difficult to grow revenues via volume increases, although price increases have been available," he elaborated. "Innovating new products and services that meet customer demands for more speed, ease of use, quality, and/or customization has been a better source of growth."

Do companies have the right leadership for their current business cycle?

Leadership can make or break a company. As The Halifax Group's Williams put it, "The governor to prudent growth is managerial talent."

Different types of leaders come into their own during different stages of the business cycle. Ben Horowitz of Andreessen Horowitz authored a defining blog post on the subject in 2011 that still holds relevance today. In the post, Horowitz defined the "wartime" and "peacetime" styles of management, noting that peacetime leaders excel at culture-making, working toward corporate goals, boosting innovation, empowering the workforce, etc. Meanwhile, wartime leaders are much more outwardly focused and must set aside blue-sky thinking in favor of a more survival-based mentality that's necessary during periods of instability.

Wartime and peacetime CEOs have very different skill sets, goals and management techniques. For Trinity Hunt's Stein, the current climate is ideal for growth-focused peacetime CEOs to excel.

"In most cases, we have CEOs in place that are focused on growth of our businesses, whether organically and/or through add-on acquisitions," he said. "This is the right time to be aggressive and our CEOs are pursuing those types of strategies.

Sowell's LaValle asserted that determining if a firm has the right leadership in place goes beyond simply assessing whether the standing CEO is a good fit for the job.

After all, good CEOs know when and what to delegate, and engage in astute executive recruiting to build strong, qualified teams. In this regard, the question of whether a company's leadership is optimal given today's business climate can only be answered by looking at the C-suite as a whole.

Keeping up with the shifting tides

Of course, no phase of the business cycle lasts forever. Myriad factors affect the length of the stages, but Fidelity's Asset Allocation Research Team ballparked each one's duration:

- Early cycle: Approximately one year
- Mid cycle: Roughly three-and-a-half years, significantly longer than the other phases
- Late cycle: About 18 months
- Recession: Less than a year, on average

Given the fact that PE firms typically invest in companies for three to five years, it's reasonable to assume that the enterprises will experience at least a portion of most - if not all - of the cycle phases during this time.

So, if CEOs tend to be more predisposed to lead during some periods than others, does this mean businesses should replace their leaders every couple of years?

"Some private equity firms look to match CEO talent to an investment, depending on where the business is in the economic cycle (e.g. growth CEO, wartime CEO, etc.), [and] some firms have even gone so far as to transition CEOs as the business moves from one stage of the cycle to the next," observed Meyer of Angeles Equity.

"In my opinion, this creates a lot of unnecessary and unproductive churn. At our firm, we are most concerned about finding CEOs [who] have the right mix of capabilities and personality to execute the investment 'full potential' blueprint throughout the entirety of our hold period."

The bottom line

A core tenet of quality leadership is flexibility and the ability to roll with the punches. With this in mind, PE firms attempting to assess whether the companies in which they're investing have the right leadership for the current business cycle should consider "zooming out" to instead consider whether the enterprises have the right leadership, period.

At Caldwell Partners, we can help you find the right CEO pre-deal, midstream or when preparing for an exit.

Some companies prefer to make a long-term bet and stick with the same CEO through changing economic conditions and phases of business, while others are open to the idea of bringing aboard someone new once their focus shifts.

Either way, turning to an executive search firm tends to deliver better results than adhering to the "hope and pray" approach.

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