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Talent Management

Perform due diligence in a firm's leadership before investing time or money

Premium content from Birmingham Business Journal by Kelly Schuck, Special

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Special

In years past, private equity investors had to evaluate investment opportunities quickly and make swift decisions.

It was a highly competitive environment that put companies seeking capital in the driver's seat. By nature of their organizational structure, venture capital and private equity groups were able to be more flexible and respond more quickly than their publicly traded competitors, which made them more attractive suitors. Private investors were able to offset the risk associated with having to make somewhat hasty decisions by deploying their abundantly available capital over several investment opportunities, thereby increasing their odds of hitting a home run.

Today, with the absence of a booming financial market and a lack of free-flowing credit, the balance of power has shifted in favor of investors. Public and private investor groups alike now have the luxury of taking the time to carefully evaluate investment opportunities and assess their options. However, because there are fewer investment opportunities, it has become critical that they perform thorough due diligence and be far more discriminating in choosing the transactions in which they will participate.

Irrespective of economic conditions, prudent and proven portfolio managers have consistently performed thorough due diligence efforts. Greg Dollarhyde, managing member of Dollarhyde Enterprise Group and president and CEO of Zoës Kitchen, noted recently that he takes three main criteria into consideration when evaluating the potential risks and rewards of an investment opportunity: 1) the business model; 2) the balance sheet; and 3) the leadership team. He maintains that if an investment opportunity lacks strength in any one of these areas,

the likelihood of a strong financial return is significantly diminished. Further, Dollarhyde asserts that the strength of the company's leadership team is especially critical. Headline-making leadership failures in recent years support this assertion.

While criteria for evaluating business models and balance sheets are fairly straightforward and consistent, assessing a company's leadership is a much more nebulous and arduous task. Traditional due diligence items like organizational charts, executive bios, confidentiality agreements and management incentive plans barely scratch the surface when it comes to truly understanding a company's leadership and determining whether or not they possess the core competencies that will be required to take the company to the next level.

There are traits inherent to innovative, startup and growth-stage companies and their leaders that may not sufficiently contribute to the organization's long-term success. By nature, company founders are innovators and entrepreneurs. They are bright, driven, technologically savvy, idea generators with a compelling vision, but when their product or idea converges with market demand they often find themselves in uncharted and uncomfortable territory – the chief executive office.

Less than half of company founders who assume the role of CEO remain in the leadership position after three years. This is largely due to the fact that the skills that make many entrepreneurs successful are quite different than the skills required to support the long-term needs of a rapidly growing company.

Take the entrepreneur whose hands-on management style and laissez-faire approach has been highly effective in his small, startup organization. His tendency to micromanage has served him well, as he has been able to "touch" all aspects of the company which, in turn, has helped him make quick, informed decisions. His casual organizational culture fostered innovation and created a close-knit group with a strong sense of loyalty to the organization. As the company grows, his approach becomes impractical, unsustainable and ineffective. Informal communication styles lead to confusion, rework and frustration. Micromanagement creates bottlenecks. Important deadlines are missed, costly mistakes are made.

When private investor groups enter the mix, an organization's landscape is changed in a number of ways. The company's needs and priorities change, as do its leadership roles and responsibilities.

Leading an organization through this evolution requires a more sophisticated approach and more formal processes. A leader's one-dimensional role of "anticipate and innovate" transforms into a highly strategic, complex and three-dimensional role. Competencies such as managing other people's money, discipline, strategic and financial acumen, people skills, delegation skills and the ability to lead and manage multiple constituencies are just a few of the basic requirements. While entrepreneurialism may have gotten the company to where it is, executive leadership traits are necessary to take it to maturity.

Jim Balkcom, operating partner of **Council Ventures**, says his firm became more successful when they began conducting formal assessments of the leaders of companies in which they had invested or were considering making investments. He noted that while most investors are highly skilled at analyzing numbers and balance sheets, they often lack the ability to effectively and objectively assess human behavior, interpersonal relationships and group dynamics.

Whether investors choose to conduct their own assessment of a company's leadership or to utilize professional assessments, ensuring that a company's leadership has the capability to effectively manage significant growth is critical. Its current leader must transition from an entrepreneurial role to an executive leadership role. Assessing these factors upfront is an absolutely critical component of the due diligence process.

As the economy begins to recover, we will see power shift again and the relationship between investors and companies seeking capital will become more balanced. The days of shotgun investing are gone, but the pace at which investors will have to move will quicken.

Optimism and confidence in product or service offerings should be weighed equally with the leadership's level of talent and their ability to execute and deliver results. Venture capitalists and private equity investor groups that take the time now to ensure they have the appropriate selection tools and due diligence processes in place upfront, will be well-positioned to make good decisions quickly and to outperform in every way.