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# How GPs Can De-Risk Investments with Human Capital Due Diligence

With the Covid-19 vaccine rollout accelerating at an increasingly rapid pace, private equity firms are eagerly anticipating a return to normalcy, including regular, in-person meetings with current and prospective leaders at acquisition targets. With deal activity booming and firms looking to deploy their accumulated dry powder, GPs cannot afford to under-club due diligence while we wait to reach herd immunity.

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Firms would be wise to bolster their human capital due diligence to compensate for the current environment's lack of real, consistent human engagement. They must add additional tools and processes to their standard playbook to ensure continued social distancing requirements don't leave unchecked human capital risks in investments that ultimately impact their pace of value creation.

While on the one hand human beings represent portfolio companies' most valuable assets, people-related issues also add risk to an investment thesis. Without intention or malice, misaligned executives can work against growth plans and undermine colleagues, creating costly delays and unnecessary distractions. And while many experienced leaders can point to impressive track records of success, these accomplishments don't historically predict their ability to lead other, distinct enterprises.

Prior to Covid, investors were more confident in their ability to examine companies, and assess, onboard, and align leaders, all with an eye towards mitigating these risks and choosing those best able to drive their acquisitions forward. The pandemic has shaken this confidence and has also shown private equity the need for a more comprehensive approach to diligence, by revealing problematic assumptions built into traditional processes.

Rigorous diligence around human capital dimensions of a transaction can be extremely effective in helping predict, evaluate and manage people issues inherent in all pre-close environments – both in Covid times and after a return to normalcy – by adding depth to evaluations in the areas of leadership quality, team dynamics, and strategic alignment. That said, the work must be performed with the intention, rigor and finesse required during the sensitive pre-transaction period. And to be most effective, certain elements of human capital strategy, such as effective onboarding, should continue post-close during the early stages of an investment's life cycle.

**Pre-Transaction**

To unearth hidden landmines that can impact valuation, firms should examine potential acquisitions against six key drivers of human capital performance: strategic alignment, leadership quality, talent and engagement, culture and identity, change agility and execution. In particular, change agility has become of paramount importance amidst the uncertainty created by the pandemic. By measuring for this specific performance driver, private equity firms can best capture the likelihood that a company will be able to pivot in the wake of aftershocks to the Covid crisis and weather future storms.

Big picture, adding examinations of these human capital elements to their standard due diligence processes can help GPs avoid costly delays and grueling headaches that often accompany unanticipated and un-mitigated people and culture issues. What's more, the evaluations can help firms uncover hidden gems – companies that have unusually strong human capital performance drivers, and thus, tangible competitive advantages within their industries.

**Leader Assessment**

While private equity firms regularly outsource assessments of senior leadership positions both pre-hire and at newly acquired portfolio companies, they have been previously limited by off-the-shelf tools that offer static performance indicators in the form of letter grades or percentage likelihoods of success. By asking standardized questions, these assessments deliver insufficient answers. They seek to identify the right person for a job, typically devoid of the business context of the company in question. What's more, they ignore opportunities to further support leaders by considering their strengths in relation to their colleagues in the C-suite.

All too often, these assessments serve as little more than box-checking exercises. Their ubiquity sheds new light on well-known but alarming statistics, including findings from a study by Bain & Co. showing that nearly half of private equity firms replace the CEOs who run their portfolio companies.

In lieu of these outdated tools, private equity firms should embrace a new generation of highly customized leader assessments that provide more in-depth recommendations, including detailed "user guides" and playbooks for supporting the success of executives and teams, tailored to the operating needs of specific companies at specific moments in time.

**Onboarding and Strategic Alignment**

Too often, GPs underestimate the difficulty and complexity of aligning leaders around an investment thesis and establishing the trust required to get people working in lockstep toward big-picture goals. They assume this happens gradually over time, only to find later on that personality differences, a lack of buy in and miscommunications have bred misalignment and mistrust, seriously hindering efforts to gain momentum around the investment thesis.

To best prepare and support executives and teams so they can perform the complex, challenging, time consuming work required to scale an organization within a highly aggressive timeframe, private equity firms must formulate concrete processes and practices that help portfolio company leaders clarify responsibilities, align on strategy, and build the relationships they will need to achieve their goals. In addition, they should consider supporting their top people with quality executive coaching to help them develop the leadership skills required to build high-performing teams and lead organizations through rapid change.

When done with rigor and intentionality, these efforts can help facilitate positive working relationships among executives, between management and the board, and with the growth plan itself. The results of such efforts are not merely touchy-feely. They best position an investment for success by helping organizations get the very best from their people, individually and collectively.

In the past year, the business world has become incredibly adept at operating in a virtual environment. However, the mere replication of face-to-face interactions over videoconferencing platforms does not provide the same level of connection or insight. In particular, the absence of informal moments leaves a vacuum in which a leader's values, motivations and true character remains unknown. This gap can pose an additional challenge for private equity firms as they seek to create the conditions in which their people and companies can thrive.

Human capital due diligence can help GPs close this gap, and not only while Covid remains a threat. Adding human capital due diligence to standard pre-close processes can bolster the long-term ability of private equity firms to conduct more precise valuations, while simultaneously assessing and de-risking the people side of the business.

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