PERTH LEADERSHIP INSTITUTE

HIRING CEOS FOR PRIVATE EQUITY PORTFOLIO COMPANIES

From Management to Behavioral Due Diligence

CEOs need to be hired based on a formal assessment of their business acumen and behavioral financial impact so that private equity portfolios achieve maximum profitability and valuation

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Executive Summary

There is a *Critical Need* for CEO Recruitment by PEG Firms to be Improved Using More Effective Approaches

Traditionally PEG outcomes have been highly variable and so has the record of predicting them. We need new approaches to hiring PEG CEOs

Traditional PEG Management Due Diligence Is Incapable of Measuring Financial Behaviors and *Formal Assessment* of Business Acumen

Traditional psychometric assessments still can't predict financial and valuation outcomes.

New Form of Behavioral Analysis Allows *Prediction of CEO Financial and Valuation Outcomes*

The fundamental principle is that all cognitive biases have financial consequences. The model shows how behaviors impact both business operating outcomes and financial and valuation outcomes.

Behavioral Alignment is Critical to *PEG Company Financial Results*

Financial behaviors drive valuation outcome. Financial styles of CEOs and top executives must be identified and understood for a successful investment.

We Can Use This to Improve *PEG Investment Success Rates*

The method, Behavioral Due Diligence, or **BDD***, can be used to construct a new behavioral proforma. It is also used to architect the combined management team so that it matches the target valuation of the entity.*

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Section 1: Private Equity Companies (PEGs) and their CEOs

Private equity (PEG) portfolios have as their aim to make money as quickly as possible. Usually they do this by buying underperforming companies, putting in a new management team including a CEO, and then managing it in a way that will lead to fast and high profitability. So PEG companies need to hire lots of CEOs.

You might think that there would be no difference between hiring a CEO for any type of company, and hiring a CEO for a company that's part of a PEG portfolio. But that isn't correct. There's a vast difference between the requirements for being a PEG company CEO, and being a CEO of most other companies.

> "…There's a vast difference between the requirements for being a PEG company CEO, and being a CEO of most other companies…."

The Aims of PEG Companies

The aims of private equity companies are actually quite simple. They aim to maximize the following:

- Valuation
- Financial returns
- Portfolio Value
- Raising capital

Although PEG companies are constantly hiring, moving and firing CEOs and their management teams, their primary aim is not to produce good leaders in the sense that they are written about in the Harvard Business Review. In academic and learned research, leadership theorists aim to maximize the following:

- Business vision
- Social vision
- Interpersonal and social skills
- Altruism
- Ethics
- Loyalty of followers
- Sustainability

These are the goals that at least in public, and in publicly stated mission statements, are also the goals of many if not most public companies.

But we have to recognize that PEG companies have short-term and less altruistic goals. Their aim is to maximize returns to investors and shareholders. So business acumen will be much more valued than most of these other goals. This is not to say that PEG companies will not try to maximize these goals also. Rather it is to say that their goals are overwhelmingly financial and will take pride of place versus the goals set out in academic and literacy tracts on leadership or in public company mission statement.

So in talking about leadership and recruitment of senior management in PEG companies, we need to stress how these companies will meet the more narrow goals set out above rather than the broader goals set out in the literature. This might be off-putting to many people, but it is simply to state a reality.

This means that in discussing leaders and their recruitment and management in a PEG context, we are going to be targeting a different set of goals than those targeted by many corporations, particularly public companies. But since public companies also have to meet shareholder financial return benchmarks, this White Paper will also be of interest and concern to them.

Approaches to Evaluating Potential Management

Traditionally PEG companies have hewed to a tacit distinction in checking out potential new CEOs and senior management. This distinction has been between **management due diligence** (MDD) and **behavioral due diligence** (BDD).

MDD means checking out a potential recruit to make sure that his or her claims are true and there is nothing in their background that could be a risk for the company in the future. These issues include:

- **Validating Credentials**: checking that they actually did earn the awards they claim
- **Checking Resume and Background**: checking that the applicant's resume is correct, that they actually held the jobs they claimed in their resume, and that nothing material has been omitted from their professional background
- **Criminal and Background Checks**: checking for police and court records, convictions, and other criminal issues that could pose a risk to the company's operations or reputation

BDD means something totally different. It means formally assessing the behaviors of the applicants or recruits to evaluate the extent to which their behavioral strengths and vulnerabilities are an optimum fit with the position in their particular company and market.

Most PEG companies don't conduct any BDD. This is largely because many feel that the types of psychometric assessments on the market do not meet their particular objectives. We could say that the psychometrics\ assessments that are used in BDD tend to meet the goals that public companies seek to achieve in their non-financial outcomes. That includes things like interpersonal and social skills, ethics and values and possibly vocational competencies.

The result is that most PEG companies have a good grasp of applicants and recruits in the formal aspects of their backgrounds, but don't have much grasp, if any at all, of their behavioral competencies, especially from the perspective of financial outcomes and business acumen. Even if a search firm or other checking organization looks at the financial outcomes from a leader's previous positions, it's very difficult to know if these were due to the applicants themselves, or to the teams and companies they were part of. Of course, the applicants themselves are hardly likely to tell the interviewers that particular accomplishments claimed by them were actually due to others.

> The result is that most PEG companies have a good grasp of applicants and recruits in the formal aspects of their backgrounds, but don't have much grasp, if any at all, in their behavioral competencies, especially from the perspective of financial outcomes and business acumen

So MDD enables boards and PEG companies to answer questions about the formal professional background of applicants but not the behavioral characteristics which will have most impact on the success of the positon they are being recruited to perform. There is very little real behavioral information on their business acumen, the issue probably of most importance to a PEG firm.

This White Paper examines how this problem can be addressed. It argues that PEG companies must switch from their current focus on MDD to a more proactive focus on BDD that has a true focus on business outcomes and financial behaviors.

The Main Differentiators for PEG CEOs

We can distinguish between the characteristics that public companies look for in their CEOs and those that PEG companies look for. Here are the main differences

1. Need higher business acumen
2. More attention to past financial performance
3. More focus on short-term financial performance
4. Higher financial literacy

Let's examine these in more detail.

Need Higher Business Acumen

You might think that any CEO would need to have high business acumen. In theory that's true. But we have been testing CEOs and senior executives for many years using our business acumen psychometric assessments.

We have found that on average, only around 12% of CEOs and senior executives have the high level of business acumen needed to usually make money **in their own right** – that is, as distinct from making money using the profit model they inherited when taking up the position of CEO. Furthermore, around almost 50% of the senior managers and CEOs have a level of business acumen that will lead to them either losing money, or not doing as well as most other CEOs even when they do make money. And around 40% will only have enough business acumen to just break even or do no better than most other companies in their industry.

Why would that be? Aren't CEOs supposed to have high business acumen? Yes they are supposed to have it, but no-one is ever tested for it. Most of the business literature actually stresses the importance of interpersonal skills and there is testing for that available. In most cases, educational qualifications such as an MBA are used as a proxy for business acumen. However they really aren't the same thing. You can have a good understanding of business and still have low business acumen, which is what we find in assessing top executives for business acumen.

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In large companies in every country, often senior executives get to be CEO not because they have high business acumen, but because they have a high level of interpersonal skills, get on well with the company senior team, and are good at working with others, even if they have low business acumen.

So you can't assume that any senior executive you hire will have the high level of business acumen needed to be an effective PEG company CEO. Actually, you can assume that generally a senior manager will not have a high level of business acumen. Then you have to figure out from his history and experience whether he has it or not. Our data shows that only 12% will have enough business acumen to consistently make money, based on them developing their own particular profit model as distinct from inheriting one.

More Attention to Past Financial Performance

When hiring a CEO, most boards will look at the financial performance of the executive's previous company or division. If it has been very successful financially, they will accept that he has high business acumen. But this is often an incorrect assumption.

For many senior executives, the good financial performance experienced in their career might well be not due to them at all. More likely they were part of a team that collectively achieved this performance. Even more likely, this good performance wasn't due to them, but to the products and profit model of the company that was set up when the company was founded, and due to the approach of the founder. Then the team just continues with the approach by the founder.

In addition there are numerous factors in the performance of a senior executive that are invisible to a board that is doing the interview. If it wasn't really the interviewee who was responsible for the great financial performance in his background, he is unlikely to tell you that. In fact he is much more likely to tell you that it was he who achieved the profitable results. He might actually believe that is the case.

It's usually very difficult for a board and its interviewers to find out the truth of the matter because the interviewee will always know much more about the real reasons for his performance – or otherwise – than the interviewers will. But of course an interviewee will always give you a rosy view of his performance. If he is particularly articulate, which most CE applicants are, most boards will believe him.

More Focus on Short-Term Financial Performance

But it's possible for a CEO to have a high level of business acumen but still not be the right person for a PEG company. That's because a PEG company requires the business acumen to be focused on the short-term and not the long-term.

> It's usually very difficult for a board and its interviewers to find out what the real truth of the matter actually was

There's a huge difference between senior executives whom we would call "visionary" and others who have high business acumen but are very practical. Visionary CEOs can indeed have a high level of business acumen but typically they will focus on the long-term, not the short-term. Their aim to is make big profits in the long-term, not the short-term.

Practical CEOs who make money very fast are focused on the short-term, on short-term cash-flow, and on getting out of trouble rather than leading the industry. The psychological characteristics of these types of CEOs are totally different. We identify them in our testing. The visionary ones we call "Profitmakers" and the practical ones we call "Arbitrageurs".

Here's the problem. Both of these types are quite rare. Maybe each of them comprises around 5% of the executive population. They will each present differently. However if they are both quite introverted people, as is often the case, it's very difficult to identify them in an interview, and to distinguish between them.

But for a PEG company, most times only the Arbitrageur, will be suitable. The Profitmaker will not be suitable, even though he has a high level of business acumen, because he is too focused on the long-term and not focused enough on the very short-term.

Higher Financial Literacy

CEOs for PEG companies are there to make money, or to stop losses, very fast. So the focus will be on their financial skills and financial literacy, rather than on other issues.

Profitmakers often have most of their experience in the areas of product or sales and marketing. Arbitrageurs, the best types of CEO for a PEG company, are often if not usually from the financial side. Often they are ex-CFOs, audit people, or financial analysts.

That means that you usually expect a good potential CEO for a PEG company to have high financial literacy. This might mean that the person has an MBA and accounting and financial qualifications.

However there are a couple of problems here. Having high financial literacy is not the same as having a high level of business acumen. In our testing of senior executives, we have found that if you have high financial literacy, it doesn't mean you have high business acumen. In fact, usually you will have quite a low level. But when boards are interviewing for a PEG CEO position, they often make the mistake of thinking the two are the same thing.

Unfortunately a CEO with high financial skills but low business acumen can often be a very bad CEO for a PEG company

Unfortunately a CEO with high financial skills but low business acumen can often be a very bad CEO for a PEG company. Firstly, financial people often have lower levels of interpersonal skills, so that can lead to other problems in leadership of the company.

Second, people with high financial skills but low business acumen often cut the wrong things. They often cut expenses that are necessary to lead to a short-term financial transformation. Many financial people will often cut expenses in sales, marketing and product so low that even if in the very short-term they make a little money, soon after their financial performance deteriorates even more.

So when you are hiring for a PEG CEO position, even the potential CEOs with high financial literacy are often probably not the ones that you want to hire since they are "only" financial people, and they have many of the problems that afflict financial people who don't have a broader understanding of business and how a company really works.

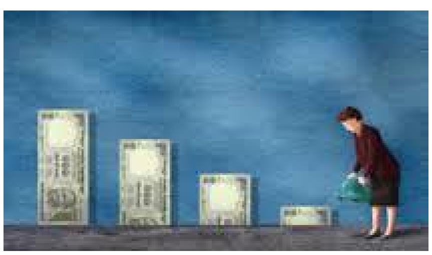
Section 2: The Impact of Behavioral Finance on Private Equity Hiring

Success in modern organizations is ultimately financial and valuation outcome

Shareholders Want to Know Where's the Beef

Leadership in modern organizations is required to increase profitability and valuation. This applies to both public and private companies alike. Scarce capital is used by these organizations and the ability to make it more effective is a key requirement of modern leadership. Leaders who do not do this are routinely removed in order to find leaders who can. So leaders must drive better financial and valuation outcomes in order to be better leaders.

Yet, the classical leadership canon, that is the set of goals that most public companies purport to desire, signally fails to enable this. Leadership assessments focus on interpersonal skills and certain behavioral competencies. While these are relevant to leadership, they do not define its success in modern organizations. Success in modern organizations is ultimately financial and valuation outcome. To be precise, if an organization gets a better valuation outcome than its competitors, then its leadership has performed better. Nothing else counts as long as the organization operates ethically and is reasonably managed.



The major criteria in the classical leadership canon for leadership success are interpersonal, team, and organizational functioning. This derives from their intellectual bases which are psychoanalytic, sociological and anthropological. Basically they look to harmony rather than outcome. They tend to be employee- rather than shareholder-focused. So they lack the intellectual underpinnings which focus on the building of financial valuation and maximization of capital creation.

The overwhelming problem with modern leadership approaches is the failure to link directly with leadership outcomes, defined in financial and valuation terms. The classical leadership canon cannot help this since it has intellectual foundations that are largely unrelated.

In order to build the necessary linkages, we need to turn to the disciplines of economics and finance. These are disciplines with which experts in conventional leadership and human resources are generally uncomfortable. This probably explains at least partially why these disciplines have not been adopted. So we shall turn our attention to them now to see to what extent they can meet the requirement of linking leadership and financial and valuation outcomes.

But Traditional Economics and Finance Assume Perfect Rationality

Classical economics has a history dating back to the 19th century. The classical economists ranging from Adam Smith to Keynes built formal models based on a very particular psychological platform. That platform assumed that individuals and corporations are rational economic actors. This allows a sophisticated structure of models to be built.

At the microeconomic level it allows for the development of utility theory. This in turn allows for the development of choice theory for both consumers and corporations involving indifference curves and the like. The assumption of rational economic actors underlies the full range of micro topics ranging from pricing, demand theory, consumer choice and more latterly decision and game theory. These theories have been extended to modern work in the areas of options and options prices, derivatives and synthetics.

At the macroeconomic level, the assumption of rationality allows for the development of theories regarding a wide variety of topics including interest rates, money supply, and consumer demand. These in turn have been built up into models of growth which incorporate linkages between investment and consumer behaviors, savings and investment, interest rates and money supply. It is from this base that the idea of the efficient market hypothesis arises. All of these models depend on the assumption of rationality to work.

Economists have always known and accepted that these theories are an approximation to the real world. The models work fairly well when conditions do not change much. <u>However it has become increasingly clear that the classical economic models do not work at all in the following cases</u>:

- When conditions change significantly
- In predicting major changes in corporate valuation

- In predicting macroeconomic inflection points and crises

It is increasingly being seen that classical economics tends to work best when conditions do not change much, and when rational behaviors dominate the market. When these conditions are infringed, then classical economics and finance break down and cannot predict the outcome.

In this sense, classical economics and finance are reminiscent of classical leadership models. In both, rationality is the basis for the model to work. When irrationality enters, the models break down. In both cases, the models cannot predict what happens if most behavior is not rational. So the classical theories have major restrictions that limit them to only being valid in particular, relatively narrow situations.

> For economics and finance to play a part in linking leadership with business outcomes, they must be able to able to address irrationality in decision-making

That is one reason why leadership approaches have not been able to incorporate classical economics and finance in order to link financial and business outcomes. These classical disciplines assume a level of rationality that is just unrealistic in leadership and thus prevents them being used for real-life leadership situations. For economics and finance to play a part in linking leadership with business outcomes, they must be able to able to address irrationality in decision-making.

Irrationality is Now Being Addressed through New Behavioral Disciplines

We have always known that leaders and decision-makers have biases. The trouble is that they are difficult to model in particular situations. We may know that a leader tends to under-spend or over-spend, but predicting that in advance for a particular leader or company is difficult and requires models that have only recently commenced development.

We know that there are numerous other types of biases that affect decision-making. However these had never been cataloged or their effects formally described. So although theorists knew that rationality was not really realistic, a formal platform had never been developed to model those biases.

The issue has been how to link irrationality – or to be more accurate, mixed rationality - in decision-making with economic and financial outcomes. The first steps in this process have been made with the emergence of the new disciplines of behavioral economics and finance. These disciplines formally relax or drop the assumption of rationality in building models of economics and financial phenomena. For the first time we now have a language and models that link financial outcomes to real-decision-making in the real world.

This allows us for the first time to formally link decision-making that is not necessarily rational to financial and business outcomes. Since this is what leaders do, we now have a set of models that can use be used to describe and predict leadership behaviors and outcomes in business and financial terms.

Behavioral Economics & Finance Open Up New Leadership Approach

Their Newness Explains Why Leadership Approaches Haven't Caught on Yet: The field of behavioral economics and finance can be said to have received formal recognition of their intellectual coming-of-age with the award of the 2002 Nobel Prize for economics to Daniela Kahneman of Princeton University for his work into behavioral economics.

Research into this field commenced in the 1960s with work by Nobelist Herbert Simon and expanded in the 1970s with the development of what is called prospect theory. Prospect theory is a theory of decision-making where decisions have uncertain outcomes and people have different ways of evaluating gains and losses. These decisions are not necessarily financial in nature although much of the work that surrounds them is concerned with economics and finance.

The research has been motivated by the increasing divergence between prediction and reality in the fields of economics and finance. It had become increasingly clear that economies and finance were not approximating reality and that a new approach was needed.

For the first time, what we term "irrationality" has been formally opened to research and investigation in the fields of economics and finance. These new fields provide comprehensive explanations and models as to what constitutes irrationality in decision-making and show how it leads to totally different types of economic and financial outcomes to those predicted by classical theories.

[MCKINSEY - GOOD ANALYSIS IN THE HANDS OF MANAGERS WON'T NATURALLY YIELD GOOD DECISIONS…

Behavioral Disciplines Explain Much That Was Hitherto Inexplicable

The new behavioral disciplines have far-reaching ramifications for most business and economic areas. .They impact decision-making, human resources, strategy, marketing, consumer choice, advertising, talent development and human resources, investor behavior, and stock market behaviors to mention just a few. So far the impact is at an early stage since the fields are still very new and practitioners of these disciplines are only slowly coming to grips with their many implications.

McKinsey Quarterly carried an article on this subject in 2010[1]. They cite some of the problems that are caused by the lack of understanding of behavioral strategy. These include failed mergers and acquisitions, large projects usually being over-budget and strategies usually ignoring competitive responses or getting them badly wrong.

McKinsey has conducted some fascinating research on this issue. This research concludes that, contrary to what one might expect, "good analysis in the hands of managers won't naturally yield good decisions…"[2] This of course flies in the face of conventional approaches that assume if we are smart, reasonably educated and have the right data, we will have a very good chance of making a good decision that will have a beneficial outcome. It explains why, to the contrary, so many decisions at all levels of management, informed by the best analysis possible, so often yield poor outcomes.

As one might expect from a consultancy that focuses on strategy, the McKinsey research has a lot to say about the implications of behavioral disciplines for strategy development. Their work suggests that cognitive biases affect the smartest executives in the most important strategic decisions in the best companies.

For leadership, this has critical implications too. It suggests that most leaders are unaware of their biases and therefore are not in a position to compensate for them. In hiring, developing and promoting leaders, those who participate in these processes cannot identify these biases and predict their impact on the quality of leadership of the managers they are promoting.

In sum, if anyone ever wanted a good explanation why so many leaders fail, and why so many boards and leadership experts tend to make so many bad hires, one has only to look at the previously unrecognized issue of cognitive biases.

The behavioral disciplines are not just about finance and economics; they are ultimately about leadership and how flawed the outcomes of leadership are likely to be. That these outcomes can also be measured in financial and economic terms is a bonus, but the behavioral disciplines provide a new perspective on any type of decision, be it economic and financial or otherwise.

In Categorizing Types of Cognitive Bias

In their new theory, termed prospect theory, Kahnemann and Tversky in the late 1970s identified and set out a number of cognitive biases that routinely impact decisions, both financial and otherwise. What they pointed out was that these biases had never been taken into account in classical economics and finance. The existence of these biases meant that the rational decisions assumed by classical theorists were very unlikely in the case of many if not most decisions.

It is not the intention of this White Paper to provide a primer on behavioral economics and behavioral finance. However it will help to provide some examples of these cognitive biases. In their book, some of the principal biases mentioned were as follows:

- **Framing effects**: The way a problem or decision is presented to the decision maker will affect their action.
- **Sunk cost fallacy**: The tendency to continue to invest in something, even if it is a hopeless case

- **Status quo bias**: people prefer that things remain the same, or that things change as little as possible, if they absolutely must be altered.
- **Endowment effect**: people value a good or service more once their property right to it has been established.
- **Loss aversion**: people's tendency to strongly prefer avoiding losses to acquiring gains. Some studies suggest that losses are twice as powerful, psychologically, as gains
- **Anchoring effect**: the tendency to rely too heavily, or "anchor" on a past reference or on one trait or piece of information when making decisions
- **Overconfidence effect**: excessive confidence in one's own answers to questions. For example, for certain types of question, answers that people rate as "99% certain" turn out to be wrong 40% of the time.
- **Survivorship bias**: concentrating on the people or things that "survived" some process and ignoring those that didn't, or arguing that a strategy is effective given the winners, while ignoring the large amount of losers.

There are numerous other cognitive biases that have been identified. These biases are not just ones that have been observed. All of them have been tested through actual experiment so that the situation can be controlled scientifically. So the existence of these biases has been scientifically confirmed, measured and manipulated to see their effects in many different situations.

It will be clear that these cognitive biases operate within the decision-making environment of any company. So these cognitive biases must be a key driver of problems in these companies. They are therefore an important microeconomic factor. Of course, this also means that they are a crucial factor in leadership, talent management and talent development for any company.

> "…this also means that they [cognitive biases]are a crucial factor in leadership, talent management and talent development for any company…"

Since these biases operate in all companies and in all organizations, including in nonprofits and governmental organizations, they also operate at the macroeconomic level. This means that they impact demand and supply at the macroeconomic level, and in the areas of growth, trade and investment. Again, this impacts leadership at the national levels as well as the international levels.

It does not take a great leap of imagination to see that these cognitive biases are crucial in assessing and studying leaders and the outcome of the decisions. Yet none of this way of thinking has yet impacted leadership approaches.

This is probably due to two main factors. First, this is a relatively new field of study. Second, many leadership experts feel uncomfortable with business issues and particularly with economics and finance so they stay away from these topics. Clearly this will have to change if leadership approaches are to keep up with the times.

But the New Behavioral Models Are Far From Perfect

Some Key Issues Not Yet Addressed: So the new behavioral models open up vast new swathes of territory not only in the economic and financial arena, but also in the arenas of decision-making, leadership, talent management and development. They also provide new perspective on strategy development and implementation. They suggest that too much information can be as dangerous as too little. They provide new ways to improve decisions and to optimize their outcomes in business terms.

But as with any new discipline, they still leave vast swathes of problems unaddressed. This is not a criticism; it is just to state that now these new disciplines have opened up new territory for investigation, they have also allowed new questions to be asked which so far have not been answered and in some cases cannot be answered without more advances in theory and more data from experience. This is the case with the behavioral disciplines.

Some of the problems that are not addressed by behavioral economics and finance are the following:

The Problem of Individual Prediction: The behavioral disciplines have identified a rich catalog of cognitive biases and described their effects. Although these effects work at the level of the individual, we can only use them predictively at the level of the group. The new behavioral disciplines provide no model that allows us to predict how these cognitive biases will act in the case of a specific individual, a specific team or a specific company.

We term this problem, the “atomism” problem. We can predict at the level of the organization, say the country, or a large group of consumers. But we cannot make predictions at the level of the individual social atom, the individual, the consumer, the manager, the specific team in a specific company. For the behavioral disciplines to be seen to be more than an academic exercise, they need to address and provide solutions to this problem.

cognitive biases impact non-financial and economic outcomes just as much as they do financial and economic outcomes

Predicting Precise Business Outcomes: Even more importantly, these do not show the actual financial outcome of these cognitive biases for any individual, team or company on business outcomes such as profitability or valuation. Yet it is precisely these issues that are of most interest and utility to shareholders, investors and economists who wish to predict these matters so that the work can have real-world relevance.

We term this problem the “outcome” problem. We need to be able to do more than just say that a particular cognitive bias will distort the outcome of a decision. We need to be able to say how this will happen in practice. In particular, we need to be able to couch the outcome in measurable and quantitative terms that are part of the financial and valuation metrics of a company so that we can link behaviors and cognitive biases directly to profitability and capital creation or consumption.

The Problem of Non-Financial Decisions: Not all or even most decisions have an explicit financial element; yet the behavioral disciplines couch their terminology in financial and economic terms, as they must give them intellectual background.

Yet it is clear that cognitive biases impact non-financial and economic outcomes just as much as they do financial and economic outcomes. The behavioral disciplines have done much less to analyze the impact on the non-financial arenas. This is because they incorporate a game-theoretical approach, garnered from the game theories of the 1960s which again have a decidedly financial approach.

In this instance the boot is on the other foot. The behavioral disciplines have a gap in the areas of social, sociological and anthropological functioning that is as much a gap as leadership’s lack of focus on business outcomes.

The Problem of Non-Financial Actors: The behavioral disciplines started their work by focusing on consumers and investors. It was only later that they broadened their focus to corporate managers but even then the focus was on corporate financial managers rather than all managers.

But the work has not yet broadened its reach to actors who are explicitly focused on non-financial issues such as corporate managers of sales for example. Yet it is clear that these players also have an impact on business outcomes through the impact of their cognitive biases. Just because they are not primary initiators of investment or P&L managers does not mean they do not have an impact on the overall P&L of the organization, or on its valuation.

But the behavioral disciplines are not comfortable in the non-financial arenas and so have tended to avoid these issues. So these new disciplines are more oriented to actors that are explicitly economic and financial which limits the applicability of the research to some of the most intriguing and important issues in corporate decision-making and finance.

Atomism and Outcome Problems Most Important: Of the above, the atomism and outcome problems are the two most important. This is because they prevent the theory being used in practice to improve the outcome of decisions. If the aim of a scientific theory is control, then the behavioral decisions are still some way away from this goal. Later in this White Paper we will show some later developments that specifically address these problems and provide some solutions.

Neuroscience and Neuro-Economics Provide Atomistic View

As behavioral economics and finance have emerged and expanded, so has the demand for other types of investigations that would provide increased knowledge on behavior, decision-making and in particular economic and financial decision-making. This new research addresses the issue of the individual level head-on and provides an atomistic perspective that advances the understanding of behaviors at the individual level.

This research relies on MRI, magnetic resonance imaging. This allows scientists to look at a brain in real-time to see precisely which areas are impacted when the brain is carrying out certain activities which the subject has been told to think about in advance. These include making decisions or thinking about certain things.

The aim is not only to look at physical brain locations involved, but also to look at the types, intensity and frequency of brain waves and other impactors such as changes in brain chemicals and neurotransmitters.

The more general science has been termed neuroscience. This broader approach investigates thoughts, decisions and emotions. The narrower research is called neuroeconomics. The aim of this science is to elucidate physiological mechanisms involved when the brain is making economic and financial decisions and making choices.

Like neuroscience, neuroeconomics can be experimental in nature so that the fully range of scientific tools can be made and hypotheses investigated. Experimental economics can be combined with neuroeconomics to gain a much deeper appreciation of the biological mechanism involved in economics and financial decisions.

This research also extends to neurochemistry and in particular to the neurochemical oxytocin, the so-called love chemical. This research also looks at the impact of certain neurochemicals on behaviors, particularly trusting behaviors and their impact in human interactions. While oxytocin has been the hot topic, it is likely that this is just one of a class of neurochemicals that mediate behaviors including financial and economic behaviors and also the mechanisms of choice.

These new channels of research are also opening up new perspectives on economics, finance and decision-making, this time from a biological and physiological perspective. However we need to note that these are not cognitive but “wetware” models that give us physical rather than cognitive explanations of decision-making and choice.

The wetware models do address the atomism issue. They add to the knowledge concerning how to make predictions at the level of the individual, something that we cannot do with current behavioral economics and finance. But these approaches still do not allow us to make predictions about business outcomes, a key requirement for relevance and use in the corporate world.

Recent Empirical Studies Address Behavior and Business Outcome

However there is increasing work which investigates the decision-making characteristics of CEOs and managers and links these to their impact on company financial and valuation performance. One pioneering piece of research by Marianne Bertrand and Antoinette Schoar[3] specifically looks at the managerial characteristics of CEOs to investigate their impact on a wide range of corporate financial variables.

This work finds a high correlation between the two. The authors find that these managerial behaviors can be characterized as distinctive financial styles that have a characteristic and unique impact on company financial metrics and performance. The authors specially note that they are departing from the usual economic approach which is to look at financial outcomes at a firm, industry or market level.

In other words, this study specifically addresses the issues of atomism and outcome in leadership behaviors. This work finds high correlations between the two. The literature now shows that the issue of managerial financial style is real and can be correlated statistically with characteristic financial and valuation outcomes.

The literature now shows that the issue of managerial financial style is real and can be correlated statistically with characteristic financial and valuation outcomes.

More recent research shows the consistency of financial styles between personal and corporate financial choices on the issue of personal and corporate leverage, again linking financial behaviors with financial outcomes[4]. It shows that a CEO’s personal financial behavior is at least partially predictive of their companies’ financial performance.

In sum, this recent empirical work addresses the issue of business outcome more comprehensively than has been done with the classical works of behavioral economics and finance. The problem is that there are no theoretical constructs or models underlying the behavioral side of the problem.

So while wetware and CEO studies address respectively atomism and business outcome, neither address both and link the atomistic level directly with business outcomes in a formal model that simultaneously addresses both. That issue has now recently been addressed as we shall show in the final part of this paper.

Leadership Training and Business Metrics

Leadership training often incorporates the words “business outcomes”. However the problem is that it rarely shows the direct linkages between behavior and business outcomes. Most work on this tends to show that a high level of investment in training leads to positive business outcomes. However it does not show any direct linkage. So a lot of this research lacks credibility since it cannot show a direct linkage.

What is becoming clear is that, <u>if leadership training is to have a direct link with business outcomes, it should be linked with business performance metrics</u>, not just outcomes broadly defined. This point has been emphasized recently in a report by McKinsey[5] which indicates that training must incorporate key business performance metrics in order to have the effect that most organizations desire. In other words, traditional leadership training that, for example, focuses on interpersonal and social skills should also incorporate these issues in order to have maximum effectiveness.

Of course, this would require a major shift in curricula. But the weight of evidence is that even talk about business outcomes is not enough if the training and development does not also link directly to business and financial metrics which reflect the concerns of shareholders and investors as well as employees.

Section 3: Behavioral Due Diligence for a Potential CEO

As you can see from the above, it's really important for a PEG CEO to have high level of business acumen.

So how do you identify high business acumen? It's actually pretty difficult; that's why hiring good CEOs has always been difficult. The best way is to use psychometric assessments such as those that my company uses. But if you don't use them, here are some tips:

Entrepreneurial Background

- Has the CEO candidate ever set up his own company? What were its financial results? (Hint; if he hasn't you don't really know how he would perform in your company)

Awareness of Own Financial Style

- How would he describe his own financial style? (Hint: if he doesn't know it, it means he doesn't understand enough about it to be able to do a good job for you).

How Others See His Financial Style

- What would his close friends and colleagues say about his financial style? (Hint: don't ask him what he thinks – ask him what others think about him).

Approach to Resource Use

- Is he frugal or "normal" in his personal financial habit? (Hint: if he doesn't say he's frugal, he's probably the wrong guy).

How Visionary?

- In his approach to products, would he describe himself as conservative, moderate or visionary (Hint: in this context, visionary is bad).

Using Traditional Assessments for PEG CEOs

Classical Leadership Approaches Are Based on Dated Thought Systems

Corporations in the developed world have essentially settled on several systems of thought that we can collectively refer to as the classical leadership canon.

We can categorize the classical leadership canon into three approaches. These are:

1. The personality approaches
2. The competency approaches
3. Other approaches

Personality approaches focus particularly on interpersonal and social functioning as well as styles of interaction with the world. They include approaches such as the Myers-Briggs type Indicator, the Five factor Model, the Hogan Personality inventory, the Minnesota Multiphasic Inventory approach to name but a few. Most of these are based on the ideas that were developed by Jung in the early 20th century.

There are, it is true some more recent approaches. These include most notably emotional intelligence from Daniel Goleman, and the Birkman and the Kolbe approaches. However emotional intelligence is really an extension of personality. None breaks new ground or introduces a new leadership paradigm and all are totally silent on strictly business and commercial outcomes defined in financial terms.

The competency approaches include systems such as the DISC, the McQuaig, the Chally and others. These take a broader view of human capabilities than the personality system and focus on abilities that have a vocational or semi-vocational aspect. The competency systems originally arose out of the time and motion studies in the early manufacturing companies that focused on individual capabilities that conferred an advantage to a manufacturing worker. These days, this set of abilities has been enlarged to hundreds. They are now used in leadership assessment although they usually possess no over-arching model of what actually constitutes a good leader in terms of the abilities they measure.

Again there are more recent variants of competency theories such as strength-finders from Marcus Buckingham. However this is essentially a pop-quiz version of other competency approaches and again breaks no new ground

There are an enormous number of other approaches to leadership which defy easy categorization. These include situational leadership, servant leadership, and numerous team-oriented approaches. These cover thought systems ranging from the social, organizational, psychoanalytic and emotional.

However the personality and the competency approaches are by far the most widespread in terms of actual use and application. These drive most formal leadership programs and tend to guide most discussion about leadership issues.

But we can say one thing definitively about the classical leadership canon – that the ideas it rests on are all fairly old. Personality theories, by far the most influential approaches underlying modern leadership theory and development, all date from Jung and Jungian theory. This set of ideas was developed at the beginning of the 20th century. Recently, there has been research that largely rejects the idea that personality assessments can predict job performance[6] and that they are largely ineffective in this purpose in predicting hiring effectiveness.[7]

Personality theories, by far the most influential approaches underlying modern leadership theory and development, all date from Jung and Jungian theory

Most Have a Psychoanalytic Bias

These ideas are from the realm of psychoanalysis, psychotherapy and psychiatry, studies which focused on personality pathologies. It is not surprising that in an age of megalomaniacs such as Hitler and Mussolini that approaches based on personality pathologies should have received such close attention and had such a major impact on leadership thinking. But, as we shall see below, the personality theories lack any direct business framework or focus, a fundamental problem in the first decade of the 21st century in which finance and economics are primary drivers of human activities.

In fact, the main focus of personality theory both then and now is interpersonal relationships. In those days, the focus was on interpersonal relationships in the family. As the assessments have been applied to corporate settings, the focus has shifted to interpersonal relationships in business and organizations. But the idea is the same: to look at the quality of relationships and the level of interpersonal functioning. They do not link directly with any commercial or business outcomes defined in financial or valuation terms.

Consider this. The personality theories were developed before the modern theories of economics were developed. They precede Keynes by 30 years and Friedman by 60. The people who developed personality theory were focused on the interpretation of dreams and on the workings of the unconscious, which dreams were felt to be able to illuminate. Neither Jung nor Freud ever led or had anything to do with a modern corporation; both ran single doctor practices and dealt with the interpretation of dreams and sexual disorders.

The psychoanalytic approaches developed by Jung had nothing to do with business, economics or finance. They could not have since he himself had no framework to describe these phenomena. Yet personality theories are routinely used for leadership assessment and development in numerous companies worldwide.

Competency approaches developed out of the time-and-motion studies of the newly-expanded General Motors under Alfred Sloan. They were essentially vocational tools to help select workers who would cope best with the pressure of the production line. Over time these approaches were expanded to cover broader classes of workers. Then they were co-opted to be applied to leadership roles.

The competency assessments have been very successful in their application to vocational issues and are highly predictive of job performance in the vocational area. However as we shall see, their performance as a leadership tool is completely different.

However [competency theories] were never designed originally as leadership systems and none incorporates any model of leadership per se, or of the commercial and business outcomes that flow from them.

The competency assessments date from the beginning of the development of industrial and organizational psychology. The focus of these approaches was the integration of humans into factories and production systems. These approaches take a reductionist view of human performance that is very useful in the milieu for which they were originally designed. However, they were never designed as leadership systems and none incorporates any model of leadership per se, or of the commercial and business outcomes that flow from them.

Supplemented Later by Sociological and Anthropological Bias

The third category of approaches incorporates a variety of models. However, these usually center on emotional and social functioning. Intellectually these approaches date from Durkheim and his sociological models. These models frequently are applied to teams and to organizations and to their functioning from a sociological and an anthropological perspective. We can encompass these approaches within the rubric of social psychological approaches.

These approaches go well beyond the original personality and competency approaches which are above all focused on the individual and his functioning. This set of approaches focus on team and organizational functioning. However, we need to note yet again that these approaches are not oriented to business per se. They have no direct links whatsoever with commercial and business outcomes.

They Also Have Fundamental Systemic Flaws

With the wisdom of time, hindsight and a lot of experience in the field, we can now see that the classical leadership canon incorporates systemic flaws. These include the following:

1. Focus on interpersonal skills
2. No focus on strictly business outcomes
3. Ignores decision-making biases

Interpersonal skills have become such a part of leadership development that it might seem strange that this would be listed as a systemic flaw. Of course, interpersonal skills are vitally important in good leadership. But the problem has been that the focus on interpersonal skills has been at the expense of approaches that focus on job performance and leadership outcome. Relatively recent meta-analyses by leadership experts have demonstrated unequivocally that personality assessment results are not correlated whatsoever with leadership performance or job outcome[8].

Relatively recent meta-analyses by leadership experts have demonstrated unequivocally that personality assessment results are not correlated whatsoever with leadership performance or job outcome

This does not mean that a focus on interpersonal skills is wrong or misguided. Nor does it mean than there should not be development of leaders aimed at improving the vital interpersonal skills needed in leadership. What this means is that there has been a systemic failure in leadership study where the focus on interpersonal skills has been at the expense of developing outcome and performance and the skills related to these.

Business Outcomes: It is clear that ultimately good leadership must result in increased organizational or company value. Most times this will be reflected in business and financial metrics such as profitability and company valuation. But until very recently there has been no work whatsoever on the direct behavioral links between leadership and business and financial outcome and the associated financial and valuation metrics. We will explore this work further below.

Leadership approaches that focus on personality, competencies and team dynamics are all useful in themselves. However they do not link with the financial and valuation outcomes in a direct and measurable way in a manner that is desired and required by shareholders. These leadership approaches are inward-looking, focusing on the competencies that lead to better interpersonal and organizational functioning, which is fine in itself but does not address directly the links between leadership and profitability and competitive outcomes.

When boards and shareholders examine the performance of a CEO and his management team, their attention will ultimately be directed to the business and financial metrics rather than the organizational and interpersonal metrics. Until leadership approaches gather these concerns directly into their ambit, this issue constitutes the major systemic gap in modern leadership approaches.

Ignores decision-making biases: The classical leadership canon makes a distinction between rational leaders and those with personality pathologies such as narcissism. Clearly the leaders with pathologies will have problems in leadership performance. But this canon has not addressed the issue of why leaders who are rational may still underperform or even fail badly.

In effect, the classical leadership canon equates rationality with good performance. Yet, as we shall show below, the existence of universal cognitive biases in all humans and in all leaders and managers means that most decision-making is fundamentally flawed. This, along with classical economics and finance, assumes that rational actors will have the best performance and that lack of performance can be addressed merely by ensuring that the leader has more information and knowledge at his disposal.

A number of PEG companies have used psychometric assessments in their selection of CEOs. These include personality and competency assessments and also assessments of cognitive function such as IQ tests. There are a number of companies who provide these types of assessments to PEG companies. However their usage is not widespread. The reasons include:

- They mainly focus on psychoanalytic and vocational competencies rather than financial outcomes
- They were never designed to reveal financial or valuation outcomes
- They don't reveal what financial outcomes will occur for particular executives
- Thus they cannot show how to change behaviors so as to improve financial and valuation outcomes

The New Kid on the Block is Business Acumen Assessments

We have commenced to do this in our own particular way through our research into the financial traits of executives, some of which is published in E. Ted Prince's book **The Three Financial Styles of Very Successful Leaders** (McGraw-Hill, New York, 2005). This recognizes that business acumen is a very new topic in the field of leadership[9], examines the issue of business acumen in executives, and identifies what we term their "Financial Signature®." The Financial Signature® is part of a formal model which links the personal financial traits of individuals with financial outcomes, including valuation outcomes.

Our research identifies behavioral drivers which constitute an internal calculus. This calculus assesses situations involving risk and reward and cost and benefit. All of us have such an internal calculus. The Perth Leadership Outcome Model™ formally models this calculus and shows us how it relates to modern economic and financial theory.

Thus it [our research] predicts that most executives, as long as they are not aware of their financial traits, will impact the financial performance of their company by either generating no capital or consuming it

Our research reveals that all individuals have distinct, identifiable and measurable financial traits or competencies, which differ significantly between them. These financial competencies are characteristic and have highly predictable impacts on their financial decisions and actions and ultimately on their own financial performance and the performance of the organizations they serve. We can use this knowledge in a developmental manner to improve the financial performance of individuals and organizations, as we will discuss below.

The Three Financial Styles from Perth Leadership Institute

In our model[10], there are three distinct styles. One is the value-centric style, which, over the longer-term will result in capital generation. Another is the resource-centric style, which, again over the longer-term, will lead to the consumption of capital. The third is the balanced style, which over the longer-term will lead to neither capital generation nor consumption, Each of these styles has its place depending on a number of factors. These factors include the degree of market maturity, the stage of evolution of the company, and the extent of capital intensity of the product or service. The key is to align the Financial Signature® of the individual with the valuation objectives of the company. Over the longer-term, companies will usually want to have a majority of executives with value-centric styles but there will also be a significant need for executives with resource-centric styles. The key is to know when, where and how to use such styles to the best valuation advantage of the company.

Perth research[11] has discovered that the majority of executives have resource-centric and balanced styles. Thus it predicts that most executives, as long as they are not aware of their financial traits, will impact the financial performance of their company by either generating no capital or consuming it. Furthermore our research[12] shows that most executives do not have an innate comfort with financial issues, even when they have undergone extensive business training such as through an MBA program. Furthermore this lack of comfort extends to most leadership coaches. (A CEO colleague who is undergoing coaching recently indicated to me that his coach not only did not touch on financial matters with him but deliberately avoided them.)

"…most executives, as long as they are not aware of their financial traits, will impact the financial performance of their company by either generating no capital or consuming it…"

Difference between Financial Signature and Financial Mission

(not clearly differentiated)

In our model, one cannot change one's Financial Signature®, since it is innate. However one can change one's financial mission, the expression of one's Financial Signature® in one's own behavior. Thus Financial Signature® is not necessarily destiny.

However, generally individuals will not change their financial mission significantly although a few people can change it a lot. **<u>The aim of business acumen training is to identify the Financial Signature® of an executive and to show how their financial mission can be improved so as to better align with that of the organization and to make it more appropriate to the business and market circumstances in which the executive and the company are situated</u>**.

(See my comment re eliminating Page 32 on my cover email)

The possession of business training is no guarantee in itself of a value-centric financial competency. Indeed, having a business qualification and significant experience can often lead an executive to erroneously believe that she has a value-centric financial competency, leading her to adopt failing financial strategies.

This fact may explain why otherwise experienced and seasoned executives such as Carly Fiorina could fail. Even in the cases of such fallen icons as Bernie Ebbers, Jeff Skilling and Dennis Kozlowski, it is likely that the problem was not that they set out to defraud or otherwise but that their overconfidence in their view of their innate financial competency led them to make what now, in retrospect, look to be disastrous financial decisions.

> "…their overconfidence in their view of their innate financial competency led them to make what now, in retrospect, look to be disastrous financial decisions…"

Without any doubt these were strong and talented leaders who, by many conventional leadership criteria had it made. They almost certainly possessed resource-centric styles, of which they were, of course, unaware. This led them to financial and valuation failure, as a result of their lack of awareness of this issue. In this they were aided and abetted by their boards, which were similarly unaware. We need to reflect carefully on the extent to which this may be less an aberration, but rather a widespread phenomenon with far-reaching business ramifications.

In our model, leaders such as Ebbers, Skilling et al fail not just or only because they have personality defects – the often unspoken assumption behind media and academic judgments on them – but because they had resource-centric styles of which they and their boards were unaware. This led them to fail and to take actions to cover up their failures for as long as they could. In our model, if they could have discovered their Financial Signature®, they would have had another alternative, albeit not particularly attractive to them but nonetheless legal.

The issue, then, for companies, is to identify the type and degree of business acumen possessed by an executive and to help the executive develop the appropriate types and degree of financial mission required by the organization to meet its financial performance and valuation objectives. This process should be integrated into a Succession Planning Program (SPP).

Linking Behavior to Better Financial Performance

The aim of incorporating business acumen into SPPs is to directly impact the financial performance of individuals, teams and their organizations overall. Ultimately the objective is to increase the valuation of the organization relative to its competitors by allowing it to harness executive financial competencies directly to the aim of achieving the valuation objectives of the company.

Financial signature has extensive application in SPPs. These will apply in particular in the following components of SPPs:

- Selection and development of high-potential executives including CEOs
- Design and structuring of accelerated learning programs.
- The types of training programs offered to high-potentials.
- Formal assessments of the Financial Signatures® of high-potential executives.
- Inclusion of business acumen assessments in assessment centers.
- Integration of financial competencies into conventional competency models and approaches.
- Integration of business acumen into active learning approaches.
- Use of Financial Signature® in the choice of the most appropriate job rotations and assignments for high-potentials.

Certain issues stand out with business acumen assessments. These are:

1. The issue of team (as distinct from individual) business acumen and impact.
2. The issue of alignment between an executive's Financial Signature® and that of the company.
3. The appropriate balance between senior and mid-level executives in development of business acumen.
4. P&L managers versus cost center managers as participants.
5. The level of experience necessary to take advantage of business acumen assessments and programs.

1. Team Financial Signature and Impact

It is not sufficient to look simply at the Financial Signature® of an individual. We must also assess the Financial Signature® and the mission of a team. Just as conventional leadership approaches assess the relationship between the leadership types in teams, so must we undertake a similar analysis of Financial Signature® at the team level.

> In financially powerful teams, the financial mission of the team must be aligned with similar, not different Financial Signatures®.

However, with conventional team design, the approach is to structure them with complementary leadership competencies. But with financial missions, the reverse is the case. In financially powerful teams, the financial mission of the team must be aligned with similar, not different Financial Signatures®. Otherwise there will be basic disagreement within the team on how best to pursue market value in everyday decisions regarding cost and value. This is a counter-intuitive issue from the viewpoint of conventional leadership analysis but it is crucial in designing financially high-performing teams.

2. Alignment of the Financial Mission of an Executive and the Organization

Alignment between the financial mission of an executive and his organization involves more than the usual issues. On the surface they should be aligned in order to achieve a productive working relationship. However if the financial mission of the company is not appropriate to its market or stage of evolution, then this alignment will ultimately be unproductive and will lead to poor financial performance. Thus alignment is a necessary but not sufficient condition for optimal organizational financial performance. The sufficient condition is that the organizational financial mission also be appropriate and correct to the circumstances.

This introduces levels of complexity with which many leadership and HR professionals, not to mention finance professionals, will lack familiarity and expertise, but which are nonetheless crucial to successful implementation. We have conducted research[13] into the drivers of business, as distinct from financial performance which reveals more of the behavioral characteristics that are linked with value-adding and resource-centric behaviors.

The choices are a more short-term oriented approach by working with the top executives who can have an immediate impact on financial performance. Or it can be a longer-term orientation which focuses on developing the mid-level profit-leaders of the future, who, currently, it should be noted, are the implementers of profit-making strategies today

3. Balance between Senior and Mid-level Executives

Traditional SPPs have been focused on the CEO and the top management cadres. Recent developments are moving this focus to mid-level executives in recognition of the fact that they form the basis for a leadership-oriented culture. Managers of SPPs need to decide where the optimum balance should lie. The choices are a more short-term oriented approach by working with the top executives who can have an immediate impact on financial performance. Or it can be a longer-term orientation which focuses on developing the mid-level profit-leaders of the future, who, currently, it should be noted, are the implementers of profit-making strategies today. This decision requires a high-level leadership focus which is fully integrated into strategic financial and valuation goals.

An even deeper issue involves mid-level managers in SPPs. The Achilles heel of SPPs which focus on mid-level managers is that they have no way of judging their business acumen and hence their potential financial performance since many has never been in a P&L position previously. Many may not even have occupied a cost center management role. Business acumen assessments offer a solution to this problem. This area is probably the one that offers the greatest long-term payback for SPPs since it offers the possibility of identifying, at a far earlier stage, executives who are naturally high performers financially and those who may need developmental opportunities to improve their financial performance.

4. P&L versus Cost-Center Managers

The tendency in SPPs has been to focus on P&L managers. Business acumen training for these executives will have a major impact. However many of the most important players in large corporations are cost-center managers. Many of these have little understanding of their power over valuation improvement since they work to a budget rather than to a P&L. Business acumen training for these executives shows them their impact on the virtual P&L of which they are a part and sensitizes them to their role in valuation improvement for their organization. <u>We believe that one of the most important elements in an SPP is a focus on the cost-center managers to provide them with real-world understanding of their impact on the overall P&L..</u>

5. Experience Levels of Participants

Many of the concepts and issues in business acumen assessments and programs are more meaningful to participants who have at least a certain level of business experience or understanding. Very high-potentials may be appropriate participants even at entry-level. Others may require more experience to take full advantage of the program. The design and management of an SPP involving business acumen needs to take this into account. Experience is probably an even more important element than in conventional SPPs which do not incorporate a business acumen component.

This also raises the issue of whether or not an executive needs to have current discretionary power over spending and margin decisions in order to be able to benefit from the program. We are evaluating results of existing programs and the jury is still out. But our gut feeling is that, just as in quality programs, over the longer-term, it is better to go deeper into the organization so that even the lowest levels of management understand what is required of them financially and in order to improve financial mission alignment at all levels of the organization.

The Behavioral Proforma©

In assessing business acumen, most working investors will want to know about the level of business acumen of a potential CEO and his management team. But they will want more than that. They will want to know what this is likely to mean in quantitative financial terms for the particular company she will lead. They would particularly like to know how much profit she will make and how much she will improve the valuation of the company.

Until now there was no way to do this. But Perth’s research has allowed us to develop a robust approach to this based on psychometric assessments that will let us move directly to predicting the likely financial and valuation outcomes. This has resulted in the Behavioral Proforma© product family.

This unique product forecasts income statements based on the behavior of top managers including CEOs and their senior management teams. These income statements are based on behavioral data from Perth's psychometric assessments which identify and measure the financial impact of a person's or a team's behaviors. The Behavioral Proforma™ product family also provides forecasts of valuation based on individual and team behaviors.

> "…This unique product [Behavioral Proforma©] forecasts income statements based on the behavior of top managers including CEOs and their senior management teams…"

The Behavioral Proforma™ product family is targeted particularly at private equity portfolio managers. It is essentially used for management and behavioral due diligence. There are 4 uses of the product:

1. **Deal Behavioral Proforma™:** used in evaluating the future performance of a proposed deal based on the behavior of its proposed managers.
2. **Hiring Behavioral Proforma™:** used to compare the relative profitability and valuation performance of managers who are short-listed to lead a company.
3. **Company Behavioral Proforma™:** used to assess the performance of an existing portfolio company and whether problems are due mainly to the market or the company's management team.
4. **Portfolio Behavioral Proforma™:** used in an overall portfolio to assess which CEOs will underperform and to assess which senior managers who are not CEOs could provide a better profitability and valuation outcome for the portfolio.

The Behavioral Proforma™ product family is also used to assess CEO and top management behaviors which are best suited for companies in particular markets, at particular levels of market evolution, at particular levels of company evolution, and with particular levels of capital intensity. As part of the final report we also provide detailed behaviorally-derived valuation analytics.

The Behavioral Proforma™ product family is unique and provides private equity with a new and innovative set of behavioral tools that can have a dramatic impact on portfolio profitability and valuation.

Making Executives Self-Aware

Once a participant completes a Financial Outcome Assessment™, one of our instruments, they become aware of their Financial Signature®. This triggers a series of reactions and responses in the participant. These can be complex and need to be understood in order for the best results to be achieved in an SPP.

In the vast majority of cases, knowledge of one's Financial Signature® will be a revelation. This is mainly because for most people, this will be the first time they have heard of the concept of financial traits. Whether or not they have heard of the concept, they will almost certainly never have contemplated the issue of their own Financial Signature®.

Furthermore, in the majority of cases, the participants will not possess a value-centric financial style. For executives who pride themselves on their financial knowledge and skills, this may be a surprise, or even a shock.

We have found that the knowledge of their financial traits sets off a strong process of introspection and self-learning on the part of most participants. For most, there will be a productive response, which may or may not be sustained, depending on the level of organizational reinforcement. For a few, there will be varying degrees of defensiveness and rejection, and the learning opportunity, if it ever existed for them in the first place, will be reduced or even lost.

However, even some who react defensively will change their behavior as insurance, just in case the assessment is correct, which they may often suspect it is. In these cases there will be a positive impact on their financial performance, despite their concerns.

Participants with all three types of styles tend to react productively to feedback providing it is communicated in a developmental context. It should be noted that the mere possession of a value-centric style is not, in itself, a reason to feel satisfied, since the type of value-centric style they possess may still not be appropriate or aligned for their organization.

Many senior-level executives may feel threatened by business acumen assessments and may feel they have more to lose by undergoing them than by not doing them at all, even if by completing them, they may improve their own and the organization's financial performance.

This raises issues as to how to introduce these types of assessments into some senior-level components of SPPs. Yet business acumen assessments offer much to these executives that is not included in current SPPs, including the promise of fast returns for those who have the necessary degree of self-awareness to make fast and productive changes.

Resulting in Rapid Financial Impact

Participants and their supervisors generally report an immediate financial impact. This impact is generally more pronounced in the area of expenses. For margins, the impact will take longer. How long will be a function of the product cycle of the organization since the value-adding impact can only be felt ultimately through improvement of product or service margins and this usually may derive from product and service changes, which take time.

The aggregate impact of a business acumen program which focuses on cost center managers will be reductions in avoidable expenses and more sensitivity to their valuation impact.

Our programs have been in place long enough to measure the overall corporate impact of these programs. We have observed that, at individual and team levels, the expense and margin impacts are significant. When these programs are adopted company-wide, they can have a material impact on the overall financial and valuation metrics of the company.

Section 4: Outcomes of Behavioral Due Diligence

Short Case Studies

- COO of major publishing company completes assessments and immediately starts making financial decisions in a very different way that immediately improve profitability – states that he paid for full Perth program with first major financial decision he made after completing the program.

- CFO of Fortune 500 restaurant company indicates to QA that his financial performance increased 30-50% within 3 months of completing program and that he started putting recommendations into effect immediately after completing Perth program.
- CEO of multi-billion dollar company for the first time understands what is holding back his financial performance and makes major and dramatic new decisions which have major impact on profitability.
- CEO of energy company uses Perth assessments and coaching for his senior management teams and sees significant impact on profitability in his senior staff, plus is able to spot the ignored profit achievers who could be elevated to more senior positions.
- General Manager for innovation in Fortune 100 company indicates that his financial impact improves dramatically after doing Perth program.

Client Quotes ((MORE!))

"What I liked best was how the Perth approach provided a different perspective on myself and how to approach business situations"

"How do you get to the conclusions with the information I gave you? Was quite surprised with the accuracy, yet not sure how that visibility into my Financial Signature® was achieved."

"The day after my coaching session was completed I had to make a financial decision. I made it in a different way and it resulted in major savings. These savings more than paid for the cost of the Perth program

Outcomes from Perth Assessments and Training

1. Participants become aware of their own impact on financial outcomes and will change their behavior to improve this impact.
2. Participants become more cost conscious. Where reducing cost will increase value, they will reduce costs, but if reducing costs will reduce value, they will know how to make the correct tradeoffs.
3. Participants understand how their behavior impacts gross margin and make behavioral and process changes to increase the gross margin impact of their actions and decisions.
4. Participants know how to assess their own business acumen and that of their managers and how to use this information to improve financial and business outcomes.
5. They understand how to improve their alignment with the organization's financial performance, innovation and market value goals.
6. They understand how to integrate this approach into other organization-wide approaches, both in the human capital and other areas such as finance, marketing, sales, production and distribution.

The Financial and Valuation Benefits of Behavioral Due Diligence for Private Equity

Profitability: This will increase in the short-term mainly due to changes in cost-structure; it will change in the medium-term due to increase in gross margins tied to product and service design

Valuation: This will increase steadily for the following reasons:

1. Reductions in cost and increases in gross margin as above
2. Existing executives and staff who complete the assessments and training will change their behaviors to focus more on cost reduction and gross margin
3. The organization will start to recruit managers and executives with higher business acumen as they assess new hires and use this in their selection criteria so the overall level of business acumen and hence profitability-increasing behaviors will increase over time
4. Some staff will receive special business acumen coaching which will either resolve issues with them or result in their departure
5. Succession practices in both the company and the private equity company will improve meaning that the level of business acumen of top executives in the PEG portfolio will increase

6. The PEG portfolio companies will become progressively more aligned with the financial and valuation culture and targets of the parent company; this will occur not just at the top levels but also throughout the organization bring in a widespread culture where everyone feels they own the financial results of the company. Thus personal accountability and responsibility for overall financial results will increase.

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