

Selecting a CEO for a Leveraged Middle-Market Organization

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I have been a CEO and Interim CEO of Leveraged Middle-Market Organizations (“LMMO”) and involved in many CEO searches. My recommendations are based on these experiences.

CEO turnover is a major challenge facing boards, and it’s both disruptive and expensive. Selecting a CEO, then, is a most important responsibility for a board of directors—since the new CEO will be a major determinant of the organization’s success or failure:

- “CEO departures are on pace to hit the highest level on record this year,” according to executive outplacement firm: Challenger, Gray & Christmas (2019).
- PricewaterhouseCoopers published a 2019 report that found “successors to long-serving CEO’s are likely to have shorter tenures, worse performances and more are forced out of office than the CEO’s they replaced.”
- Forbes.com reported that “some 40% of new CEO’s are fired or ‘retired’ within their first 18-months.”

Much has been written about the CEO search process for Fortune 500 sized organizations. Less information is available, however, for an LMMO, whose CEO selection process may be even more difficult because of the additional constraints: debt levels, limited cash, fewer resources and a less-predictable revenue stream. It may also encounter a more limited candidate pool—as some qualified CEO candidates don’t want to work for an LMMO.

Business environments continue to be more ambiguous, complex and disruptive as consumers and customers have better purchasing information available to them. CEO’s must either be able to anticipate or adapt quickly to sudden

changing competitive conditions. **Different strategic environments require different CEO skill-sets and experience bases.**

The CEO candidate must have strategic as well as operational skills. Many of these candidates may excel at creating efficiencies but might lack strategic thinking. No amount of counseling or coaching can make the wrong CEO suitable.

Based on over twenty-five years of experience, I have found the **common threads** for an unsuccessful LMMO CEO search are:

- Focusing on CEO’s past experiences—when such experiences may not be relevant to this organization’s current situation;
- Hiring CEO’s who were efficiency experts but couldn’t pivot to developing and implementing a strategy in order to organically grow the revenue base;
- Succumbing to search fatigue and “settling” on a candidate.

Required Foundation for the CEO Search

RECOMMENDATIONS	WHY?
<p>1.) Establish a Board of Directors CEO Search Team—a three-member team must include diverse experience bases. These board members must be able to commit significant time for at least six months, in addition to board meetings.</p>	<p>* Search Team should include board members with different functional expertise—strategic, operational, marketing, financial and technical—so the search specs won’t be geared toward a single discipline. * Oversight should not be delegated to a search firm or to a senior officer within the organization.</p>
<p>2.) Conduct a Quality of Earnings Examination—Board Search Team must engage and directly oversee the examination—excluding senior officers so independence isn’t impaired. Team should engage seasoned financial as well as operational professionals to conduct the Quality of Earnings Examination.</p>	<p>* An audit by an independent CPA firm doesn’t determine Quality of Earnings. * The board must understand the true financial condition as well as what income and expenses are not recurring in order to develop appropriate CEO specs. Reversing reserves is not a source of recurring EBITDA, but is frequently used to manipulate earnings and mislead stakeholders. * Examination requires both skill-sets.</p>

<p>3.) Conduct a Strategic-Operational Evaluation—the Search Team must engage highly-experienced independent professionals skilled in strategy, operations and finance—who must summarize the challenges and opportunities that the new CEO may face by evaluating the:</p> <p>√ Business Model √ Operating Model √ Value Proposition √ Resources to implement √ Management Process the strategy √ Organizational √ Cost Structure Structure & √ Culture Management Depth</p>	<ul style="list-style-type: none"> * Financial consulting firms are generally incapable of performing a strategic review because their professionals don't have a meaningful strategic experience base. * Independent professionals should advise the Search Team on whether the organization's Value Proposition and Operating Model must change. * The Team must agree on the problems, challenges and opportunities facing the organization before developing the CEO specs. * The CEO specs will be different based on the organization's growth strategy.
<p>4.) Meet with customers, suppliers, industry experts and people from all levels of the organization to better understand the organization's current position and its future challenges and opportunities.</p>	<ul style="list-style-type: none"> * The Team should not rely solely on board meeting information, which may be inadequate to understand the business. * Given the organizational strategy, the Team should determine the few competencies most important for CEO candidates. * The Board Search Team should also identify possible CEO candidates during this process

Some board members will read these recommendations and say, wow, that's a lot of work. Absolutely it is. However, hiring the wrong CEO could result in a viability crisis. The Board Search Team will gain the necessary CEO search foundation if it implements all four of the above recommendations.

Required Foundation for the CEO Search (continued)

All stakeholders—equity, debt, customers, suppliers, employees—must play important roles in the CEO Search Process. For instance, a highly-leveraged organization—pushing its debt limits—may have to discuss how to fund the search process with its lenders so its limited availability won't be interrupted.

Example: Quality of Earnings

The independent auditors concluded their examination of the financial statements without identifying any significant write-offs. Our Strategic-Operational Evaluation began at this time. As a bi-product of our evaluation, we identified significant write-offs related to the current year as well as the two previous years. Such write-offs immediately

triggered debt covenant defaults and significantly reduced projected cash flows. Most importantly it forced the company to begin fixing its serious problems.

After “recording” the write-offs in the proper years, we found that the company had been in violation of its debt covenants for the last two years. If they had known previously, lenders would have forced the company to fix the problems two years earlier. The company wasted two years it had to begin fixing the serious problems. **Getting a Quality of Earnings Examination is a must.**

Example: Research Study at Over 850 American Companies

I highly recommend reading “Searching for a Corporate Savior: The Irrational Quest for Charismatic CEO’s” written by Rakesh Khurana, an Assistant Professor of Organizational Behavior at the Harvard Business School. Khurana’s findings are based on a study of the hiring and firing of CEO’s at over 850 of America’s largest companies and on extensive interviews with CEO’s, corporate board members and consultants at executive search firms.

Dr. Khurana found that “corporations have increasingly sought CEO’s who are above all else charismatic...but whose experience and abilities are not necessarily right for companies specific needs.”

Again, **to determine the specific needs of the organization**, the Board Search Team must:

- Engage a Strategic-Operational Evaluation by highly-experienced independent professionals, and
- Meet with customers, suppliers, industry experts and people from all levels of the organization to better understand the needs, opportunities and challenges facing the organization.

Preparing the CEO Criteria

RECOMMENDATIONS	WHY?
<p>1.) A Search Team should develop CEO specs based on the results from the four recommendations above.</p> <p>They should list a few competencies—the most critical—that the CEO must have and not prepare a wish list.</p> <p>The Search team must determine how they will assess the competencies required by the CEO candidate.</p>	<ul style="list-style-type: none"> * A CEO who excels in the few competencies that the organization needs should be hired—rather than someone who just meets a laundry list. * CEO specs should be aligned with the strategic needs—current as well as future—of the organization. * The Team should agree on how to assess whether each candidate possesses the agreed-upon competencies.
<p>2.) The Team should not copy the skill-set of prior successful CEO's.</p>	<ul style="list-style-type: none"> * The future business environment will be different from the past, so the Team shouldn't try to duplicate a prior successful CEO's skill-set.
<p>3.) A successful CEO must be able to communicate with the market-place as well as with all levels of the organization.</p>	<ul style="list-style-type: none"> * The Team should be careful not to be “completely swayed” by a candidate with outstanding presentation skills.
<p>4.) The CEO specs must state what industries to avoid as well as what experiences would not be appropriate for this CEO position.</p>	<ul style="list-style-type: none"> * The Team should avoid candidates from near-monopoly type industries, candidates that have spent their entire career with Fortune 500 companies, as well as CEO candidates that view their insurance knowledge as a key skill-set.
<p>5.) CEO specs must specify what values and beliefs can't change.</p> <p>What cultural fit must CEO candidates possess?</p>	<ul style="list-style-type: none"> * Although this sounds obvious—it is not. * For example, if the culture includes the CEO making regular visits to all the operating locations, then the candidate must have a history of regularly interacting with all levels of their prior organizations.

Example: Preparing the CEO Criteria

During a consulting engagement with a LMMO medical technology company, the CEO —previously a senior executive of a Fortune 40 company—told me that he shouldn't have accepted this CEO position because he didn't have the resources he was accustomed to having—such as:

- Strong brand name
- Adequate cash to pursue opportunities
- Skilled and deep talent pool

Again, the CEO specs should list industries, company size and experience that are **not** appropriate for this specific CEO search.

I also highly recommend “Why Smart Executives Fail: And What You Can Learn from Their Mistakes,” written by Sydney Finkelstein, Professor of Management at Dartmouth's Tuck School of Business. Finkelstein said a critical issue that kept coming up was “the tendency to overestimate the quality of managerial talent by relying on a track record, especially in situations that differ markedly from the present new venture.”

Search and Interviewing Process

RECOMMENDATIONS	WHY?
<p>1.) An executive search professional that fits the organizational culture should be engaged. The executive recruiter should spend time at operating locations to understand the business before beginning the search process.</p>	<p>* Executive recruiters are highly-skilled consultants, but they can't be if they're spoon-fed the situation.</p> <p>* The executive recruiter should attend management meetings at various locations to better understand the culture and organizations' dynamics.</p>
<p>2.) Both the executive search firm as well as the Board Search Team should identify CEO candidates.</p>	<p>* The board will be more engaged in the search process if it also identifies possible CEO candidates.</p>
<p>3.) All levels of the organization should be involved in the CEO interview process.</p>	<p>* The CEO must be able to interact with the entire organization in order to implement significant changes required with LMMO's.</p>

4.) Each CEO interview should include two interviewers.	* After the interview, the two interviewers should not discuss their observations with each other but instead send observations directly to the board's point person
5.) To minimize surprises, an independent firm — not engaged in the search process— should be hired to conduct an extensive background search.	* Normal reference checking is not useful because most people “sanitize” what they say because of legal liability concerns.
6.) At least one of the CEO interviewers should have already been a CEO.	* CEO's will have more relevant experiences to “dig deeper.”

Example: Search and Interviewing Process

The ownership group headed up the CEO search and conducted the initial interviews. As the Interim CEO, I next interviewed candidates. The ownership group liked each of the first two CEO candidates, but I told them why each of the candidates would not be a successful CEO. The ownership group again liked the third candidate, but when it was my turn, they wanted to be in the room with me while I interviewed the candidate. After about 45-minutes, we took a break, and the ownership group asked what I thought. I said the candidate wasn't appropriate. Upon hearing my observations, the ownership group agreed—even though they had previously thought the candidate was appropriate.

It is necessary to make sure the **CEO interview team includes someone who has been a CEO**—so questions reach a more detailed level than those provided in buzzword-type discussions.

Selecting a CEO for a LMMO is one of the most important as well as most difficult duties of the board of directors. A successful CEO search process requires the commitment of several board members and a defined search process—beginning with a solid independent information foundation. Given its importance, **don't rush the CEO search process.**

Please read my other articles at flatironsmanagementgroup.com

- “How to Profitably Grow Underperforming Companies”
- “Why Middle-Market Organizations Struggle Developing and Implementing a Strategy”
- “Strategy Process for a Leveraged Middle-Market Organization”
- “Tips to Turn Around a Distressed Company: A Nuts and Bolts Approach”

- “Culture in Leveraged Middle-Market Organizations”

References

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