1 The Landscape of Leadership Risk

1.1 INTRODUCTION

One of the central ideas upon which this book is based is that, in order for private equity investors to maximise the chances of creating value in their investee companies, it is better to focus on assessing 'leadership risk' rather than simply assess 'leadership'. Although the distinction between leadership and leadership risk may seem a minor one, it is in fact highly significant. The assessment of leadership is a fairly narrow activity focused on certain key individuals whereas leadership risk is much broader and takes as its starting point the chain of value creation and destruction. Whilst the primary emphasis of this book is related to *how* leadership risk can be assessed and managed, the current chapter sets the scene by considering the question of *why* leadership risk represents the problem it does. Before introducing the leadership risk mapping framework, which is described in detail in the following chapters, the current chapter is therefore dedicated to a consideration of the landscape of leadership risk which confronts private equity investors and the problem of how best to make sense of that landscape.

We will argue that, to manage risk of any kind it is important to minimise uncertainty and raise awareness of the variables which may enhance or inhibit success. To make effective decisions it is essential to have a broad and deep understanding of the territory in which one is operating. This is critical in providing the insight required to ask the right questions and identify which areas require attention. It can be argued that the most serious risks facing any business are those which are not already in the awareness of the management team or stakeholders. In such situations, where the boundaries of the risk map are too narrowly drawn, there is a false sense of certainty and security. Several of the dimensions of leadership risk which will be explored in subsequent chapters fall into this category.

Irrespective of the particulars of a specific investment, there are two general problems associated with leadership and leadership risk which

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often arise in the context of private equity-backed businesses. Firstly, in rapidly growing businesses, the future is always different from the past and, ultimately, the extent to which the business is able to anticipate and adapt comes down to leadership. When unexpected leadership issues manifest without prior awareness or preparation and there is insufficient time to explore these in sufficient depth, decisions may be taken which lead to extreme or inappropriate measures. Secondly, in fast growing businesses, leadership assessment and development is often seen as a low priority and does not appear on the investor's 'dashboard' as being a significant dimension through which the business is driven. As a result, the topic of leadership often begins to attract attention only when it becomes a problem. Significant leadership-related decisions may therefore be rushed and made on the basis of an inadequate understanding of the links between business performance and leadership. When such decisions are rushed in this way it becomes difficult to evaluate the possible consequences, or other possible options in any depth. We will explore the problems related to rushed leadership-related decisions further in Chapter 2.

We begin this chapter with a critical examination of the 'dominant lens' which is used to understand business – that of accounting language. We will highlight some of the many advantages which accounting representations offer whilst also indicating some of the limitations of this perspective. In particular, we will suggest that the apparent rationality of accounting is much less robust under conditions of rapid change, complexity and uncertainty – which are the conditions surrounding many private equity investments. We will also explore the issue of uncertainty further and its links with the history of the development of the idea of risk. Having identified some of the problems arising from the use of accounting under conditions of risk and uncertainty, we will also consider why the leadership agenda associated with private equity-backed businesses often poses a particular problem. Having set out the limitations of both an accounting perspective and a leadership perspective we will then make the case for using the leadership risk framework, not as a means of managing risk in a formal sense but as a useful metaphor for identifying and addressing some of the critical issues which can create or destroy value in private equity-backed businesses.

1.2 THE FINANCIAL PERSPECTIVE

Accounting is widely recognised as being the 'language of business' and financial data will always be the central reference point on a private equity investor's 'dashboard'. Financial analysis supports decisions about which opportunities to explore, which investments to make and how much to pay. An understanding of the numbers guides the many decisions made both by the investor and the investee management team on the journey through to exit. The accounting view is so dominant that it is taken for granted. However, but for the purpose of the current discussion it is useful to examine the characteristics of accounting which make it so appealing, and highlighting some of the critical functions which accounting language performs:

- Enabling communication – accounting represents a highly convenient 'universal shorthand' which enables the quick and straightforward description and communication of widely differing scenarios in equivalent terms.
- Establishing a sense of order – accounting creates a clear sense of balance, order and structure and so forms the basis for 'rational' management and control.
- Reducing complexity – the way in which accounting achieves the above functions is by reducing complexity and, in reducing complexity, creating a greater sense of certainty.
- Managing the 'problem' of time – underpinning the above functions of accounting, the way it solves the problem of time which is described below.

One of the central themes of the current chapter is the link between complexity, uncertainty and risk. A central challenge facing a private equity investor is how to make decisions about a business as it moves from a 'known' past into an 'unknown' future. To understand and manage risk it is necessary to view what is known in the present in terms of its future implications. Indeed, it could be argued that the basis for successful business planning and management is rooted in a view of the business which unites past, present and future. Businesses are able to achieve precisely such a view through the use of accounting systems.

The language of accounting reduces past and future business events to equivalent terms, linking them seamlessly and giving a sense of continuity. Beyond that, it offers the enticing possibility of playing with time. Alternative accounting treatments can provide alternative accounts of the past. They can also be used to generate an infinite range of future scenarios. Accounting systems present the past, present and future in a consistent way with financial statements and management accounts showing what has gone before and business plans and budgets indicating what is to come; both time periods are expressed in equivalent terms. Any given moment – past, present or future – can be frozen and expressed in terms of assets and liabilities in a balance sheet. The objective and impartial flavour of accounting language makes it an ideal framework upon which to build a 'rational' view of the world.

Accounting therefore provides a guideline for rational management, reduces complexity and provides a sense of order. However, this sense of certainty comes at a price and so brings with it a number of problems, not the least of which is the simplification entailed in translating the complexities and uncertainties of business reality into the neat order of numbers. For over half a century, researchers have suggested that, in practice, accounting frameworks are used in different ways depending on the level of uncertainty which prevails. In situations where the business being accounted for is relatively stable and there is a high degree of clarity about the cause and effect relationships which create value, accounting lends itself well to the function of building understanding and making decisions. However, the more rapid the rate of change in a business, the greater the difference between its past and future and the more complexity there is, the less useful accounting language is as a basis for making decisions and making sense of the business. Here, although accounting provides the same sense of order, what is actually happening is a process of post hoc rationalisation. Major decisions have to be made on the basis of incomplete or ambiguous information and only afterwards can any degree of certainty be achieved. The scenario confronting private equity-backed investment teams and the general partners who invest in them almost always involves significant change and uncertainty. The closer one gets to this scenario, the more decisions are based on 'leadership inspiration'. As a result, a proper understanding of 'leadership' becomes more important as the basis for understanding and managing the business.

From this perspective, it can be argued that when it comes to understanding and managing risk, the value of an accounting frame of reference decreases as the rate of change and the degree of complexity increase (see Figure 1.1)

1.3 A BRIEF HISTORY OF RISK AND UNCERTAINTY

The issue of risk and uncertainty and the distinction between the two extends well beyond the world of accounting and it is useful here to consider briefly how these themes have developed over time. Over the

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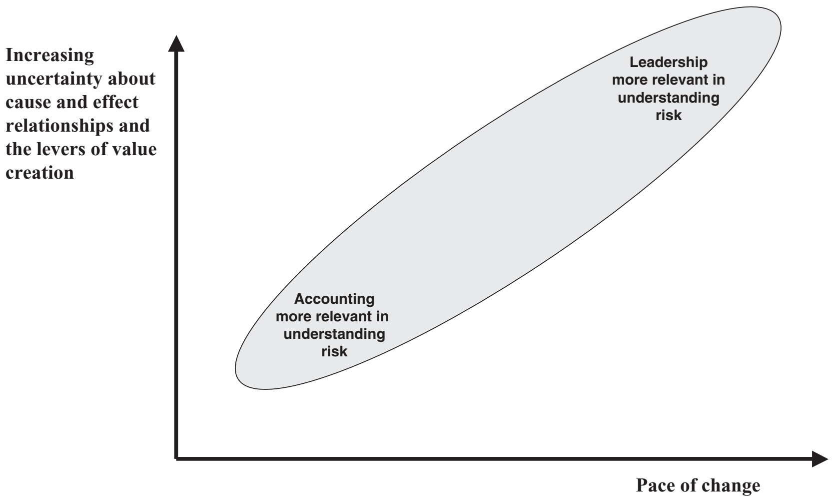

Figure 1.1 Accounting, risk and uncertainty

centuries, human beings have responded in differing ways when confronted with the inevitable uncertainty of events and the consequences of decisions. There has been a general tendency to assume that things which are more readily quantifiable are more important than things which are more nebulous and subjective; and more time is devoted to analysing those aspects which are quantifiable than those which are not. By their nature, investment decisions revolve around uncertainty and risk and it is important for investors to recognise the boundary between the quantifiable and the unknown. In his book *Against the Gods*, Peter Bernstein notes: 'Today, we rely less on superstition and tradition than people did in the past, not because we are more rational, but because our understanding of risk enables us to make decisions in a rational mode.'

A key distinction, highlighted by the economist Frank Knight early in the 20th century, is that between risk and uncertainty. The statistical frameworks which had been developed in the preceding centuries were often too firmly rooted in the analysis of probability applied to games of chance, such as roulette or dice. In this context, probabilities can be established with some precision, and risk assessments can be made. However, in business and the wider economy, there will always be factors that are unknown, unquantifiable and unexpected. For all the apparent rigour and scientific method in applying probability theories to the real world, they are essentially irrational to the extent that they exclude factors which cannot be quantified. Knight wrote: 'Uncertainty must be taken in a sense radically distinct from the familiar notion of risk, from which it has never been properly separate. It will appear that a measurable uncertainty, or risk proper, is so far different from an immeasurable one that it is not in effect uncertainty at all.'

The ever-present element of surprise means that any attempt to extrapolate from the past frequency of events is inherently dangerous. Techniques developed from areas where probabilities can be accurately calculated may be pleasingly neat, but that does not mean that they can automatically be translated to other areas merely because data can be generated to be able to perform the calculations. In the real economic world, even if certain patterns appear to be stable, there is no guarantee that they will continue.

In a similar manner, Knight's contemporary John Maynard Keynes argued that the probabilities of events in the real world are not subject to tools of measurement. In 1937, in *The General Theory*, Keynes wrote: 'The game of roulette is not subject to uncertainty. The sense that I use the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest 20 years' hence, or the obsolescence of a new invention. About these matters, there is no scientific basis on which to form any calculable probability whatever. We simply do not know.'

Keynes was scathing about the reliance of classical economics on past events, arguing that the unstable and dynamic nature of an economy means that the mathematical patterns established in the recent past may have little or no relevance today, as the underlying context has changed, and the players never have perfect information.

The implication of this dimension of risk – or more accurately defined, uncertainty – is that a different kind of assessment is needed. In business contexts there has traditionally been a bias towards managing and analysing aspects of the company that are measured, over those that are harder to quantify but may be equally influential. However, the true measure of a robust risk management framework is not the depth and complexity of analysis it generates but the extent to which it can embrace and facilitate understanding of those factors which ultimately influence performance and can create or destroy value.

The distinction between risk and uncertainty is perhaps at its most stark in the area of leadership risk Leadership risk is uncertain and

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complex because it relates people and their capacity to lead businesses, and this is a complex and uncertain process. Although leadership can have a significant impact on business performance, the mechanism by which this occurs is opaque so that precise causal relationships cannot be discerned. As a result, predictions cannot be made and probabilities cannot be calculated. Moreover, the drivers of human behaviour, actions and reactions lie below the surface and may not even be within the awareness of those concerned. As we will set out in the final section of this chapter, such problems are not insurmountable and the leadership risk mapping framework described in the rest of this book can provide a way forward.

The above discussion suggests that the value of accounting, as a means of truly managing and understanding business and risk, diminishes as uncertainty and complexity increase and, indeed, the whole issue of the distinction between risk and uncertainty is problematic. It can be argued that, the more uncertainty there is surrounding a business, the more the success or failure of that business hinges on the leadership capability of the senior team but, as we will explore below, the whole concept of 'leadership' also represents something of a problem.

1.4 LEADERSHIP THEORY

The previous section suggested that the conditions of change and complexity associated with private equity investments are such that an understanding of leadership is of key importance and that the language of accounting, the predominant 'lens' used to understand business, is ill-equipped to provide useful insights in this area. A further problem is that there is no equivalent universal 'language' for tracking and managing issues relating to leadership risk. The literature on leadership is diverse and, arguably, inconclusive. Just as accounting language can be seen to be problematic, so can the language of leadership, and some of the associated problems are set out below.

Firstly, leadership assessment and development is often seen as peripheral to the main business agenda. It is seen as a worthy activity to engage in when sufficient time and resources are available but it is really something which larger, more stable organisations can address and not a central topic within the context of private equity investments. One reason for this is that the leadership behaviour agenda is not sufficiently rooted in the business context – it is seen as being too general and too abstract. Many leadership development courses are only intermittently relevant and contain components which will not be used. This perception will be reinforced by the personal experience of many private equity investors who have completed an MBA. For many, the value of an MBA lies in its demonstration that the individual has gained entry and survived in the highly competitive environment of a high-prestige business school rather than the actual knowledge acquired. As a result the actual content of the programme, particularly in the area of leadership theory, is often forgotten.

The framework described in subsequent chapters of this book is not about presenting an ideal type of leadership or adopting a new persona, but about raising awareness in those areas where increased attention will take leadership to the next level and so boost business performance.

1.5 LEADERSHIP RISK AND UNCERTAINTY

In the Introduction we defined leadership risk as follows:

> The risk that senior management, either individually or collectively, do not have, or fail to apply the necessary capability or motivation to deliver the expected performance and/or that their leadership of the enterprise limits or destroys value.

In light of the previous section it is clear that leadership risk does not represent 'risk' in any formal sense as it is not possible to calculate probabilities in the areas of leadership behaviours. However, it can be argued that the use of the term 'leadership risk' and the use of a 'leadership risk mapping framework' are useful if 'risk' is understood in a metaphorical rather than a formal sense. The advantages of a risk mapping metaphor are described below.

1.5.1 Emphasis on the 'Asset'

Thinking in terms of 'risk' brings attention to the fact that there is an 'asset' which holds the potential to generate value in the future. This encourages the investor to constantly look and think ahead and reflect on issues such as how the potential of that asset will be realised. This helps to sharpen focus and helps to ensure that attention is given to the question of what will create and destroy value in the business.

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1.5.2 Systematic

Using a risk metaphor helps to ensure that the business is explored in a systematic and disciplined manner. This kind of systematic perspective is useful because it brings attention to the way in which threats, opportunities and other invariables are interconnected. A risk management framework therefore enhances awareness of how these factors are connected rather than looking at them in isolation.

1.5.3 Structured

Exploring issues from a risk management perspective helps to ensure an approach which is structured and disciplined. As we will see further in the next chapter, it helps to achieve balance and rigorous understanding and ensures that issues are worked through in a methodical manner.

1.5.4 Prioritisation

Use of a risk management metaphor helps to provide a basis for considering issues in equivalent terms, which helps to ensure that priorities are clearly set.

1.5.5 Decision Making

The structure provided by the risk management framework also provides a sound basis for making important decisions. It helps to ensure that the decision maker is well prepared to make important decisions and is able to act quickly and confidently when the need arises. It thereby reduces the likelihood of unexpected threats manifesting.

1.6 LEADERSHIP RISK IN BUSINESS PERFORMANCE

To manage leadership risk successfully it is important to identify as clearly and systematically as possible the links between leadership performance and business performance. A useful starting point in understanding leadership performance is the work of Timothy Gallwey, who initially looked at how to improve performance in sport and then went on to show how similar principles could be applied to the world of work. Gallwey's work centres on what he refers to as the 'inner game', at the heart of which is a simple formula relating to human performance:

$$Performance = Potential - Interference$$

We will show that this formula has significant implications for leadership risk. Working though the framework which is set out in subsequent chapters makes it possible to unpack the two variables of potential and interference in order to ensure that the performance of the leadership team is as effective as possible, which in turn will maximise the chances of achieving business success. In introducing the formula it is useful to consider the significance of each term in the inner game equation from a leadership risk perspective.

1.6.1 'Performance'

Performance relates to what the members of the management team, both individually and collectively, actually do. In essence, this relates to the way they lead the business. It relates to the decisions they make, the extent to which they motivate and inspire their people, the way they manage one another and their relationships with key stakeholders and the way they interact with the investor. Their 'performance' in the management team as leaders will be directly linked to the 'performance' of the business. However, whereas business performance is ultimately an outcome expressed in accounting terms – '*what* results has the business produced?', leadership performance relates to the more complex question of *how* those results are achieved. Performance, then, relates to whatever it is the leadership team actually does, and the essence of leadership risk is to understand the factors which drive the performance.

1.6.2 'Potential'

The potential of the leadership team relates to how far they actually possess the requisite knowledge, skill and experience to lead the business to a successful exit. From a leadership risk perspective this factor in the equation centres on the question 'Can they do it?' The assessment techniques described in subsequent chapters attempt to gauge the depth of potential on which the management team can draw. Where gaps exist between the potential of the management team and the requirements of the business, this can form the basis of the leadership development plan. However, to fully maximise business performance such a development

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plan also needs to take full account of the final element of the equation – interference.

1.6.3 'Interference'

The third element of Gallwey's equation, interference, is arguably the most opaque and most often overlooked, and the leadership mapping framework attempts to address this. Interference relates to any factors which could get in the way of the leadership team realising their full potential and which could therefore impede business performance. Although some sources of interference may be obvious, many are not and can only be identified through a process of careful exploration. Sources of interference may exist within the minds of the management team and could include factors such as their level of motivation and clarity of understanding. Other sources of interference may stem from the limit of human capabilities (for example, from exhaustion). However, interference is not solely located within the leadership team. Problems may arise in the relationship between the investor and the investee teams which may impede performance. As we will see in Chapter 8, interference may also arise on a wider organisational or cultural level, for example where there is resistance to change.

One reason that the 'inner game' model is particularly relevant for private equity-backed businesses is that it deals with learning and how best to facilitate learning. Given the complexity and rapid change associated with private equity-backed businesses, the challenge of managing and leading these will almost inevitably require the senior leadership team to learn and develop in some way. As we will explore further in the next chapter, problems can arise when either the members of the management team themselves, or the investor, attempt to bypass this learning process and either 'teach' or impose solutions. As we shall see, rather than 'solving' leadership weaknesses, this approach may compound the problems which it attempts to address. The alternative put forward in the leadership risk mapping framework is to follow three key principles which Timothy Gallwey found to be highly significant in learning and development. The first, and possibly the most significant, of these is the importance of raising *awareness* and doing this in a nonjudgemental way. As described further in the following sections, the framework is built upon techniques which raise awareness on a number of levels. The second of Gallwey's key principles is to *trust* in the inner potential of the leaders in the business. Gallwey found that learning takes place quite

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naturally merely through the process of raising awareness. For the purpose of the current discussion, the important thing to bear in mind is that both the investor and the investee management team need to maintain faith in the ability of the management team to learn appropriately in light of the insights which come from raising awareness. The final one of Gallwey's principles is to keep the *choice* with the choice maker. In the case of private equity-backed businesses, this means that the investor should resist the temptation to dictate approaches and solutions and allow the leaders of the business to decide for themselves what to do. As long as both parties have a clear shared understanding of the ultimate outcomes which are sought, and awareness is raised appropriately, this should maximise the chances of success.

Of the three principles set out above, awareness is probably the most significant within the context of management risk mapping. Throughout the following chapters we will emphasise the importance of maintaining awareness on a number of dimensions using the model described below.

1.7 THE FOUR QUADRANTS OF AWARENESS

At the beginning of this chapter we suggested that the essence of effective risk management was the reduction of uncertainty. Effective risk management therefore begins with the raising of awareness of whichever factors may ultimately influence success or failure. In the previous section we began to set out the high-level elements of leadership risk and we will now develop this idea further by introducing a model of awareness which underpins the framework set out in subsequent chapters. Given the complexity and subtlety of leadership risk it is important not to oversimplify and to be aware that factors influencing value creation and destruction may or may not be obvious on the surface. For this reason, the first dimension of this model relates to the inner and outer world. The outer world relates elements which are observable and, to a certain extent, measurable. This includes factors such as behaviour, systems, processes and policies. The inner world relates to what is going on below the surface on an emotional and psychological level in the minds of those involved. This includes factors such as knowledge, emotions, hopes and fears. The other dimension of the model relates to the two stakeholder groups most directly affected by leadership risk, the investor and the investee. It is important to maintain awareness of this dimension as, if it is the investor who is conducting the assessment of leadership risk in the investee management team, then they need to

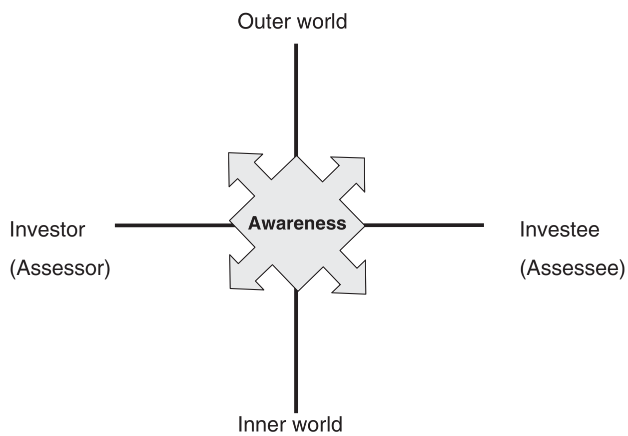

Figure 1.2 The four quadrants of awareness

remain aware that they are not independent of the process. As mentioned earlier, the mere fact that one is being assessed in itself influences the result of that assessment. Given the tensions and pressures surrounding private equity-backed businesses it is vital that the assessment of leadership risk is done in a way which enhances rather than impairs the relationship between investor and investee, so maintaining an awareness of the relationship between the two and the impact of one party's actions of the other is critical. In a wider context this dimension can also be equated to whoever is conducting the assessment (the 'assessor') and whoever is being assessed ('the assessee'). Taking these two dimensions, it is possible to identify the four quadrants and these are shown in Figure 1.2.

Throughout the remaining chapters we will return to the relevant factors arising in each of these quadrants and look at how a fair consideration of the interplay between them can greatly enhance one's insight into leadership risk and ensure that the process of assessing it is as painless and effective as possible.

1.8 SUMMARY

- To be truly effective, it is important that a company's risk map embraces all the factors which can influence success or failure. The biggest risks of all are the ones that do not appear on the risk map.

- Leadership risk presents a particular problem in private equity-backed businesses because the rate of change means that a great deal depends on effective leadership, yet leadership assessment and development are not seen as being a high priority.
- Accounting works well as the language of business, acting as a guideline for rational management. However, it does this by presenting a highly simplified version of reality.
- As uncertainty increases in the business, it becomes harder and harder to extrapolate from the past, accounting is less and less useful as a true guideline for 'rational management' and tends to be used more as a vehicle of post hoc rationalisation.
- The distinction between risk and uncertainty is often blurred. In a formal sense it is only possible to talk about risk when all outcomes can be defined and probabilities calculated.
- Leadership risk is associated with significant uncertainty because it depends on human behaviour, which cannot be predicted.
- Leadership theory does not provide an alternative to accounting. It is often difficult to reconcile the leadership agenda with the business agenda.
- One way to approach this is to think in terms of leadership risk and use risk as a metaphor to frame the various issues and factors which can impact business performance from a leadership perspective.
- In exploring the link between leadership risk and business performance, the formula: 'Performance = Potential – Interference' is helpful.
- It is also useful to cultivate awareness in four dimensions: the outer world of the investee, the outer world of the investor, the inner world of the investee and the inner world of the investor.
- This 'four quadrants of awareness' framework underpins much of the leadership risk framework. The aim is not just to raise awareness in the four quadrants, but also to consider how they relate to each other.

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