Leadership and Organizational Theory Dynamics Between Middle Market Private Equity Firms and the Portfolio Companies They Control

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Private equity firms manage funds on behalf of limited partner investors. Private equity funds invest directly into middle market businesses. Satisfactory investment results affect private equity firms’ ability to raise successive funds. Successive funds dictate business continuity for private equity firms. Several variables impact expected investment results, variables too numerous for the scope of this essay. This article will explore leadership and organizational variables between private equity firms and the portfolio companies that they control. The relevance to consultants is averting miscues that threaten private equity firms’ investment theses for their portfolio companies, as well as the relationships across diverse stakeholders.

According to Doug Lowenstein, President of the Private Equity Growth Council, private equity firms have invested $1 trillion in their portfolio companies in the past decade (PEGCC, 2010). The Private Equity Growth Council reports that one out of every 20 private sector jobs is supplied by companies whose capital base includes private equity investment (PEGCC, 2010).

Arundale (2003), the World Economic Forum (2009), and Kaiser and Westarp (2010) provide valuable foundational insights to private equity industry norms. Private equity firms function as a general partner to manage investment funds that, in many respects, resemble mutual funds. However, incentives differ from a mutual fund in that the general partner managing the fund on behalf of the limited partner investors enjoys performance incentives—a strong endorsement of agency theory. The general partner typically receives a portion of the upside for investment performance, but only after the return exceeds a certain threshold. As a governance mechanism, funds typically have a claw back provision to stem potentially risky general partner behavior, i.e., profits from successful investments may be clawed back to cover losses of unsuccessful investments.
Larger, publicly-traded private equity firms tend to pursue relatively bigger investments. For example, in 2009, Blackstone Group invested $2.3 billion in SeaWorld Parks & Entertainment (The Blackstone Group, n. d.). However, comparatively few private equity firms are publicly traded. Most are closely-held firms. Some are self-funded. The exact number of private equity firms is unknown; however, the Private Equity Growth Capital Council reports 1824 U.S. firms (PEGCC, 2012). These private equity firms tend to describe themselves in terms of their generic middle market target market: lower middle market, middle market, and upper middle market. Middle market descriptors are potentially confusing because there is no trade association glossary of terms and definitions denoting precise boundaries for the segments.

Private equity firms relate their market focus in terms of verticals. A vertical is clearly understood as a type of business that roughly corresponds to a standard industrial classification code, or SIC code. For example, Chicago-based Linden, LLC, focuses on healthcare and life sciences (Linden, 2012). Private equity firms also describe the size of company in which they prefer to invest in terms of sales volume or EBITDA (earnings before interest, taxes, depreciation, and amortization). For example, Boston-based Riverside Partners, LLC, (2012) describes their investment “strike zone” as companies with $10-100 million in sales (para. 2).

While sales volume may communicate a clear message to potential portfolio companies, Gilligan and Wright (2008) explain that the true focus for investment professionals is EBITDA as a measure of cash flow. Cash flow is a key variable in determining the amount of debt the company can support in the capital structure. Accordingly, the private equity firm would much prefer a smaller sales volume with a strong EBITDA margin than a large sales volume with a modest EBITDA margin.

Insights attributable to Gilligan and Wright (2008) suggest that private equity firm organizational structure is more easily defined in legal terms than managerial terms. Firms typically post their investment professional bios on their websites. Two characteristics loom omnipresent. First, their academic credentials reflect the best business schools in America, e.g., Harvard. Second, the academic credentials may appear inversely proportionate to leadership or management positions outside of private equity in the portfolio company verticals in which the funds invest—notwithstanding board memberships in those companies.

Entrepreneurial leaders of portfolio companies in which the middle market private equity firms invest also have interesting pedigrees. Leibenstein (1968) offers an apt definition for these leaders: An entrepreneur (a) “connects different markets” (p. 75), e.g., buyers and sellers across geographical regions; (b) corrects “market deficiencies” (p. 75) by supplying, for instance, private information for which there is no market; (c) creates, and is responsible for, “time-binding” (p. 75) implicit or explicit contractual arrangements and input-transforming organizational structures, e.g., building an organizational culture of trust; and/or d) completes inputs, i.e., marshals resources needed to produce and market a product (p. 74-75).

Stock in a middle market company may represent the bulk of the founder’s estate. One of entrepreneur’s motivations for recapitalizing the company in a private equity transaction is that he or she may be motivated to monetize at least a portion of his or her equity (Goldberg, 2008).

At this point, the leadership and organizational challenge is clear. Private equity investment professionals with comparatively limited line management experience gain controlling interest in
portfolio companies whose management may be unschooled in skills necessary to execute the investment thesis. Such managerial unfamiliarity includes, but is not limited to, outside control, leverage, and aggressive growth expectations. The growth expectations may include acquisition(s) and consequent integration(s).

Block (2000) imparts that consultants have “influence over an individual, a group, or an organization” (p. 2). In private equity, all three constituencies are influenced simultaneously. Private equity firms engage numerous types of consultants relative to three stages of the investment. Due diligence consultants assist private equity firms in establishing the enterprise value of the targeted investment. For example, accounting firms establish the quality of earnings against GAAP (generally accepted accounting principles). Similarly, marketing firms frame the strength of the vendor-customer relationship. Due diligence consultants directly and indirectly affect the investment thesis.

Consultants engaged during the hold period of the private equity investment tend to be focused on investment thesis execution and realization. Two venues prevail: growth and efficiency. Growth addresses the Build or buy? question. Consequently, some consultants cater to organic growth challenges, whereas others focus on acquisitive opportunities. Efficiency consultants focus on robust scalability, e.g., Lean manufacturing. A typical framing question for efficiency consultants is: If the company tripled tomorrow morning, what bottlenecks occur?

The third type of consultant assists in the sale of the company at the end of the hold period. Indeed, investment bankers fit Block’s (2000) general definition for consultants. Selling consultants help substantiate the success of the investment thesis and its further value to potential purchasers. In addition to the subject matter expertise these consultants bring to the table, they must be keenly aware of the leadership dynamics within and between private equity firms and their portfolio companies. Moreover, these consultants may steer a transaction toward a particular purchaser based on a fit at least partially attributable to leadership compatibility.

Although less frequently than portfolio company engagements, private equity firms engage consultants for the direct benefit of the firm. Perhaps the most prominent example is fund raising. In this example, the consultant helps communicate the firm’s story for distinct types of limited partner investors for the fund. Again, leadership style is a relevant issue.

**Investment Thesis**

An investment thesis encapsulates the private equity firm’s objective for the portfolio company investment. Barber and Goold (2007) specify the firm’s goal of realizing the investment thesis within six years of the transaction consummation (p. 54). Investment thesis and strategy are functionally interchangeable terms. Hold period consultants should be particularly cognizant of their engagement relative to the investment thesis. To wit, their deliverables must be synergistic to the objective.

Private equity firm financial stewardship of fund investments is affected by several dynamics, some of which the firm controls and others over which the private equity firm may exert influence. Investment professional leadership requires Covey’s (2004) right brain, or creative hemisphere (p. 130 & 147).
Montgomery (2008) states that, “as private equity firms proliferate and supply chains open up around the world, nothing is more important for complex corporate entities than a clear sense of purpose, a clear sense of why they matter” (p. 57). Montgomery continues that “the most viable statements of purpose are easy to grasp and true to a company’s distinctiveness” (p. 58). Montgomery offers a litany of present state versus future state leadership suggestions: (a) the CEO should be the chief strategic officer and press beyond protracted competitive advantage; (b) the strategic plan should be dynamic instead of static, continually and fluidly reacting to changing conditions; and (c) the CEO should constantly press new types of competitive edge instead of guarding the status quo. The catch for portfolio companies is that, whereas the founder-CEO may have done this historically with great latitude and discretion, he or she must now execute these functions in collaboration with private equity firm investment professionals who may see things differently—or at a bare minimum challenge the CEO’s assumptions and analysis.

Treacy and Wiersema (1995) conclude that all companies must be competitive in three categories: product/service, customer relations, and operations. However, companies must limit their differentiable focus on one of the three to the exclusion of the other two. Treacy and Wiersema describe this differentiation in terms of product/service leadership and innovation, customer intimacy, and operational excellence. Their study of more than 80 companies concluded that any business attempting to differentiate in more than one category failed to produce the desired results. The practical conclusion is that there comes a point at which the decision is either/or—not both/and. By implication, effective agency requires the private equity firm and the portfolio company leadership team to agree on differentiable focus.

Capital Structure and Stakeholder Returns

One of the reasons for the metric focus in private equity is that the capital structure is leveraged, e.g., debt-heavy. Hence, these transactions are often regarded as leveraged buyouts. According to Gilligan and Wright (2008), the portfolio company capital structure is deferential to two axioms. First, the tax code favors debt because interest is tax deductible. Second, the less equity the fund contributes to the capital structure, the easier it is to realize equity internal rate of return targets. Dandridge (1979) indicates that middle market companies are less tolerant of inefficiency than big companies (p. 57). Given the need for strong cash flow to support a leveraged capital structure, adherence to good leadership theory helps private equity firms and their portfolio companies reconcile their objectives to effectively execute the investment thesis.

Leadership Theory Overview

Northouse (2006) forewarns that no single leadership style applies to all scenarios. Consultants should evaluate leadership theory issues between the private equity deal team and its portfolio company. While it may be obvious that leadership variation exists across portfolio companies, it may be less obvious that each deal team within a private equity firm may possess leadership style variation—even when professionals may be common to multiple deal teams across the firm. Consultants should further consider similar engagement team variation within its own firm. The take-away is that assumptions are treacherous and may result in unintended consequences that threaten repeat business with a private equity client, as well as its reference for pursuing peer
private equity firms. Consequently, a review of leadership theories germane to middle market private equity is advisable.

Schruijer and Vansina (2002) offer insights on leaders and leadership useful to the discussion of leadership theory overview:

The term leader refers to an individual person enacting a particular role as “leader” or from a particular role exerting leadership behavior. The term “leadership” refers to a function, which can but is not necessarily fulfilled by a person. Leadership can be shared and exerted by a group for example, or, may be part of an organization’s culture. The same distinction can be made with respect to the terms “follower” and “followership.” (p. 869-870)

Paglis and Green (2002) provide a useful definition of leadership that complements the leadership theory overview:

[Leadership is] the process of diagnosing where the work group is now, and where it needs to be in the future, and formulating a strategy for getting there. Leadership also involves implementing change through developing a base of influence with followers, motivating them to commit to and work hard in pursuit of change goals, and working with them to overcome obstacles to change. (p. 217)

Hoy (2010) supplements leadership theory overview with a concise definition of theory: “[Theory is] a set of interrelated concepts, definitions, assumptions, and generalizations that systematically describes and explains regularities in behaviors” (p.10).

An understanding of founding entrepreneurs would be beneficial. However, Amit, Glosten, and Muller (1993) contend that “there is no consensus among researchers as to the exact meaning of entrepreneurship and the role of entrepreneurs” (p. 816). Amit, et al. continue that “entrepreneurs can be categorized into those who are profit-seeking, either working individually or in a corporate setting, and those who are not profit-seeking, working in charitable, government and other not-for-profit organizations…” (p. 816). The focus here is on profit-seeking.

Amit, et al. (1993) state that researchers remain perplexed by the differences between entrepreneurs and managers. Perhaps the explanation is that entrepreneurs create chaos, whereas managers create bureaucracy to tame the chaos. Amit, et al. rationalize that entrepreneurs spark the ideas that result in larger entities—perhaps publicly traded ones. If entrepreneurial traits comprised a tuned four cylinder engine, Brockhaus and Horwitz (1985) would name the cylinders: (a) desire to achieve, (b) preference for control, (c) ability to manage risk, and (d) the capacity to tolerate ambiguity.

Self-efficacy appears to align with entrepreneurial traits. Gist (1987) defines self-efficacy as “one’s belief in one’s capability to perform a task” (p. 472). Paglis and Green (2002) add that leadership self-efficacy “is a person’s judgment that he or she can successfully exert leadership by setting a direction for the work group, building relationships with followers to gain their commitment to change goals, and working with them to overcome obstacles to change” (p. 217). Schruijer and Vansina (2002) describe leadership self-efficacy as “a personal characteristic pertaining to an individual’s judgment that s/he can successfully exert leadership” (p. 869-870).
Pearlmutter (1998) posits that successful change agents perceive themselves as possessing high self-efficacy. Pearlmutter continues that, “because of their self-beliefs and efficacy expectations, they (change agents) will recognize the possibilities for introducing change, see their roles in accomplishing those tasks, and be willing to undertake the difficult and complex tasks inherent in the process” (p. 37).

Hendricks and Payne (2007) speak in terms of “the big five” leadership traits: (a) agreeableness, (b) conscientiousness, (c) emotional stability, (d) extraversion, and (e) openness to experience. Hendricks and Payne make a case that the biggest beneficiaries of leadership training are likely those with strong extraversion, conscientiousness, openness to experience, learning goal orientation, motivation to lead, and self-efficacy—and weak tendencies for “performance prove” goal orientation, and “performance avoid” goal orientation (p. 339).

Collins (2001) captures four traits for effective leadership: (a) humility, (b) will, (c) ferocious resolve, and (d) giving credit to others while taking blame. Becker as quoted by Coutu (2002) argues in more succinct terms: “More than education, more than experience, more than training, a person's level of resilience will determine who succeeds and who fails” (p. 47).

**Agency Theory**

Private equity is a poster child for agency theory. Meuleman, Amess, Wright, and Scholes (2009) draw from Fox and Marcus (1992) and Jensen (1993) to define agency theory as “the predominant theoretical lens used to study buyouts, with emphasis on controlling and incentivizing managers’ behavior to improve performance” (p. 213). However, agency applies to both the firm and the portfolio company. Agency compels the firm to be an activist investor in the portfolio companies of the fund. But what constitutes agency for investment professionals overseeing portfolio company performance? Rogers, Holland, and Haas (2002) frame four accountabilities: (a) create an investment thesis, (b) identify critical performance indicators, (c) optimize the capital structure, and (d) assure superior returns for the limited partners in the fund.

Meuleman, et al. (2009) communicate that traditional agency perspectives suggest that the principal role for private equity firms in buyouts is monitoring (p. 214). Clark (2009) adds that private equity firms are inherently short-term focused (p. 2040). Moreover, Clark continues that private equity investor rationale is to enhance cash flow and reduce costs to both improve profitability and draw attention from potential acquirers. This necessitates good management metrics. In addition to the typical post facto measures, e.g., EBITDA, firms seek leading indicators of performance, e.g., order backlog. The metrics point aligns with Covey’s (2004) comments about managing from the left side of the brain, which is associated with logic and analytics (p. 130, 147).

Good, timely metrics enable leaders to fluidly adjust to conditions. Haspeslagh, Noda, and Boulos (2001) promote value-based management that relies on incentives tied to the correct measures (p. 65). Of course, this is compliant with agency theory. Haspeslagh et al. warn, however, that success also relies on preparing the business culture for this approach (p. 67). Haspeslagh, et al. advise that five bases be covered: (a) cultural commitment to create shareholder value, (b) training to support change(s), (c) incentive alignment with controllable metrics to instill responsibility, (d) organizational architecture that defers to objectives, and (e) scope that is sufficiently broad and inclusive (p. 65).
Skills Leadership Theory

Northouse (2006) summarized skill theory composition in three categories: (a) technical skills, (b) interpersonal skills, and (c) conceptual skills (p. 40-43). Baum & Locke (2004) indicate that “entrepreneurs’ traits, skill, and motivation categories are significant direct or indirect predictors of venture growth for a period of six years following initial measurement” (p. 595).

Kim and Mauborgne (2003) frame “tipping point leadership” as being comprised of four skills. Two of the four skills are described as “rapid strategy reorientation.” Kim and Mauborgne discuss a cognitive hurdle that requires leaders to improve communications to engage stakeholders in problem solving. The other orientation point regards a resource hurdle. This compels leaders to allocate limited resources to address priorities. Kim and Mauborgne’s remaining two skills are described as “rapid strategy execution.” These are change management functions. One is a motivational hurdle to point the culture in the right direction. The other is a political hurdle to weed out antagonists.

Goleman (2004) discusses skills in relative terms. Whereas technical skills and IQ are prerequisites to effective leadership, Goleman confirms a more significant correlation with emotional intelligence, or EQ. Goleman continues that EQ has five components—three are self-management skills and two are interpersonal skills. The self-management skills Goleman itemizes are (a) self-awareness, (b) self-regulation, and (c) motivation. The interpersonal skills are (a) empathy and (b) sociability. Kirkpatrick and Locke (1991) itemize distinguishable, differentiable attributes: (a) industry expertise, (b) intelligence, (c) self-assurance, (d) character, and (e) motivation.

With respect to private equity, skills theory may be summarized in terms requisite execution competencies. Knowing how creates value. Gilligan and Wright (2008) explain that consummating a transaction is highly technical.

Investment professionals routinely complement their skills with supplemental subject matter experts, e.g., due diligence vendors. The ability to work with multiple stakeholders substantiates interpersonal skills. Creating an investment thesis draws upon conceptual skills.

Portfolio company leaders have technical expertise in their market segment. Interpersonal skills are important with vendors and customers. Conceptual skills are substantiated by the enterprise value created to attract the private equity firm.

Skills theory most assuredly applies to consultancy. Indeed, the engagement is precipitated by the skill possessed by the consultant that the private equity firm and its portfolio company require to solve a problem.

Style Leadership Theory

Style is a form and substance theory. Northouse (2006) explains style theory in terms of task and people terms. Argyris (1973, p. 57) sheds light on leadership style. First, Argyris states that leaders set ambitious goals for themselves. Additionally, leaders’ task orientation is pronounced. Moreover, leaders desire constant feedback. Finally, leaders may be jealous of their turf.
Goffee and Jones (2000, p. 64) share inspirational leadership discoveries. First, leaders demonstrate humility and approachability by revealing their uniqueness and weaknesses to their team. Next, the timing of leaders’ actions is intuitive. Lastly, leaders are genuinely empathetic to the welfare of their charges.

Robert R. Blake and Anne Adam McCanse (1991) modified a Managerial Grid® originally constructed by Blake and Jane S. Mouton (1964) that explores the people-task interaction. A byproduct of their work is a matrix that reveals seven profiles: (a) impoverished management that is deficient in both people and task realms; (b) authority-compliance management that emphasizes task over interpersonal relationships; (c) middle-of-the-road management that moderately emphasizes both people and task issues; (d) country club management that emphasizes interpersonal over task points; (e) team management that strongly emphases both people and task aspects; (f) paternalism/materialism management that vacillates between country club and authority-compliance styles; and (g) opportunistic management whose results trump methodology. Blake and Mouton conducted additional research that supports the conclusion that a leader has a primary style and a fallback style.

Professionals within the private equity firm and portfolio company may run the gamut of Management Grid® profiles, as well as mirror each other. For example, the authority-compliance profile may be preferred when the portfolio company is not performing adequately against the investment thesis. In diametric opposition to this scenario, the country club style may be the norm when the portfolio company is performing beyond expectations. A third practicality is team management when an acquisition opportunity is the scenario.

Consultants are routinely selected based on style. This may be particularly true when the stakes are high and the execution environment is tenuous. Relationship development between the private equity firm and the consulting firm should emphasize the consulting firm’s ability match resources in deference to stylistic requirements.

**Situational Leadership Theory**

Blanchard, Zigarmi, and Zigarmi (1985) describe four basic situational styles: (a) delegating, (b) supporting, (c) coaching, and (d) directing. The leader’s choice among the four is rooted in his or her determination of suitability for the scenario. Delegating requires the least leadership investment. Northouse (2006) explains that, to accomplish delegation, the employee has demonstrated sufficient acumen to warrant nominal supervision from the leader.

A supporting style may be the reward for a subordinate who successfully navigated the coaching encounter. Northouse (2006) explains situational coaching in similar terms to Bell’s (2002) definition of mentoring. This leadership approach includes inputs and feedback. As explained by Northouse, the leader uses “supportive behaviors that bring out the employees’ skills around the task to be accomplished” (p. 93).

Northouse (2006) describes a directing leader as one who provides instructional detail to subordinates who are expected to execute precisely against these instructions. By way of example, a senior member of the private equity deal team may instruct a junior member to conduct due diligence tasks against a tight script. Similarly, the CEO in a portfolio company may specifically direct a subordinate in a disaster recovery scenario.
Despite acknowledgement of the merits of empowered employees, Argyris (1973) warns that CEOs may lack the ability or willingness to choose the right situational style. Argyris offers observations in substantiation of the point (p. 53). CEOs tend to be competitive and dominant. CEOs tend to foster competition within the team instead of cooperation.

Barnes (1981) offers additional insights for evaluating situational theory (p. 108). First, Barnes warns against the temptation of would-be black-and-white options. Second, Barnes cautions against the assumption that empiricism always trumps opinion. Finally, Barnes advises not to conclude that all situations include hazards.

Situational leadership may be potentially fertile ground for consultants. For example, coaching is akin to “teaching a person to fish.” This may be part of the investment thesis strategy, i.e., prove to a potential purchaser that a critical skill has been developed within the company. Even though that may indeed be a longer term objective than is typically scoped in an individual consulting engagement, coaching imparts knowledge such that the portfolio company may be able to resolve the next issue with less—or no—reliance on external resources. Such accomplishment may actually endear the consulting firm to the private equity firm.

Contingency Leadership Theory

Contingency theory is a viable option within private equity. As the moniker implies, the leadership style is influenced by environmental conditions. Northouse (2006) explains that contingency theory operates on a continuum whose endpoints are task and people issues. For example, a “situations” private equity firm investing in distressed businesses may be expected to focus more on task, whereas a normal majority interest in a performing company may opt for an interpersonally-skewed approach.

Several considerations impact the efficacy of the task-people continuum. Schruijer and Vansina (2002) offer comments on the “soft” skills. They state that leadership development rests upon “increasing one’s emotional intelligence, one’s self-confidence, learning to win support, and overcoming resistance to change” (p. 871). Schruijer and Vansina continue that “the concepts of leadership and management are theoretical constructs that are hard to distinguish in practice” (p. 872). The tenor of Schruijer and Vansina’s comments suggest that leadership may be more associated with people whereas management may be more attuned to task.

Baum and Locke (2004) opine that leadership traits are less reliable performance indicators than comprehension of the growth vision by the team (p. 595-596). Their studies substantiate superior performance when this is clear to the constituents. They also discovered that this rings more true in smaller rather than larger companies. This clarity induces predisposition on the task-people balance.

The people-task continuum is another flexible opportunity for consultants. Indeed, it may be a simple means of communicating competencies to the private equity firm. For example, leadership development consultancy might involve the implementation of a performance management system. Task consultancy might entail the implementation of a new operating system.
Organizational Theory

Whereas leadership theory is important, it must be practiced within a compatible organizational design. Middle market organizational design is a ripe area of potential consulting contribution. Argyris (1973) noted that “the problems of leadership style are being seen in terms of the total management system” (p. 61). Ford and Slocum (1977) identify four organizational structure dimensions affected by size, technology, and environment: (a) complexity, (b) formalization, (c) centralization, and (d) administration.

Covey (2004) offers useful leadership perspective: “Leadership is not management… Management is efficiency in climbing the ladder of success; leadership determines whether the ladder is leaning against the right wall” (p. 47). If Covey’s wall is the leadership challenge, then organizational design reconciles to the ladder.

Kotter (1982) further clarifies Covey’s (2004) ladder. Kotter equates management to three core functions: (a) planning, (b) staffing and organizing, and (c) directing and controlling. Parker, Bindl, and Strauss (2010) state that “if an individual believes he or she can implement an improved work method and has a strong reason to do so, he or she is likely to pursue proactive goals to improve organizational functioning” (p. 848).

Minkes and Foxall (1980) assert “that [companies] are, in reality, complex social organizations. [This] means that decisions are made through a network of processes and procedures, formal and informal, and this influences the character as well as the effectiveness of those decisions” (p. 297). Minkes and Foxall encourage leaders to “investigate how the multiplicity of decisions made by individuals within the firm as an organization yields what everyday language chooses to describe as the policy, strategy, decisions of the organization as a whole” (297).

Brickley, Smith and Zimmerman (2007) write that organizational architecture is comprised of three key attributes. The first regards spans of control, or assigned responsibilities. The second entails rewards. This includes compensation and incentives. The third concerns the performance management system that measures at the micro and macro levels, i.e., individual and functional units (p. 5). Smith (1945) describes the elements of administration in similar terms; however, he rationalizes that an effective administration is determined by how well a leader dynamically reacts within this framework.

One of the challenges for both private equity firms and their portfolio companies is the degree of bureaucracy required to avoid anarchy and chaos. Both camps tend to eschew all that the word bureaucracy connotes. However, a certain amount of bureaucracy is a necessary evil to maintain governance amid growth. Smith and Miner (1983) document high correlation between growth and adaptation of a proper level of bureaucratic structure. This may be one of the distinctions in investment style between a venture firm and a private equity firm. The private equity firm’s risk is mitigated by pursuing investment in portfolio companies whose leadership has shown at least some receptiveness to scalable structure as opposed to autocratic control of the business model.

Daft (2006) defines an organization as a deliberately structured, goal-directed social entity whose activities articulate with the external environment (p. 10). Daft’s definition makes an organization an “open system” (p. 14). Organizational theory has to encompass Daft’s structure and contextual dimensions. Structural dimensions include codification, specialization of
function, chain of command, centralization, job qualifications, and departmentalization (p. 17-20). Contextual dimensions include headcount, technology, externalities, goals, strategy, and culture (p. 20). Daft continues that organizations must execute in effective and efficient means. Effectiveness is a measure of customer satisfaction. Efficiency is another term for productivity.

Organizational theory must reconcile hierarchy with **boundarylessness**, and vertical with flat, and economies of scope with scale. Additional considerations are function, division, geographic, matrix, and virtual configuration (Daft, 2006, pp. 102-110, 117). Despite the configuration, Seiler (1963) explains that success is understood in terms of quality, quantity, and timeliness. Organizational cognizance of these criteria may regard as productive the dynamic tension that which others would deem conflict. Covey (2004) conveys that the ability of parties to understand each other’s positions and motivations may be foundational to the trust that underwrites synergistic outcomes.

Seiler (1963) reminds managers that people have limited capacity and instinctively prioritize demands on their time. The manager’s anticipatory reaction to this reality is to assure alignment of the individual with the macro objective. Managers must invest effort to assure that the formal and informal communication systems are supplied with facts. Even so, managers will have to resolve misunderstandings. Roethlisberger (1953) itemizes five possible catalysts of misunderstanding: (a) difference of opinion, (b) conflict between personalities, (c) social role contrast, (d) struggles for power; and (e) breakdown in communication” (p. 57).

McGregor’s (1960) Theory X assumes that people prefer to be treated as irresponsible because they dislike work. Therefore, employees must be strongly supervised. McGregor’s Theory Y reflects an opposite orientation. Here, responsible employees seek empowerment to solve problems. Chen and Klimoski (2003) make points that vindicate Theory Y. New hires perform better when challenged early in a supporting environment and acknowledged for modeling desired behaviors (p. 603). Bandura (1997) accentuates the point for knowledge workers.

Frederick Herzberg’s hygienic and motivating factors, as documented by Nelson and Quick (2006), also offer clues to leadership motivation. Herzberg explains that hygienic factors could only be demotivators by their absence. These characteristics are policy, relationship with a supervisor, work conditions, salary, perquisites, status, security, relationship with subordinates, and personal life. Herzberg’s motivators include achievement, recognition, nature of the work, responsibility, and advancement. Again, one may question how a leader’s values influence the degree that Herzberg’s motivators influence leadership style.

Beer and Nohria (2000, p. 134-137) compare and contrast economic (Theory E) and organizational (Theory O) dynamics. Theory E goals focus on enterprise value while Theory O goals focus on organizational capabilities. Theory E leadership is top down while Theory O is bottom up. Theory E focuses on systems and structure, but Theory O focuses on culture. Theory E embraces regimented process; Theory O pursues experimentation. Theory E motivates with financial incentives, much like agency theory, while Theory O appeals to individual commitment. Consultants provide turnkey solutions to Theory E firms. Consultants teach Theory O firms how to author their own solutions. Beer and Nohria write that the Achilles heel of Theory O is that these leaders struggle with people choices (p. 138).
Summary

Goffee and Jones (2000) itemize four leadership myths: (a) everyone can lead, (b) leaders always deliver results, (c) leaders always wind up in charge, and (d) leaders make great coaches (p. 67). Reddin (1970) warns that there is no evidence supporting a single best leadership style. Reddin continues that such pontification is indicative of normative error, or one’s belief over fact. Reddin’s assertions align with the value creation potential for middle market private equity consulting.

The caveat to both private equity and portfolio companies is that the right approach may be as unique as a set of fingerprints. Moreover, the one-to-many ratio of a private equity firm and its portfolio companies may mean that each leadership and organizational configuration may, of necessity, be customized. Whereas this may be logical for the portfolio company, this places a special burden on the private equity firm. However, the fiduciary responsibility of firm professionals leaves them no choice but to be proficient leadership chameleons.

Good fund performance, i.e., the performance of the portfolio companies, lays the foundation for the next fund. Therefore, private equity firm success rests upon choosing the best leadership and organizational theory approaches in complement to their agency of the funds they manage.

Private equity tends to be tightlipped about intimate transaction details—especially painful experiences. However, anecdotal evidence within the industry overwhelming includes leadership issues among the root causes of problems. In reaction, firm leaders are increasingly focused on the Collins (2001) point about the right people in the seats on the bus. One of the unresolved challenges in private equity is how to refine leadership due diligence without scaring away the investment target. This is a potential opportunity for consultants.

Private equity is a highly networked industry. Good vendors tend to enjoy buzz. Kotler and Keller (2006) opine to the value of word of mouth advertising. Of course, the flip side is that poor vendors also enjoy buzz. Samson (2002) reminds us of the “restaurant principle” whereby dissatisfied clients are more likely to vent their frustrations within their networks than sing the praises of their delight. Social media only enhances the dissemination process. Indeed, Angie’s List is a business model built around this concept. This is an interesting de facto governance mechanism. Consultants serving private equity who eschew the one size fits all leadership approach in favor of a more Socratic, analytical, and chameleon leadership analysis will fare better. Accordingly, these consultants are more valuable not only to their private equity clients, but also their broader constituency.

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