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RATIONAL OR EMOTIONAL?

THE REAL WORLD OF PRIVATE EQUITY

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Foreword

The amount of time and money spent by private equity ("PE") firms on due diligence, the amount of information resulting from it and the amount of analysis undertaken have all risen inexorably as the sector has grown and matured.

However, there is a sneaking feeling among many practitioners that the law of diminishing returns has started to apply to all this activity. Is that feeling correct? Should we even let feelings intrude at all into the serious task of making good investments? These are some of the questions that this research report asks and investigates; through a poll of around 100 of the industry's most senior executives and stakeholders, combined with years of academic research in the area of emotional finance.

Whether you like it or not, or are even prepared to admit it, there is emotion in PE. The laws of supply and demand – manifested in the persistent increase in the amount of money raised that then needs to be invested in a finite universe of investible companies – has driven competition (and pricing) ever higher. That means a rising level of fear. Fear of getting it wrong, fear of not doing deals and of missing out. At the same time, there is a need by PE executives to present a confident and rational appearance to themselves, investors, colleagues and investment committees. This report looks at how some of those inherent contradictions are reconciled, even if sometimes it's more about the language that gets used and the language that doesn't.

And what about gut-feeling? In my experience, it is probably the most under-rated tool in the PE toolbox. Is it your unconscious mind trying to order and reconcile the results of all that due diligence? Do too many discrepancies give you a bad gut-feeling? Do you listen to that inner voice or let your rational brain or the conflicting emotional desire to close a transaction override it? On the other hand when all the pieces fit together and you feel good, can you express that good gut-feeling to colleagues and will they listen to you? And of course, how do you get on with the management team? Do you know what sort of personalities you tend to like and believe? What makes you think somebody is a good manager? Is it for example how well they present? Does that emotional reaction color your judgment of other things like the analysis of business models, market positioning or operational gearing that might be just as or even more important to the outcome of the investment?

Private equity produces strong emotions in most of its participants and these can affect financial outcomes profoundly. This report is a first step in trying to understand the role of emotions in financial decision making in this sector. It is a thought-provoking read that could have a real impact on your personal track-record.

About Neil MacDougall:
Neil joined the pan-European, mid-market buyout firm Silverfleet Capital in 1989, led the buyout of the company from Prudential plc in 2007, and was Managing Partner from 2004 to 2019, before moving to the position of Chairman. Having led some of Silverfleet Capital's most successful investments, Neil currently chairs the Investment Committee of the firm.

Neil was also Chairman of the UK & European Capital Committee of the BVCA, before joining the Council in 2019 and from the beginning of April 2020 became Chairman of the association.

Prior to joining Silverfleet Capital, Neil was a management consultant at Bain & Co. He read Natural Sciences and Computer Science at St Catharine's College and received an MA from Cambridge University.

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Executive summary

After two decades of growth, PE has come out of the shadows and into the mainstream. But does the increased importance of this once very private asset class hide some inherent contradictions? And what are the implications of acknowledging one of the industry's biggest taboos - it's emotional.

1 **There is a contradiction at the heart of Private Equity**
Although actual investment outcomes are by their nature inherently unpredictable, PE practitioners are required to present a sense of certainty to their stakeholders, and need to believe this themselves.

2 **Analysis is not enough**
Whilst formal analysis is a fundamental component of the PE toolkit, at least some of this appears to be designed more to meet practitioners' need to alleviate feelings of anxiety, typically driven by uncertainty, surrounding potential future outcomes - rather than providing real insights.

3 **Never enough time**
PE practitioners work under enormous pressure and often don't have enough time to reflect on or effectively process the huge amounts of data generated by analysis. This may naturally have an impact on the quality of their investment decisions and their ability to think more strategically.

4 **Working in PE triggers strong feelings**
PE practitioners recognize that their work can give rise to strong emotions, such as confidence, stress, and impatience; they also recognize the huge importance of interpersonal relationships.

5 **Actual discussion of emotion is taboo**
Emotion itself is viewed as irrational and thus negative, yet 'intuition' and 'passion' are considered key in PE decision making – what are they if not "emotional"?

6 **Emotions are at the heart of PE**
PE is a highly-charged asset class, not least from an emotional perspective. Failing to engage with this reality and its major implications for PE practice will lead to less rounded investment decisions and increase the risk of stress and burnout.

7 **Covid-19 and increased anxiety**
The recent global crisis due to the Covid-19 pandemic has had a huge impact on PE firms and their portfolio companies, increasing anxiety and pressure on firms and individuals even more. We feel this report is a timely reminder of the raw emotional aspects which play a central role in investing in the face of significant uncertainty, particularly in private markets.

Private Equity is a highly-charged asset class, not least from an emotional perspective. Failing to engage with this reality and its major implications for PE practice will lead to less rounded investment decisions.

Dr. David Cooper
Managing Partner, Cooper Limon

Source: DWS, Private Equity Team, June 2020.

Introduction The emotional side of equity

The PE industry attracts a great deal of attention in the media and academia and PE funds have owned some of the world's most well-known brands. With almost US $6.5 trillion[1] assets under management and nearly US $2.5 trillion[2] in dry powder (including $830bn[2] in buyout funds) waiting to be invested, PE now represents a significant and increasingly controversial branch of finance.

The performance of PE firms impacts millions of people at all levels of society, be they indirect investors through their pension funds or employees of PE-backed businesses. Yet nearly all the discussion and attention in PE focuses on the amounts invested and the outcomes and returns achieved, financially and, more recently, in terms of ESG (environmental, social, governance) dimensions.

There has been little consideration, to date, of how PE practitioners actually engage with challenges and opportunities as they arise or of how this feels. This is especially relevant, as the emotional element of PE is likely to be greater than in other areas of finance for the following reasons:

_ The PE investment cycle centers on a relatively small number of large, high-stakes decisions. This brings a high degree of sustained pressure.
_ PE brings investors and investees into close contact. As a result, personal chemistry has far greater significance than in most other areas of finance.
_ Increased availability of firms to invest and powerful incentives to raise larger funds is driving competition, at the same time as the market chases a finite number of potential deals. This increases the pressure to invest and make deals, and may fuel wishful thinking in the valuation of assets and the potential use of unrealistic multiples.
_ The strong interpersonal aspect also means that trust and credibility play a key role in forming judgements, despite the unreliability of predicting future performance on the basis of interpersonal rapport.
_ Despite the rapid growth of the secondaries market, the defining characteristic of PE is its illiquidity. Investment decisions are difficult to revoke, meaning that investors need to build extremely high levels of conviction to make the necessary 'leap of faith' required to invest.
_ PE investments unfold over longer time periods, away from the glare of market scrutiny. This increases the scope for ungrounded and fantastic thinking to incubate unchecked.
_ Significantly, it may also allow investors to defer confronting uncomfortable truths about loss-making investments, compounding the issue.

[1] Global Private Markets Review 2020 (Mckinsey & Co.) February 2020.
[2] Bain & Co. The Impact of Covid-19 on Private Equity, April 2020.

These factors were the key catalysts behind the current research. At a high level, gaining a clearer view of the emotional dimension of PE brings with it the possibility of making enhanced investment and operational level decisions:

Identifying ways of expanding practice to embrace practitioners' feelings and acknowledge the power of their unconscious needs in driving what we do can only lead to clearer insights and sounder judgements.

Mitigating the risk that hidden or unacknowledged emotions impair judgments and compromise effective decision making.

Encouraging more candour and openness around the real world of PE practitioners, so reducing stress and increasing the level of fulfilment and satisfaction.

Accepting the "emotions" (bad?) and "intuition" (good?) dichotomy is a false one. Intuition is inherently emotional and it is this which adds power in PE decision making.

Findings

1 There is a contradiction between what PE practitioners experience and what they must convey to their stakeholders

96% of survey respondents agreed (50% strongly) that living with uncertainty is an unavoidable part of PE; 70% agreed that investments usually do not play out as expected.

BUT: 85% believed they need to convey a sense of certainty to their stakeholders to convince them.

Typical respondents' comments:

- "The only thing you can predict is that there will be uncertainty."
- "There will always be unknowns and events that have not been / cannot be foreseen. It is our job to adapt and overcome, to derive and to drive value through uncertainty."
- "Demonstrating confidence is part of capturing a management team's confidence or a seller's confidence. Those showing doubt are far more likely to lose out, even if their doubts are based on detailed analysis and sensible questioning."

Discussion: PE practitioners know that they operate in a world where the future is inherently uncertain and unpredictable. But their work requires them to act as though this was not the case. In order to make investments they have to overcome doubt and build sufficient 'conviction'. They also have to project confidence and certainty to their stakeholders. On a, possibly unconscious, emotional level, this may relieve stakeholders' anxieties about the future.

2 Many practitioners felt that there is too much data

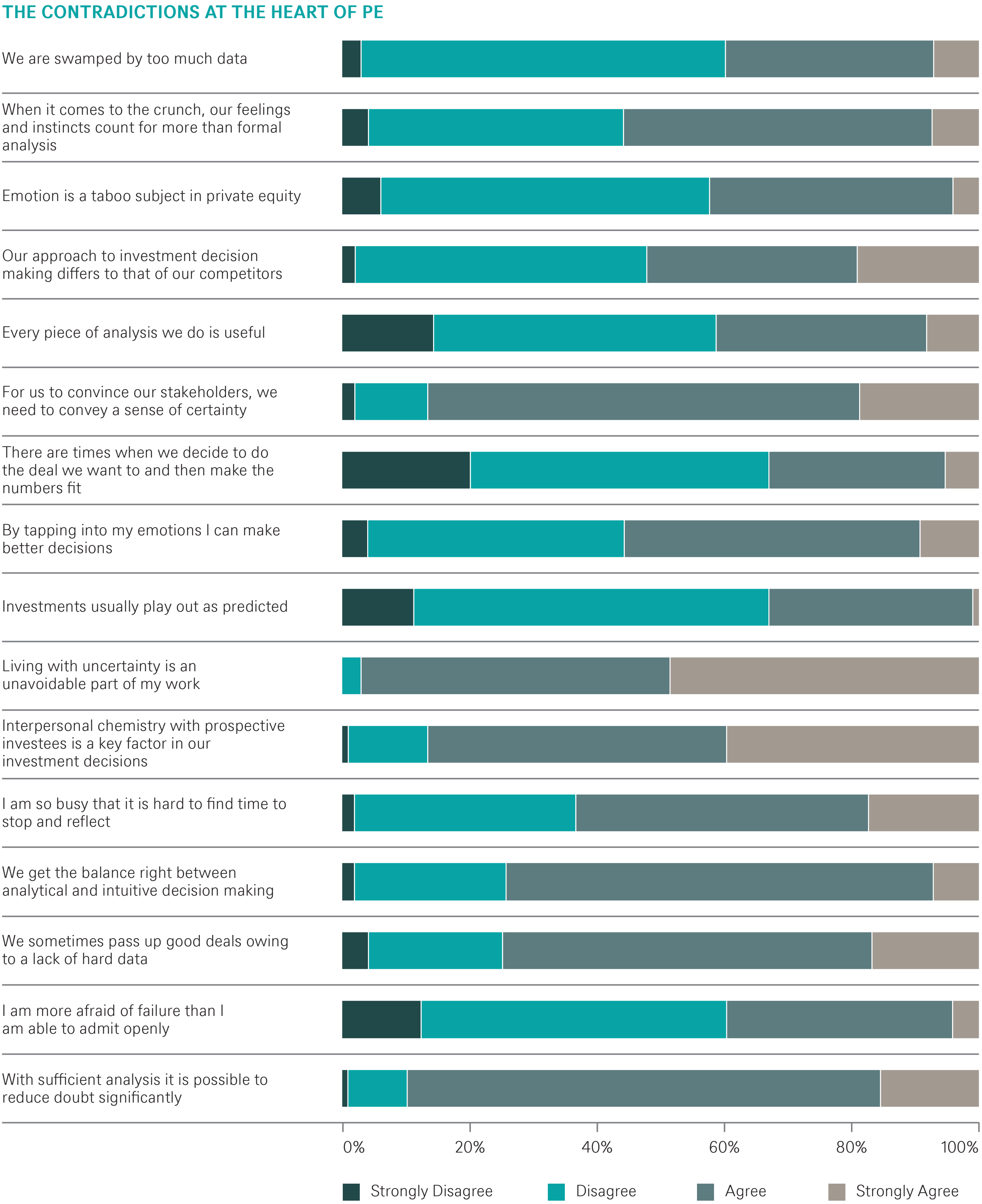
40% of respondents agreed that they are swamped by too much data.

HOWEVER: 76% agreed that they sometimes have to pass up on good deals due to insufficient data.

Typical respondents' comments:

- "This would be my biggest complaint about PE (i.e., too much data)."
- "Not swamped but arguably overburdened".
- "It is our job to wade through it and do the analysis, however much is out there."
- "We would only pursue a deal if we can access all the data we need to support the investment proposal."
- "How do you know it is a good deal if you do not have the facts on the business?"
- "Many PE houses ... suffer from analysis paralysis, wanting to look under every pebble for potential negatives. This stems from a fear of failure, a fear of making a poor judgment."
- "I suggest this (fear of failure) is prevalent in the industry if people are honest. A good question."

Discussion: The amount of data available for analysis appears to provide some emotional comfort for PE practitioners even though there is a conscious recognition that not all of it is useful. However, the anxiety created by having too much data can potentially lead to analysis paralysis. Does the parallel need for a sense of certainty and search for reasons 'not to do a deal' (in case things subsequently go wrong) lead to the missing out on potentially profitable investments? Is 'fear of failure' an under-recognized driving force in PE decisions? Are practitioners channeling such unacknowledged anxiety into collecting more data than they need in an attempt to provide some 'comfort'?


THE CONTRADICTIONS AT THE HEART OF PE
We are swamped by too much data
When it comes to the crunch, our feelings and instincts count for more than formal analysis
Emotion is a taboo subject in private equity
Our approach to investment decision making differs to that of our competitors
Every piece of analysis we do is useful
For us to convince our stakeholders, we need to convey a sense of certainty
There are times when we decide to do the deal we want to and then make the numbers fit
By tapping into my emotions I can make better decisions
Investments usually play out as predicted
Living with uncertainty is an unavoidable part of my work
Interpersonal chemistry with prospective investees is a key factor in our investment decisions
I am so busy that it is hard to find time to stop and reflect
We get the balance right between analytical and intuitive decision making
We sometimes pass up good deals owing to a lack of hard data
I am more afraid of failure than I am able to admit openly
With sufficient analysis it is possible to reduce doubt significantly
0%
20%
40%
60%
80%
100%
Strongly Disagree
Disagree
Agree
Strongly Agree

3 Private equity practitioners work under extreme pressure

64% felt that it is hard to find time to stop and reflect.

Typical respondents' comments:
_ "Time spent on reflection is well spent".
_ "Sometimes we are far too reactive (rather) than proactive."
_ "This isn't a good place to be in; it's imperative to have time to contemplate the current and future environment."

Discussion: 'Busyness' and acute pressure are inimical to considered decision making. Finding time to reflect is essential when dealing effectively with complexity and uncertainty. As well as impairing decision-making excess 'busyness' can also get in the way of forming open trusting relationships which are key in PE. As a result, there is a clear risk that excess pressure in PE may ultimately compromise returns. The hyperactivity seen in the PE industry can also take a significant physical and psychological toll on practitioners. The energy and attention of PE practitioners are finite and precious resources. By discriminating more carefully when it comes to 'busyness' and making more space for reflection, practitioners can improve results as well as their own wellbeing.

4 Analysis does indeed enable practitioners to reduce doubt but this is not enough. Tapping into instincts and emotions and balancing analysis and intuition improves the quality of decisions

90% of our respondents believed that sufficient analysis can significantly reduce doubt, and
75% believed they get the balance between analytical and intuitive decision making right.

HOWEVER:
Only 40% agree that every piece of analysis is useful, 57% felt that when it comes to the crunch feelings and instinct count more than analysis and 58% thought that they make better decisions when they tap into their emotions.

Typical respondents' comments:
_ "We inherently make decisions based on imperfect information, but analysis can help reduce uncertainty significantly."
_ "But if you do not [conduct sufficient analysis] you may miss something."
_ "Some of the analysis done ends up being useless but you don't know when starting the work."
_ "Both (analysis and intuition) play an important and complementary role."
_ "We don't openly admit to intuition, but it's clear when people rely on it to buttress arguments that have weak data."
_ "Fall in love with a deal = magical thinking = ignoring reality = stupid investment decisions."

BUT:
_ "My EQ is at least as high as my IQ."
_ "The analysis supports the intuitive decision making."
_ "The firm is intuition first; data to support comes later."
_ "Emotional intelligence yes ... pure emotions no."
_ "Emotional investment is dangerous. I think intuition is different to emotional."

Discussion: To what extent is an emphasis on analysis being used by practitioners as an attempt to 'control' the ultimately uncontrollable future and defend emotionally against what on one level are the 'unknown unknowns'? Practitioners need to guard against the risk of becoming entrenched in excess analysis, to the extent that instinct and intuition are `crowded out'.

76%
agree:
Good deals can be passed up due to insufficient data

64%
feel:
It's hard to find time to stop and reflect

86%
agree:
The importance of chemistry with prospective investees

58%
make:
Better decisions tapping into their emotions

40%
agree:
Emotion is a taboo subject in PE

40%
are:
more afraid of failure than they admit

5 Personal rapport plays a vital role in PE decisions

86% (40% strongly) agreed the importance of interpersonal chemistry with prospective investees.

Typical respondents' comments:
_ "We don't go into a deal unless we are convinced we are backing the right people. (GP)"
_ "The most important factor by a distance."
_ "Relationships are critical in PE: GP with management teams; GP with LPs; GP with lenders or other types of capital providers; LPs with other LPs."

Discussion: Are intuitive feelings of liking and trusting always a reliable basis for judgements about successful future outcomes? Or are they inherently biased, with little predictive value, in line with the extensive academic research into the fallibility of face-to-face interviews? To what extent is the face validity of 'liking' being used as a way of dealing with the uncertainty of investment outcomes? Is it used to unconsciously shift responsibility or blame for future failure from the investor to the investees themselves? How can PE practices be enhanced to explore the interpersonal dimension more systematically?

6 Emotion is not talked about in private equity

More than 40% of respondents agreed that emotion is a taboo subject in PE.
Almost 40% admitted they were more afraid of failure than they were able to admit openly.

Typical respondents' comments:

- "The code word for emotion in doing a deal is 'conviction' ... we go out of our way to take emotion out of the decision-making process."
- "There is a general view that allowing emotions to enter your decision-making process will lead to poorer decisions being made."
- "Emotion is not really talked about .... It is more passion than pure emotion."

Discussion: Putting the last two points together we find that although, generally, emotion is recognized as facilitating good decision making in PE, this belief only holds if it is not referred to directly as `emotion'! Apparently, however, `intuition', `conviction' and `passion' are more acceptable. Whether these emotions are any more `rational' than `emotion' itself, is a moot point. Why, given that PE practitioners clearly recognize the key role emotions play in everything they do, are they so coy in formally acknowledging this? Does the view that emotions are potentially dangerous distract from the fact that they are vital to effective decision making?

7 Although financial outcomes matter, PE is not just all about the money

When asked which aspects of their work they enjoyed the most, many respondents highlighted aspects such as relationships and interactions with others and the intellectual challenge and stimulation, which the work provides. Monetary rewards, interestingly, were hardly mentioned, possibly because the potential of high levels of remuneration (typically driven by performance) are the norm in the industry and thus are taken for granted. One respondent seemed to be speaking for many when he commented: "Best job on the planet. Like catching a baseball in every play/pitch."

The greatest sources of disappointment and dis-satisfaction also related to the interpersonal dimension – people mentioned greed, dishonesty and lost trust. Several respondents also mentioned the pressure of work and bureaucracy.

We see from the graphic (on page 13) that working within PE certainly drives a lot of emotions, but it is important to recognize what is presented may only be what practitioners think they experience. Emotions which arise in practice may be somewhat different and unconscious, or even repressed, emotions that figure less - due to a sense of the "need" to present a certain idea of what PE is.

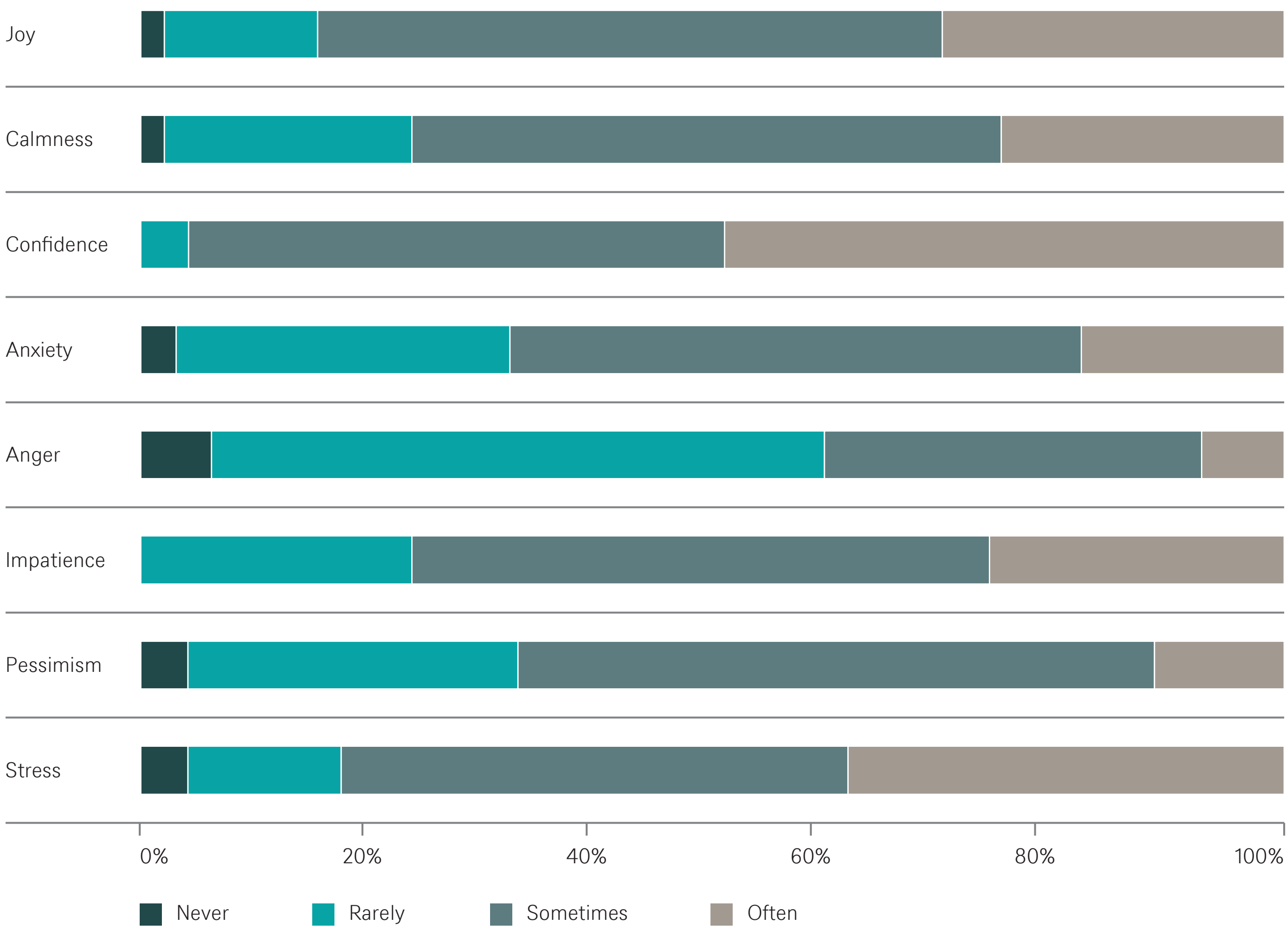
This cognitive dissonance is ostensibly weighted in favour of positive emotions, such as joy, calmness and confidence, which jar against anxiety, impatience, pessimism and stress. As 64% of the respondent group report not having enough time to stop and reflect, it may add to the possibility that oftentimes practitioners are not fully in touch with their feelings, "in the moment".

Despite this caveat, the scores do indicate that working in PE does generally trigger positive emotions, certainly more positive than earlier survey responses would suggest – which indicated PE as inherently stressful and unpredictable with chronic 'busyness'.

The assumption that PE practitioners are only in it for the money is overly simplistic. Indeed, anecdotal evidence suggests that overtly `greedy' behavior is more closely correlated with failure than success over time.

Prof. Richard Taffler

THE EMOTIONAL LANDSCAPE OF PE



Does this high level of confidence (only 4% of respondents stated they experience feelings of confidence rarely or never) act as a shield for more troubling emotions? Anger and anxiety are more likely to arise at, or beyond, the edge of awareness and it could be that some of the 'busyness' and excess financial analysis, which respondents reported, represent attempts to suppress or manage some of these difficult emotions.

In summary, it may be that PE practitioners feel the need to exaggerate positive emotions, whilst repressing the more difficult ones, presenting their lived experience as they would like it to be, rather than as it is, in reality. Or it could be that PE draws the kind of people (confident, analytical, strategic multitaskers) that thrive in a multi-faceted business and relationship environment.

Whichever is more plausible, the earlier finding that practitioners feel they make better decisions when they connect with their emotions would benefit from further consideration - by all practitioners in the market.

Conclusions and opportunities

Certainty is highly prized in PE, yet there is increasing recognition that certainty is itself an emotion. As such, it is not necessarily any more reliable as a guide for decisions than other emotions. Moreover, uncertainty and unpredictability are inescapable elements of the PE experience and no amount of analysis will remove these. This is just one of a number of paradoxes and contradictions which PE practitioners confront, all of which indicate that working in PE is not, and cannot be, an entirely 'rational' process.

The risks

Our findings suggest that there is a good deal of emotion in PE. Whether or not emotions are in the conscious awareness of practitioners they are ever present.
If emotions are unconsciously repressed or denied, this brings with it several risks which can undermine returns and detract from the quality of the lived experience of practitioners:

_ Over-entrenchment in analysis and exclusive focus on a narrow financial perspective in the mistaken belief this makes uncertainty 'controllable'.
_ Missing out on good deals purely due to an absence of analyzable data.
_ Squandering valuable resources (money, time and attention) on extra analysis which not only fails to contribute to understanding but may also cause confusion.
_ Depriving practitioners of the space and time they need to reflect adequately.
_ Pushing practitioners to their limits, triggering deepseated stress and anxiety through the strain of trying to find and convey certainty in an inherently unpredictable world and increasing the risk of burn-out.

Opportunities and recommendations

If PE practice can be expanded formally to take more overt and systematic account of the emotional and interpersonal dimensions, this provides a number of potential opportunities:

_ All parties can be more open about the inherent unpredictability of PE investment outcomes. This will relieve the tension needed to 'hold' the paradox that, on one level, stakeholders (and implicitly PE practitioners), crave certainty, whereas, ultimately, they have to deal with the lack of underlying predictability.
_ Rather than attempting to strive for rationality and certainty practitioners need to be more open to their less tangible and more experiential factors and recognize the benefits of diversity of thought and practice.
_ Focus more explicitly on the human experience and explore ways to facilitate resilience, resourcefulness and adaptability.
_ Prioritize relationships and manage these in a way which builds trust and transparency.

The suggestion here is not to drop the tools of financial practice but to use them with more awareness and discretion. The marginal utility of extra analysis should be evaluated critically.

Next steps

The findings described above suggest that PE practitioners could gain value on a number of fronts by reflecting on the following questions relating to their standard systems, habits and practices:

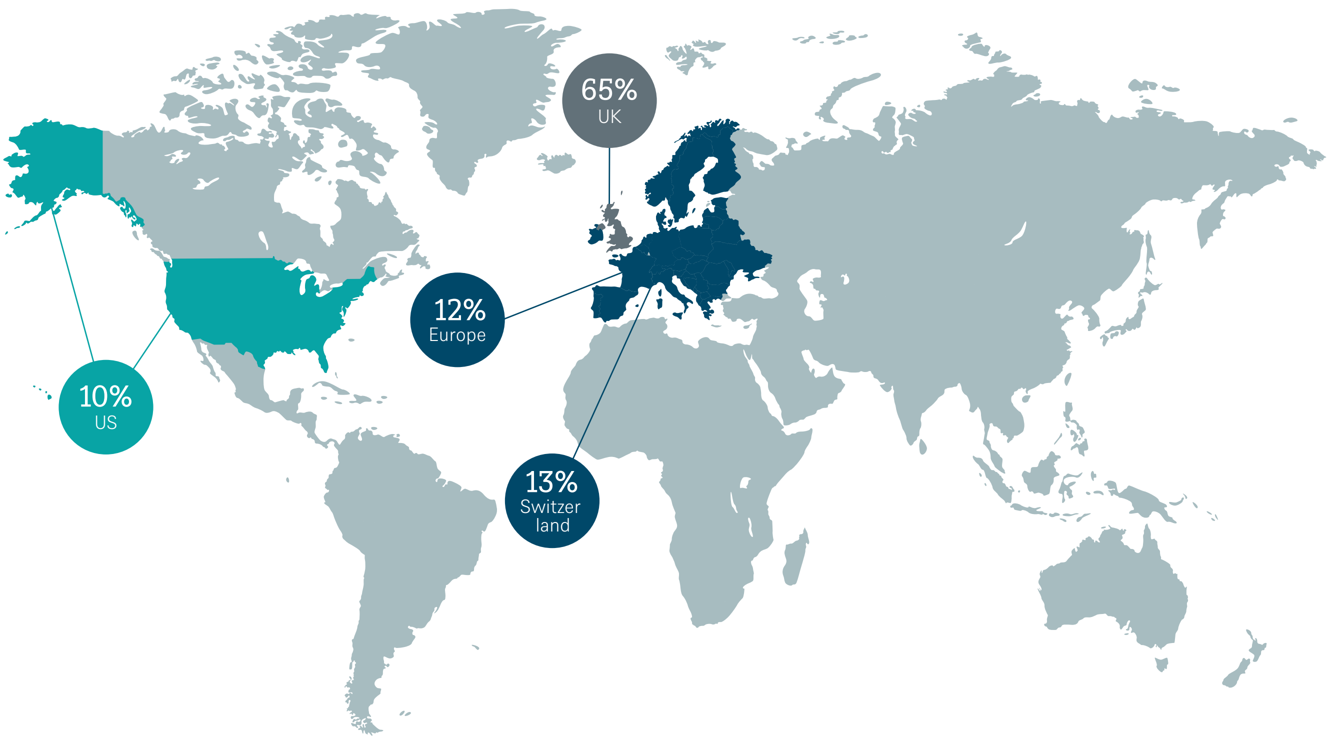
_ How can we build more wisdom into our processes and decisions?
_ How can we improve our approach when it comes to understanding and managing the interpersonal and relationship aspects of our work?
_ How well do we understand the triggers (events, information, insights etc.) which influence gut feel?
_ How can we track gut feel more systematically?
_ How well do we understand which 20% of analysis brings 80% of the benefit?
_ How can we find more time and space for reflective thinking?

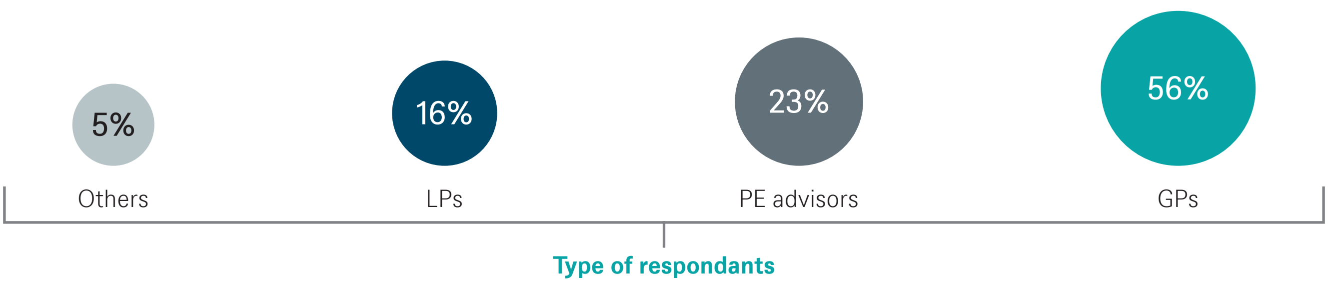
Research

Our initial research was based on in-depth interviews (average length 75 minutes) with a number of senior, highly experienced PE practitioners (three LPs and three GPs) on their lived experience in PE. Together with the personal experience of members of the research team and years of academic experience in emotional finance, these interviews guided the questions we would pose in our online survey which we first piloted. In order to encourage as many responses and as much openness and candour as possible, the questionnaire was short and entirely anonymous. It was circulated initially to approximately 400 LPs, GPs, CEOs and advisers, most of whom had well over ten years' experience in the industry.

Participants were invited to circulate the questionnaire further to their own contacts. In total 104 usable responses were received, broken down by 'type' and 'region' as follows:

RESPONSES BROKEN DOWN BY TYPE AND REGION





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David is a recognized pioneer, international speaker and media commentator in the area of leadership risk in PE. He works both with general partners and investee management teams in order to maximise value creation, develop greater foresight and address the 'syndromes of PE practice', which can cause value to be leaked.

With over 20 years' PE experience, he brings a depth of understanding of the specific leadership challenges which arise in the industry and of how to address these. He authored 'Leadership Risk: A guide for Private Equity and strategic investors' (Wiley) and co-authored 'Managing the people dimension of risk' (Corporate Research Forum). In 2018 he received his doctorate at the Hochschule St Gallen, for what was one of the first pieces of in-depth behavioral research to look at the leadership dimension of PE investments. He is a Fellow of the Institute of Chartered Accountants in England and Wales, an Associate Fellow of the British Psychological Society and an EMCC accredited coach.

Now in its 16th year, Cooper Limon has a well-established track record of providing specialist advice on leadership risk to PE and financial services firms.

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Richard is Professor of Finance and Accounting at Warwick Business School. An authority on behavioral finance and investment, he has published over a hundred academic and professional papers and books.

Richard is the father of the new paradigm of emotional finance which complements traditional and behavioral approaches to investment, and focuses on the vital role emotions and the unconscious play in driving investor decisions and market behavior. He is now engaged in applying the insights of emotional finance to the private equity industry. Professor Taffler's other recent research and publications relate to market mispricing and the exploitation of stock market anomalies, including the market's inability to deal with investor emotions and bad news appropriately, fund manager performance and skill, retail investor behavior and the part gambling plays in financial markets, the role of storytelling and trust in finance, and stock market and property bubbles.

An active speaker at industry events Richard also has a background in fund management and investment consulting and this directly informs both his research and teaching.

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Mark is the Global Head of Private Equity at DWS. He is responsible for all aspects of the private equity business including business development, investments and fundraising and also sits on the firm's Executive Committee for Alternatives and the board of DWS Alternatives Global Ltd. He joined DWS in 2017 from Credit Suisse, where he was global head of secondary advisory.

Mark has over 21 years of experience, including 18 years in private equity with Barclays Capital, 3i, Keyhaven Capital Partners and Pomona Capital; where he led EMEA and sat on the boards of various underlying investment partnerships.

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Matthew has more than 20 years of experience in market research and communications, advising high-growth firms, fund managers and service providers to these communities. He has spent 17 years interviewing institutional investors and intermediaries on investment preferences, with a strong focus on alternative assets. Prior to launching MJ Hudson's IR, Data & Analytics services, he ran the syndicate desk of a Mayfair merchant bank and was a founder of Incisive Media's asset management research division.

Matthew advises clients on all aspects of research and thought leadership, positioning and communications, particularly in regards to attracting and retaining investors. Matthew is an active networker in the alternative assets industries and a frequent speaker at conferences and workshops. He has been a judge of the Private Equity Africa Awards since their inception.

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