The Factors That Create Outperforming Stars

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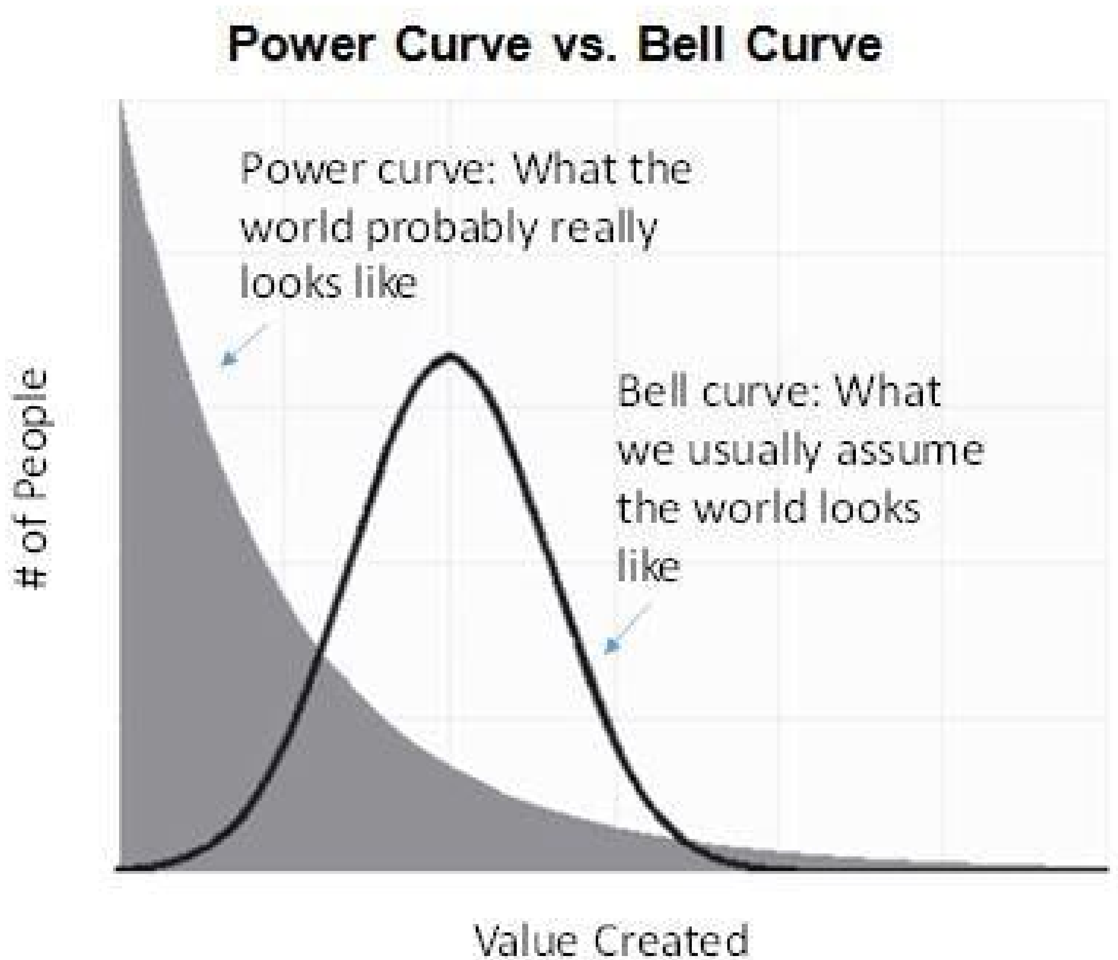
A small number of people account for the vast majority of value creation in private equity.

What do basketball player Kareem Abdul-Jabbar, actress Cloris Leachman and Microsoft founder Bill Gates have in common? Research conducted over the past 15 years or so has found that, across industries, jobs and fields of human endeavour, a small number of people are responsible for the **vast majority of value creation**. Whether we call it the 80/20 rule, the "1%" of the world's wealthiest people, or use the formal statistical term "power curve", whenever we measure the outcomes of human behaviour some version of this phenomenon seems to apply.

In the case of the people listed above, Abdul-Jabbar's 38,000+ career points make him the all-time **NBA points leader**, Leachman's eight U.S. Emmy Awards make her history's **most awarded TV actor**, and Bill Gates's US$75 billion makes him the **world's richest person**. Each of these individuals has performed so far above average that they have made the concept of "average" meaningless in their fields. In other words, they and people like them account for a far greater portion of success than a bell curve would predict.



Source: Based on a graph by **O'Boyle & Aguinis, 2012**

I have spent most of my career working in private equity, and statistics on the returns of PE investments make it clear that the industry works the same way. Intrigued by this fact, I recently completed an in-depth study of one of the world's leading private equity firms to find out why. Since it is relatively easy to attribute value within PE to individual investment professionals, the industry turned out to be a very good laboratory for this type of work, and the findings apply across industries.

Reinforcement of competencies

In my paper, "**Competencies, Clusters, and Star Performance at a Leading PE Firm**", published in the *Journal of Private Equity*, I found that the more "competencies" a person has, the more these competencies reinforce each other. For example, exceptional strategic thinkers may be very valuable to their organisations. However, if they lack the energy to drive change, their impact will be limited. Now, if you take the strong strategic thinker and add high energy to the mix, you achieve "multiplicative reinforcement", that is the two competencies build upon each other such that each one makes the other more powerful. If you then take the same person and give them strong influencing skills, they benefit from multiplicative reinforcement again, moving closer to the outperforming tail of the power curve, and closer to becoming "stars".

Statisticians have known for a long time that multiplicatively reinforcing factors lead to right-tailed distributions, with a small number of exceptional actors accounting for the **lion's share of value**. Researchers have also found that competencies **can reinforce each other** in this way, and Richard Boyatzis of Case Western Reserve University **has claimed** that human behaviour as well as almost all change in his Intentional Change Theory (the concept that sparked my interest in this subject) is power-law distributed.

Not all value levers are created equal

INSEAD recently published a look at private equity's value creation levers, called ***Value Creation 2.0***. These levers are the different ways that private equity firms create value for the companies that they own, and include sales growth, margin growth, multiple expansion, debt pay-down and the leverage effect. My study indicates that not all value levers are created equal. Specifically, at least within this private equity firm, extreme outperforming companies differentiate from the pack primarily on the basis of sales growth.

Then, similar to the phenomenon of competencies, sales growth helps to pull the other levers and to reinforce them, creating an "interdependent-multiplicative" effect. Interdependency means that the better you are at one value lever, the better you will be at the others. For example, rapid sales growth can lead to higher margins, and higher sales growth can also lead to a higher valuation multiple if the company is sold. Multiplicativeness has the same effect on value levers as is described above for competencies.

Underperformers abound

The flip side of the tremendous value created by a small number of extreme outperformers is that a surprisingly large number of people within any environment seem to create little-to-no value. Warren Buffett recently observed that in corporate America, it seems that "lots of employees **aren't doing anything**". Organisational behaviour researchers **have proposed** that within a typical organisation, the top decile of workers creates 30 percent of value, and the top quartile creates 50 percent. My study indicates that this idea holds within private equity, and the percentages are perhaps even more skewed than these researchers have proposed.

To make matters worse, some employees may be so lacking in competencies that they are caught in a negative reinforcement trap, with the interdependent multiplicative reinforcement phenomenon working against them. If someone is a poor strategic thinker, has low energy and is poor at influencing others, it is unlikely that fixing any one of these will lead to an exceptional or even acceptable performance.

Developing and training team members

If a small number of people create the vast majority of value, a large number create little value, and the "average" is far less common than we would think, then how can companies best train and develop their people? Designing programmes to focus on the average employee or average situation does not seem adequate. Rather, this study indicates that companies should focus on opportunities to use multiplicative reinforcement to their advantage. For example, they could examine what differentiates their extreme outperformers from the rest, and use these learning to train people who don't quite measure up but have the opportunity to get there. Similarly, if companies have employees who have a strong suite of skills but are lacking in a core area (such as the great strategic thinker who is poor at influencing people), then training that person in additional core skills could have a powerful multiplicative effect. Importantly, researchers have shown that competencies **can be learned**.

Thoughtful value creation

Just like in private equity, it seems clear that across industries, different ways of creating value are more powerful than others (e.g. sales growth is more important than cost cutting in PE) and that the interactions between the levers are important too. When investing in new projects, companies can take advantage of this phenomenon by looking for opportunities that can create value through multiple levers (e.g. a project that will both grow sales and increase margins). On the flip side, companies should, perhaps, be suspicious of projects that can only pull one lever.

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