KEYNOTE INTERVIEW

An industry in constant evolution

Private equity has changed significantly in the 30-plus years that Clayton, Dubilier & Rice chairman Donald Gogel has been in the industry but, he explains, the critical ingredients for outperformance remain the same

Q You have been in the industry for over 30 years. Can you give us a sense of what the industry was like when you started out?
I have been at CD&R since 1989, so I have seen a lot of changes along the way. The industry clearly has grown enormously in both scale and importance to the economy. In 2000, assets under management were just $650 billion; today, they are probably over $6 trillion. When I joined CD&R, we had a $300 million fund. Today, we are investing from a $16 billion fund.

The term private equity did not even exist when I started my career. I remember going to a Harvard Business School venture capital club event around 1990 with CD&R co-founder Marty Dubilier and there were a couple of classes of students who came along to see him speak, but for most it was more out of curiosity than a desire to get into the industry. There were not a lot of private equity jobs back then – the whole industry probably hired a few hundred people a year. Today, some individual firms might hire hundreds of new people each year.

CLAYTON, DUBILIER & RICE

Q What do you think have been the most significant changes over that time?
Capital structures have changed dramatically. When I started out, everyone was focused on deploying the smallest amount of equity possible – in some cases as low as 10 percent. Today, capital structures reflect companies' growth opportunities and so firms like ours are willing to put up 50 percent equity, with some deals financed up to 100 percent.

Another big difference is the globalisation of the industry. In 1989, less than 15 percent of private equity AUM were outside the US; now it is more like 50 percent. Supporting that AUM growth and geographic spread has been a meteoric rise in the number and type of LPs. When I started, there were few investors – mostly endowments and foundations, plus a couple of banks. Yet today there are over 11,000 institutional investors committing to private equity across the world, and that includes funds of funds, pension plans, sovereign wealth funds and family office platforms, which have grown very rapidly in recent years. When we raised our first $1 billion fund, nearly 25 percent of our LPs were non-US; in our latest fund, almost 60 percent of our LPs are based outside the US.

Over the years, we have also seen the GP-LP relationship evolve from passive to active, to in some cases, competitive. LPs have always had an emphasis on negotiating terms with their GPs, but we are also seeing larger LPs increase their exposure more actively to co-investments and then, competitively, to direct investments.

Naturally, as the industry has grown, it has gone from unregulated to regulated. And I expect regulation will expand in multiple areas, including M&A, antitrust, special purpose acquisition vehicles, as well as taxation.

Overall, the industry has been through an extraordinary period of growth and that has resulted in the greater dispersion of performance and drop in consistency of returns we see today – firms really need to work hard to deliver for investors.

Q Having lived through six different cycles, what are the biggest lessons you have learned?

When you go through your first downturn, you wonder whether you will be around for your second. But you develop a perspective over time and for me, the changes in cycles are a bit like changes in the season. I have learned they are not cataclysmic for firms with a solid investor base and a strong culture. Rather, they create new opportunities.

> *"Over the years, we have seen the GP-LP relationship evolve from passive to active, to in some cases, competitive"*

According to a 2017 Cliffwater study, PE has outperformed public markets by nearly 700 basis points in periods of market distress. So, the first lesson is to lean into uncertainty and keep on investing.

The second lesson is related to portfolio stability. When you have an existing portfolio that is stable, you can focus on creating new opportunities during more difficult times. Companies with strong capital structures and plenty of cash on hand can capture growth and pursue acquisitions, growing stronger while their weaker competitors are sitting on the side lines and putting out fires.

Another big lesson is to leverage operating skills. We have known this for many years, but a McKinsey study from 2020 found that investors with genuine operating capabilities achieved returns roughly 500bps higher than those without in recession-era vintages. When I joined CD&R, we had three operating partners; today, we have nearly 40 operating partners or advisors to the firm's funds, reflecting our heavy investment in this area.

Finally, you must work hard to keep your firm together. You must keep your culture strong and have a unified vision where everyone is committed to protecting your reputation and sustaining your values. Being known as a trusted and reliable partner with operating capabilities to solve complex challenges is particularly valued at times of economic dislocation. I believe that is at least partly why, after a brief pause for breath in March and April last year, we were busier than ever through the rest of 2020 and into 2021. Since March

2020, we have completed 14 transaction representing close to $5.5 billion of equity investment.

Q How profoundly will the pandemic affect the industry?

There are economic, political and societal changes in motion all the time, but the pandemic has accelerated many trends. New technologies are an obvious shift that affect everything. Digital adoption has been accelerated by 10 years. For us internally, this means employing technology to improve operations, investment due diligence, LP relationships and reporting. Over the past 12 months, we have conducted over 25,000 video calls with LPs, and we don't see that trend stopping. For our companies, technology affects how they operate, as we see the increased impact of artificial intelligence, automation, and data analytics on operating margin improvements.

The increased focus on environmental, social and governance issues is another big theme to emerge. It has always been there, but there is more self-consciousness in the industry as the pandemic has highlighted income inequality, unequal access to healthcare and failures by some companies in addressing ESG issues. Some might have been paying lip service to ESG before – that is no longer a viable option. ESG is a big deal, and it must be, because consumers today really care about this, as do employees.

"A big part of creating a sustainable firm relates to culture. Every organisation is paying more attention to this"

I believe that private equity's high degree of influence over the businesses it owns puts it in a strong position to drive the transformative change the ESG challenge requires. Research shows positive correlation between ESG and financial performance, and I believe this will support continued growth in both purpose-built impact funds and ESG strategies in existing funds.

Q Given the increasing maturity of the industry, how will private equity firms deliver outperformance in the coming years?

Some of this may sound obvious, but I believe the critical elements of outperformance have remained constant: more discipline, better talent and heightened focus on staying in your lane and doing the basics well. You need an advantage to buy well in a competitive market, whether that's superior knowledge, experience or a good relationship with the management team. You also need strong operating experience to drive growth – for us, operational improvements account for 80 percent of our value creation.

Of course, cost and productivity measures are always important, but you must invest in top-line growth. If you can work with companies to develop better pricing, product innovation, productivity, lower cost delivery to market, better branding and so on, you get a business that can grow more than GDP and that is where you get value uplift. That can be the difference between doubling and tripling your money.

Sector specialisation is another differentiator in returns. I believe you need domain expertise to really understand how to grow a business. And finally, add-on acquisitions play an important role – particularly in times of distress, where you can really strengthen a company's position.

"You need to create a strong firm that attracts the best talent and manages growth and succession well"

Q What will differentiate the most successful firms from the rest as the industry continues to evolve?

You need to create a strong firm that attracts the best talent and manages growth and succession well. We have now been through four succession processes. Private equity firms are relatively fragile organisations, but investors are not just looking to invest in one fund. They have very long horizons and want to invest for 20 or 30 years. Some want you to be building a firm for the next 50 years.

A big part of creating a sustainable firm relates to culture. Every organisation is paying more attention to this. You want to create a vibrant culture that people want to join, participate in, and stay. CD&R is an intergenerational and diverse firm with people in their 20s right through to those in their 70s. Our commitment to diversity and inclusion is deeply rooted in our belief that more diverse teams are demonstrably stronger and more effective.

You must create room for people to grow and to do their best if you want to attract extraordinarily talented people. It is not about offering yoga or even flexibility to work from home, because these in the end are simply just checklist items. What is important is creating an organisation that people believe in, has a strong sense of shared purpose, and stands for something bigger than just making money. ■