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PRIVATE EQUITY

How private equity adapts: A discussion with Don Gogel

A longtime private-equity CEO reflects on the advantages of pure-play firms, how to deploy virtual expertise, and why general partners are like wineries.

Bryce Klempner and Mark Staples

Don Gogel is the chairman and CEO of Clayton, Dubilier & Rice, a private-equity (PE) firm that in its nearly 40-year history has acquired more than 70 companies, for a total transaction value of more than $100 billion. Gogel has served as CEO since 1998. McKinsey's Bryce Klempner and Mark Staples spoke with him in August 2016 in New York.

McKinsey: *You have been in private equity for a while, as it has expanded and changed. How do you see it progressing? Is private equity a scalable asset class?*

Don Gogel: If we're talking about PE funds under management as a percentage of all assets, I think there's enormous opportunity, simply because private equity is just another form of ownership. There's no ceiling, no regulatory-capital issue. It's just about relative performance. PE has some structural advantages, which increase the power of the best firms to outperform. PE has better alignment of incentives between GPs [general partners] and LPs [limited partners] than public companies have between shareholders and management. Alignment in management and the resulting reduction in agency costs is a great structural advantage. Another is the relatively small size of PE firms, which allows them to make more coherent decisions and to act on those decisions more efficiently.

Donald J. Gogel

Vital statistics
Born February 19, 1949, in Brooklyn, New York

Married, with 4 children

Education
Received a BA with highest honors from Harvard College in international relations and studied politics on a Rhodes Scholarship at Oxford University's Balliol College, where he received an MPhil; also received a JD from Harvard Law School.

Career highlights
Clayton, Dubilier & Rice
(1989–present)
Chairman, president, and CEO

Kidder Peabody
(1985–89)
Managing director, cohead, Merchant Banking Group

McKinsey & Company
(1976–85)
Partner

Fast facts
Serves as chairman of the SeriousFun Children's Network, senior vice chair of the Mount Sinai Health System, trustee of the Rhodes Trust, and trustee of the Cancer Research Institute.

A third advantage for PE stems from a disadvantage of public companies, where the distractions of public markets drive weaker performance in a number of ways. All the public-company CEOs I know say they spend 20 or 30 percent of their time on public-related issues, which they know are important but diminish the time they can spend improving their business performance. That's a lot of lost productivity. And there are other problems with public markets, such as short-term and quarterly earnings and activists.

McKinsey: *What benefit does PE derive from all these advantages?*

Don Gogel: Adaptability. The asset class's adaptability is extraordinary. First, we are not forced to be fully invested. When people ask me the best years we've had, I often cite the three years we made no investments. What a wonderful asset class. You don't like what you see, and for whatever reason you can't make the numbers work, so you don't invest. That flexibility is terrific and a luxury that other asset classes simply do not have.

Another way PE is adaptable is in its ability not only to follow areas where value is likely to emerge but also to go deeper and deeper into them. Take healthcare. We started largely as investors in industrial companies. Until several years ago, we did very little healthcare investing, mostly because either the industry dynamics didn't lend themselves to our model or there were such heavy regulations that it wasn't very attractive to us. But the disruptive effects of the Affordable Care Act have created some interesting investment opportunities.

We have continued to expand in healthcare. Unlike acquisitive public companies that venture into businesses beyond their core activities, often with mixed results, we've been able to organically build staff with highly relevant skills and experience and then find opportunities that match up well with our capabilities. And, as we demonstrate proof of concept, we build more staff and go deeper, all at our own pace. We don't have to put the capital to work until we're comfortable that we have the right talent in place and the timing is right.

Those kinds of things lead me to think there's plenty more for PE to do. And the external environment is only pushing us further ahead. All the problems with public markets remain in place, as does the persistent low-interest-rate environment.

McKinsey: *Most LPs come to this asset class looking for relative outperformance. McKinsey and some other market observers are projecting a prolonged period of low returns across both public equities and fixed income. How might that affect PE?*

Don Gogel: I'm confident that PE will outperform the public markets because of its structural advantages. The more interesting question is how to choose among GPs. When I started in this business, if there were 100 legitimate institutional-style GPs, that would have been a lot. Since then, of course, it's gotten more competitive, and competition drives down returns. But over time you have still seen some persistence of the top-quartile firms, and the gap between the top quartile and the bottom quartile is something like 3,000 basis points. So the question is less whether private equity is a good asset class and more whether good managers can continue to perform, and how they can scale.

Although I think the industry will continue to scale, I also think there are limits on creating alpha within an individual firm because each firm's investment process is highly idiosyncratic. Yes, there are some common standards and criteria among firms—everyone looks at the same data for markets and competitors—but it's the magic of the particular firm that allows it to find uncommon or obscured opportunities. As PE grows, a risk is that what happened to hedge funds will happen to this asset class. At one time, there were hedge funds that saw things that others didn't see, and then so many people started hedge funds that the industry wound up with crowded trades everywhere. In PE, we already see crowded trades when there's a big auction for a good property. These are the common opportunities that everybody sees the same way.

McKinsey: *Given those dynamics, you might expect industry consolidation over time. But to date we haven't seen that. Any given LP will say it is cutting its number of external managers, but the share of the 10, or 20, or 50 largest managers has not gone up.*

Don Gogel: That shift might be under way. Many LPs have concluded that they have too many managers and should concentrate more capital with fewer managers. We're certainly seeing that among our investors. You may not see consolidation just because the asset class is growing. So the market share of the big firms is not growing.

The GP has some meaningful constraints on its particular combination of organization, people, talent, culture, and style. As firms get larger, that combination just doesn't scale the same way it did when the firm was young. A GP is a little bit like a winery. Sure, you can bottle hundreds of thousands of cases, but then it doesn't taste like Screaming Eagle or Château Haut-Brion or a top-notch Barolo.

McKinsey: *You sell artisanal returns.*

Don Gogel: In a way. I really think there is some limitation on scale. Not all firms have hit it, but I do think firms that grow too fast and get ahead of their staffing earn lower returns. To deal with that, we have artificially constrained the growth of our funds based on my sense of what we can sensibly do to grow. Most of the time when we have had excess demand, when other firms would say to take the money and put it to work, we've said we'd rather create alpha, which we can't do unless we remain an appropriately scaled firm. My rule has always been that I want all the partners in the firm to know about every investment. The full partnership is the real investment committee for the firm. And when we have partner meetings, I want everyone to sit around one table. In recent years, I've had to make the table a little bigger, but I can still fit the entire partnership around the table.

McKinsey: *The pressures to grow are pretty strong. Beyond all the capital that's out there looking for great returns, you can also face pressures from your people. How do you balance those things?*

Don Gogel: From time to time, there are periods when it's a challenge to either find new investments or monetize existing ones. At these times especially, there's a groundswell of voices: "Look what they're doing; maybe we should start a hedge fund; why don't we do a special ops fund." And so on. I've been accused of just waiting people out as we study these things because inevitably, within six or eight months, we say, "Aren't we glad we didn't do that; that would have been a dumb idea." There are lots of ways to expand. I just think we have a better business than any of the options we have looked at.

Clearly, some PE firms have been spectacularly successful in other fields, such as real estate. But some have not. My view is that PE is a talent-based business and that we have finely honed our understanding of that talent. We know what it is, we can value it, and we can develop it. I'm not sure what our success would be in attracting, understanding, and managing talent in hedge funds or real estate.

We have also thought about expanding within PE. Could we set up a lower-middle-market buyout fund and deploy many of the same skills we use currently? Yes. But we are mindful that smaller investments of tens of million dollars take just as much effort and skill as a $500 million or $600 million investment. When we consider smaller transactions, we're selective and have a strong conviction that we will produce an outsized multiple of investment to make it worthwhile. Coming back to talent, it's a lot harder to bring in five or six world-class people to a company with $300 million in revenue than to a company with $3 billion. As long as there are a lot of opportunities in our sweet spot, we just channel the pressure to go elsewhere into an urge to go back to work and make our deals more successful.

McKinsey: *LPs sure love it when you stick to your knitting, especially when you give them nice scarves. So let's talk about LPs a bit more. How have GPs' relationships with LPs evolved in recent years, and where do you see them heading?*

Don Gogel: They have not changed dramatically for our most sophisticated investors, mostly university endowments and private foundations. The sovereign-wealth funds are a class by themselves and have a particular issue with their need to deploy massive amounts of capital. With pressure on commodity prices, many are at risk of big gaps in their funding, similar to US pension funds. Most have committed 5 or 6 percent to PE; my sense is that they will roughly double that. And I think managed account relationships will increase. We have not done these, because of the potential for misalignment among investors. "Keep it simple, stupid" has been a pretty good mantra for me for a long time.

Coinvestment has become big. We have been providing coinvestment opportunities to our LPs for about 15 years and have had a good experience. To be fair, everybody says they want it, but very few LPs have the staff and the quick decision making needed. Coinvestment actually enhances some strategic options for us because we can routinely commit more capital than we want to invest, knowing that we have a half dozen big investors that want to participate with us.

McKinsey: *Do you see more LPs building the skills to extend from coinvesting into true direct investing?*

Don Gogel: I do, but it's the exception rather than the rule. Five years from now, I'd guess that we'll see more of this trend.

McKinsey: *If it grows from there, do you think LPs' lower internal deal hurdles will affect deal pricing?*

Don Gogel: Inevitably, yes, but only on the margin. Because if you conclude, as I do, that outperformance requires a special team with a special level of expertise, then you also have to recognize that it's hard to build that, even in pure-play private-equity firms like ours. In any event, I think the greater pressure on pricing is from the low-return environment. If returns stay low, a number of PE firms think that investors would be quite happy with a 12 to 15 percent return.

McKinsey: *Especially if you promised them 10 percent?*

Don Gogel: Exactly. I'm more worried about that pressure than I am about direct-investing LP competitors. If you believe that equity returns for the next decade will fall from, say, 7 percent annually to 2 or 3 percent, and PE as an asset class maintains its outperformance at 3 to 5 percent, then the average industry returns come in below the preferred return. That's trouble. I'm not going to say it's a train wreck, but it could be less than optimal for both GPs and LPs. That said, I have seen very little change in the preferred return.

McKinsey: *The industry's 2-and-20 pricing structure is a venerable institution. Do you see any change coming?*

Don Gogel: I don't see a change, but to be fair, it's not really a 2-and-20 pricing structure; it's a 1.5-and-20 structure. In this environment, the LPs have lost a little clout, as they're trying to deploy more and more capital with a concentrated number of managers. They're not pushing terms as hard, except for special accounts. There's another dynamic at work, with respect to those GPs that seem to want to accumulate assets and not necessarily to invest them. The various forces are pretty much in balance and are unlikely to move dramatically in the next five or ten years.

McKinsey: *Do you see any divergence between the firms that are asset gatherers and the firms that are more focused on achieving top returns? Are they starting to exhibit different characteristics?*

Don Gogel: I think so. For many of the largest firms, private equity is now a much-diminished portion of their activity. We believe that our focus on PE gives us a competitive advantage, particularly with our staffing model, which includes both investment professionals and seasoned business leaders, or what we refer to as operating partners. Even if our larger distinguished competitors wanted to, they could not argue that their culture is all about creating operational improvements in portfolio companies. We can. We can hire very senior executives from the world's largest companies because they love getting their hands around a business and coaching senior people. That gives us an enormous edge in competing for talent, at every level, from our associates to the portfolio-company supply-chain manager, the head of marketing, and the head of our digital platform. I think you're going to see some dispersion of returns between firms that focus on generating alpha and the others that don't.

McKinsey: *How does that edge affect your recruiting?*

Don Gogel: We think about two kinds of recruiting, financial and operational. Most of the major private-equity firms now recruit financial talent in the same way, by hiring young people with two or three years of work experience in finance with a major investment bank. We typically have them for two years, occasionally three, and most of them then leave to go to business school. What's less typical is how we recruit operating partners. At most PE firms, operational recruiting is opportunistic; when they need to do something, they hire an operational expert to do that one thing. We've always had a different model, distinguished mainly by how much time our operating partners are willing to spend with us. We have seven full-time operating partners, four in the United States and three in Europe. They are full partners of the firm, they sit on our investment committees, and they participate in the life of the firm in the same way a financial partner does. Their key role, though, is to be deeply engaged with our portfolio businesses, serving as chairman. Before that point, they're part of the due-diligence team, and they help sort through investments. We also leverage their networks to source new investments.

Very few firms have effectively implemented this model. The reason we developed this approach is our founders. Marty Dubilier was an operating guy, and Joe Rice was a financial guy, and so we grew the firm on both sides. We've also broadened the role a bit. In addition to our full-time operating partners, we've found out there are a lot of talented people in their mid- to late 50s who no longer want to work as hard as is required to run a public company. They don't want to be in the office all the time, and they don't want to routinely participate in all the administrative activities of the firm. They just want to work on our portfolio businesses.

One thing that our operating partners and I spend a lot of time on is identifying the next generation of talent. We don't just hire successful CEOs, because a successful CEO who replicates here what he or she did as CEO won't work. First, we're nonhierarchical; it's a partnership. Second, although the role that our operating partners take is typically executive chairman, the job is to build the management team at the portfolio company so that it can be successful when it goes public or is sold. Not every successful CEO has a coaching ability. Not every successful CEO understands that the management-team members are the stars, or is comfortable working with high-performance people. CEOs also have to get along with 26-year-old whippersnappers who happen to know a lot. In the 27 years that I've been recruiting people, the mistakes I've made were mostly people who thought they were good coaches but were actually great CEOs. If they don't give the portfolio-company CEO enough air, it doesn't work.

McKinsey: *Your firm is one of the few that has managed to integrate seasoned, high-wattage executives into your model—people used to running companies with thousands of employees and tens of billions of dollars in revenues. How do you help them adjust to helping run much smaller companies?*

Don Gogel: A lot of it is in our selection process. I see 30 or 40 CEOs a year who are interested in making a move to private equity. Many of them are just trying to figure this stuff out and are unlikely to be suited to it. At many companies, the higher you go, the less feel you have for what's really going on in the company. We look for people who have kept that feel.

They have energy and enthusiasm; they don't mind traveling commercial; they still want to work hard.

Say, for example, they've had great success in thinking about structuring, recruiting, compensating, and organizing sales forces. I want someone who loves that work. Here, the sales force might be only 300 salespeople, not 3,000, but they love the game; they love the challenge of solving the puzzle.

Another reason that few firms have adopted our model is that it's expensive. Our operating partners get carried interest in every deal, regardless of how close they are to the portfolio company. The model many other firms use is a pay-by-the-drink approach. They hire someone for a specific deal and offer carried interest in that deal and none of the others. It's less expensive for sure, but it's not our style.

McKinsey: *Can you say more about how, in addition to serving as executive chairman of a portfolio company, an operating partner is expected to help bring particular expertise elsewhere in your portfolio?*

Don Gogel: That's the expectation. But we have a portfolio of about 20 companies, and not all our operating partners are full time. It's up to us to identify where each person's help is most needed. Even better, we try to get portfolio-company CEOs with a particular skill to help other portfolio companies. It's what GE used to call boundaryless behavior. The issues where this kind of help is particularly valuable are functional, like sales-force management. Pricing is enormously important and always a big opportunity, so we try to share our best practices there as well. Our operating partners and advisers meet once a month to identify issues in their companies, ask one another for help, and so on. It would be inaccurate to say we're mimicking a decentralized holding company with a big central staff, because we have no staff, but we have expertise. It's virtual experience and insight. The core of that model is being able to identify high-impact areas where that expertise can make a difference.

McKinsey: *Does it fall to you to know what everyone's abilities are in this regard, to spot the problems, and to identify the person who can solve that problem?*

Don Gogel: Ultimately, I'm the chief talent officer and recruiter. But I couldn't possibly do that across all our portfolio companies, so we have a number of processes to make this visible. We have our monthly operating meetings. When we identify bigger issues, we have a series of operating reviews, two or three times a year. Each portfolio company comes in with a full management team. We used to have just the CEO and CFO, and we enhanced the process by opening it up to more members of the leadership team. The portfolio-company management group makes a thematic presentation to our operating partners. It's not the typical review of last quarter's sales and gross margin. Instead, it's on a theme such as new-product innovation, pricing, or sales-force management. Out of that emerges a to-do list, either for the management team or for us to worry about.

These kinds of robust processes designed to identify issues ensure that we are able to quickly mobilize and deploy the best resources against them. For most private-equity firms, this is difficult because their style is highly proprietary to the financial partner involved. The partner usually has the right to say, "That's my deal, and I don't want your help; I don't want you looking over my shoulder." I had a conversation recently with a very senior executive who joined a leading PE firm and built a staff of strong functional experts. He said that he would go to portfolio companies, thinking he was the good guy, and suddenly he would see there was a moat around the castle, the drawbridge would go up, and then they're shooting arrows at him and pouring hot oil on his head. He left rather quickly.

I wouldn't say that's the whole industry, but I do think there is a structural difference between our kind of firm and others. Our partners recognize that inclusiveness is key, and the portfolio CEOs get what we're doing. We're not always welcomed with open arms, but if we're ever in a situation where people say "Uh-oh, here comes headquarters," we're in deep trouble.

McKinsey: *Establishing that level of trust and understanding is difficult. We have touched a few times on the topic of institutionalization—building the firm. One thing that distinguishes your firm is that your last name doesn't start with a C, a D, or an R, yet you run the show; your firm has already passed the mantle of leadership. What made your succession work well, and how are you planning for future succession?*

Don Gogel: Fortunately, Joe Rice thought a lot about it. It was important to him and to a lot of our long-term investors, who said, "It's not going to help us if you guys are here for only ten years, so what are you going to do to make that work?" Joe thought a lot about it, and fortunately he was willing to give the reins to a young kid, me, earlier than he might have in other circumstances. Every firm has to go through this, and if you pay a lot of attention to it, really work at it, you're more likely to get it right. If you don't, then you won't; we see some founders are getting thrown out now. And we're going to face the issue of succession again. I, of course, feel immortal, but that's probably not an accurate self-assessment. I don't have a window for retirement. I'm telling investors in our next fund that I will certainly be here through the entire life of the fund. And we have established a management committee of five very talented leaders, and I have started sharing management responsibilities with them. So we now have senior people thinking about these issues in a different way.

Further, they feel as acutely as I do about the right size of our funds. I'm not the only keeper of the flame—they are, too. We have different points of view, but there's much more collective management.

PE firms are not like public companies. They are more fragile institutions, which makes succession probably more important—and more complicated—because it's not just about managing the business. My own sense is that PE firms should be led by someone who is fundamentally an investor, not a manager.

McKinsey: *One final topic. Among the general public, there's a good deal of doubt, confusion, and even hostility toward private equity?*

Don Gogel: The biggest problem is that it's a complicated asset class. Take the studies of employment in PE.[1] Josh Lerner and his coauthors looked at census-level data, literally by office and warehouse, and found that PE outperforms public companies, but there's a nuance that makes it hard to explain. In the first two years of PE ownership, there's a reduction in employment, and in the following five years, there's an increase that more than makes up for the reduction. PE firms spend the first two years getting rid of things that aren't working and are inefficient, and then they build on a stronger base.

That's a complicated story. PE is still waiting for someone with the ability of a Michael Porter or a Thomas Friedman to explain the industry to the outside world. We have contributed to some research efforts. One we did with the World Economic Forum found that on three outcomes that are important to companies and to society—innovation, employment, and governance—private-equity firms did better than the control group of public companies on things that everybody assumes is the opposite.[2] No one paid attention, but at least I felt good that we produced some unbiased data. And we've helped to establish the Private Capital Research Institute, which we hope will yield some objective and credible insights into PE.

To date, however, the general and business press have usually published a popularized view of the industry, using high-profile examples that are not always representative of the industry as a whole. ■

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[1] See, for example, Josh Lerner et al., "Private equity, jobs, and productivity," *American Economic Review*, December 2014, hbs.edu.

[2] *The global economic impact of private equity report 2008*, World Economic Forum working paper, globalization of alternative investments series, number 1, January 2008, weforum.org.

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