PRIVATE EQUITY FINDINGS

Insights from private equity research worldwide

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"WE WERE SURPRISED TO FIND THAT THE PERCENTAGE OF CEO REPLACEMENT AND THE PERCENTAGE OF OUTSIDE APPOINTMENTS WAS SO HIGH. THE STUDY REALLY DOES CONFIRM PE'S MANTRA OF MANAGEMENT, MANAGEMENT, MANAGEMENT"

Paul A Gompers *Harvard Business School*

BUT WHAT ABOUT *THE WORKERS?*

Private equity has historically focused its attention on bringing in and incentivising the best management teams, as a recent academic study details. Yet another piece of research suggests that firms may be less concerned about the wider workforce in the companies they back. Can they afford to do this at a time of labour shortages? By Vicky Meek

For decades, the private equity industry has pursued the Holy Grail of finding the best management teams for its portfolio companies, on the basis that these individuals drive significant value. And it's this philosophy – and the fact that an earlier study on public companies showed that they tended to recruit internally – that led three academics to study where PE firms were looking for their CEOs. In *The Market for CEOs: Evidence From Private Equity*, Paul A Gompers, Steven Kaplan and Vladimir Mukharlyamov studied CEO appointments in larger US buyouts between 2010 and 2016.

They found that PE firms go to great lengths to find the CEOs that they think will best fit their portfolio companies, in contrast to what happens at public companies, as Gompers explains. "This paper follows on from a previous study that found 72% of the S&P 500 CEO appointments were internal promotions, and that of those that weren't, 90% were already known to board members," he says. "We thought it was hard to reconcile with the idea that they were finding the best talent. That's why we looked at PE – it is known for being good at improving company operations and generating strong returns for limited partners.

"We wanted to see if the labour market for PE CEOs was the same as for public companies. And it was dramatically different: in the sample, 70% of CEOs were replaced at the time of the deal. This suggests that finding the right talent for the top is an important value creation lever in PE."

The research also suggests that this situation benefits the CEOs themselves, with their average compensation higher than for those in similarly sized public companies.

Overall, the study suggests that management is one of PE's top priorities in deals. "The results were directionally what we expected," says Gompers. "But we were surprised to find that the percentage of CEO replacement and the percentage of outside appointments was so high. The study really does confirm PE's mantra of management, management, management."

THE BROADER PICTURE

So far, so good. Yet for an industry with such a laser-sharp focus on value creation, some are questioning whether PE is missing a trick. "PE has traditionally been far too focused on the C-suite," says Matt Brubaker, CEO of human capital advisory firm FMG Leading. "Yet there are often groups of people who create a disproportionate amount of value – perhaps 10 to 20 times more than others, and yet this isn't always recognised."

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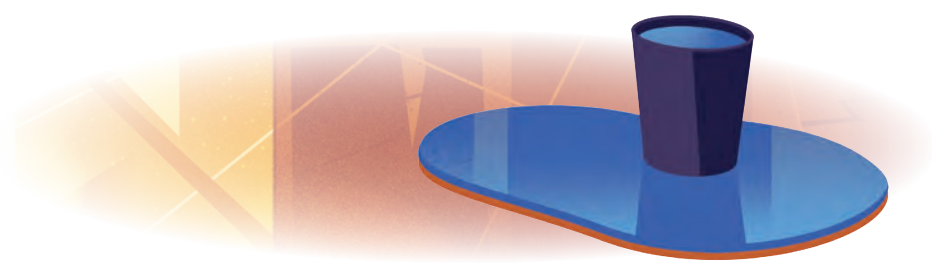
>
> **Will Gornall** *The University of British Columbia, Sauder School of Business*

He offers the example of a multisite ambulatory healthcare provider. "You might have a site manager who has the ability to personally affect the most crucial performance metrics, such as clinical outcomes, employee engagement, and provider satisfaction," he says. "These are the fulcrum roles that drive disproportionate value."

Indeed, a recent piece of research suggests that PE firms could be doing a better job with the broader employee base in the businesses they back. And this is a particular concern at a time when the labour market is tight and finding workers is both expensive and time-consuming. In their paper, *Do Employees Cheer for Private Equity? The Heterogenous Effects of Buyouts on Job Quality*, Will Gornall, Oleg Gredil, Sabrina Howell, Xing Liu, and Jason Sockin examine employees' satisfaction levels with compensation, culture, senior management and work-life balance following a buyout (see Research box for methodology and detailed findings).

"The broad trend of PE becoming more important in the economy – and in some ways supplanting public equity – makes this an important area of study, given how many employees are now in portfolio companies," explains Gornall. "Many people want to know whether PE is just better at managing companies, or are firms extracting value from others, such as employees?"

The researchers found some interesting – and quite nuanced – results. Employees felt that company culture had been negatively affected by the buyouts and their perceptions of compensation also worsened, but not perhaps for the reasons that might have been expected. "The principal reasons we found for an increase in dissatisfaction were around cost-cutting and pursuing greater efficiencies, rather than, for example, lay-offs," explains Gornall. "What we didn't find was a decrease in overall compensation, which broadly remained the same."



The explanation for this, adds Gornall, is down to employees' perception of higher risk and lower stability within their organisation, for which they expect to receive higher compensation. "Dissatisfaction levels were correlated with the amount of leverage in a deal, both at the time of the buyout and after refinancings, for example, for dividend recapitalisations," he says. "Overall, this suggests that employees see increased leverage as a risk transferred to them – there is a greater pass-through of returns to employees, so that if the company does worse, so do the employees, because there is a need to cut more deeply and/or more quickly than in public companies."

It also found that incentive-based compensation increased following a buyout, with managers in particular receiving more performance-related pay (although these employees were also more likely to be dissatisfied with work-life balance, according to the study). Perhaps unsurprisingly, employees receiving incentive-based compensation in strongly performing companies were happier than in other PE-backed companies. As Gornall says: "The reverse is true, however, since options or performance-related pay – sharper incentives – also pass through to employees. So if the business does well, the employees benefit."

THE CASE FOR SHARE OWNERSHIP?

This last finding may add some weight to the rise of share ownership schemes for employees across the board in PE-backed portfolio companies. Ardian, for example, has had such a scheme in place for well over a decade, while KKR executive Pete Stavros last year launched a non-profit organisation, Ownership Works, to promote share ownership schemes to companies and their investors. The aim is to create at least US$20bn of wealth for working families by 2030 by making them employee-owners in a move that, the World Economic Forum claims, can "reshape company cultures, boost engagement and drive down absenteeism". Stavros says that broad-based ownership can "build a sense of shared mission".

While not a member of Ownership Works, it's a view that Steve Lebowitz and his fellow founders of deal-by-deal PE firm Brand Velocity Group (BVG) share – up to a point. The firm has launched a scheme called Share the Gains, which has been the subject of a Yale University case study. Lebowitz explains: "Our Share the Gains initiative was born out of the question: senior management receive equity incentives for their efforts in PE deals, but what about everyone else at the company? We decided we wanted to find a way of sharing the wealth with all those who helped to create it."

The firm now commits to employees receiving a share of 10% of the carry the GPs achieve on each deal at exit. "We think this is a meaningful amount and because it comes from carry, it doesn't affect our investors' returns," he says.

BVG has also gone a step further. "In our most recent deal, we asked LPs in our subscription documents whether they wanted to participate, too," says Lebowitz. "More than 20% are participating in some way."

INCOMPLETE ANSWER

Yet even Lebowitz, who is enthusiastic about this approach, is clear that share ownership schemes are far from the whole answer to employee satisfaction – and therefore retention. "Part of the issue is that, broadly speaking, PE subscribes to a scientific management approach – that people are economic machines that respond to economic incentives," he says. "But that doesn't take account of what actually makes people tick, so it's an incomplete response. That's why share ownership is a good first step towards recognising and valuing the people who are helping to generate returns, but it's not the whole solution."

The fact that the research found evidence of a negative impact on culture following a buyout suggests that PE owners might do well to look at the whole picture. "We need to take a holistic view if we want people to feel they belong at a company," Lebowitz says. "That's something that most founders get because they understand how important people and the culture are. Employees want to know that you have their backs. That's in an economic sense, but it's also about whether you are prepared to invest in them, coach them and train them. Employee initiatives need to be sincere, as opposed to providing perks as a bit of window dressing, so they need to align with what makes people tick as human beings."

There is clear room for improvement here. The academics found that dissatisfaction among employees was in large part driven by people who had been at the company longest and by lower-skilled workers. While it may not have mattered to the bottom line too much in the past if these employees left, in today's market, this makes far less economic sense.

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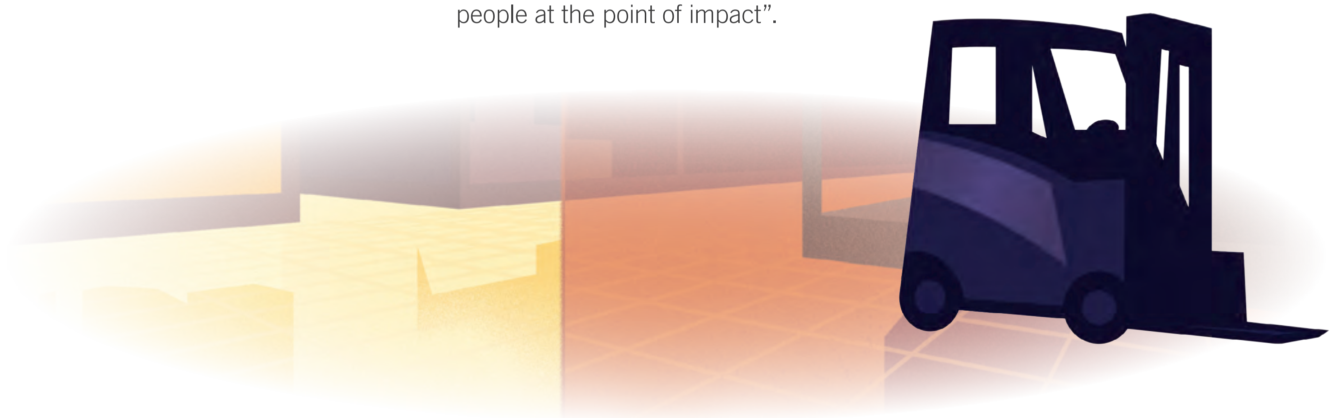
A study by Deloitte found that there may be a shortage of two million US manufacturing workers by 2030. And while automation may partly fill this gap, companies will still need people. Training lower-skilled workers has the potential to create value as well as a sense of loyalty, and if companies can retain long-haulers, they are less likely to lose important institutional knowledge.

DO VALUED WORKERS CREATE VALUE?

Gary Hoover, vice president of the global PE practice at consulting group TBM, knows this only too well. He advises PE firms on operational due diligence, leadership and excellence in manufacturing businesses, many of which tend to be employers of lower-skilled and longer-tenure workers. He says that the firm's work "touches people at the point of impact".

"If you empower people, train them to solve problems as they occur, and give them some decision-making authority and autonomy, you'll see results in employee engagement and productivity," says Hoover. "While share ownership is a great tool, it's not the whole answer – it's transactional and doesn't necessarily connect employees to what you are trying to do. They may feel that there's this investment thesis someone has come up with, but how are they connected to that? And are their interests aligned with those of investors?"



Instead, he advocates a root-and-branch approach to understanding employees and their daily experience of working in a business – only then can improvements be made. He explains: "To me, the first question should always be: what's the engagement level with employees? That takes in all sorts of areas, such as the shop-floor environment, whether it is safe, whether people can be successful every day, whether working conditions are reasonable, whether they have the resources to perform well, whether they are listened to – and I don't mean a mysterious suggestions box in the corner of the room that gets opened once a month. We are referring to real and lasting change through meaningful engagement."

Further, he adds that this approach is essential in an industry that focuses these days on operational improvements. "If you are truly seeking to make operational capability a competitive advantage, you have no choice but to engage with the workforce," says Hoover. "PE firms really should care, because they need their employees to work with them for growth."

CULTURAL SHIFT

And there is evidence that PE is starting to take more notice following Covid-19 disruption and as worker shortages bite. "A growing segment of investors are becoming more sophisticated over their human capital strategies," says FMG Leading's Brubaker. "The pandemic definitely accelerated this trend. PE sponsors recognised that their portfolio companies needed to keep employees happy during Covid because they would need the staff to be there once the lights went back on. By definition they have a flexibility to do things that public companies couldn't do – and they were more able to keep their staff."

He adds: "The Great Resignation is reinforcing the idea that if you keep employees happy, you can stay two steps ahead of the competition."

Given the need today for PE to focus more on retaining people and for a greater appreciation of the value the broader workforce can create in a business, perhaps if the Gornal et al study were to be repeated in a few years' time, the results could be very different. It's a change Lebowitz would be keen to see happen. "Currently, when PE comes into a business, there can be a lot of concern among employees over what the new ownership will mean for them, whether benefits will be cut and whether leverage will increase," he says. "It would be great if PE was not associated with ruthless efficiency, but instead regarded as a means to support the growth of the company – and by extension, its people."

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Steve Lebowitz *Brand Velocity Group*

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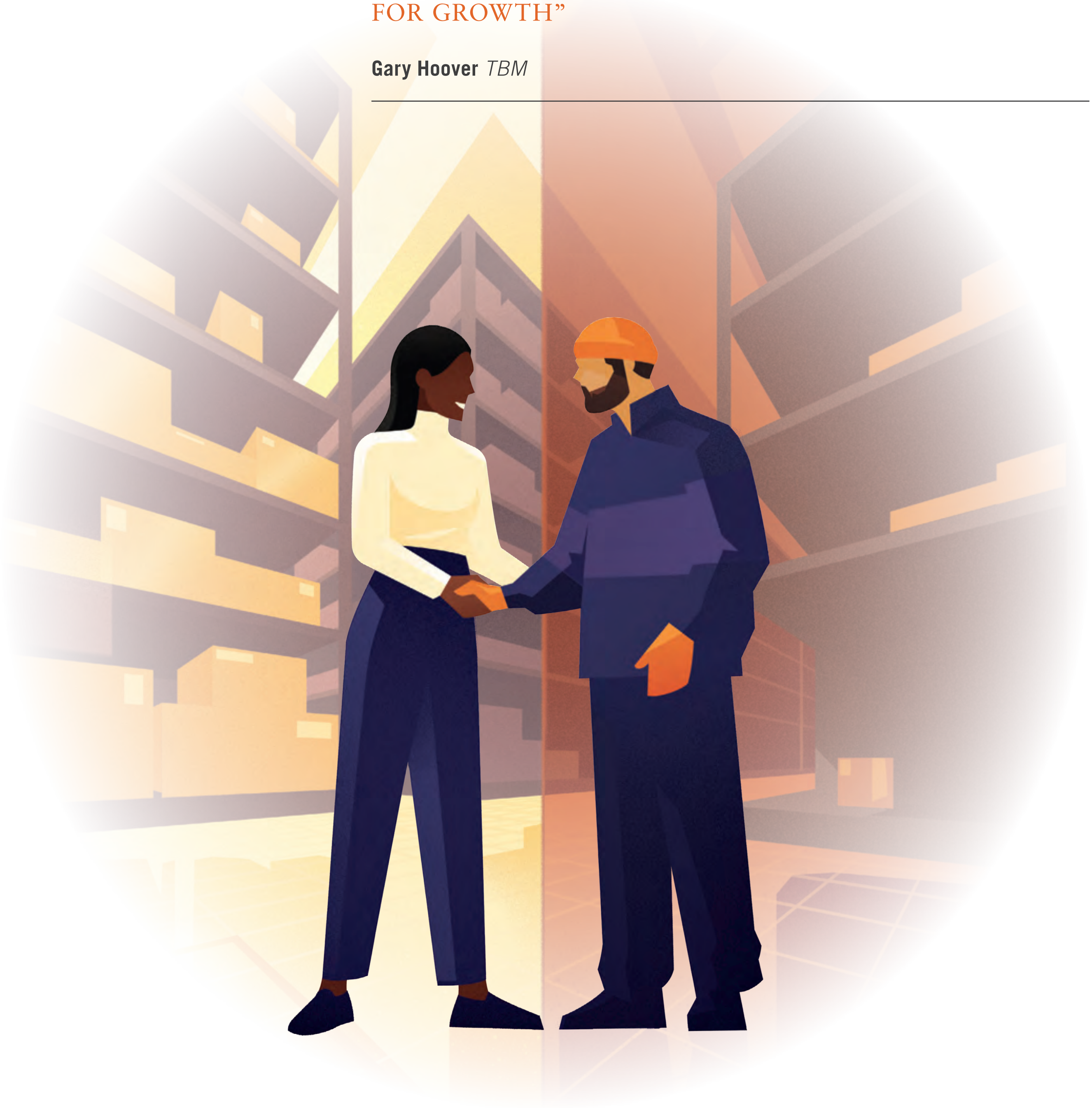

THE RESEARCH

The Market for CEOs: Evidence From Private Equity, by Paul A Gompers (Harvard Business School), Steven N Kaplan (The University of Chicago Booth School of Business) and Vladimir Mukharlyamov (Georgetown University, McDonough School of Business), focuses on the extent to which PE firms replace CEOs and where they source them from.

The authors find that in US PE deals valued at more than $1bn between 2010 and 2016, the CEO was replaced in 71% of cases, and among these, 75% came from outside the portfolio company. Of the external appointments, 67% were from public companies (including 32% from the S&P 500) and most had experience of an industry relevant to the portfolio company. The authors then estimate the compensation of the CEOs using deal-level performance and other evidence on equity incentives and compensation. They find that the average buyout earns 2.5x equity investment and that, with an average realised pay of US$9.4m to US$17.3m per year, private equity CEOs earn more than CEOs in similarly sized public companies and a similar but somewhat lower amount as S&P 500 CEOs on average.

Taking a wider perspective, *Do Employees Cheer for Private Equity? The Heterogenous Effects of Buyouts on Job Quality*, by Will Gornall and Xing Liu (both The University of British Columbia, Sauder School of Business), Oleg Gredil (Tulane University, AB Freeman School of Business), Sabrina T Howell (New York University, Leonard N Stern School of Business) and Jason Sockin (University of Pennsylvania), examines whether PE buyouts reduce perceived job quality among targets' employees.

Analysing more than three million job reviews on Glassdoor from employees of 271,000 companies between 2008 and 2019 and matching these with PitchBook and Capital IQ data on PE deals, the researchers find that post-buyout, employee satisfaction with compensation declines by an "economically significant" 0.083 points on a one-to-five scale (despite no evidence of a fall in average pay), with a larger negative effect on company culture and a slightly smaller negative effect on satisfaction with work-life balance and senior management. They find the use of terms such as "cost-cutting" and "uncertainty" increase in these deals. The effects are compared with control data from companies that are not backed by PE.

The academics also find a strong relationship between the amount of leverage in a deal and job satisfaction levels, yet that immediate post-deal lay-offs have a far less negative effect. This relationship holds not just for leverage secured at the time of the deal, but also in cases where debt increases following a PE owner's dividend recapitalisation.

Using StepStone data on deal-level returns, the paper also explores the degree to which company success is passed on to employees. It finds that the best-performing PE deals are associated with happier employees and that a 1% higher IRR on the deal maps to 0.7% more incentive pay. They suggest, therefore, that risk is transferred to employees post-buyout and that staff are "dramatically more exposed" to a company's fortunes.

Finally, the researchers conclude that employees view the loss of stability as a real cost and therefore expect greater compensation, and that those with a longer tenure at the company (those with the most to lose) and/or those working in industries where unemployment is high are the drivers of lower satisfaction ratings post-buyout.

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