Partners' Meister on how private markets get to $20trn

Unless front-line employees are excited to work at a PE-backed company, the industry will struggle to respond to its critics, says Partners Group executive chairman Steffen Meister. By Toby Mitchenall

Private equity firms were taking some heat in the 'normal' times before the coronavirus outbreak became a pandemic. The industry was increasingly viewed by the public and political classes as an extractor, rather than creator, of value. In the words of Blackstone president Jon Gray in April's *Private Equity International*: "There's this monolithic perception that we're not good actors."

In the past, this negative perception had been easily dismissed as either simply wrong, or driven by envy, or both. At any rate, it didn't matter. To generalise: as institutional capital kept pouring into the asset class, the need to make other stakeholders in society feel good about PE had not been a priority.

It is a topic that we've been exploring under the broad banner of private equity's "licence to operate" and it is one that industry leaders are starting to take seriously.

Indeed the debate around whether private equity-backed companies should be able to access government rescue capital amid the covid-19 crisis – such as the life-giving Paycheck Protection Program in the US – has highlighted the importance of being perceived as a good actor by more than just limited partners.

On Partners Group's annual results call in mid-March, the firm's executive chairman Steffen Meister introduced a potentially important shift in the way it engages with portfolio company employees.

At a time of growing negative public attitude to PE, Partners Group – which has $94.1 billion in assets under management – plans to discuss with its institutional clients a proposal to divert a percentage "of the value that is created" at its portfolio companies to employee programmes that could be in education, the environment, social initiatives or more straightforward financial support (a share in the profits at exit), through a so-called "stakeholder benefits programme". There was also mention of a portfolio-wide hardship fund (sort of an internal insurance programme) to account for business failures and job losses.

Meister posed the question: while private equity firms can credibly claim to outperform other ownership models when it comes to returns and job creation, can it claim to be better at engaging with employees? "I think we have to take a step back and agree: no, we cannot," said Meister. Why not? "It's not a lack of willingness or intention. It is cost. These initiatives come with costs."

PEI's Toby Mitchenall caught up with Meister to discuss the proposition in more detail.

Here's an edited transcript:

Q What prompted Partners Group to start thinking about the licence to operate issue? Was there pressure from

any one stakeholder group to improve the way the firm or the industry does business?

Like many firms in our industry, we believe the public perception of private equity is unfortunately not reflective of the reality that we are pretty good corporate citizens on the whole, creating a very real positive impact for the economy and society.

However, we've been insulated from a lot of the bigger, more public discussions in the US, specifically around transactions like Toys 'R' Us and a couple of other high-profile investments, so the conversation around PE's licence to operate has so far not been directed specifically at us by either LPs or the broader community.

Instead, the stakeholder benefits programme is something which developed from internal discussions. We looked at the factors that have contributed to our success to date and tried to identify those that may slow us down in future. Off the back of that, we defined a 'roadmap' for the next phase of our firm's sustainable development, which follows two key themes: "own the business" and "care for people". Both themes apply to our own operations as well as to our investment portfolio.

Q So, if there was no external pressure to be better corporate citizens, why is now the time to focus on this?

With the growth we've seen in private markets, the question nowadays for businesses raising funds or looking for liquidity is, do you want to be in public or private markets? I think there are a lot of good reasons for these businesses to say, "why not stay private?" So, you could also ask: why is the private markets industry only worth $7 trillion or $8 trillion (depending on what you include)? Why shouldn't it be worth $20 trillion?

Except there is one other question, which is what do other stakeholders – and that's first and foremost employees of private markets-owned companies

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– think about it? And in fairness, there haven't been a lot of reports or surveys measuring how good private market firms are as owners, not just on the commercial side of things, but in terms of stakeholder impact. How do employees feel about private equity?

I think there are certain things that are clear. I do believe, for instance, that job growth, which has been questioned by a couple of industry studies, is better in private markets. According to our limited information – our own portfolio, but we also have the secondaries business, so we see other firm's portfolios – on average, private markets are much better at creating jobs than public markets. But are private markets as successful with employees, in terms of giving them development opportunities, a secure future, a work environment with the positive aspects of teamwork and diversity, as public markets are? Some would say that's an esoteric question; we believe it's a fundamental one, because it's probably to some extent the missing piece.

So, what are the KPIs? A very obvious, non-financial KPI will be engagement surveys of employees. How do employees feel one, two, three, four or five years into private markets ownership? I think these are the right KPIs, and we should make them more visible.

Q Are you not just talking about dialling up the 'social' in ESG?

I would argue that most of the ESG projects we do today fall into two categories. There are a large number of more standardised projects that we run systemically across the whole portfolio – related to energy use, health and safety, fraud and cybersecurity, for example. Then, in addition, we usually launch at least one more significant, high-impact ESG project per portfolio company, for example, something around reducing employee turnover, improving the general work environment or enhancing corporate culture. These projects are usually carried out with a very direct discussion of benefits and impact and are often oriented towards creating financial impact.

The discussion we're having today is, shouldn't we really bring this to the next level, like we do in our own organisation, where there is a budget for 'employee care' projects with no expectation of financial gain? At Partners Group, team leaders are also given their own budgets for training and teambuilding.

These things come at a cost and they don't bring a direct, immediate and measurable financial benefit, but I do believe they build a better and, therefore, also more valuable firm. It's a longer term investment – it is essentially bringing ESG up to a new level.

Q So, what happens next?

In addition to the internal discussions, the most important step is to discuss this with our LPs.

One thing that I really have difficulty understanding is that the public discussion [around private equity's licence to operate] is framed as one between politicians or society and GPs. I think that's too simplistic and that the discussion also needs to include LPs, who are the ultimate beneficiaries of private equity's licence to operate.

In our specific situation, in which we are proposing to reinvest a portion of profits into stakeholder impact initiatives before we pay them out to investors, we believe our LPs definitely need to play a role in discussing and shaping our approach. If you read how we are regulated – by the Investment Advisers Act in the US, for instance – we have a fiduciary responsibility which is pretty clear: we have to generate returns and be very thoughtful in how we work with LPs' money.

Q Why would investment in what you call a stakeholder benefits programme require LPs'

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consent? Are you not just building a better, more valuable business, as if you were investing in better cyber-risk management or energy efficiency, for example?

First and foremost, it's a question of fairness and transparency. But I also believe that, philosophically, it's a very different proposition that we are making – essentially, to reinvest money into portfolio companies without an immediate and clear business reason to do so.

I invest in cybersecurity because I want to defend the business: there's a clear business purpose. If you take a step further and invest into things like employee development, an LP could feasibly say, "this won't have an impact during the time of your ownership of the asset".

Today, if you read the typical private equity private placement memorandum, firms will say things like: "We are super-effective not only in growing revenues, but we are also super cost-conscious." That's a typical claim that firms make – and that LPs want to hear. I think that, with the buy-in of LPs, you'd probably need to rephrase it to say: "We try to be very cost-conscious, but we do so in a way that we believe honours our obligation to be a good owner, not only on behalf of our LPs, but also for the broader stakeholder universe, including employees".

We are working with the assumption that some of these stakeholder impact-focused reinvestments will be paid back in the form of higher valuations for better companies – but they might not if there is no value attributed to them by the next buyer. To give a sense of the impact this might have on the outcome for LPs, in the worst case, we are potentially looking at a multiple of say, 2.35x, versus a potential multiple of 2.5x if we hadn't made those reinvestments.

However, if, in five years' time, 80 percent of employees in private equity-owned companies tell us that "with all due respect, it is much better to work for a company in the public markets", then that's going to be a huge issue for the industry. I think it would have significant repercussions, and rightly so. It cannot be that the industry performs better financially against public markets, but worse in terms of the treatment of employees or other stakeholders.

Lastly, I personally find this a very rewarding topic. If we can help lead private markets in a direction that is evidently more sustainable because people will see fewer negative aspects to the industry, then I think that's very positive.

Q So, stepping back, is it fair to say that you believe the thing holding private markets back from becoming a larger part of capital markets is the employees and their view of private equity?

I wouldn't say it's the only thing standing in the way. I would turn the argument around and say: unless there is more evidence available within the wider society that employees feel good about private markets ownership, we will always have challenges. We as an industry need to become more transparent, but as long as the public is unclear about how employees view private markets – or, if they don't view us positively – then any broader discussion around other aspects of the industry will be very difficult.

Q This was an idea conceived in a pre-pandemic world. Are you concerned that it will be deprioritised as companies and investors focus on either survival or opportunistic investments?

Quite the contrary – after seeing current events unfold, our leadership team has an even higher level of conviction for our stakeholder benefits programme, and for our hardship fund initiative in particular.

We are doing what we can at the moment to make funds available for hardship initiatives at our various portfolio companies via a portfolio support fund. We view this contribution as a necessary stop-gap in this moment of crisis. But we remain highly motivated to develop the final format of stakeholder benefits programme over the coming months, which will prepare us to take care of portfolio company employees during any such future events.

Difficult situations arise and compromises and trust are required in the relationship between employer and employee, and between owner and stakeholder. We care deeply for our investors, as well as our stakeholders, and we are committed to aligning ourselves with them both, not just on the upside, but also on the downside. ■