Privcap/ Report

Supporting Portfolio Companies in Times of Disruption

An expert discussion about human capital challenges and other operational opportunities during and after the COVID-19 pandemic.

The Panelists:

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Privcap: On the subject of human capital, Anne, what are you seeing now that so many employees in private equity-owned portfolio companies have entirely rethought what it means to work?

Anne Arlinghaus, KKR Capstone: People saw their work and home start to blur together in a way that they hadn't before we were all working out of our kitchens or bedrooms or spare rooms, before we heard each other's kids and pets in the background. In a way, work has become much more personal than it used to be for a lot of people. We have seen, both in the data and anecdotally across our portfolio, companies trying to adjust to this as everyone starts to think more and more about what they're looking for in their work.

There's a trend that's accelerating with the coronavirus pandemic where people are looking for more meaning, and they're expecting their employers to reflect their values or at least acknowledge them in a way that reflects different ways of working.

Right now, there are two imperatives that we're seeing our companies have to deal with in order to be competitive in the war for talent. One is around figuring out how to make flexible and hybrid work arrangements work in the long run. There was an intense period over the last year where people were forced to do some unnatural things and experiment with different ways of working. We'll continue to see that as people start to return to the office in situations where people have largely been out of the office for the last year.

> "There appears to be a significant uptick in carve-outs, and there's a potential to see more of that."
>
> –William Bundy, AlixPartners

The second imperative that our companies are dealing with is around diversity, equity and inclusion—focusing a lot more effort around ensuring not just a flexible workplace, but an equitable one as well, where people can bring their whole selves to the job.

We've been focused on supporting our companies to tackle both problems, and we have created a bunch of resources that enable companies to work through both angles.

Will Bundy, AlixPartners: We're seeing a lot more willingness to adopt hybrid models. There's always a discussion on the operating model of the company itself and what business they're in, as far as what you can allow in the staffing models. But we are seeing increased inclusion. We've all been in the situation where we had to step off a call in order to go deal with a crisis on the home front. We've started to open the aperture as far as what work really means and what we can allow our talent to do.

How does that manifest itself in how talent is viewed? Talent is starting to see itself as more of a valuable resource. And you're seeing that as far as cost of talent. That's very well televised at this point, where McDonald's is paying signing bonuses. But you're also seeing it in what Anne was talking about as far as talent asking, "What is the company doing for me and how does it tie into my lifestyle?" Versus, I'm a cog in the machine. People are starting to get that sense of, I like to call it, personal entitlement. The last year has allowed them to do that.

Ted Bililies, AlixPartners: Private equity investors and CEOs are really struggling around the issue of how to attract talent and how to retain talent. We're living through a disruption in leadership itself. Setting a vision, implementing a strategy, holding people accountable, paying them well—those are all table stakes. What do effective leaders need to do now? There are four things they need to capture the energy and the commitment of their employees. They need to connect authentically with them. They need to provide real, very clear purpose, mission and values—what they stand for. They need to cascade that mission and those values throughout their executive team. Finally, they need to transform, which means they need to either strengthen or recreate a culture where there's behavioral stability. A renewed culture will be an enabler of strategy.

Leaders are asking, "How do I do that? How do I put people over profits?" (to Anne's point around diversity and inclusion). "What do I stand for? And how do I demonstrate to the five generations of workers in my company that I'm really committed to that?" It's

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not just leadership, it's followership, right? What's important to Millennials isn't necessarily what's important to Gen Z. Millennials have lived through two very, very serious disruptions already. They've lived through the Great Recession a little over 10 years ago. We're living through COVID right now that's done severe damage, in some cases, to their own career development and wealth creation plans. So, the premium is on a new kind of leadership, a new ability for leaders to connect in a very authentic and meaningful way with their people.

Arlinghaus: I agree with Ted's overarching point that, fundamentally, leadership needs to be increasingly authentic. There are a lot of stakeholders involved in a business. At KKR, we have made broad-based employee ownership at our portfolio companies a key part of our approach. It's something that we've done for a long time in many of our industrial companies. We increasingly are rolling this out across our whole portfolio. Structurally, it's a great way for private equity owners to support our leaders at businesses, to make sure that everyone in a company is thinking like an owner and is sharing in the success of the company and the private equity investor.

When you align interests across the whole organization, it changes the conversation. It's no longer about what senior management of the company thinks versus the employees. It's about everyone, together, building a more valuable business. We found that it leads to more employee engagement and fundamentally better businesses. When you empower everyone in a company to think like an owner, the best idea wins, and a lot of ideas get surfaced that potentially otherwise wouldn't.

Bundy: One of the pivotal roles for transformative leaders will be tying in those aligned incentives with the organizational mission, in order to bring the best version of the person to the organization.

Bililies: That's exactly right. People like Mary Barra of GM are saying they want to create an environment where people can bring their whole selves to work. Never before have we seen such a premium on good leadership. We've been in this global leadership stress test from the schoolhouse to the White House. In the war for talent, people can go where they want. It puts a huge premium on good leadership.

Privcap: Did the disruption of the pandemic produce an opportunity for companies to play offense with regard to adding resources and capabilities?

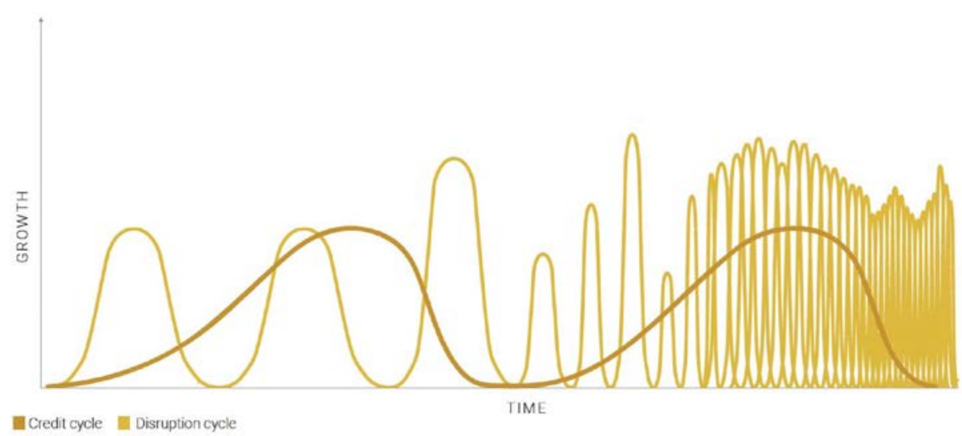
Arlinghaus: Our portfolio was really fortunate to be on the right side of a lot of COVID trends. We made big investments in digital content and essential consumer and retail businesses. Luckily, there were a number of areas where we could really lean into

Privcap: AlixPartners has put together a couple of visuals based on a recent survey the firm did. I'm going to ask Ted Bililies to briefly walk us through why these help set the stage for this topic.

Ted Bililies, AlixPartners: We're kind of blown away by this. Generally the economy has been able to be predicted through economic cycles, particularly through the credit cycle, but we're finding that we're living through a period of so many disruptions, and not just the pandemic. Economic cycles are becoming largely irrelevant in their ability to predict the future. The cycles of disruption are more regular and more profound than any economic cycle. This heralds a sea change in our economy.

ACCELERATING DISRUPTION HAS MADE THE CREDIT CYCLE UNHELPFUL FOR THE PREDICTING THE FUTURE

Traditional Credit Cycle versus disruption cycle



SOURCE: ALIXPARTNERS

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the opportunity presented by the pandemic. We were able to support management teams and get them additional resources and encourage them to lean into the market opportunity.

We did have a few companies that were in heavily impacted sectors, like travel and leisure. Frankly, the crisis was terribly clarifying for those businesses. We were fortunate to work with strong leaders across

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–Anne Arlinghaus, KKR Capstone

our management teams to navigate the issues. These were examples of the benefits of long-term oriented PE ownership. A great example is Apple Leisure Group, a hotel manager and all-inclusive vacation distribution company. Their business essentially came to a total standstill. By the end of March of last year, we were able to respond with really quick actions to stabilize the business. At the same time, we recognized that we were in this for the long run, and we could take the time to assess our strategy. It jettisoned anything that wasn't absolutely critical to the strategy and that focus allowed us to invest, even in a very difficult period, in key priorities for growth.

It's also an example where leadership played an incredible role. Our CEO there, Alejandro Reynal, launched a new five-year strategic plan in the middle of the crisis and allied the whole company around it. He then backed that up with meaningful investments in technology to drive customer experience as well as resiliency and efficiency in the back office. We were able to not waste a good crisis, to really help clarify and focus the business on the growth priorities that are going to matter as it comes out of what was a very difficult year.

That's just one example where the private equity model enabled us to support great leaders in our portfolio companies, and to use the crisis moment to clarify for the organization what really matters and then double down on it.

Bundy: We're seeing upticks in talking about playing offensively coming out of the pandemic, specifically on the deal front. There appears to be a significant uptick in carve-outs, and there's a potential to see more of that. Two major drivers are, one, public corporations jettisoning non-core assets. Two, with the new White House administration, there's the potential for increased scrutiny over proposed mergers. We're seeing some deal flow associated with that.

Another form of playing offense involves taking a look at the profile of the consumer, which has been accelerated by the pandemic. For instance, in the health and beauty space, there's less need for in-person consultation and more use of virtual consultation. When you go down that path, there's obviously cost structure and operating models. There's also a discussion around maximizing the tailwind coming out of the pandemic. Some investors, either one through secondary or PIPE investments, are partnering with the management team or primary PE partners to invest in the growth engines of the firms, to create scale in the organization and to capture as much of that tailwind as possible.

Bililies: Last night, I had dinner with a CEO of a company in the infrastructure space. There's legislation slowly moving through Washington, but something will pass. So, there's all of that opportunity. But the gating issue for this gentleman is, no surprise, finding workers. That seems to be a critical bottleneck in terms of playing offense.

AlixPartners has data gathered in the last couple of months which shows that senior executives and even mid-level executives aren't confident in their people's ability to manage the speed of change and the speed of disruption. They are focused on whether they have the right people in the right roles. Are they hiring resumes or are they hiring mindsets? That's a more subtle but important aspect of that bottleneck around getting the right people in place.

Privcap: Have you seen an increase in human capital due diligence?

Bililies: We have. We actually found that 53 percent of private equity respondents reported an increase in human capital due diligence during this time of disruption. So, it's definitely on the minds of many investors.

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Billilies: The second slide comes out of our latest research. We sampled over 140 private equity investors and portfolio company CEOs, CXOs, on a number of factors related to valuing human capital. We asked a simple question, which is, in this period of disruption, what are the most valuable levers of value creation? What are the biggest priorities of value creation in your portfolio companies? Leadership and human capital came out as number one. Sixty-nine percent of private equity investors and, coincidentally, 69 percent of corporate portfolio executives, both selected leadership and human capital as number one. Second was organizational efficiency. Third, organic growth.

This was our sixth annual survey. Our fifth annual survey found essentially the same thing. So it's very clear that creating value through talent, from a private equity perspective, is coming into its own.

IN PERIODS OF DISRUPTION, WHAT LEVERS DO YOU CONSIDER TO BE TOP PRIORITIES FOR GENERATED VALUE WITHIN THE PORTFOLIO COMPANY?

SOURCE: ALIXPARTNERS

Arlinghaus: We're not only increasing the human capital due diligence, but we're also changing what we look for. Historically, we might have focused on the experience of the management team. We're becoming much more keenly focused on some of the softer skills around leadership and the ability to connect authentically with employees across the organization, and on the ability to be resilient and nimble and able to change.

Privcap: Can you share examples of strong moves made during the pandemic in anticipation of the company coming out stronger and healthier on the other side?

Bundy: The infusion of liquidity into the market has been unprecedented. There was a lot of anticipation of a significant amount of distress deals that just haven't panned out. But in 2020, about 72 percent of the deals were actually add-ons. So, people in core lines of business were actually buying the downturn and tucking in a number of acquisitions, which would then allow them to accelerate out of the pandemic in a much better position. Those that had to retrench are now looking at how to capture that group. So, we're seeing a lot of people investing in the growth engine of the firm, tailoring their order to cash processes, and getting themselves into that operational position where, as the growth returns, they can accelerate into that revenue profile and capture as much of it as possible.

Privcap: Anne, you mentioned a "clarifying" moment for companies that got hit hard during the pandemic. Can you expand on that?

Arlinghaus: What I meant by that was, in a moment where you have literally no revenue or cash coming into a business because of an incredible shock, it forces leaders in the company to think very critically about every expense, about every activity that they're spending time on. In those crisis moments, there's an enormous focus on serving the customer and ensuring that the customer's experience through all of this is as good as it can be.

Our management teams were able to recognize some of those non-core activities that had crept into their time and their team's time. They were spending really valuable resources and quickly recognized that these were not critical to the mission of the business, and they let those go. This very much clarifies priorities around your customer and your people. Our management teams got very, very in the weeds around the experience that customers were having and the experience that their teams were having. That's clarifying because those fundamentally drive the business.

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Privcap: Are management teams putting more focus on ESG considerations coming out of the crisis?

Bililies: That's a really, really important question. Starting with the data from our survey, we asked a couple of questions around ESG and got a lack of response. But we did get 56 percent of PE investors saying that they want to learn more. I'd especially be interested in Anne's perspective on this. What I'm seeing with the investors and CEOs that I'm talking to is that this is very much on their radar screens, but we're still in very early innings in knowing what to do about it and how to integrate it into the whole value-creation discussion.

Arlinghaus: We focus on ensuring that our companies are considering all the stakeholders when they needed to make an unfortunate decision to furlough or lay off any workers. We put a lot of effort behind that, and we also developed a program to provide transitional support services to employees of our portfolio companies who were impacted by COVID-related workforce actions. That will be embedded in our firm going forward, regardless of whether we're in the middle of a pandemic.

> "Never before have we seen such a premium on good leadership."
>
> –Ted Bililies, AlixPartners

KKR has long aspired to leadership in ESG. I don't think anybody across the industry has totally figured out how to balance all the competing interests perfectly. But I would say that we have only seen it become more and more important, both in terms of maintaining our license to operate and our reason for being a compelling business model for companies to partner with. It is also of increasing importance to our LPs.

We've only redoubled our efforts and are investing more in providing resources and structure to ESG issues across our portfolio, including climate change, shareholder and people issues, and our focus on DEI.

Privcap: Have you seen a change in hold times and exit plans as a result of the disruption?

Bililies: Forty percent of investors are extending hold times as a result of COVID, but a very low number of them are saying that they're changing their fundamental investment strategy.

Privcap: Are you sensing optimism from private equity firms about what comes next in a post-COVID world?

Bililies: I'm hearing a lot of optimism for the macroeconomic rebound. The pessimism I'm hearing is around whether they're going to be able to meet their needs for talent. As I mentioned earlier about my dinner meeting last night, there is worry about the ability to source and hire and retain the right talent. It seems to be the key gating issue at this point.

Privcap: Anne, when a CEO comes to KKR Capstone in need of one of the tools in your toolkit, what does that interaction look like?

Arlinghaus: We rely a lot on the power of our portfolio. Because of the scale of our firm and the investments that we have, we actually have great things happening across the portfolio. It almost becomes an opportunity to share best practices. Oftentimes, as human capital leaders in our portfolio reach out, we actually source a lot of the solutions back through the portfolio. We also have a really strong partnership with a number of providers in the human capital space, so we're able to make those introductions and bring trusted partners to bear, depending on the topic.

One of the things that we've been particularly focused on developing over the last several years are resources around diversity and inclusion. Not only on helping companies create DEI programs, but with a lens on what Ted was just talking about: how do we open up new sources of talent that we might not have thought about previously?

Privcap: For private equity operating partners, what have been key skills that were most useful during the pandemic, that could really move the needle for these portfolio companies?

Bundy: It varies. There are different types of models associated with different operating partners. Common amongst all the successful operating partners is really wanting to see the companies they're working with succeed. They put themselves at the disposal of the management team to make sure that management

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team is successful. That is penultimate. That is an attitude discussion.

The operating models of the individual private equity firms are anything from hands-on interim roles all the way through to just advisory roles. Success is going to be dependent on how you fit in to that operating model at a given private equity firm, and the advisors that you typically bring on to help you. The key element that I've always seen with leadership is, know what you're not good at and hire against it as quickly as you can. That way you never have that weakness exposed.

Arlinghaus: The critical success factor is to make your management teams successful. And, if the management team is successful, then you're successful as an operating partner. It's all about going back to aligned incentives and being focused on driving the right outcomes for the business in a supporting role.

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