How can private equity transform into positive equity?

Perspectives on the future of private equity from industry pioneers

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Our research

EY commissioned Roubini ThoughtLab to frame a vision of the future of private equity based on strategic insights from industry founders, leaders and market visionaries. To do this, Roubini ThoughtLab conducted high-level interviews with industry pioneers and top executives, including David Rubenstein of Carlyle, Stephen Schwarzman of Blackstone, David Bonderman of TPG, Charles (Chip) Kaye of Warburg Pincus, Glenn Hutchins of North Island and John Canning of Madison Dearborn, among others.

To get a full perspective, Roubini ThoughtLab also interviewed a pension fund executive, Shane Feeney of the Canadian Pension Plan Investment Board (CPPIB), and academic pundits, such as Professor Josh Lerner of Harvard Business School and noted economist Dr. Nouriel Roubini, founder of Roubini ThoughtLab. Finally, we spoke to EY professionals, including EY Global Chairman and CEO Mark A. Weinberger, US Chairman Stephen Howe and partners Glenn Engler and Bill Stoffel of Ernst & Young, LLP.

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Our perspective

Private equity (PE) has expanded enormously from its 1960s bootstrap beginnings to an industry with more than $4 trillion under management. Over that period, private equity has not only grown, but its toolset has evolved in sophistication. In a 2016 paper in the Harvard Business Review, University of Michigan business professor Dave Ulrich laid out three phases of this evolution, which we have seen unfold with our private equity clients:

1. The buy and sell phase. From 1979 to around 1990, the industry was chiefly geared toward leveraged buyouts centered on financial engineering rather than corporate turnarounds.

2. The buy and hold phase. During the 1990s and early 2000s, PE firms began to look more at improving companies through cost-cutting, strategic mergers and more prudent management.

3. The buy and transform phase. Over the past 5 to 8 years, firms have focused on reinvigorating or even reinventing companies to drive growth, not just cut costs.

The private equity industry has changed more since the financial crisis than in the previous 45 years. Not only have investment strategies shifted, but over that time many PE firms have abandoned their partnership structures to go public. The number of PE players has also multiplied over this period: from some 4,700 in 2008 to more than 7,000 today.

Meanwhile, the industry has seen an enormous influx of money from sovereign wealth funds, family offices and high-net-worth individuals, as investors seek higher returns in a low-interest-rate environment. As long as this performance advantage continues, so will the progress of the PE industry, which could reach $15 trillion in assets under management over the next decade, according to Forbes.

To understand where the PE industry is heading we went right to the source: the business founders and leaders who have shaped the industry and continue to have a major stake in its future. In this paper, we share our research results in four sections: an executive summary, followed by a strategic vision of the future, then a view from the top highlighting the perspectives of private equity leaders and finally what executives should do next to cope with the market disruptions ahead.

In today's world of rapid technological, regulatory and market change, and with a new generation of leaders entering the scene, we expect that the transformation of the PE industry will continue apace.

William Stoffel

EY US Private Equity Leader

Herb Engert

EY Global Private Equity Leader

Executive summary

The industry is at a critical turning point. The new focus on business transformation in PE firms' portfolio companies, combined with technological, market and regulatory shifts, is pushing PE firms to re-examine their strategies, products and processes for doing business in a fast-changing global environment.

As PE founders pass on the reins to the next generation, it is all the more urgent for firms to reassess their forward plans and carve out a sustainable market niche. Tomorrow's PE leaders will require the entrepreneurial and deal-making capabilities of the old guard, tempered with the management and digital skills needed to truly capture the industry's future.

Our research with industry pioneers has confirmed that to succeed in this next business phase, PE leaders will need to come to grips with the following forces that will continue to reshape the industry.

Key challenges to PE future state	Recommendations from industry pioneers
The evolving competitive landscape: Increased competition from overseas PE, sovereign and pension funds, new start-ups and traditional financial institutions	Carve out a sustainable competitive niche by building subsector and geographical knowledge
The value imperative: Greater challenges in finding and building value in underperforming assets, developing unique deal flow and transforming businesses	Invest in innovation, management teams and CEO change management to create value and avoid being disrupted
The next-generation investor: New institutional and retail channels emerge to morph the traditional investor base	Diversify your sources of investment and watch for family offices as a growing force
Technology as a competitive advantage: In an information economy, deep technology knowledge is essential for finding market value, analyzing trends and risks and driving performance	Make digital core to your business. Hire a chief digital officer to focus solely on how digital disruption will affect the firm and portfolio businesses
The globalization backlash: Rise of economic nationalism and populism around the world may shift the dynamic for cross-border investments, data and people	Tailor your approach to the local market. Understand and monitor geopolitical issues that could impact trade and cross-border growth for those investments
The regulatory reset: Likely regulatory easing in the US and fallout on other world markets	Understand and prepare for the regulatory changes that will impact the firm as well as your portfolio companies
Ensuring the legacy: Transfer control to the next-generation talent while preserving the culture and values that made the firm successful	Institutionalize the firm to not identify only with the founders, and create lucrative opportunities for younger partners who are the future lifeblood of the business

Part 1
Vision of the future

The evolving competitive landscape

As the private equity industry has grown, so has competition — for deals, business and capital. The widening field includes a rash of new players in the US and abroad, including investment by sovereign wealth funds and even select pension funds. At the same time, lines are blurring in the global financial ecosystem, pitting increasingly diversified PE firms against traditional asset managers and investment banks.

Competition for deals and capital

In today's low-interest-rate environment, a combination of accommodating credit markets and a growing investor appetite for higher returns has resulted in more capital chasing fewer quality assets, driving up prices for PE firms.

"If you're a public company, you can now only essentially sell yourself through an auction," says John Canning, Chairman of Madison Dearborn Partners. "It makes it very difficult for PE firms to have any kind of edge at all."

The competitors include more than just US and foreign PE funds, which have proliferated dramatically. According to Preqin, there were 6,628 PE firms in 2015, of which 620 were founded that year. Others vying for the same deals include strategic corporate acquirers and traditional PE clients such as sovereign wealth funds.

Adds Canning: "Not only do strategic buyers have war chests, but they have healthy stock prices from the bull market over the last seven years. And on top of that, there are several new entrants into the competitive arena, including large pension funds."

As the number of PE funds multiplies, competition for capital and limited partners is also heating up. According to Preqin figures, a record 1,865 funds are seeking $624 billion in capital in 2017. These include non-US global PE firms, which are expanding in both size and influence.

Meanwhile, some large investors, such as CalPERS, are looking to streamline. The fund is ultimately seeking to trim its manager lineup to just 30 institutions by 2020, down from roughly 100 at present.

According to Melvyn N. Klein, initially a senior officer of Donaldson, Lufkin & Jenrette, Inc., Founder of GKH Partners, LP, and a pioneer in the private equity industry, funds also need to "listen carefully to decision-makers and their strategic advisors about their expectations and requirements for risk and reward." This particularly means getting to know the "gatekeepers," the increasing army of consulting firms that help institutional and large private investors make private equity decisions.

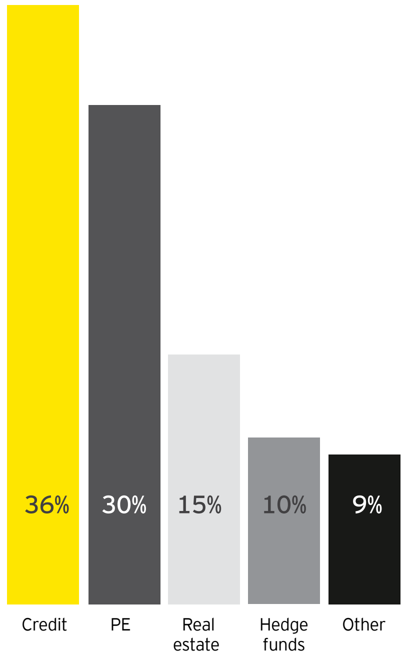
Competition from shifting roles in financial services

Another source of competition derives from the larger hybrid PE firms. These players, such as Kohlberg Kravis Roberts (KKR), Blackstone Group, Apollo Global Management and The Carlyle Group, are continuing to diversify their alternative investment offerings, including private debt and credit funds, real estate funds, hedge funds, venture capital and special situation funds.

Some hybrids compete with investment banks in a few specific areas, while others are morphing into — and competing with — full-service asset managers. Indeed, among the five largest US publicly traded alternative managers, buyout and traditional PE investment is an increasingly smaller percentage of the business, with just 30% of total assets.

"I suspect that the large PE firms will migrate a bit to doing more asset management and more of the asset management firms will migrate to doing more PE. You'll see a blurring of these lines because PE firms can't really grow that much more doing PE or private investments," says Carlyle's David Rubenstein.

David Bonderman, Founding Partner of TPG Capital, highlights two drivers behind the diversification efforts of large PE players. "PE firm clients, particularly pension funds, are looking to have fewer, but more in-depth, relationships," he says. The second driver is that the largest players are now publicly traded. "The public markets like broad-based earnings, as opposed to the lumpy ones the PE business gets," explains Bonderman.



Source: EY 10k research

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The value imperative

To succeed in today's competitive marketplace, private equity managers must excel at finding and building value. This involves investing in a steady flow of underperforming assets and then adding value through business rationalization and transformation.

The current era of auction-driven buyouts often means PE funds overpay for assets as a host of rival bidders bring to bear their huge mountains of "dry powder." Preqin estimates that PE funds held $541 billion in uninvested funds as of April 2017, up 15% from 2015's $473 billion and exceeding the roughly $470 billion on hand in 2006–2007.

This makes unlocking value even more difficult, says Shane Feeney, Global Head of Private Investments, CPPIB. "You have to sweat the asset and work harder to generate decent returns, just because of the multiples that are being paid. It's a tough grind." According to S&P Leveraged Commentary and Data, PE multiples in the last two years have averaged more than 10 times, which is where they were in 2006–2007.

Madison Dearborn's Canning points out that low interest rates do not help. "The low cost of money inures to the benefit of the seller," he says. "While you might be able to keep your equity commitment lower, you're hurting your returns because you're paying a higher price."

> "You don't create value by just buying the S&P on leverage. You actually have to transform the company."
>
> – Stephen Schwarzman, Chairman, CEO and Co-Founder, Blackstone

Excel in deal sourcing

Finding real value requires PE firms to gain a competitive edge in deal flow by developing expertise on industries, technologies and countries, nurturing extensive business relationships, and drawing on top-notch operating resources, talent and shared services.

According to Warburg Pincus's Chip Kaye, creating differentiated deal sourcing is the trick for finding value. "One of the ways to enhance deal sourcing is to have deep sector knowledge and geographic presence. That way, you can both identify the right investment opportunities and speak the same language as the entrepreneurs in those companies," he says.

The search for value is driving many PE funds — particularly those focused on technology — toward growth equity investments in earlier-stage companies, where they bump up against venture capital firms. Most larger firms now have separate growth equity funds, or their terms permit their main buyout funds to invest in growth equity.

Build value through top-line growth

To get the kind of returns they need, PE firms must build value not just through leverage and cost cutting, but by revamping the portfolio company's strategy, processes and business models to drive top-line growth. Says Blackstone's Schwarzman: "You don't create value by just buying the S&P on leverage. You actually have to transform the company."

Glenn Hutchins, Chairman of North Island and Co-Founder of Silver Lake, is a big believer in "activist" investing. "The only way that you're going to be able to outperform is when there is something you can do to make it a better business, and that something is within your control," says Hutchins.

However, the shift toward "buy and transform" requires a strong set of operating resources. To build up these capabilities, PE firms are hiring cadres of operating partners with experience in different industries and countries. They are also bringing in talent specializing in the latest technologies, digital business techniques and analytical tools.

Still other PE firms are taking a different tack. Instead of hiring in operating resources, they are developing networks of consulting executives and former C-level executives who can be parachuted in place to manage newly acquired companies.

Says Kaye, "Once we've invested in something, we've got access to talented people, resources and relationships that can enhance the outcome. Whether that's pulling in a talented entrepreneur, CIO, CFO or capital markets person or managing a complicated regulatory or marketing challenge, we've got the resources that increase the odds of success."

The next-generation investor

Over the past few years, PE firms have expanded their investor base, absorbing an influx of money from new sources. This trend is likely to continue over the next five years as pension fund investors push for lower fees, new institutional channels emerge and high-net-worth investors become richer sources of funding. PE firms are even looking to the potential of tapping retail investors. "In life, you have to have a dream," Schwarzman said recently on an analyst call, "and one of our dreams is to have more retail access to alternative asset products."

Meanwhile, the search for higher returns has led family offices, sovereign wealth funds, endowments, insurance companies and high-net-worth individuals to significantly increase their allocations to private equity. According to an SEI survey of 200 PE firms, 70% of them expect to see an additional investment from family offices over the next few years. For sovereign wealth funds and endowments, this figure was 50%, and for high-net-worth individuals, 58%.

The consumerization trend

With the appetite for alternative investments growing across wealth levels and customer segments, the consumerization of private equity will gain momentum, spurring PE funds to explore the creation of new products and different business models. Although current regulations prevent retail investors from investing in PE directly, there are signs that the rules may ease in the future.

In a recent speech, acting SEC Chairman Michael Piwowar voiced concerns about the "forgotten investor" in the private equity market. "In my view, there is a glaring need to move beyond the artificial distinction between 'accredited' and 'non-accredited' investors," he said. "Prohibiting non-accredited investors from investing in high-risk securities amounts to a blanket prohibition on their earning the very highest expected returns."

In the past, corporate pension plans ensured that most people had investment exposure to private equity, but this is no longer the case. Says Warburg Pincus's Kaye: "The real cost in the US of the move from defined benefit plans to defined contribution plans is that it largely took away access to the entirety of the alternative and illiquid world for retail investors."

PE firms have long looked for ways to tap investment from the $6.8 trillion held by US individual retirement plans like 401(k)s. Says Madison Dearborn's Canning: "The SEC has done a spectacular job of making sure that the man on the street does not get access to good investments. But I do believe the KKRs, Carlyles and Blackstones of the world have created brands that will help them reach the man on the street — the 401(k) money."

Carlyle's Rubenstein expects this to happen in less than five years. "Eventually, everybody will have some kind of PE component in their 401(k) and IRA funds. And whoever figures out the best mousetrap to capture that money will have a big advantage, at least for a period of time," he says.

In fact, over the past few years, Carlyle, Blackstone, Partners Group and KKR have developed 401(k)-friendly products, enabling plan advisors to offer private equity stakes to investors as part of a "target fund." Blackstone, for example, reported on its fourth quarter earnings call that 17% of recent fundraising had been sourced from retail and high-net-worth channels.

The rise of registered investment advisor (RIA) aggregators and new financial technology platforms from firms such as iCapital, Artivest and CAIS will accelerate the democratization of alternative investments.

Craig Huff, Co-CEO of Reservoir Capital, which both invests in private companies and seeds new private equity funds, agrees that aggregation of smaller investors is one way to get around the problem of accreditation, but he is still skeptical. "It is happening to some extent, but so far I haven't seen a way to do it cost effectively," he says. "However, the people investing $25,000 may be so happy to get into private equity that they may be OK paying a couple of extra points in fees."

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Technology as a competitive advantage

"Everybody has to pay attention to the digital revolution," says TPG's Bonderman. "It's like investing in electric cars or anything else. You have to be digitally literate to understand the business." In today's hyperconnected marketplace, where technology is transforming business strategies, processes and models, digital knowledge has become a source of competitive advantage for PE firms.

Digital know-how is necessary for finding and creating value, not only in technology-driven companies but also in more conventional businesses that can drive top-line growth and improve their market positioning through digital transformation. This has become abundantly clear to companies across industries, from retailers competing with Amazon and Alibaba to music companies competing with Apple and Spotify. "We see technology disruption across almost all of our portfolio companies," says CPPIB's Feeney.

Because of the strategic challenges, digital reinvention to avoid a "Kodak moment" is often best done away from the public markets. Along with financial acumen and deal-making skills, understanding digital is now becoming a prerequisite for PE teams who must leverage technology not just to cut costs but also to rethink business models and reposition firms for digital growth.

To get the highest value from digital transformation, forward-looking PE firms are going beyond the "SMAC stack" — social media, mobile, analytics and cloud — and embracing the smarter technologies of the future. These include artificial intelligence, machine learning, robotics, predictive analytics, Internet of Things and blockchain, to name just a few, which PE firms are using to boost the performance of portfolio companies. "We are always thinking how could technology both disrupt and provide tail winds for these businesses. We are trying to be very smart on the use of artificial intelligence and other emerging technologies," adds Feeney.

Filling the digital talent gap

Surprisingly, despite the importance of digital business, most PE firms currently don't have a chief digital officer (CDO) focused on digital disruption and transformation. Filling such a role will be essential for PE firms as they look to reinvent their portfolio companies for the digital age.

Glenn Engler, EY Americas Digital Strategy Leader, argues that the potential impact of digital disruption on portfolio companies runs much deeper than most PE firms realize. Figuring that the biggest digital opportunities and risks concern data, marketing and sales, PE firms tend to delegate responsibility for all things digital to the IT and marketing groups.

However, Engler says, a CDO should also be looking at the impact of digital disruption on the supply chain, customer service, data privacy, contracts and procurement, talent, legal, tax and corporate development. Says Engler: "To truly embrace digital disruption, forward-looking companies need to reframe the question from 'What is our digital strategy?' to 'What is our business strategy in a digital world?'"

Physician, heal thyself

Portfolio companies are not the only arena where a CDO's know-how will come into play — it will be essential for transforming PE firms themselves. PE firms are typically lean, and remain disproportionately focused on deal flow and portfolio companies. But few appreciate that the risk of digital disruption begins with their own firms, particularly in five core areas: technology, talent, legal, tax and regulatory.

Savvy PE organizations will take account of this digital risk, given their critical role as the gateway to their portfolio companies. In PE organizations' external dealings, digital disruption could affect how PE firms engage with investors, analysts and partners when it comes to deal origination, analysis and communication. In internal operations, data usage, privacy risks and next-generation analytics may all be part of the mix.

Having a CDO can help firms drive not only digital strategy for portfolio companies but also help to transform the management company, streamline processes, curtail costs and make the best use of data. This may accelerate the shift toward shared services, outsourcing and offshoring, as PE firms look to develop an informed digital business strategy to thrive in the years ahead.

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— Glenn Engler, EY Americas Digital Strategy Leader

The globalization backlash

Since its early roots in the US, the PE industry has looked across borders for opportunities. "The Pritzker and Rockefeller families have been investing overseas since the 1970s," says Mel Klein, a founder of GKH Partners, LP. "Many of the PE firms have been global for a long time."

Globalization will remain a huge engine of growth for PE firms and their portfolio companies in the years ahead. With the World Bank forecasting that emerging markets will expand at 4.5% per annum over the next three years — more than twice as fast as the 2.1% per annum growth it expects for the US economy — PE firms will have an ongoing incentive to invest internationally, particularly in fast-growth markets like China, Southeast Asia and Africa.

Overseas opportunities abound

Noted economist Dr. Nouriel Roubini, Professor of Economics and International Business at New York University Stern School of Business, believes that PE firms are wise to focus on the global marketplace, not just because of higher growth but also to capitalize on coming disruptions across different sectors and regions. "Wherever there is the need to take over assets, fix them and improve them, there will be an opportunity across countries for PE firms," he says.

Over the next 5 to10 years, Dr. Roubini sees these opportunities arising from the uncertainties surrounding the US economy and regulations under the Trump Administration, the future of the European Union after Brexit and the shift of economic power to emerging markets, particularly China. "These global headwinds will be more complicated than in the recent past," Dr. Roubini says. "To be successful, PE leaders will need to figure out how their business models can leverage this."

In the coming years, PE firms, particularly the larger ones, will expand their global footprint. "The really big groups are all striving to become global asset managers because that allows them to continue to grow and gets them global scale and diversification," says Reservoir Capital's Huff. "That then leads to globally diversified fee streams that trade at better multiples."

Taking advantage of these opportunities will require local knowledge of markets, business mentality and regulations, as well as contacts — none of which are easy to develop. "Human capital skills and specific expertise are important in operating in global markets," says Dr. Roubini.

Chip Kaye of Warburg Pincus agrees that country specialization and presence is a competitive advantage for firms. Industry specialized Warburg Pincus, like many other top firms, has discovered that going global is essential for finding the best values — particularly in today's more competitive and efficient market. "The buyout business in the US has become highly intermediated; investors are offered packaged transactions and standardized capital structures that everybody gets. Where's the differentiation in that?" Kaye asks.

According to Kaye, half the firm's investments are outside the US, and 40% are in Asia, where the firm has had an established presence for more than 20 years. He sees a lot of potential for differentiation in these global transactions. "This is particularly true in a place like China, where the culture gap is enormous. For many Western firms this has been a significant challenge," he says.

Globalization pressures emerging

But the growing wave of economic nationalism and populism around the world could complicate globalization strategies. "The increased nationalism we are seeing around the world is a continued threat to the global economy and its growth potential," says Mark A. Weinberger, Global Chairman and CEO of EY. "Globalization is an opportunity, but it has to be managed with an eye toward inclusive growth. PE needs to be part of solutions that address the downside and tensions globalization brings."

Dr. Roubini agrees, citing recent developments around the world as indicating a populist backlash against globalization, free trade, foreign direct investment and supranational regulation. "While we still don't know the extent of this backlash, it could impede the global expansion strategies of PE firms and their portfolio companies," he says.

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A regulatory reset

For private equity firms, one of the most promising aspects of the Trump Administration is the likelihood of a major regulatory reset from the tight financial controls following the 2008 market meltdown. While it is still not clear which regulatory changes will be made, Blackstone's Schwarzman believes that the entire policy mindset in Washington will shift. "We will see an entirely new regulatory approach that will accelerate the growth of the economy, job creation and all kinds of other things that benefit investors," he says.

> "To some extent, the regulations unintentionally create a barrier to entry that favors the industry's larger players — that's the reason why you don't hear them complain as much. That's costly in that it stifles innovation within the sector itself."
>
> — Charles (Chip) Kaye, Co-CEO, Warburg Pincus

Deregulation ahead

President Trump has already taken actions to revise or eliminate many rules enacted by the Obama Administration in the wake of the financial crisis. These include an executive order to comprehensively review the regulation of the US financial system and the June 2017 implementation of the Department of Labor's fiduciary rule, which demands that all types of investment advisors — including private equity firms — act in the best interests of their clients.

Also under review are SEC rules prohibiting retail investors from investing directly in private equity. SEC Commissioner Piwowar has publicly questioned the wisdom of regulations restricting private equity investment to only "accredited investors" with income of more than $200,000 and a net worth of more than $1 million. As another sign of change, the House recently passed legislation that widened the definition of accredited investors to individuals licensed or registered with the SEC as a broker or investment advisor or whose "demonstrable education or job experience" qualifies as professional knowledge of a subject related to a particular investment. Jay Clayton, a Wall Street lawyer, was confirmed as chairman of the SEC. His background and perspectives on capital formation raise the possibility of regulatory reform.

While much of Trump's agenda involves regulatory easing, populist sentiment for reining in the financial industry is still strong. In fact, it has already influenced the direction of financial services reform measures in Congress as well as Trump's position on several issues. For instance, Treasury Secretary Steven Mnuchin has said he supports aspects of the Volcker Rule, which prohibits investment banks from proprietary trading and private equity investment, and he might even like to see a return to elements of the Glass-Steagall Act, which once prevented commercial banks from engaging in investment banking activities.

The impact of change

Regulatory easing might be most helpful for smaller PE firms. "People like to complain about filling out forms and paperwork, but in the aggregate, it's all reasonably manageable," says Warburg Pincus's Kaye. "To some extent, the regulations unintentionally create a barrier to entry that favors the industry's larger players — that's the reason why you don't hear them complain as much. That's costly in that it stifles innovation within the sector itself."

A US shift in regulatory direction might have knock-on effects for financial regulation around the world if other nations follow the US lead to keep their financial industries competitive. European regulators are not in favor of financial deregulation. Mario Draghi, President of the European Central Bank, told the European Parliament's Committee on Economic and Monetary Affairs in February that a relaxation of regulation is "the last thing we need" and that he found the idea of returning to pre-financial crisis conditions "very worrisome."

If regulations do ease under the Trump Administration, PE firms may need to balance this against investor pressure for greater transparency and prudent internal controls. Some PE firms may pull back from building up their internal systems, processes and reporting frameworks to save cost and time. Others may decide that they still need this data for investors and shareholders. "Investors have certain reasonable expectations for transparency," says North Island's Hutchins. "But it's something that can be handled contractually. Big sovereign wealth funds don't need government regulation to help them figure out how to get the information they need."

As Stephen Howe, Ernst & Young, LLP Americas Managing Partner, says, "Making the US economy more competitive with other nations is a good thing for the US and global trade. It is important to have the right balance of governing risk, allowing companies to prosper and reach their potential."

Ensuring the legacy

Most founders of the major PE firms are near (or past) retirement age, with many in their 70s. They must consider not only how best to pass on the reins to the next generation of leaders but also how to ensure that their organizations have the right talent and culture to meet future challenges.

This could be tricky for some founders who built these organizations as extensions of their personae. "The PE industry is still very personalized, and not very institutionalized. Most of the big businesses are still run by their founders. There will need to be a generational change over time," says TPG's Bonderman.

Developing a successful transition plan

Chip Kaye, based on his experience at Warburg Pincus, one of the first PE firms to make a successful generational transition, sees three dimensions to effective succession planning: "First, operational control; second, money — in the world of finance that is always important. And third, governance, which is the hardest one."

Canning of Madison Dearborn Partners agrees with the need for a well-defined transition plan with strong career path management. "Partnerships are the most fragile organizational structure conceived by man," he says. He argues that partnerships can't be run like a democracy, especially when it comes to allocating carried interest and pay. "There has to be mutual trust and respect with the people running the firm, or everybody will abandon ship," he says.

It's dangerous, for example, to compensate based on deal volume, giving people an incentive to simply get deals done. "If people are going to get paid more for doing more deals, that's a recipe for disaster," Canning argues.

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> — John Canning, Chairman and Co-Founder, Madison Dearborn Partners

Professor Josh Lerner of Harvard says that the industry has "not been serious enough" about managing internal compensation issues. He cites a study his team did of 750 PE firms showing that the split of carried interest among the partners had a strong influence on their stability and ability to survive in the long term.

"We saw that there was an enormous amount of inequality within the groups; typically for larger firms, the founder got at least twice as much carry as the average senior partner," Lerner says. "Groups with more inequality tended to be less stable. Partners with good track records but a lower share of the carry tended, not surprisingly, to be footloose. Losing these senior partners ultimately hindered these groups' ability to raise additional funds relative to their peers."

Cultivating an enduring culture

Another key aspect of the transition for a PE firm is ensuring that its culture persists. "Maintaining your corporate culture is obviously of great importance," says Bonderman of TPG. "We started with three people, and now we have 1,000. You can't exactly have the same culture, but you can try to maintain as much of the entrepreneurial flair as possible."

Making sure the firm has the right talent in the first place is part of the solution. In the past, skills in financial and company analysis, dealmaking and financial engineering might have been enough. But the future will require PE firms to nurture a wider set of capabilities, including knowledge and experience in industrial sectors, digital transformation, smart technologies, risk management and global markets.

They are also ensuring that they hire talent with the right interpersonal skills. Says Kaye: "Investing is a skill set that requires touch and feel and connectivity. We need to have people who know how to invest. And we need a few people who know how to manage people who invest."

Part 2
View from the top

Capturing the opportunities ahead

Stephen Schwarzman

Chairman, CEO and Co-Founder, Blackstone

From his perch atop the private equity industry, Stephen Schwarzman gazes ahead at a vista of opportunity for continued expansion and profitable investment — at least for those with the ability and resources. Blackstone, the world's largest alternative investment firm with some $368 billion in assets, has no shortage of either. Since its founding in 1985, Blackstone has transformed itself from a mergers and acquisitions boutique into a highly institutionalized public company that is always at the industry's leading edge.

Delivering returns

Schwarzman argues that private equity's superior returns should ensure the industry's continued progress. This has increased the appetite for alternative investments across a broader set of investors. "People are having huge difficulty generating acceptable investment returns. As a result, different classes of investors are switching their asset allocation," he says. "That affects wealthy individuals, as well as individual investors who haven't been a large part of the asset class. It also affects institutional investors, who are continuing to increase their allocations. It really is across the board."

Schwarzman sees three reasons for private equity's success: access to superior information, management control and ability to implement plans for improvements to accelerate growth. "If you put leverage on top of that, all logic would suggest that you will outperform an unlevered index where there is no ability to control management or fashion and improve business plans," he says.

However, it's not something that a firm can do by gut instinct alone. "Every time we buy a company or buy a piece of real estate, we always have a plan before we buy it. We are in the transformation business — we don't buy a company to be the S&P on leverage," says Schwarzman. "You have to bring value to a company, and you can't do it by getting eight smart people around a conference table and hoping that it all works out. There has to be a system, a process, with enormous up-front costs to figure things out before you decide you want to own a company."

Part of that is getting the resources in place. "We have a major staff of domain experts at Blackstone, led by Dave Calhoun, who was Vice Chairman of GE," says Schwarzman. "Domain expertise is where we add value to companies just as a matter of course."

Digital transformation is now a vital part of a PE firm's repertoire, says Schwarzman. "Corporate transformation is our basic challenge. Sometimes it's digital transformation. Sometimes it's repositioning the business to attack other markets. Sometimes it's reconfiguring the asset base — and doing it out of the world of quarterly earnings reports," he adds.

Regulatory reset

Schwarzman believes that this task will be easier under President Trump and foresees greater industry growth through a combination of tax cuts and lighter regulation. "There is going to be a major regulatory reset with a Trump Administration, a rollback of rules restricting the extension of credit that have consequently lowered overall growth rates in the country," he contends.

While he believes some of the disclosure rules put into place after the financial crisis "are good and healthy for investors and for the industry," there needs to be a balanced approach to regulation, and there is opportunity for change.

While the resulting changes should be positive for the industry, Schwarzman believes firms will need to steer a careful path through the ongoing upheaval. "Everyone who invests now or owns businesses realizes that their businesses will do either better or worse as a result of these very significant changes," he says.

"You have to be very thoughtful about the type of assets you're buying and when you decide to sell other assets you own," he warns. "While our businesses always do better when economies grow faster, you must make sure you're in the sectors that benefit most. When major changes are afoot, it's not quite business as usual."

Preparing for industry disruption

David Rubenstein
Co-Founder and Co-CEO, The Carlyle Group

In a profession that rewards capitalizing on opportunities as they arise, Carlyle's David Rubenstein has always stood out among private equity's luminaries for his ability to think ahead of the curve. "Almost every industry is disrupted at some point," says Rubenstein. "My peers might not be that worried about this, and I can't say they will necessarily be wrong in the short term. But eventually, people — probably in their 20s or 30s — will come up with a better mousetrap. And when they come up with it, it will probably transform the industry."

An industry in flux

Rubenstein believes that the PE industry has already changed more over the last five to six years than it has since its beginning in the 1970s. Over that time, PE firms have grown into large global organizations welcomed all over the world, according to Rubenstein. He also believes the industry's image has improved. "I won't say that we're seen as agrarian reformers yet, but people no longer think of us as destroyers of Western civilization as we know it," he says.

In the future, he expects a greater convergence between traditional asset managers and private equity firms. "They can grow by doing much more in the traditional asset management area," he says. Rubenstein believes that at the same time, traditional asset management firms will move into the PE space to tap into higher margins.

He also anticipates other major changes. In the years ahead, PE firms will find ways to raise money from non-accredited retail investors, in Rubenstein's opinion. He also expects to see "more clever ways of doing deals, not just the traditional buyout, but many more minority stake deals." The geography of investing will also shift in his view. "There will be a considerable influx of PE money from emerging markets," he says. Rubenstein points out that emerging markets now represent about half of the world's GDP, but only about 17% of PE investment dollars.

Headwinds ahead

As these global shifts play out, Rubenstein believes that US firms will not continue to completely dominate the business. "If you take a look at the 10 largest PE firms, they're essentially all American. We are 5% of the world's population and maybe 18% of the world's GDP but why are we 100% of the world's PE firms? I think at some point, you'll see Chinese firms, maybe European firms, maybe some firms from the Middle East, perhaps helped by government sovereign wealth funds, getting started," he says.

The main challenge Rubenstein sees to the industry in the shorter term is declining returns. "The industry's principle raison d'être is that it offers better rates of return than virtually anything else you can do legally with your money," he says. Rubenstein argues that the industry has averaged between 600 and 800 basis points over public market averages over the last 10 or 20 years, but that it has come down about 25% as money pours in, competition for deals increases and prices rise.

He worries that if the spread over the public markets drops too low, investors will not want to pay the fees and put up with the illiquidity. "It's still attractive enough to get everybody's interest, but at some point, if our returns go down too much, then we'll have a real problem," says Rubenstein.

Those pain points are where Rubenstein sees the potential opening for that industry-disrupting better mousetrap — which he thinks will probably come from a FinTech firm. "If you were to point to an area of financial services ripe for disruption, you could say this one. We are using essentially the same business model that we've used for 40 to 50 years, which is a fee on committed capital and 20% carry," he says. "If you can reduce the fees and reduce the illiquidity in some ways by some kind of private equity proxy or liquid index, that would be the biggest potential threat to the industry."

Back to the future

Charles (Chip) Kaye
Co-CEO, Warburg Pincus

Unlike most of its peers among the top 10 firms, Warburg Pincus has remained true to its pure private equity roots, eschewing the trend toward diversification, or even full-service asset management. And according to Chip Kaye, his firm will stay the course in the years ahead.

While Kaye is a fervent believer in keeping up with the times, he thinks the best way to do that is by focusing on the fundamentals of private equity investing. "There will always be a role for investment in the world that is long-dated and illiquid and designed around an alignment of interests between the investor, the entrepreneur and the entity," he says.

A differentiating edge

For Warburg, one aspect of focusing on the fundamentals means specializing in industries — and countries or regions — to develop the network of contacts and expertise needed for finding value and differentiated deal sourcing. "Starting 25 years ago, the answer for us has been deep domain expertise and geographic presence so that we get closer to the action, better able to calibrate who we want to do business with, and what we want to invest in," says Kaye.

"Someone once said about us that we have a habit of knowing what we want to do before it shows up," he adds. "That's a difference. It doesn't mean everything we do is proprietary, but it is crucial to have some real edge, angle or source of differentiation. If you just wait for sell-side banks to show up with a book for an auction, you're already behind."

Kaye believes that technological expertise can also provide a competitive edge. "Having the ability to understand how technology will change the way consumers behave and businesses function is critical. Our ability to read the trends and stay ahead of them is one area of differentiation for us," he notes.

Another vital ingredient to Warburg's strategy is working collaboratively with portfolio companies to build value. However, Kaye believes in doing this without losing sight of his firm's true role and core competency. It may be trendy for private equity firms to parachute in their own managers, but he believes it's important to avoid going to extremes.

"While we have the management resources when we need them, we don't set ourselves up as a holding company to actually manage and control these businesses," he says. "Our DNA is as an investor." He says the trick will be to build scale without sacrificing agility: "You might get big and bureaucratic and lose your edge. You need to find the balance."

Global approach

That collaborative approach works particularly well when investing overseas. A pioneer in global investing, Warburg Pincus now holds half of its investments outside of the US. About 40% of that is in Asia, with concentrations in China, India and Southeast Asia, all of which are challenging markets for the uninitiated.

"When many Western PE firms went to Asia — and China in particular — their approach was based on their home-market experience: control, leverage and scale. None of those fit there," he says. "It's not at all clear that we should buy control of a company from a first-generation entrepreneur. Leverage is somewhere between unavailable and illegal, and the whole take-private approach doesn't really work yet."

Looking ahead, Kaye sees a fast pace of change — including the rise of sovereign funds, the development of more innovative retirement schemes outside of the US and a growing pool of assets controlled by high-net-worth investors. But Kaye believes his firm will withstand future disruptions by staying true to its core investing principles.

"What we invest in will look completely different, just as what we invest in now looks very different from what we did 25 years ago," he says. "But that core skill set of working with talented entrepreneurs, figuring out how to get in and then get out of a company at the right moments — having made money for our investors — that DNA won't change. And I don't think it's something that can be automated."

Evolution, not revolution

David Bonderman

Chairman and Founding Partner, TPG

When TPG's David Bonderman looks ahead to the future of private equity, he sees continued change — but at an evolutionary, not revolutionary, pace. In the nearly 20 years since its founding, TPG, ranked as the eighth largest private equity firm with about $72 billion under management, has been involved in some of the biggest shifts in the industry. These include an early move toward globalization, a separate operations group, diversification into a variety of alternative assets, and participation in groundbreaking club deals.

TPG has also taken a leading role in the industry's turn toward growth equity, making major investments in some of the most notable digital disrupters of the past decade, including Airbnb, Uber and Spotify. However, Bonderman remains cautious about predicting radical effects on private equity from the wave of digital transformation washing through the global economy.

"Obviously, we live in a world with rapid technological change, and we have to pay attention to that, whether that means running our back office more efficiently or investing in software companies where we like the technology," he says. Bonderman adds: "Do you want to invest in virtual reality or not want to invest in virtual reality? It's no different than do you want to invest in speedy cars or slow cars. It's now a fact of life."

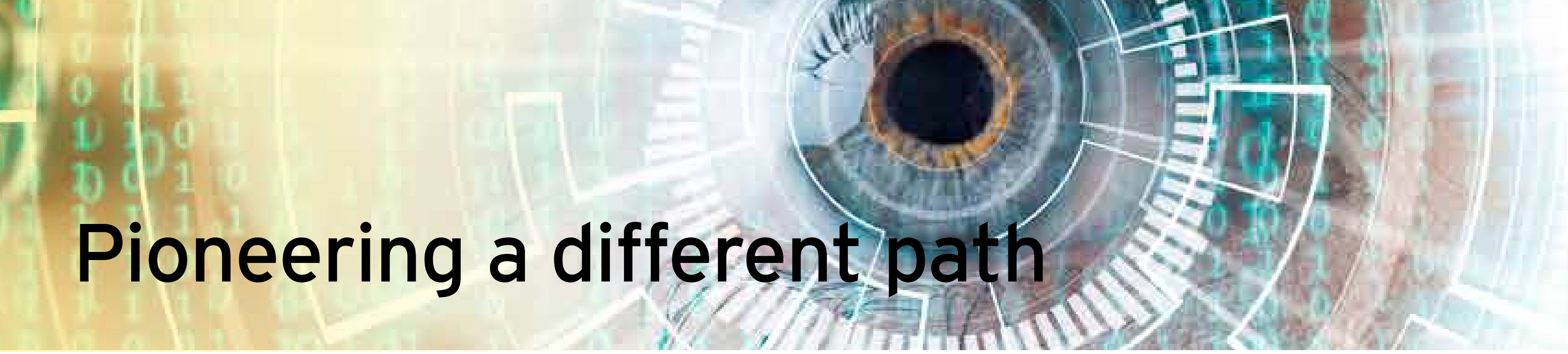
Shifts at the top

Bonderman expects continued diversification in the industry, particularly among the largest firms. He also sees a major shift in the management of the major firms as the founders — many now in their 70s, like himself — begin to retire. "I think it's a challenge for the industry," he says. "The question is, are you able to institutionalize yourself so it's not just Henry Kravis or David Rubenstein or whomever it is? Everybody will have to face up to that, since all the founders are more or less in the same age bracket."

One thing firms should emphasize, Bonderman suggests, is "depersonalizing" the firm to ensure that major investors accept the generational transition — something that is easier if it has gone public. "One thing to focus on is your capital base; the other is who your shareholders are," he says. "Pension funds care a lot about who the CEO is; in the public markets, they don't care at all."

Another important concern should be the corporate culture. "Every firm has a culture — good, bad or indifferent — and you need to pay a lot of attention to it," he says. "Try to maintain as much of the entrepreneurial flair as you can."

Bonderman believes that there will be new areas of diversification for his firm in the future. "But I can't tell you what they are. Not that I'm unwilling to, it's just that I don't know what they will be," he says.



Pioneering a different path

John Canning
Chairman and Co-Founder, Madison Dearborn Partners

When John Canning and his partners spun out of First Chicago Venture Capital to establish Madison Dearborn in 1992, they came at the industry from a different direction than many of their peers. At that time, leveraged buyouts based on financial engineering dominated the industry. But because of their background in venture capital, they devoted a significant portion of their funds to growth equity — taking minority stakes in later-stage companies. Today, Canning says, the firm's $23 billion in funds under management is "evenly balanced" between buyouts and growth equity investments.

Growth equity

As it turns out, Madison Dearborn blazed a trail that others in the industry are now following, particularly in a market that has become more efficient and in which auctions of public companies have become more common. "There is infinite competition," he says. Faced with this growing competition and lower returns in today's low-interest environment, PE firms have increasingly added growth equity to their portfolios.

"PE firms are doing smaller-sized transactions and earlier-stage investment — coming way down in market size and development — when a company really needs money to execute a growth strategy. In our own case, we have currently a $4.5 billion fund with which we haven't done a leveraged buyout in two to three years."

Specializing to succeed

This growth equity strategy fits nicely with another major trend — the one toward industry specialization and acquiring operating expertise in those industries. "All PE firms now pride themselves on trying to actually improve businesses, either through bringing in necessary resources for management that knows what to do, or by bringing in new managers and strategies that make sense," he says.

The best opportunities, however, come from using this specialized knowledge and contacts in a disruptive industry. "The most important thing will be identifying industries undergoing restructuring, industries being influenced by new technologies," he argues. "It will be gigantic for the PE industry — it's been gigantic for our firm."

What's Canning's advice for PE firms right now? He says the best place to look for value is in imperfect markets where information flows and the ability to forecast the future are particularly problematic. "You have to make yourself the smartest person around," he says.

"The most successful firms will be those that have specialized expertise, focusing on industries where they can have an advantage because they're willing to roll up their sleeves and take the risk — and trust that the disruptive industries will continue to come. After all, 10 years ago, no one even knew what an iPhone was," he notes.

Canning also believes that PE firms need to build a strong culture to stay on top. "Managing a PE firm is a very, very challenging socioeconomic experiment. That's where culture is so important. Longevity of your partners is essential," he says.

Activism in a slow-motion shakeout

Glenn Hutchins

Chairman of North Island and Co-Founder of Silver Lake

When Glenn Hutchins worked on his first private equity transaction in 1983 as an associate at Thomas H. Lee Partners, the industry was still in its early "entrepreneurial" phase. "I remember when Kohlberg and Kravis had a $400 million PE fund," he says. "That seemed like all the money in the world. They were so big that none of us could even think about competing with them."

More than 30 years later, the firm that Hutchins co-founded has more than $39 billion in combined assets under management and committed capital, with a team of about 100 professionals. Silver Lake is the 18th largest firm in the PEI rankings, but it punches above its weight in its area of specialty — technology. When Hutchins and his partners founded the firm in 1999, they were pioneers in focusing on buyouts of more mature tech companies rather than early-stage venture investing.

A new phase

Hutchins believes that since its bootstrap beginnings, the PE business has passed through an "institutional" phase, when pension fund money came pouring in, to a "mature" phase, when firms specialized to succeed. "That's when we started Silver Lake to pursue investment success by specialization — and also to occupy a territory that the PE firms had previously eschewed because it was thought to be unaddressable by their kind of capital," Hutchins explains.

In Hutchins' view, the industry is now in a "deconstructive" phase and undergoing what he calls a "slow-motion shakeout." As he explains, PE firms leave the business very slowly because of the long-term capital commitment by investors. "Firms that are unsuccessful in one part of the cycle stay around for a long time and only go away or get downsized to very small levels over an extended time period," he notes. While the allocations to PE continue to increase, explains Hutchins, "The firms that are doing well in this fundraising cycle will be the ones that did well in the last downturn and came out as the winners."

An activist strategy

What should firms be doing? "Right now, I'm a fan of what I call activism," says Hutchins. He says that outperformance will depend on two factors. The first is whether there is something that a firm can improve in a company that's within its control. "The second is when there is some growth tail wind behind you because growth creates a lot of value and covers a lot of errors," he says.

The technology industry offers North Island the opportunity to create value in several ways. One is providing a firm with the capital to invest in new products. "In the technology industry, if that new product works out well, you can see unusually high growth," says Hutchins. Another is acquisitions, which he says works best when "you have a good technology mousetrap inside your business — and you buy firms that are in the same business but are not using the technology as efficiently as you are. This allows you to put their revenue on your 'engine.'"

Nonetheless, finding companies with some combination of a growth prospect and real opportunity for creating value can be challenging. "That's why there are strategies now that are taking activism to an extreme," he says.

He mentions 3G Capital with its "zero-based budgeting" policies that continue to transform the entire operations and cost basis for portfolio companies in traditional industries. Hutchins also cites Vista Equity Partners strategy for taking whole areas of management and operations in its portfolio companies and centralizing them within its own organization.

Looking forward, Hutchins believes that PE companies will need to sharpen their focus on digital transformation to stay successful. "Across all parts of our economy — as well as culture, society and politics — digitization is driving massive amounts of change. If you are not staying abreast in a host of ways, you're falling behind," he cautions.

New directions in pension fund investing

Shane Feeney

Global Head of Private Investments, CPPIB

To reduce fees and boost returns, some large public pension funds are taking a more active role in private equity investing, a trend that will likely accelerate in the years ahead. This can include co-investing with PE funds on deals or directly investing in their own deals.

"Our decision to go direct was partially driven by the desire to try to invest larger equity checks," explains Shane Feeney, Global Head of Private Investments at the Canadian Pension Plan Investment Board (CPPIB). Until then, the fund had been doing more passive co-investments. "Generally, there is a huge amount of demand for that, so even the largest limited partners will get cut back to a small check. We thought that getting involved earlier in deals not only gave us an opportunity to deploy much larger checks," he says, "but we also thought we could make better investment decisions by being involved throughout the life of the deal, and that on a net basis would get better returns."

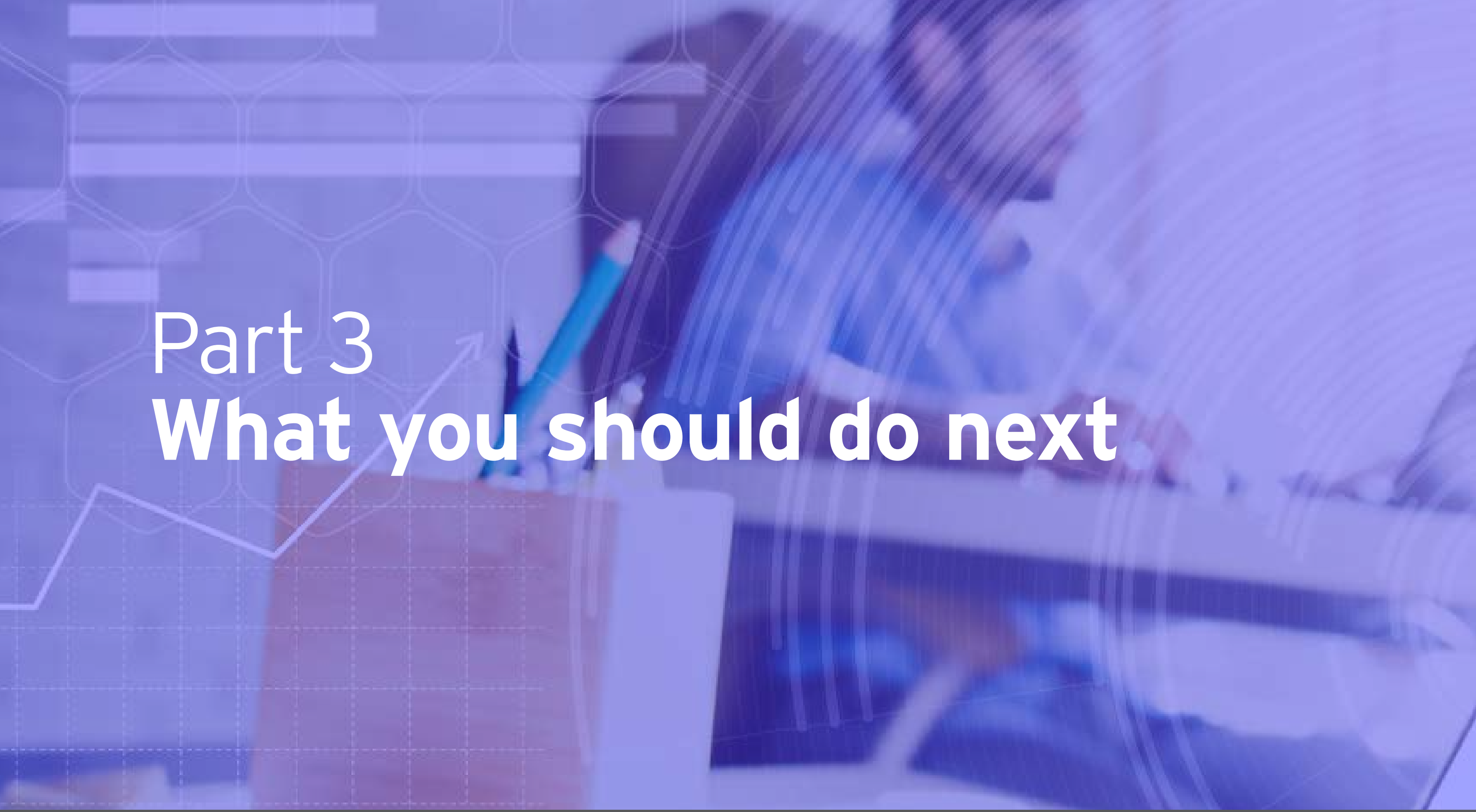
While CPPIB often works on a "partnership" model — independently co-investing with funds on large-cap deals — it sometimes elects to act as its own general partner (GP). "Generally, they've been transactions where we haven't really been competing with our PE funds, because we view these assets as longer-term holds well suited to our comparative advantages of scale and a long time horizon — it's a very small number of strategic transactions for us," says Feeney. He cites CPPIB's June 2015 acquisition of Antares Capital, a leading lender to middle market private equity sponsors, from GE Capital.

CPPIB's approach is more aggressive than that of its US counterpart, the California Public Employees Retirement System (CalPERS), which also does direct investing. CalPERS has done a couple of transactions as its own GP, but for the most part it has concentrated on co-investing in partnership with PE firms.

Feeney says that creating the internal capability to act as a GP on transactions is very challenging for pension funds and sovereign wealth funds. "It is a huge undertaking," he says. "You can't just hit a button and one day decide you want to start going direct. You need the internal investment committee processes and structure that can move in a timely fashion, and even when you're partnering 50/50 with a GP it still requires a direct investing team that's very experienced."

This is more difficult for US state-run pension funds, which are unable to pay people market rates. The Canadian funds and sovereign wealth funds have fewer constraints, Feeney says.

Nonetheless, acting as their own GP may be worthwhile for big institutions, according to Harvard's Lerner, who has studied the performance of their direct investments in venture capital and private equity. "Contrary to our expectations, the solo deals actually did substantially better, and the co-investments underperformed," says Lerner. "Certainly, I think that this suggests a rather sobering view of the strategy that we see so many institutions doing, which is to focus on co-investments."



Part 3
What you should do next

1

Carve out a sustainable competitive niche for the new playing field

Says Madison Dearborn's Canning, "To build a competitive edge, PE firms will increasingly need to specialize by industry. We will need people who understand that industry from an investment standpoint, as well as people for our advisory councils and boards that can bring a management perspective to these companies."

EY's Bill Stoffel agrees: "Funds in the last 5 to 10 years have started to get more sector-specific. They have people that live and breathe in that industry, and partners on staff that were CEOs of businesses in the industry. Building subsector and geographical knowledge will be vital for succeeding in the next PE phase of buy and transform."

2

Develop new skills and innovative approaches to create value

"All the initial tricks of the PE world were recognized by everybody 20 years ago," says Carlyle's Rubenstein. "Everyone has had to find new ways to add value to companies. PE firms will have to continuously reinvent themselves to avoid being disrupted."

North Island's Hutchins believes a shift in skills and strategies will be required: "You need to have some combination of value-added skill set and a range of growth strategies that enable you to outperform your peers." He sees more growth investing in international and technology companies – as opposed to buyouts – in the industry's future.

Rubenstein thinks that PE firms would be wise to keep a close eye on FinTechs, since innovation often occurs from outside a core industry. "FinTechs are the logical ones to watch because they're experimenting," says Rubenstein. "You've got a lot of people looking for new areas."

Create differentiated deal flow and the management team to develop it

3

Says Kaye of Warburg Pincus: "An ability to create a network of relationships where you know whom to trust and whose opinions to value is hugely important; so is knowing that you are on someone's speed dial early in the process, when they are just beginning to think about raising money."

Stoffel adds that the most successful PE firms focus on investing in the best management teams. "They invest in somebody that's really smart and on a day-to-day basis can pivot and move. Being skilled at CEO change management is particularly important," he says.

Prepare for coming investor shifts that could disrupt your firm's access to future funds

4

Says Madison Dearborn's Canning: "Relying on traditional sources of investment is not a healthy way to live, because they change. One of the reasons public pension funds have been such prominent players in PE is their need to get above-market returns because they are underfunded, which sooner or later is going to catch up with them. Public pension funds eventually will not be meaningful players."

Instead, Canning believes that PE firms should focus more on family offices, which he sees offering huge potential for funding. "Today's family offices — and remember there's so much wealth being created now even at families that don't have family offices yet — are rapidly increasing their involvement in funding PE. They're going to be a real force."

To gain an edge in fundraising, PE firms need a compelling value proposition. Kaye explains: "There may be a lot of capital in the world, but you still need to tell a core story that appeals to investors about why they should invest with you. You must invest in long-term relationships with them — the funds are not going to just show up."

Make digital core to your business

5

Blackstone's Schwarzman sees technology as a major game changer for the PE industry: "Disruptive technologies create advantages when you're on the right side of them, and they can really hurt you if you're on the wrong side of them. You always need to look at every investment you make in terms of what the balance is, between hurting you and helping you."

North Island's Hutchins echoes the sentiment: "Across our economy and culture, our society and our politics, digitization is driving massive change, as part of the transition from the industrial to the information economy. If you're not seeing the full breadth of that, you're falling behind."

Despite the essential role of digital technology in strategic transformation, many PE companies still have not made enough progress. Says Stoffel: "Five years ago, people were talking about digital transformation as their value-creation angle; and now they are still saying that digital is going to change the world. But the reality is when you pull back the covers, they aren't there yet. One priority for PE firms should be to hire chief digital officers that are solely focused on how digital disruption will impact their organization and portfolio businesses."

What you should do next

6

Stay focused on economic, business and policy shifts in the next era of globalization

Blackstone's Schwarzman believes paying close attention to macro trends is essential: "Everyone who invests now, or owns businesses, realizes that there is a possibility that things they own will do either better or worse, as a result of very significant market changes. There will always be bigger winners, just because of sector rotation that's more in favor. There may even be some losers."

Regardless of the economic changes ahead, Carlyle's Rubenstein believes that firms need to tailor their approaches to the local market. "As firms become more global, they need to adapt to local customs and have to recognize that in many of these countries, minority stake transactions are much more prevalent and effective than majority stake transactions," says Rubenstein. "They have to recognize that government might be less willing to tolerate some practices, like firing people, that are tolerated in the US."

Watch out for the nascent nationalist moves against globalization, which may shift prospects for global trade, cross-border resource flows and economic growth for PE firms, according to Dr. Roubini. He believes that PE executives need "to stay acutely aware of constraints in a world where labor is at risk and people worry about their livelihood."

7

Build a path for the next generation of leaders and business talent

According Bonderman of TPG, PE firms need to institutionalize themselves to ensure that they are identified with not just the founders. "It means having the business be depersonalized as opposed to thinking of Carlyle as David Rubenstein – you think of Carlyle as a conglomerate," he says. Going public is one way to do that. But in doing so, firms need to maintain their corporate culture, Bonderman says.

Making sure there is fair compensation and recognition for the contribution of the next generation is crucial for retaining younger partners, the future lifeblood of your business. Says Harvard's Lerner: "Our research did suggest that there were some very big challenges for firms in how they deal with splits of carried interest – questions about stability that give real pause for thought."

And always hire the best people, says Madison Dearborn's Canning. "All of us have hired people smarter than we are. PE has this allure so that we are able to continue to upgrade the caliber of people. Our founder's joke: we couldn't get a job here now. The truth is, we couldn't," he says.

How we can help

EY can help you make better-informed investment decisions, improve portfolio company performance and increase realized value. For the last 20 years, we have helped funds decide the strategic direction for the business, improve operations, originate deals, conduct diligence on potential investments, contribute to value in portfolio companies and decide on the right exit strategy. We also work directly with portfolio companies. We have helped dynamic and ambitious companies grow into market leaders. And we have strong C-suite relationships across sectors that help promote deal flow for all parties.

PE priority	We can help clients:
Your investments	
Deal insights	Consider attractive sectors and themes and provide perspectives on deal opportunities ▸ Sectors — understand niche and hard-to-define businesses and hidden opportunities in out-of-favor sectors, as well as traditional business models ▸ Emerging markets — understand trends, challenges and opportunities across Africa, China, India and Latin America
Diligence	Conduct commercial, operational, IT, human capital and cyber diligence, as well as environmental, social and governance (ESG) diligence, in addition to the traditional financial, operational and tax diligence
Value creation	Investment inception — develop Day 1 readiness, 100-day and working capital plans in addition to assisting with other operational and organizational needs Value-creation advisory — growth strategy includes customer segmentation, geographic expansion, and product line and M&A strategy. We also help with marketing and sales force effectiveness, pricing optimization and post-merger integration, as well as initiatives to improve margin and capital efficiency
Exit strategy	Decide among exit alternatives, assess exit and IPO readiness and create a value story for targeted buyer
Fund level	
Fund operations	Improve firm and fund performance and efficiencies, including assessing competitive positioning, governance structure, operations functions and costs, compliance, cybersecurity and enterprise risk management
Finance and reporting	Navigate a drastically changing financial and reporting environment with broadening regulatory requirements and stakeholder demands
Tax	Understand changes in the global tax landscape, seizing opportunity in global compliance and reporting and building tax-effective supply chains

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