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Getting a Seat at the Table: Exploring Diversity in Private Equity

Disruptive Forces in Investing

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Gabe Feghali: Over the past two decades, private equity has had a large and meaningful impact on today's economy. The number of companies owned by private equity firms from 2000 to 2018 has increased over five times, from around 1,800 to over 9,000 companies. PE firms employ around nine million Americans, and the companies they own make up a material portion of our economy. In times like these, when we're striving for social justice and equality around the world, we wanted to focus today's conversation on diversity in private equity. If you look at the numbers, only around five percent of PE firms are women-owned, and less than four percent of PE firms are minority-owned. With such a fast-growing asset class, why aren't diversity numbers growing commensurately? I'm your guest host, Gabe Feghali; and I'm joined here today by Patricia Miller Zollar, head of NorthBound Equity Partners and managing director here at Neuberger Berman. Pat's going to help us dive into the topic of diversity in private equity. Pat, thanks for joining us today.

Patricia Miller Zollar: Gabe, thank you. It is a pleasure to be here.

Gabe: Just to give our listeners a bit of background on your role, would you mind telling us a bit about NorthBound Equity Partners? And maybe more broadly, you can touch upon the challenges that emerging and diverse managers face in the PE space?

Pat: Sure. Sure, Gabe. Thank you. So we started NorthBound in 2007; and we started it, first off, because we believed – and clients were asking us – to look at this area of the early, younger managers; emerging managers, if you will. At that time, and even now, many of our clients felt like their portfolios mostly consisted of the most seasoned private-equity firms; and if they didn't start investing in these newer, younger managers, they would have no managers for the future. You know, they wanted a farm team, if you will. They were especially interested in diversity; and again, NorthBound defines emerging managers as managers that are smaller, kind of funds that are under $750 or $1 billion; funds that are newer, on their first or second institutional fund; and then funds that are diverse, funds that, you know, have significant representation of women and minorities in their ownership. And so, the idea for NorthBound was to build portfolios that consisted of these smaller, newer, younger, more diverse private-equity sponsors, with the idea there that there would be a greater alignment of interest because these managers are putting a big part of their own personal net-worths in their firms. When we look at our diverse managers that we've been invested in here, you know, over, you know, over the last 14 years, and compare it to our platform, the managers, the more seasoned ones across our platform, we see that these diverse managers have performed attractively. You ask about NorthBound. I know that this is actually a segment around disruption. And we see that these emerging and diverse managers are doing just that. They are disruptors because, by definition, they have to be. They can't do the same things that everybody else is doing and expect to get a seat at the table.

And it actually reminds me a little bit around the reason we call it NorthBound. We call it NorthBound for three reasons. The first is NB, connected to Neuberger Berman. We think that a platform like Neuberger Berman, having more than $350 billion of assets under management and $90 billion in our private-assets markets group, really is a really powerful set of resources and a powerful platform that we can bring to any newer manager. The second part of the name is that that's where – northbound, and that's what we want the performance to do. We want it to go up. We're all fiduciaries when we're investing this capital. We want to make sure that we're investing because we think that the returns will be attractive. And the third reason for the name NorthBound harkens back to the Underground Railroad. If you're a student of it, as I am, you'll remember that Harriet Tubman's Railroad was northbound, and the idea was that these people that had been oppressed, the people that had been mistreated, the people that were not allowed to bring their full selves to their, to their lives and their society, they got an opportunity by getting on this railroad. And we believe that, when we think about the Neuberger Berman platform, investing in funds, co-investments, doing investing in the debt and their portfolio companies, the ability to buy stakes in management companies; we believe that that is a very powerful partnership that can actually allow these emerging, diverse managers to come into their own.

Gabe: I think that's amazing; and, both the work that you do and the name fits great. And related to that, I've actually been getting a lot of questions on the allocator side related to diversity. And this comes from all sorts of allocators; endowments, pension plans, family offices. Those questions have obviously escalated in light of recent events. And so my next question is, you know, why is diversity so important when it comes to private equity? Is it just some ethical obligation that we have as humans to promote it; or is there an economic benefit to it as well?

Pat: Absolutely, Gabe, and we are getting a lot of those questions, especially in this moment. So, it is an ethical question; but it goes beyond that, because all of us, uh, that sit in the fortunate seats of investing capital on behalf of clients or beneficiaries know that, at our heart, we're fiduciaries. And so, in the absence of any other guidelines, we have to go and invest in those markets, in those funds, in those different investment classes, that we believe will create the highest returns for a given set of risk parameters within a portfolio. So, you know, the great thing is that you don't have to choose. When it comes to emerging and diverse managers, you don't have to choose between doing what's ethically right and wanting to have great returns. And in fact, that was really a lot of what was driving the portfolios that we started building back in 2007. And in fact, as an aside, we look at our performance over the last decade of investing in diverse managers versus just our overall platform; and our overall platform is always expected to outperform a given benchmark. So the question, Gabe, is: Why is that? What is it that emerging and diverse managers are doing that maybe the broad cross section of managers are not doing? Well, simply: Diverse managers are going where others are not. They're getting their first – they're going in places where they believe they have a distinct advantage. And let me give you some examples around this.

So for instance, there's one firm that we invested in that is very well known now. But when we met them back in 2006, and we were looking to build portfolios, they were talking about investing in an industry and in a sector that no one was doing in a methodical way. It was enterprise software. And we thought, enterprise software; why would anyone build a whole, a whole portfolio, a whole investment fund, around enterprise software? Well, um, you know, it's a long story short now. That firm is Vista Equity, and the success they've had not only in this particular sector but, obviously, the success of the founder in all of his philanthropy is unparalleled. But, but Robert Smith, when he showed up to talk to us, knew that enterprise software was an area where very few private equity firms were investing in a methodical way. He saw the recurring revenues. He saw the amount of white space. He saw the number of undermanaged businesses, and he had that background. So going places where no one else is going.

Another example is Stefan Kaluzny at Sycamore. Stefan invest in the consumer space, in the consumer segment. Everybody knows that the consumer segment is one that has been turned on its head. Everyone knows that a consumer segment is a space where certainly – and he's invested in bricks and mortar; and again, the bricks and mortar piece of the business has actually been really challenged. But the way he comes in and evaluates these companies, we don't know anyone else who can do this in the way he does it. So I say that to say that, by their – just by definition, uh, these diverse managers know they cannot achieve outsize value and great returns if they go the same place where everyone else is. So they're looking to go those places where very few are.

Gabe: Right. And Pat, maybe I'll ask you to clarify this. You talk about emerging and diverse managers, somewhat together and I guess when I think of emerging managers, I think of, you know, smaller managers that are hungry. Specifically on diverse managers, you know, is there a benefit to a manager being diverse? Maybe they have a different perspective? Does that come into play?

Pat: I think it all does. I mean, I think – you know, so one of the, um, one of our overarching tenets around investing in emerging managers is that we love investing in first-time funds. We love doing it because you – there's a lot of hunger. There's a lot of alignment of interest, and a lot of it comes from the fact that, if you're a first-time fund, you know, if you're not successful, there will be no second-time fund. We love that alignment of interest. So they are, they are out there, and they're doing it for all they're worth to make sure that this, this firm and this fund is successful. So, absolutely. So you have a hunger. You have an alignment of interest. The percentage of their net worth that is generally in their fund is a really large, large percentage. They know that, if the fund is not successful, they will not be successful, because they're getting paid through carry, not through management fees. We love all of that alignment of interest. And then, so you've got the young and the hungry; and then you add the diversity piece of it. And then what you're doing is, you're adding a whole other set of relationships that probably have not been fully penetrated in by the larger firms or by the non-diverse firms. Everyone comes to investing based on their own unique relationship, their own unique skills. And we think it's important: As you look, certainly at this country; and you look at where the opportunities are. You shouldn't just be talking to one segment of a community in order to find companies in which you can add value. Being able to offer and talk to all of the segments of the population, I think, really positions you for the best performance.

Gabe: Pat, that is really helpful. And related to that, based on current events, the question on a lot of investors' mind is, what are we going to do about racial inequality from an investment standpoint? And you addressed a lot of this, but maybe we hone in on it a little bit. What aspects do you look at when you speak to GPs in regards to diversity? And, and what can they do to improve from where they're at today?

Pat: You know, Gabe, that's a great question. So every single firm we invest in, whether they're diverse or, especially, if they're not diverse; one of the things we do is, we have a set of questions that we ask managers around diversity. It's all part of the ESG analysis that we do for our primary investments as well as our co-investments. Oftentimes, you can look at their management company, and you can see what their diversity is. But it goes beyond just looking to see what the faces look like. It really goes to the point around, what is their, what is their philosophy around diversity? How do they view it? I mean, everyone believes in diversity of thought, but does it go beyond that? Do you think diversity of thought also goes beyond, having women, having underrepresented minorities, kind of as part of your investment team? How are you going to be diversifying your boards? So, private equity – you mentioned the nine million employees. So private equity firms own lots and lots of companies. And so, oftentimes in these companies, I mean most time, many times, people have just thought about, who are you selling to? So again, everybody knows the broad population is diverse. But in addition to that, what other things can you do in the C-Suites of your company? What kinds of things can you do on your boards? And so, I've been excited to hear this, that two of the firms that we invested in and started our relationship at Neuberger, through NorthBound, both Vista and Clearlake, have announced this really exciting initiative wherein they are committing to make sure a third – and sometimes even a half – of the boards of all of their portfolio companies are diverse. And so, when it comes to diversity, so not only are we asking majority companies what are they doing and what their philosophy is; but across the board, you see private equity firms really making sure that the whole private-equity ecosystem, all of the things that it does – and again, to your earlier points, private equity is doing more and more and able to impact the country more and more. How are you using that position in order to extend the goals of diversity and equity in our society?

Gabe: That's amazing. Yeah, thank you, Pat. And thank you so much for your perspective on, on this extremely important topic; and, most importantly, thank you for the fantastic work that you do.

Pat: Thank you. It's been exciting talking to you, Gabe. Thank you very much for this opportunity.

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