

Exchanges at Goldman Sachs
How Employee Ownership Models Can
Boost Returns: KKR's Pete Stavros
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Alison Mass: Welcome back to another special edition of Exchanges at Goldman Sachs Great Investors. I'm Alison Mass, chairman of the investment banking division at Goldman Sachs, and your host for today's episode.

Today, I'm really thrilled to be joined by Pete Stavros, who's a partner and co-head of America's private equity at KKR. Pete joined KKR in 2005 and covers investment strategies across traditional large and mid-cap private equity, core private equity, and growth equity. Pete also launched Ownership Works, a nonprofit that's focused on broadening corporate ownership to help working families build wealth. We'll be discussing Pete's career in private equity, his views on the economy and investment landscape, and his efforts

to enhance the financial resilience of the workforce. So Pete, welcome to the program.

Pete Stavros: Thank you for having me. I'm honored to be here.

Alison Mass: So I want to start with your background. You grew up in Chicago as the son of a road grader and was the first in your family to go to college. So how did your early experiences shape your work ethic and, more broadly, your approach to investing?

Pete Stavros: Well, on the work ethic side, I think it was just observing my parents working incredibly hard to pull themselves up by their bootstraps. So my folks didn't go to college. My mom was a secretary. My dad, as you noted, worked for a construction company, and they worked all the time. My dad really worked a second job rehabbing old apartments. So he would leave at 4:30 in the morning, drive to the job site, work all day, come home, get a bite to eat, and then he was working at night. So it's hard to have that as your childhood and not have it rub off on you, for sure. So that's where my work ethic comes

from.

In terms of my approach to investing, I think observing my dad in particular feel not respected, not listened to, not having a voice, I think that did lead me to have a more human capital oriented approach to investing. My dad being in a union and us living through a lot of worker strife and strikes certainly led to a real appreciation of the importance of labor relations. And my dad also spent a lot of time trying to explain to my sister and I around the dinner table how important the most junior colleagues are at any organization, and they can make or break you. If your construction workers don't care about the quality of the work they're doing, you're going to suffer as the company.

Alison Mass: So tell us about some of those specific stories your father shared with you around that table, about his work in construction and how it sparked your lifelong interest in the power of employee ownership.

Pete Stavros: Let's see, one would be if you're an hourly worker, a blue-collar worker, the fight is over hours.

You want more hours because you get paid for every hour you work, and your employer wants to control labor costs so they want fewer hours. So that lack of alignment is what drove my dad crazy. He used to talk about the need to work steady. You know, if you worked too hard as an hourly employee, your paycheck goes down if you're too productive, which is crazy the way that --

Alison Mass: Crazy.

Pete Stavros: -- that half of Americans earn an hourly wage. It's a crazy way to compensate people. So my dad always dreamt of alignment. Profit sharing. It didn't have to be ownership but some reason to benefit from being more productive.

Alison Mass: And aligning incentives.

Pete Stavros: Aligning incentives, yeah. So that fight over hours, here's one specific story. They took away my dad's drive time to the job site. Then they took away the drive time home. And then they took away the paid lunch hour. And if you make \$15 an hour, like, that's a problem.

So my dad, who was a bit of the leader of his gang at work, said you know what we'll do to get people's attention is we will have all the road aggregate delivered intentionally at the lunch hour. And then we can refuse delivery because we're not getting paid, we're not on the job, and then we'll run the job out of material, we'll shut the whole job down, and then the ownership will come and say, "What the heck is going on?" So that was what they did. It was effective, but my dad would come home and say, "Can you believe this is what we're doing?" As opposed to, if I'm productive, I'm doing a great job, I should make more money. It's, like, the opposite. And all we do is fight over hours.

So anyway, there were a lot of stories like that where my dad would say what if we had alignment? What if we could all benefit from doing the job the right way, on time, on budget, wouldn't that be great?

Alison Mass: So in the same way that your father shared his experiences with you, what are some of the stories you're sharing with your children today that you hope will inspire and shape their work ethic and values in the future?

Pete Stavros: Some of the stories just around the economy and the inequities that exist we try to actively talk about. And some of it's just bringing work home where, hey, we paid a dividend on the stock at Company XYZ and it was \$2,000 and people were moved to tears. That's the financial situation that they're in. Thinking about their character, determination, and resilience is obviously a big thing in raising kids. So trying to make sure they know how many times I've failed and gotten myself back up. I applied to KKR three times, three different points in my career before I got a job. So.

Alison Mass: Wow. By the way, I never knew that.

Pete Stavros: That's true. Yeah.

Alison Mass: Okay. Stavros history.

Pete Stavros: And some of it they have to just see it in action. Actually, a company that you all helped us with called Capital Safety, I have always been passionate about safety, partly because of my dad and the importance of

workers on a construction site being safe. But it's also, generally speaking, those are good businesses.

So there was a company called Capital Safety. This was probably almost 15 years ago. And it was for sale with another bank, and it had a UK headquarters but it was a US business. And so they inadvertently called my European colleague who is no longer at the firm. And he said, "Eh, I don't like it. Safety. Equipment. Doesn't sound exciting. Pass." And then I found out about it, like, a month later and it was almost over. There were three finalists.

So I called the bank -- I think it was UBS -- and begged them to let me into the process. They said, "It's not up to us. The client said no." So then I got the CEO's cell phone number and I got in touch with him. It was Pat Velasco. And I said, "Pat, I know you don't know me. I'm telling you, we need to own this company. We are the right owner." And I gave this whole spiel. And he said, "But you guys passed on it." And I explained the disconnect with Europe and US. And he said, "Well, you're really passionate about safety. Is that right?" And I said,

“Hugely passionate about safety.” “And safety equipment in particular?” I said, “Absolutely.” He said, “It's really interesting because I'm in Düsseldorf, Germany. There's a trade show for safety equipment companies. It's only once every four years. This is, like, the trade show. Your competitors, the finalists, they're all here.”

Alison Mass: Ooh.

Pete Stavros: “And you're not here.”

Alison Mass: Ooh.

Pete Stavros: So this was 4:00.

Alison Mass: So you got on a plane and flew over?

Pete Stavros: Run home. Pack a bag.

Alison Mass: Love that.

Pete Stavros: Call my assistant on the way, like, “You got to get me to Düsseldorf, Germany.” So I show up at his

booth in the morning.

Alison Mass: Love that.

Pete Stavros: And he's, "You're the guy I was just talking to yesterday?" And so they let us in, and then we just went a million miles an hour and bought the business. And obviously I bring that back to the dinner table and try and explain to the kids of, like, "You just can't take no for an answer."

Alison Mass: Love that story. By the way, that's another story I didn't know about Cap Safety. I knew the end story but I didn't know the beginning.

Pete Stavros: And then you guys sold it for us.

Alison Mass: So you also went on to study employee-owned stock plans, or ESOPs, at Harvard. What did you take away from that?

Pete Stavros: So ESOPs, just as two seconds of background, are these very technical tax structures. They

were started in 1974 as a part of the ERISA Act, and it was an incentive Congress put in place to share ownership with workers. And I was totally fascinated with that idea. I worked with Professor Josh Lerner [sp?] at HBS. We published a paper on this. And basically what we did was we traced the steps of why did Congress pass the law, how did it work, why did it not achieve its potential?

There was a boom in ESOP activity in the '70s and '80s, and then it really has stalled. And so we basically just documented -- it's still online if any of your listeners are having trouble falling asleep one night. It's very boring. But it traces all the steps of what went wrong.

And so the takeaway was the idea behind all of this is not complicated, sharing ownership. The execution of it is complicated. And the execution of that law was not optimal.

Alison Mass: So you talk about the execution. What do you think has been key to the execution of all of these plans that you've driven into the employees of the companies that KKR has owned?

Pete Stavros: Leadership. Everything in life starts and stops with leadership, and if you have the right leadership at these companies and they care, like, at a deep level -- because this is a ton of work to do well -- they feel it's their responsibility. There's a lot of good people who are just like, "I hate the way the world's rigged, but it's not really my problem. I didn't create it. It's just the way things are." The best leaders and the best CEOs at this don't feel that way. They feel like, "Okay, I can't change the world. I can change the world for my employees," and they're willing to make it a huge priority.

Alison Mass: So at KKR, you're helping to implement this broader employee ownership model across a growing number of portfolio companies, not just the ones that you are on the board of. Talk about the ownership structure and how it can align incentives and change the culture and performance of the companies you invest in.

Pete Stavros: And maybe I'll just give an example. So Ingersoll Rand, another company you all have been closely involved with us for ten years, when we bought that

company, there were 86 people out of thousands who had stock ownership. They had never measured employee engagement. Worker safety was not great. It had all the indications that the culture was off track.

We brought in an amazing leader named Vicente Reynal, who I think part of it was personally he grew up poor in Puerto Rico, really felt this was a mission of his to change the culture and to help all of his employees build wealth. And it took us ten years. That's one of the things I always emphasize is none of this happens overnight. But the percentage of workers quitting every year went down 90%. The engagement scores went from the 19th percentile as measured by Gallup to the 90th.

Alison Mass: Engagement scores meaning what?

Pete Stavros: There's a Gallup survey called the Gallup 2-12, which is basically 12 questions that you ask your employees to answer that then you can benchmark and measure how much are they bringing their full selves to work, how engaged are they on the job. And that is directly correlated, as you can imagine, with customer

service, productivity, on-time delivery, cost efficiency.

And so at Ingersoll Rand, we went from 86 people having stock to 16,000 in 80 countries.

Alison Mass: Wow.

Pete Stavros: Hourly workers generated 600 million of wealth for themselves. We think it's the biggest such example of worker value creation ever.

Alison Mass: That's extraordinary.

Pete Stavros: And we made a \$4 billion gain, and it worked out for our investors and for workers and for the company and the communities that the company operates in.

Alison Mass: So Pete, you were involved in closing the sale of CHI Overhead Doors to NewCorp for \$3 billion in 2022, a deal that was notable in a number of ways. And it was a significant one for KKR, generating the highest return of a KKR deal in I think 30 years. But it was also a huge

payday for the CHI workers. So tell us about the operational improvements KKR made along with the management team and perhaps, more importantly, how the employee ownership model was implemented.

Pete Stavros: So similar to Ingersoll Rand, we bought a company where a small sliver had ownership, so 18 executives. And then over seven and a half years, created this ownership culture where all 1,000 or so employees had ownership. We started measuring employee engagement, acting on the feedback that we got, delegating decision-making rights to workers. So for example, here's a million dollars a year of CapEx that you can direct that will make the facility a better place to come to work every day.

So we built a health clinic. We built an on-site cafeteria. We built new break rooms. All of these manifestations of worker voiced in the facility had a big impact. We were able to reduce scrap. We were able to drive inventory down, drive labor productivity in the plant, increase the efficiency of the routes our truck drivers drove. It was a million things that took the EBITDA margins from 20 to 35. And we were the fourth PE firm to own it, and people would

have said, “Not possible.”

Alison Mass: Wow, wow.

Pete Stavros: “How could you possibly take the margins up that high?” There's probably 0.1% of industrial companies in the world have 35% EBITDA margins. And this is a garage door company. Doesn't have a software business hidden it. This is making garage doors.

So when we sold the business, we made 10 times our money for our investors. Workers made hundreds of millions of dollars. We had truck drivers make almost a million dollars, factory workers make six and a half times their annual income. It was a real win across every dimension.

Alison Mass: So to give listeners a sense of what it was like to be on that factory floor when workers found out about the sale of the business, we have a clip which we're going to roll now. And Pete, we'd love to hear your perspectives of what it felt like to be on the factory floor in person that day.

Pete Stavros: So logical question would be what does this mean for you financially because you're all owners in this business? You guys ready to get into it? [Cheering]

Even our newest colleagues are going to get a meaningful payout of \$20,000. [Cheering]

Well, if you think that was good, hold onto your hats. If you joined last year, the payout is \$40,000. [Cheering]

So for this cohort, the payout is one and a half times annual pay. So the average payout is \$70,000 for this group. [Cheering]

Alison Mass: So Pete, tell us what that felt like to be there in person on that factory floor.

Pete Stavros: It felt amazing because we knew this was going to be life changing. "Life changing" is just, like, an overused term. But you did get up to people making hundreds and hundreds of thousands of dollars who came into the transaction in debt. So that felt amazing. And I

also -- it felt amazing because we were so prepared. We were showing up with Goldman Sachs Ayco to do free financial counseling, which we had prepaid for. We showed up with Ernst & Young, who was going to do everyone's taxes. We had already done years of financial literacy training. And I think we did a good job of making sure along the way everyone understood this was earned. This was not a gift.

There's a lot of research on lottery winners squander their money and can often end up worse, so it is really important along the way that people understand they're earning it. There's a weird thing with blue-collar folks. Like, my parents who feel like, when something good happens, it's luck. You know? And you really need to fight against that.

Alison Mass: Yeah, it's just, I've watched that clip many times, and I said to some of my colleagues yesterday, every time I watch it, I get emotional. It looks like an extraordinary moment.

So in addition to your role at KKR, you're also the found of something called Ownership Works. Can you tell us what

that is, what the mission is of that nonprofit, and why you started it?

Pete Stavros: It's a nonprofit that we started with Goldman Sachs and McKinsey and nonprofit foundations like Ford and Rockefeller and labor leaders. It was this really cool collection of over 60 and it will soon be 100 organizations all coming together to say we know sharing ownership broadly can be great for the economy and great for workers and great for companies, but we know it's hard to do. Let's all work together to figure out how to optimally do this.

So the mission of the nonprofit is to be a convening for CEOs. For example, in April we're going to have 100 CEOs together working on this. Day and a half workshops that will represent 500,000 employees. Convenings of investors, of policymakers, of nonprofit organizations. And again, trying to optimize this model, which we know is difficult.

And then it's about building a movement. So it's storytelling. It's standards setting. I spend a fair bit of time in DC now making sure people understand what we're

doing and why and how they can help. And so those are the dual missions of how can we optimize this approach? And how can we build a movement?

Alison Mass: And do you think the model can work across a range of industries?

Pete Stavros: It can definitely work across a range of industries. Some are easier than others. And the factors to consider are how many employees are there relative to the value of the equity? So think of a low-value-add service company or retailer. Tons of employees. Equity value is not that significant. That's harder. It's harder to do something meaningful for workers.

How stable is the workforce? Use that retailer example again. A lot of retailers have 100% worker turnover every year. That's hard to start talking about 5-year plans.

And then I would say how distributed is the workforce? So CHI was easier than Ingersoll Rand. CHI, most of the employees were in northern Illinois. Ingersoll Rand was in 80 countries. That's --

Alison Mass: A different challenge.

Pete Stavros: That's a different challenge.

Alison Mass: So why isn't this model of making more employees into owners more common across the private equity industry when it so clearly drove returns?

Pete Stavros: It's very hard to do. It takes an enormous amount of time and effort. This is something companies have to live every day. It's not like hand some stock out and then fly back to headquarters or to New York City and watch the results roll in. This is daily effort around employee engagement and teaching financial skills and sharing financial information and sharing KPIs you're chasing, and then making sure people get the feedback on how they're doing.

The number one reason people are not engaged on the job is they get no feedback. So workers in factories, they go home to their partners and they're like, "How was your day?" "I have no idea how we did today." As opposed to

them feeling like they're in the game and, like, scrap's the goal and I know how we did today and I know how I'm going to benefit over time if we achieve our goal.

So one of the things we're fighting against, to your question of why is this not more common, it's really hard to do and everyone is overwhelmed. So when you talk to CEOs, it's like, "Okay, Pete, you want me to double my profits, decarbonize, reduce water waste, energy consumption, drive diversity in the company, you want the financials in the 12th of the month." It's like they're drowning.

Alison Mass: Right.

Pete Stavros: And then we say --

Alison Mass: And now you want to communicate with all of your employees and make --

Pete Stavros: Share ownership with everyone, drive employee engagement, improve worker safety, and all the other. Financial literacy and all the things we want to do. People are drowning. The key is the CEOs and leadership

teams seeing this as an enabler. If you do this, all those other things are going to be easier to accomplish. I think that's the key.

The other things I would say we're fighting against are a deeply held belief that blue-collar workers will never get this. Like, they'll never understand stock. Like, it's a waste of time, waste of money, don't bother. We're fighting against that.

And then we're fighting against, if we're being honest, we have a winner-take-all economy where, you know, people at the top make tons and tons of money. And everyone else, it's become, like Darren Walker at Ford Foundation, who's one of our supporters in Ownership Works, often says, "It's become normal to work 50 hours a week and be dirt poor." That's become normal in the country. So I think we're fighting against a lot, but we'll get there.

Alison Mass: So I want to pivot to the macro and get some of your perspectives. 2022 was a challenging year, to say the least. We've seen record inflation, rising interest rates, and a significant slowdown in M&A activity, which I know

you feel. How have these headwinds affected the private equity industry and you at KKR?

Pete Stavros: Yeah, it's a tough environment. As you say, the M&A market is down, so deployment is harder. Because valuations are down, particularly the middle market, not the S&P 500, values can really be down. Financing markets aren't there, so it's hard to sell. Not a great time to sell. It's hard to sell. Strategics aren't disactive. And then that all trickles down to it's harder to raise money because our LPs, our investors are not getting money back. So it is a tough environment.

What's the flip side? The flip side is this is when the best deals are made. You know, if you look over history, our head of macro, Henry McVey, who you know well, he correlated basically stock market returns to private equity returns. And this is not going to surprise you. When the stock market is sideways to down, private equity massively outperforms because we can take advantage of the volatility and it's when our operational improvement efforts really shine through because you're not just riding a wave, you're piercing through an otherwise sideways market to perform.

So it's a tough environment, but there's some bright spots, too. And across our private equity business, we have 64 billion of dry powder, so lots of ability to go take advantage of it.

Alison Mass: And before you became co-head of KKR's Americas private equity business, you led the industrials team. So how are the manufacturing and industrials sectors coping with the broader slowdown in economic growth?

Pete Stavros: It's very mixed. Once you go one layer deep than industrials as the overlay, there's everything from aerospace and defense to packaging. So some of them doing better than ours. We have a company that does food packaging that's doing great. Defense businesses are doing great. Things that are more tied to interest-rate-sensitive sectors like new housing are struggling.

I think it's really shining a bright light not only on the macro factors that the industrial company is exposed to, but the quality of the business, whether it has pricing

power to pass through all the inflation that it's seeing and the quality of the leadership team. One of the things that's interesting is, if you think about inflation, both raw material and labor inflation, the prevailing model in industrials for four decades was always raw material inflation you pass through. Labor inflation you offset with labor productivity. When labor inflation is 8%, that's impossible. No one can drive 8% labor productivity. And raw material inflation, look, it's steel. Steel doubled. So it really required a whole new way of attacking inflation that no one had ever seen because this had not happened in so long.

So we found we needed to retrain people on how to think about pricing. You need to start removing raw material from your products. You just can't pass all this stuff through. It was almost a retraining of some of the really senior, really talented executive teams who had just never seen it.

Alison Mass: And sitting on the investment committee and looking across all of the KKR portfolio companies, how are you helping your management teams and companies

prepare for operating in a recessionary environment?

Pete Stavros: I am not a big fan of “the markets are going to be down, let's go take out a bunch of costs.” I've seen people do that and quickly regret it. The markets come back, and then you're scrambling to find workers, find capacity, retrain everyone. And so particularly in this labor market, I think the worst thing a CEO could do is go remove capacity because it's going to be that much harder to replace the capacity and to retrain people.

My encouragement to our CEOs is take advantage of the downturn. Your competitors are probably going to do those things. This is an opportunity for you to take market share, to be closer to your customers. Don't make those short-term decisions, and go on offense. You know, this is a great time to do add-on acquisitions. Our portfolio companies have capital structures in place that allow them to be acquisitive. So my hope is, if we hit a recession -- now people are saying 2023 is going to be more, like, flattish as opposed to a big downturn -- but if we hit a recession, I hope we're smart enough to think long term and try and take advantage of the environment.

Alison Mass: So finally, I want to close with a lightning round. Some short-answer questions. So Pete, what was your very first investment that you made?

Pete Stavros: Very first investment was Gleason Corporation, a machine tool manufacturer industrial company that was an old ESOP.

Alison Mass: Were you at KKR when you --

Pete Stavros: I was at Vestar Capital.

Alison Mass: All right. So what's the biggest lesson you've learned from an investment, either one that went well or sometimes we learn the best lessons from an investment that didn't go so well?

Pete Stavros: Oh, gosh, I would say in terms of lessons for things that don't go well, if you get the macro wrong, you're in big trouble. It's hard to swim against macro currents that are going against you. And for things that go well, I would say really emphasize customer

feedback. Outstanding companies delight their customers.

Alison Mass: So what sector do you feel is not getting enough attention right now?

Pete Stavros: I think there are ways to play this long-term issue we all have with labor availability. So there are productivity tools that we've found ways to invest in that I don't think the labor challenge, when you look at our immigration policy, demographics, early retirements due to COVID, like, that's going to be with us for some time. So some of those productivity-enhancing tools that companies sell, those businesses are of interest to us.

Alison Mass: So what's the best piece of investment advice you can give to our listeners that you wish someone had told you when you were younger in your career?

Pete Stavros: It's not all supposed to go perfectly. If everything's going perfectly, you're not taking enough risk. So being comfortable with -- I mean, Ingersoll Rand, we bought that business, and they did have an oil business at the time and it tanked because Saudi Arabia refused to cut

production in 2014. Things are not supposed to be linearly up to the right, which, as a young person, is hard to stomach. But you just need to keep in the back of your mind you're investing in a portfolio, and it's not all supposed to go perfectly well.

Alison Mass: All right, my last question. So what book are you currently reading?

Pete Stavros: I am reading a book by Arthur Brooks called *From Strength to Strength*. It's about finding fulfillment in the back half of your career. And it's a lot of you would expect find ways to contribute and continue to grow, but there's some real wisdom in there. He's a smart guy.

Alison Mass: I'm going to have to get that. Maybe finding wisdom in the last quarter of my career. So Pete, thank you so much for joining us on this podcast. It's always such a pleasure to speak with you.

And thank you all so much for listening to this special episode of Exchanges at Goldman Sachs Great Investors. If

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