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McKinsey conversations with global leaders: David Rubenstein of The Carlyle Group

A founding managing director of The Carlyle Group reflects on the future of the private-equity industry, China's role in a rebalancing global economy, and the leadership gap between the public and private sectors.



David Rubenstein, a founding managing director of The Carlyle Group, one of the world's premiere private-equity firms, has built a career on assessing companies across industries and around the globe. In this video, the latest in our interview series McKinsey conversations with global leaders, Rubenstein shares his insights on how to manage a diverse and decentralized organization, how to identify the markets of greatest potential in a changing world economy, and how to attract leaders who are both intelligent and "have their ego in check." He also discusses the new ecosystem he sees developing for the private-equity industry as pressures build for some of its largest players go public. Richard Elder, a director in McKinsey's Washington, DC, office, conducted the interview.

The big picture: Global rebalancing

The Quarterly: People would say we're at a fledgling recovery. You travel the world; you have investors around the world. We'd love to have your perspectives on how you see the recovery playing out.

David Rubenstein: Very few people predicted how serious the recession would be or exactly the timing of its length. And therefore any prediction about how great the recovery will be or how it will occur probably should be taken with a grain of salt. Nobody really knows, is the point.

My perception, though, is that the recovery is underway in different ways around the world. The United States is recovering nicely but not as great as we would like. We'll probably grow at 2 to 3 percent this year. I believe that we will have very serious problems, though, with our debt. We still have \$14 trillion of debt coming out of this recession. We have an annual deficit of \$1.6 trillion. We have unemployment that is stated to be 9.7 percent but that is actually about 16.5 percent, if you count people who are looking for full-time jobs that have part-time jobs. And we have a serious problem with our currency.

In Europe, I think growth is probably going to be even less than in the United States. The northern European countries by and large, with the exception of England and Ireland, perhaps, are growing quite nicely. I'm not sure there's going to be any real growth in the southern European countries; and as a result, the growth overall on year will probably be 2 to 3 percent at best case. Maybe 1 to 2 percent overall.

Asia and the other emerging markets that have become very important of late are probably going to grow anywhere from 5 to 10 percent a year. And as a result, that's where many of the investors around the world really want to put a lot of their money. So China, India, Brazil, Turkey, Saudi Arabia, Korea, Taiwan are all great emerging markets, and I think they're all likely to go pretty well.

We find the greatest single emerging market in the world in China. There's nothing close to it because of its size and entrepreneurial spirit, the encouragement of private equity, the great growth opportunities we see all throughout the economy in China. We have 45 full-time Chinese natives working for us now in China doing deals through various funds that we have. We have three regular funds, a buyout fund, a growth fund, a real-estate fund, and now two renminbi funds—so I don't think you can deploy too much money in China.

I don't really want my competitors to come there and realize that, but right now it is a little bit more competitive than it has been in the past. And the competition is not just from global private-equity firms or American private-equity firms investing there. Indigenous Chinese firms are probably now our biggest competitor in China.

The Quarterly: Given all the changes that have happened as you think about the portfolio that you all have, especially outside the United States, and what regulation might or might not come, how has Carlyle then rethought how it assesses risk?

David Rubenstein: Political risk is something that's on your mind all the time when you're investing overseas. To be honest, the greatest political risk that I see is the United States. In other countries around the world, sometimes you have a better sense of what they're going to do and they're more consistent than the United States. But sure, you do have political risks in all countries. You never know what a government might do at a change of power in a country.

We have people around the world who help us assess risk, and we actually have a lot of people who are specializing in government and understanding government and who help our investment teams assess whether or not the investment makes sense.

The Quarterly: How do you then think about some of the developing markets out there?

David Rubenstein: Well, in the year 2014 the emerging markets will surpass the developed markets in GDP. And therefore, it's not really fair to call some of these markets *emerging* any longer. If China, by the year 2035, is the biggest economy in the world, how much longer can you call it an emerging market?

India will probably be the second biggest economy in the world at that time. How much longer can we call that an emerging market? The emerging-market concept is a little dated, and I think we really have to bifurcate emerging-market countries that have emerged—like China, India, Brazil, Turkey, Korea, Taiwan—and those that are much smaller and are not likely to emerge as great economic powers for some time.

Right now, we think that the greatest emerging markets are China, India, Brazil, Turkey, Taiwan, Korea, Saudi Arabia. Countries in Africa have great appeal to people like us. I

don't think you can deploy that much capital there in sub-Saharan Africa or in South Africa, but we do think that the opportunities will be considerable as those countries begin to develop further their natural resources.

The Quarterly: One country you haven't mentioned is Russia. How do you think about Russia?

David Rubenstein: We opened in Russia twice and we closed in Russia twice. I don't think that the opportunities are as great there for Western private-equity capital as for other countries. And one of the reasons is, there is a fair amount of excess capital in Russia, certainly held by the oligarchs, and they don't really need our capital to develop deals.

I would say that in countries like China, they don't really need our capital either. At this point I think what China really wants is expertise, contacts, management skills. What they would like to do is to have the private-equity skills and techniques and contacts of Western firms come to China, teach the Chinese how these things are done in the West, and then when those skills are imparted, probably the Chinese will be able to do some of the same things we've done in the West. So they don't really need our capital so much, but they tolerate our capital in order to get the other things that I think they would like.

In the industry: Private equity

The Quarterly: As the private-equity industry continues to evolve, are you seeing that there's going to be a fewer number of larger firms like Carlyle, Blackstone, KKR, et cetera, and the middle tier might get squeezed out? Or are you seeing a proliferation of funds—and therefore companies out there—going forward?

David Rubenstein: I think it's very difficult to get a new fund or firm off the ground today. On the other hand, I don't think a lot of the funds or firms that went into business years ago are going to implode or go out of business. Some may. Some may have track records that are so damaged as a result of the recession they can't raise a new fund.

I think what you will begin to see is some of these smaller firms in certain niche areas be acquired by larger firms, and I do think that some firms will probably not be as dominant in their area as they once were because their track record isn't as good or they can't raise as much money as they once did.

On the other hand, I do think that the large private-equity firms, the largest ones—KKR, Blackstone, Carlyle, TPG, Apollo, Bain—will aggregate even a larger percentage of capital that's available, because their brand names, I think, give investors some comfort. These firms all survived the recession in reasonably good shape. And I think all these firms are going to become what I'll call "alternative investment-fund managers." They won't just

be private-equity firms. They're now going to expand their offerings so they have not just private equity but they might have real-estate funds, infrastructure funds, distressed debt funds, and credit funds, and just all kinds of different funds. Hedge funds. Hedge funds of funds. Private-equity fund of funds. So they can use their brand name and help sell those funds around the world, but also acquire very talented people who could manage these funds. I think virtually all of these funds and firms will probably be public entities within five years or so.

The Quarterly: When you say a public entity, how much of it do you think will be public? Is there a certain amount that you would say is probably always going to be retained within a small group of founders?

David Rubenstein: Well, I think that the large, global private-equity firms—most, again, of which are American—will go public in part because having currency to make acquisitions of the kind of firms I think they can acquire to expand their offering base will be possible with the currency of a public stock.

Secondly, the currency will enable you to retain and recruit employees and, particularly if your competitors have those currencies to offer, you need to do that. And third, the monetization of the founders is an important factor that shouldn't be ignored. Most of the founders of these global private-equity firms are probably between 55 and 65. And at some point, they want to monetize what they have built, and I think the IPO helps monetize it. It also helps to reduce the share the founders have and probably spreads the wealth within the firm, and maybe that's a healthy thing. So I think for all these reasons, we'll probably see these firms go public in the not too distant future.

The Quarterly: Do you find that when you talk to a lot of other private-equity firms, and certainly the banking industry, that Asia is the next big run and that people are going to leave alone some of these others as they're waiting for things to sort themselves out?

David Rubenstein: All of the large, global private-equity firms are more or less American. I don't know if that can continue forever, because at some point other parts of the world will say, "We should have global dominant private-equity firms here."

The United States, right after World War II, was 48 percent of the world's GDP. We're now about 22 percent. So the world may say, "Why is it, with just 22 percent of the world's GDP, that all the global private-equity firms are based in the United States?" That probably will change. At Carlyle, which is an American firm, we started out just investing in the United States. Now we invest more money out of the United States than in the United States; we have more people outside the United States than we have inside the United States investing.

Management lessons: The art of the deal

The Quarterly: Over time, Carlyle has gotten bigger and bigger and therefore more geographic, with more people, more systems, et cetera. How do you manage that from where you started—which was just a few of you—to a very, very diverse, very decentralized firm around the world?

David Rubenstein: All of us that are doing this are kind of making it up a bit on the fly. Obviously we're looking at other global firms and what they've done. In our case, what we tend to do is control all the investment decisions centrally, so we have centralized investment committees—not one committee, but several different committees, that approve the deal.

So to make sure we have quality control, all the deals have to be approved centrally and by experienced people who are serving on those committees. Secondly, we do have training programs, extensive training programs, to give people a sense of what we are about, how we regard ethics as an important part of our business, and make sure there's a common culture in the firm.

We call it One Carlyle. Everybody is part of one firm. No matter what part of the firm you're at, you're part of Carlyle. It's one Carlyle. We also try to make sure that the people in the firm get together on a regular basis at conferences or at training sessions and retreats to make sure they understand who they're working with. And we also incent people. Those people who cooperate with other people in the firm, no matter what part of the firm they're with, we take note of it and we reward people in bonuses and other types of compensation. So, through many different ways, we try to inculcate a common culture. In many different ways we try to manage it. We do manage things centrally a bit by the investment approval process, and the hiring process is largely central as well.

The Quarterly: Carlyle has always had the famous "DBD"—the three of you [David Rubenstein, Bill Conway, Dan Daniella] get together. You've been very vocal that you don't necessarily socialize outside but that you actually work extremely well together inside.

David Rubenstein: There are three people who really have been running Carlyle for most of its history, and we do get along quite well, in part because we have different areas of responsibility. Bill Conway tends to oversee most of the investment activity. Dan Daniella oversees a lot of the operational activities, as well as our real-estate energy businesses. And I tend to oversee fundraising and probably recruiting a bit and somewhat the strategic vision of the firm. I have been more or less the face of the firm because I've been willing to do interviews and make speeches. But all of us are equal partners and all of us consult regularly on all matters, even though one person may be taking the lead.

If you're a public company, it's difficult to say you have three CEOs. And so we recognize that. Without conceding that we're going to go public or even saying that we will, if we were to go public I suspect we might have to change our model a bit and have either a CEO or designate one of us to be the CEO—or find someone else within the firm to do it.

There's no doubt that, as long as the three founders are there, it'd be difficult for somebody else to completely be the CEO, but we recognize that we might have to step back a bit if somebody else were the CEO. We just haven't decided that yet, in part because we haven't yet decided if we're going to go public.

The Quarterly: What have you really learned—and how has that changed over time—from the different management styles and the different types of companies you all have owned?

David Rubenstein: One, you don't really know how good a company is going to be when you buy it. Ninety-five percent or more of the projections of what you're going to earn are wrong. We're just not right on how good companies are going to be or how bad they might be. Secondly, when you don't have a good manager at the outset, you need to get one. And if somebody is not a very good manager in the first year or so, he's probably not—or she's not—going to get much better, so you probably should make a change.

You should be very careful about the assumptions, in terms of the economy, that you get in your projections. Some people often assume the economies are going to go very well all the time, and that's probably a mistake. Buying companies that really have a good culture is extremely important. Making certain that the people in your firm know how to add value—that's also very important. Making certain that the numbers you see when you do the due diligence are accurate, and making sure the accounting that you look at when you're buying a company works. I'd say generally there are many different mistakes we've made, and I think we've probably made every mistake you can make, but actually we've generally done pretty well.

We've averaged about 30 percent gross internal rate of return on all the money we've invested—almost \$60 billion of equity over the 23 years or so of the firm. So we've been right more than we've been wrong. And I like to focus a bit more on our mistakes, because I like to look at what we did wrong—and the deals we should have done that we didn't do, or the deals we shouldn't have done that we did do. And I tend to focus on that. But obviously the deals we've done that have worked out have been much greater than deals that we've had that didn't work out.

The Quarterly: How do you actually get that level of insight into what really makes a company tick before you commit the capital?

David Rubenstein: The gestation period from the beginning of looking at a deal to the closing of a deal is probably about six months. Now if you had a year or two to look at a company, you'd probably even know more, but six months is probably an average gestation period. So during that period of time, we are retaining consultants. It might be an accounting firm, it might be a law firm—specialized insurance analysts, and all kinds of different experts who can give us some sense of what the firm is like.

Obviously we spend a lot of time with management as well. We talk to competitors. We talk to customers. There's no foolproof way, and obviously some people do make mistakes. But more often than not, buyout deals, private-equity deals, will work out; and that's in part because of the extensive amount of due diligence.

One of the reasons private-equity deals tend to work out to a higher extent than venture-capital deals is you have a long amount of time to do the due diligence. You're looking at predictable cash flows, existing management structures. Venture capital—typically, it's much less developed in terms of the management structure, and the idea may not actually work out, and the cash flow may not really be there.

So that's why venture capital deals tend not to do as well, in terms of numbers. Eight out of every ten may not work in venture capital. Two may work. Whereas in buyouts, I suspect nine out of every ten probably work.

The Quarterly: One of the hot topics right now for most businesses is organic growth. How do you all proactively think about the innovation that is required within these companies to create that organic growth?

David Rubenstein: Well, when you're looking at an emerging company—a growth company or an emerging growth company or something like that—you are looking at whether they are going to be innovative enough to actually grow a business from a relatively modest business to a real earnings business.

And at those kinds of companies, you are looking at innovation—whether they have one or two ideas that are really going to take this to the next level. In more mature buyouts, you tend not to be looking as much for innovation as for more efficiency. You want to make the company operate more effectively. Maybe they could reduce their costs in some ways. Maybe they can do a bolt-on acquisition. You tend not to focus as much on innovation in some of the larger companies, and maybe to some extent we're doing that now.

But I think you see the innovation much more in these emerging companies where you have \$10 million to \$40 million of revenue, maybe very modest amounts of earnings—but they are to the point where they really can grow to a major company if, in fact, they have one or two innovations that will take effect. And what we tend to do is spend a lot of time

in the due diligence process assessing whether these innovations they have on the drawing boards are likely to happen.

The Quarterly: When you think about all the different companies you own, especially around the world—obviously a lot of different local cultures, a lot of different practices, et cetera—how do you balance between the local autonomy for the deal team there, even though the ultimate approval is done centrally here, and all those different nuances and everything else that require you to make the right decision?

David Rubenstein: The deal teams tend to generate their own ideas. You can't completely control everything centrally, because the more and more you control centrally and squeeze your local people, they will not be happy. If you have a very, very dedicated, talented team of people and they're very good at negotiating deals, they are people who want some freedom.

And if you get people who just don't want any freedom and who will do whatever you tell them centrally, they're not the kind of people you want representing you, because, presumably, in negotiating deals with the people they're trying to buy things from they'll be as weak as they might be in dealing with you.

So you want strong people. You want people who are willing to argue with you and debate with you, because if they're not willing to debate with people on the centralized investment committees, they presumably won't debate with their own CEOs, and that's not a good thing.

Business in society: Redefining public service

The Quarterly: As you think about the private-equity industry, how do you think about the societal or environmental implications of the investments that you happen to be making?

David Rubenstein: Well, there's no doubt that many private-equity investors focused for many years on getting good rates of return and just telling their investors about those good rates of return, and then getting more money from those same investors. I think increasingly, we've recognized that if you only focus on internal rates of return, you're probably going to do a disservice to yourself. Because in the end, other people who are stakeholders in what you do are not going to be happy.

We need to make a better case that we are paying taxes, we are sensitive to environmental concerns, we are sensitive to socially responsible investment principles. I think the private-equity industry may be a little late to that game, but it's now catching up, and I think we're doing a much better job. In our own case at Carlyle, we've been very careful to

invest in certain areas and not invest in other areas. We have, for example, not invested in tobacco. We haven't invested in alcohol. We haven't invested in gambling. We haven't invested in handguns, things like that. We've been careful about investing in certain areas that we just are not happy about and don't want to be associated with.

Generally, we try to invest in companies we think are going to add some productivity to the economy that's relevant, and add jobs. We're not interested in buying companies where we're only going to make our money by destroying jobs, or taking them offshore.

The Quarterly: Can you describe a little about what social responsibility means to you, personally?

David Rubenstein: When I turned 54, I read that a person my age probably would live, on average, another 27 years, and therefore I realized I had lived two-thirds of my life, and I didn't want to just spend the other third of my life just acquiring more money and waiting for my heirs to give it away.

So, I concluded I would try to give away as much as I could while I was alive. And therefore, I decided to get deeply involved in a lot of philanthropic areas, particularly ones that were helpful to me: schools that were helpful to me, causes that were helpful to me, things that were important to my community.

I'm deeply involved in education, deeply involved in performing arts, deeply involved in medical research, and deeply involved in a number of other areas that I think are important to our country. I think at a younger age, people still are very interested in going into public service. And I have underwritten a program at Harvard Business School where people who get a joint MBA and MPA degree from the Kennedy School get scholarships. And that program is designed to encourage people to go into business at some point in their career and to go into public service. And it's designed to show that you can mix these two types of careers.

I do encourage people to go into public service. I think it's easier to do it early in life—when you can have more responsibility, probably, in the government than you would in the private sector—and then come out and make money, if you can, and then perhaps later in life you can do things in public service.

But the important thing from the time that I went into government to now is this: when I went into government in the 1970s, if you wanted to serve your country, typically you did it in government. You might be in the military, the Peace Corps, or in federal-government service. Now there are many NGOs—nongovernmental organizations—that are providing extensive public services to our country, that you can serve in these NGOs and do a very good job, or create your own NGO. And so, I think many people who want to go into public

service today don't feel they have to go into government. And I encourage them to not, necessarily, go into government if they want to do something in public service.

Everybody has a social responsibility to make the earth a little bit better than when you came into it. And so, when I die, I hope people will say that I did something to make the world a little bit better in one or two areas. And I hope my children will take the same kind of responsibility in whatever wealth they may get and use it in the same kind of useful ways.

On leadership: Mending the public-private divide

The Quarterly: How do you think about leaders and leadership, in terms of today's business context?

David Rubenstein: Well, clearly there are fewer individuals around the country to look up to as leaders in the business community, for example, than may have been the case years ago. We did, in the 1970s and '80s, begin to make rock stars of our CEOs. But I don't think that today there are as many leaders in the financial-services community as I wish there were, because so many of them had problems in the recession.

I do feel, unfortunately, that we've demonized business leaders to some extent. I think the government of the United States, to some extent, has in effect implied that if you make too much money, if you're too highly compensated by the government's standards, you must have done something wrong. And as a result of that, very few business leaders are as willing to be engaged with government as they were in the past.

One of the strengths of the US government system has been that people who have private-sector experience can go freely in and can go freely out. I think our government has benefited by having people with extensive private-sector experience. And I think our private sector has benefited from people with government experience going into the private sector. Now, at the senior levels of government, people who are willing to go in from the private sector are fewer and fewer. The most talented people in the business world that I know today wouldn't consider going into government. It's unfortunate.

The Quarterly: How were you shaped by your time in public service?

David Rubenstein: Well, I was very fortunate. I was a young man. I became, at the age of 27, deputy domestic policy advisor to the president of the United States—a job that I probably wasn't qualified for. But it gave me a great thrill working in the White House, advising the president of the United States. And I did learn much more about public policy and about the world than I would have if I'd been practicing law at that time, which was probably the alternative.

As I look at myself now as a man of 60 years old, I think that experience was very good in shaping my perspectives and making me understand how government works, how our country relates to other countries. And I wouldn't have traded those four years in the White House for anything else, no matter what else I might have had in terms of financial opportunities at the time. I'm very glad that I did it. On the other hand, I don't lust to go back into government.

The Quarterly: When you go through the talent process and hiring process, do you look for people who have actually had some kind of public-service background?

David Rubenstein: Private-equity firms have gotten a little bit into a rut of hiring people who have gone to very good colleges, spent two years in an investment-banking firm, then gotten an MBA, and then either spent a year or two in private equity, and then come to them.

And I think we are now increasingly looking for people that have operational skills, as well as finance skills. And because government is increasingly an important part of our lives, we're probably going to have people with more government skills. Right now, I spend more time dealing with governments around the world than I did 10 or 15 years ago, because governments are increasingly looking at what private equity's doing; increasingly looking at what investment firms are doing.

And I think understanding what governments are thinking and how they relate to private-equity firms is important. So I do look at those kinds of skills as well. But generally, I'm looking for people that have good overall qualities. And if you are a talented person and you're willing to work hard, whether you were in the government or not in the government doesn't make that much difference to me—particularly when I'm hiring somebody under the age of 30. Now, if I'm hiring somebody who's 40 years old, 45, 50 years old, they're more fully formed, in terms of their career. Then I'm going to assess whether their government connections and their government responsibilities and their government knowledge is really going to be helpful to our firm, or whether it really wouldn't be as helpful as having somebody the same age that had private-sector experience.

I tend to look for people that have certain skills that transcend what part of the government they serve in. I'm looking for people who are intelligent, but not geniuses. Geniuses are difficult to deal with. Looking for intelligent people, people who are hardworking, people that know how to get along with other people, people that have their ego in check, people that want to create wealth—people that want to create wealth but not necessarily spend a lot of money, but create wealth for other purposes—people who want to be part of a bigger system than just their own entity. I'm looking for people that really

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The Quarterly: Last question for you. What's some of the best advice that you have ever been given in your career?

David Rubenstein: I would say the advice that I've pretty much tried to stick to is: Try to make yourself indispensible in the organization. Master one subject, make sure you know it better than anybody else. Keep your ego in check. Make sure you get along with other people. Try to share the credit. Make sure that you are not focused on the wrong things—you don't want to make money for the wrong reasons.

And make sure that when you do have some financial success, you give back to the community. Make sure that you are making the community a better place because of the wealth that you have. I've tried to do some of those things, perhaps imperfectly, but I'm trying to do a better job as I go along. •

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