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Executive Perspective®

Unique Viewpoints from Industry Leaders

October 2015

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Editor's Note: *In this month's issue of Executive Perspective,* ***martin****wolf interviews Michael Duran, Partner at Millstein & Co. Michael is a veteran private equity investor and leads Millstein & Co.'s principal investing activities. Previously, he was a Managing Director and member of the investment committee at Ripplewood Holdings, where he executed several successful domestic and international control investments across multiple industries. Prior to joining Ripplewood, he worked in mergers and acquisitions at Broadview, a technology-focused boutique investment bank.*

You've worked on the investment banking side and the private equity side. What led you from the one to the other, and what are some of the main differences?

It has actually been quite some time since I've been an investment banker, but while I enjoyed advising companies on M&A, for me the more interesting aspect was building businesses and helping companies transform. I saw companies become more successful in the market place and grow, and I wanted to be a part of that. I didn't want to arrange transactions and not see the resulting fruits of that labor. I really enjoyed seeing companies ask themselves "what is the strategic reason for putting businesses together, and how do you help manage and create a strategy from which they can grow and be successful?" I enjoyed operating businesses, spending time on sales and marketing, and identifying the business's competitive advantages, then using those to create value. I also prefer having the ability to control my own destiny when making an investment. Working on control investments, as opposed to investment capital, means controlling the outcome—and being able to manage that process directly is something I believe investors should be willing to pay for.

Tell me about Millstein & Co. How did you get involved, and what is Millstein's investment philosophy?

I'm the founder of our investment platform here, and I manage it as well. I got to know Jim Millstein when I was at Ripplewood—I hired him as my investment banker when we were looking at troubled situations or looking at companies that, due to one circumstance or another, were owned by hedge funds or owned through debt. We worked on some things together, and I liked his philosophy of how he went about looking at opportunities for investing. Our philosophy is that we invest in businesses where we believe we can create a value-enhancement strategy. We look for opportunities that are sub-$500M in enterprise value.

We work with operating partners in all of our transactions—executives

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who have experience running a business. These partners either become chairmen, CEOs or sometimes active board members in the businesses we acquire. I believe those individuals are very helpful in terms of sourcing transactions, recruiting management team members, financing the acquisition and building a strategy for how to enhance the value of the company once we own it, as well as in the diligence process. That's the model I used at Ripplewood, and that's the model that we use here today. In terms of industries, we invest in financial services, technology, IT services, technology-enabled business services companies, and we also spend time in the consumer and industrial areas. We have operating partners in all of those industries, mostly people I've worked with on transactions for 10-15 years and have had relationships with over long periods of time.

Let's talk about DLT. What attracted you guys to DLT as an investment?

DLT was a great opportunity for us. It's a perfect fit, basically, in that it's a combination of an IT business and a government-sector related business, with a strong financial profile, that serves as a platform from which we can grow. In terms of IT, I was originally a technology investment banker, and have spent a lot of time working on a number of services transactions. The first transaction I worked on was an IT services company in New York and my first buyout was of a telecom equipment business – Western Multiplex. Overall, we believe it's an area with the wind at its back that will continue to grow. And, depending on the area where you focus, it could be quite lucrative. DLT is focused on the software portion of the marketplace, and I think that's a much more attractive area to focus on as compared to hardware for a number of reasons. An additional advantage of DLT is that it focuses on the government space, and we have a number of people here who have spent time working in the government. Our CFO was the former CFO of TARP and the Small Business Administration, and we have relationships at Cabinet departments like HHS and Treasury. The company also has a strong financial profile, and is a great platform for growing into new technology domains, introducing new product portfolios and incorporating bolt-on acquisitions. Finally, they're a vendor-focused VAR with great relationships, and it has the potential to leverage its business model to expand into cloud and cyber security, both significant growth areas.

So DLT's focus on software made it attractive to you. What in particular is interesting about software, and how does that impact your investment criteria?

Our perspective is that many hardware providers have been under pressure in the past few years, and while they did better this year, I expect that trend to continue going forward. The model I expect to prevail is that of the hybrid cloud, in which you have a combination of things—namely hardware that is in the cloud, and consumers using a mixture of on-premise and off-premise technology. As a software VAR, we don't care whether your systems are off-prem or on-prem—you need licenses, and whether you decide to go with a new license program or an annual service model platform, either one works for us. As long as the economic model works, and, obviously, given that software company margins are as high as they are, there are many ways to do that. Today, you're clearly chosen because of your capabilities. You can then command the price you need to be successful going forward, whichever model you choose. I think that's less the case with hardware companies.

What interests you about the government space? Do you see more opportunity with the federal government or SLED?

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The federal space is massive scale, all at once. While there are different agencies within the government, and you need to work with them on an agency-by-agency basis, there is one general buying organization, and knowing how to navigate that removes a major barrier to entry. The sales process is also localized, which is nice, and does not require you to leave the Beltway. So scale and efficiency is attractive, and while there are ups and downs, it's generally quite stable thanks to its size. If you're in the defense equipment business, it's much more volatile. But in terms of technology, the government is still spending significantly—in excess of $100 billion/year—and they only need more, either because they're still migrating away from mainframe legacy platforms or because they're so concerned with cyber security and big data/analytics that there are massive growth areas available to software providers.

I'm quite bullish on government spending in the technology space. In addition, the SLED market is a high growth market. It's much more diverse in terms of its opportunities is but also paired with a much more complex sales process. The growth opportunities are larger on the state and local side, but it costs more to win. On the federal size, if you're already in the space, the growth won't be high, but it exists and you're already over the main barrier to entry.

How do current market conditions and low interest rates affect you?

Low interest rates make it much easier for us to borrow money. Basically, valuations remain high on the equity market side, which puts pressure on returns, but the availability of debt, even though recently there have been some jitters in the bond market, leverage still remains quite available at very low rates. Debt has been easy to get and rates remain low. I think given current economic conditions of unemployment around 5% and GDP around 2%, interest rates will

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rise. The only reason we haven't seen rates rise yet is that these conditions are mitigated by the fact that we have relatively low inflation I expect rates to rise—I think the recovery has occurred, it's just moving a little bit more slowly than desired—but I don't think rates will rise much. It will likely take a long period of time before it's significant or impacts our business materially.

What is your general exit philosophy for your investments?

Before I buy a business, I'll have thought through the exits. I'll ask who are the strategic buyers who would look at it at a future point in time and what can I do to make the business more attractive to them. In some cases, buyers may like it now but cannot acquire it because the industry is experiencing pressure—this is especially apparent recently with certain VARs. So I think there's opportunity with DLT, for example, in a future strategic sale.

But there are several exit options available—further recaps, IPOs (which, as means to an exit, requires confidence in continued success in the future). So I'm open to all opportunities to realize returns on a great investment, and I'm not wedded to anything in particular. With DLT we don't have a specific time horizon in mind, but we will most likely target a 3-5 year window. I've observed in my nearly twenty years of investing that if you haven't been able to execute on your strategy in the first three years of an investment, it's probably because there was a shift in the industry dynamics or you had to otherwise pivot somewhere along the way.

What advice would you give companies to position themselves for investment from a private equity firm such as Millstein?

It's very important to be clear about the market opportunity you're looking to attack and what your solution to the problem is. The clearer you can be about that, the better positioned you will be to have that dialogue with a potential buyer of that business. For example, many companies today claim they are cyber security companies—very few actually are. You're doing yourself a disservice if you try to advertise yourself as something that you are not, and people are going to figure it out. You don't have to be what's hot now if you solve a problem that's in the market. Clearly identifying that, and having a team that can discuss how they approach the marketplace and win business is a critical component of the fundraising process. You need to establish a clear competitive advantage that will enable you to succeed in the marketplace.