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2Q14

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Sam Katz

Managing Partner, TZP Group

Editor's Note: *In this issue,* ***martin****wolf interviews Sam Katz, Managing Partner at TZP Group. Sam began his career in 1986 as a Financial Analyst at Drexel Burnham Lambert. From 1988 to 1992, he was an Associate and Vice President at The Blackstone Group, where he worked on numerous private equity transactions, including the initial LBOs of several hotel franchise brands, which created the predecessor to Cendant Corporation. From 1992 to 1995, Sam invested in private and public equity as Co-Chairman of Saber Capital, Inc. and Vice President of Dickstein Partners Inc. He joined Cendant in 1996 and through 2005 led the execution of numerous transactions as Cendant's most senior corporate and strategic development executive. He also served on Cendant's Investment Committee and held various operating and management roles. After Cendant, he joined MacAndrews & Forbes Acquisition Holdings, Inc. (2006-2007) as CEO. Sam serves as a member of the Boards of Directors of DLT Solutions, The Dwyer Group, Inc. LLC, Water Cooler Group, Total Military Management, LLC, BQ Resorts, LLC, Cloud5, LLC, Lift Brands, Inc., and Global Employment Solutions (GES). Sam also serves as a member of TZP's investment committee.*

MW: US markets were really strong in 2013, but currently they're slightly down or flat YTD. What do you see going on for the market for the rest of the year?

SK: Generally, I believe the markets are going to trend higher because the economy is really picking up, tapering is working well and global markets seem to be shrugging off geopolitical risks. I don't expect major gains, but we are going to see the markets shifting higher.

How much does that affect TZP? Is the market a broad heuristic for the private equity environment?

I think it really depends on which part of the market we're talking about. At the higher end of the spectrum, the largest deals are very impacted by the market. There's definitely a correlation between a strong stock market and a strong financing market, so the impact on multiples is greatest at the higher end—but this relationship cascades down even into the lower middle market, where we participate, composed of companies between $5 and $35 million of EBITDA. The market going up affects all multiples and ultimately the financing is stronger as well, but the effect is lesser as you go into smaller and smaller companies.

Do you think M&A deal volume will be greater, less than or about the same as 2013?

I think it'll be about the same. The dynamics are similar—corporations have significant liquidity, PE firms have more capital to spend and a favorable financing environment along with a positive outlook of the economy. 2013 was a good year and I think 2014 will be similar.

Let's talk about TZP. What do you look for in an acquisition?

We look for companies that have strong underlying value propositions so that in 5 or so years when we're going to go sell that business again—

because we have to on behalf of our investors—that the companies, customers and business partners are going to want to keep buying the services or products that the companies are providing.

So value propositions are really at the core, but the second aspect is that we're looking for is a good outlook for the future. We tend to pay fair values for the companies that we invest in—we don't consider ourselves deep value buyers, we try to pay fair value—so we need to find companies and industries with good growth prospects for us to get our target return on investments.

The last thing, which is the most important, is alignment with management. In each of our deals, the sellers in the company have reinvested a significant portion in the company going forward and are running the business that they built. We're really looking for a strong alignment so that everyone benefits as the company succeeds.

What level of board control or influence do you desire?

The strategy that we refer to in our firm is being a "partner of choice." What that means is that sellers choose us because if they are going to retain a significant stake in the company, they care who their investor is and they believe TZP is the best investor—their partner of choice—while they run the business.

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Our deal structure is predominantly to do control deals. In some cases we own 50%, in some cases we own 80%—but regardless of whether we hold legal control we run all the companies we have as real partnerships and we're proud of the references we have from our portfolio companies about the way that we've allowed them to continue to run the companies.

Where we focus our energies is working with management to identify areas where they don't have the necessary capabilities or qualities today. We try to spend our time on enhancing or expending the strategic bandwidth so they don't feel like they are just getting money out of the relationship. We don't change CEOs—we're pleased to say all of our CEOs are with us today. We have had instances where we have supplemented management, but our approach means aligning with a great management team.

Do you partner with other firms?

As partner of choice, it's difficult to be partner of choice in a three-handed game. Theoretically we're being picked, so the nature of our relationship is to partner with management so that we're the sole PE investor. We have had our LPs and lenders co-invest, but they had no governance involvement in the companies.

What have you found, if anything, differentiates investments in IT companies?

We love the IT sector—we have three investments coming at it from different perspectives. It's a huge part of the economy, and it's characterized by a lot of growth and change with new business models. What we like about a lot of the IT companies we look at is that they offer really strong scalability as you increase volumes because they have really high gross margins associated with the products and services and the ability to scale without much capital required. The difference that exists, and the greater risk, is that you have to be mindful of external risks from technological change, which especially can pose challenges when you exit (going back to the earlier point about the successful value proposition). So you have to spend time investing or innovating and understanding what's going to come down the path or you'll find yourself in a situation that affects your value proposition.

What are your three investments in IT companies? Can you walk through them?

Our first deal was DLT Solutions, thanks to Marty Wolf and co. This was a real Partner of Choice situation with Rick Marcotte and Craig Adler. We felt the company had a great value proposition as a product and IT solutions provider with a great set of vendor relationships and a really unique lead generation and conversion process that added great value to its customers and built on a unique platform. We also liked the government space, which was relatively stable in '09, and the company has continued to outperform the growth and profitability that we expected.

We believe that with the economic recovery what it is, and with issues like the ACA, we believe people will continue to be reluctant to take on full-time hires—particularly in the IT space.

The next one was Thing 5, completed in 2013, which predominantly offers a PBX in the Cloud system to Hotel Operators, offering large cost savings and capital avoidance as well as allowing for owners to have more visibility into their customers and potential incremental revenue flows. This is another example of the CEO looking for an investor that would be value-added—and we've been active with them on building their sales and marketing infrastructure and other business development work. This really dovetails with what we find attractive as the recurring revenue model—leads to meaningful profit growth and stickiness as we add customers.

Most recently we have invested in Global Employment Solutions, an IT Staffing company. Management continues to run the company and made a significant reinvestment We've been looking at the staffing space for years, looking at quite a few assets, and IT appealed to us the most. Furthermore, we believe that with the economic recovery what it is, and with issues like the Affordable Care Act, we believe that people will continue to be reluctant to take on full-time hires—particularly in the IT space, which by virtue of its project nature and specialized skills, creates strong sustained demand.

Relative to the other staffing companies we looked at, we liked GES because it was middle-market focused, has a diverse number of clients, and ultimately again it's a business where we have offices that can grow their profits efficiently without having to increase overhead.

Do you have other broad segments that you're looking at?

We have a couple core segments but we also like to develop things that are adjacent. One of them is Lift Brands, which has five gym concepts and combines our knowledge in franchising and our enthusiasm for the wellness category, which we think is an attractive category. We think the staffing investment is a good example of us spending a few years researching an area before building a thesis and making an investment. We have a nice complement of industries and business models that we're comfortable with, but at the same time we're always learning about new industries and building relationships in those verticals.

What makes your firm so attractive to your investors?

Investors care about our results, and we've had exceptional results. The partner of choice value proposition has been attractive to our investors in the context of actually being able to validate through their due diligence that we have done things to create additional value in the portfolio. Our positioning is a strong positioning—we compete with a lot of good firms, and the success we've had testifies to our firm's strengths. Additionally, we're a small firm but we have strong industry expertise, so we bring a lot to our portfolio companies.

What can PE offer a company that a strategic can't?

It really depends on who the strategic or private equity is and what their business model is. There are some acquirers who opt for a hands-off approach, and there are some that look for more integration and more ways in which to leverage the strengths of the acquirer to bring value to the acquisition target. Both strategic acquirers and private equity firms can bring some discipline around financial planning or investment prioritization. Additionally, the line is blurred—many strategic acquirers are themselves backed by private equity investors. Really, any target company in IT services should understand the philosophy of the buyer and decide what they ultimately want. In terms of upside, with strategic acquirers the leaders are typically bought out and often leave the company—while with private equity deals, management in companies that get acquired usually have the opportunity to roll over equity into the new company and participate in the further upside from the growth in their business.