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Rob Palumbo

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Managing Director, Accel-KKR

***Editor's Note:** In this issue, **martin**wolf interviews Rob Palumbo, Managing Director at leading technology-focused private equity firm **Accel-KKR**. Prior to joining Accel-KKR, Rob co-headed the software investment banking practice at Thomas Weisel Partners in San Francisco. Prior to Thomas Weisel, he spent three years at Deutsche Bank where he built the technology investment banking practice in the southeastern U.S. and later headed the software practice in Silicon Valley. Rob is a Director of Infinisource, Paymentus, Layered Technologies, Applied Predictive Technologies, Pinstripe, North Plains, and EA Holdings, Inc. Rob's former selected directorships include IntrinsiQ Research (sold to AmerisourceBergen Holding Corporation in 2011), Saber (sold to EDS in 2007 for $460 million) and Systems & Software.*

How would you characterize some of the trends that have affected tech mergers & acquisitions in 2013?

First, it's a good lending environment. Credit is available and the cost of capital is cheap. So, that certainly drives M&A. Second, there is a slow but steady improvement in the macro-economic environment and that gives companies greater visibility into what is happening in their businesses. And third, I think that both strategic buyers and private equity firms have cash.

Together these forces make for a fairly robust M&A environment right now.

With a good environment for M&A right now from a buyers' perspective, how would you describe the quality of the opportunities you are seeing? Especially given your focus on software, are there good software companies to acquire?

We've been at this as a firm for over 10 years now. My partners and I have been in the business for closer to 20 years. I'll tell you at the most macro level software companies are still being born that are taking mundane tasks that were done on spreadsheets and automating them through software. We still invest in businesses that are replacing an Excel spreadsheet, something really that simple. And I don't foresee any time soon that the opportunity to automate workflows and business processes is going to change.

Also, given the nature of software, you do not need a lot of capital to get started. So, we continue to find a lot of very interesting, entrepreneurial people who see an opportunity in a vertical market and decide to start a company with a credit card. In particular, we're interested in companies that are building mission-critical applications that are automating and

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increasing productivity for core end-markets.

So as a firm you are more interested in companies that see an opportunity to do something better, faster, and cheaper over companies with breakthrough or disruptive technology?

If it's truly disruptive it's probably more of a venture capital-type investment as opposed to private equity, where we play. We are much more interested in what we would describe as stable, strong businesses in established industries that can provide a very, very obvious return on investment to their customers. It's usually in the form of some sort of productivity enhancement.

Does that lead you, then, to certain sectors? Or are you agnostic to the sector or the niche and instead look for some of the qualities you just described?

We like vertically focused software companies so we look at the end market space being served. It might be healthcare, it might be government, it might be human resources. If you look at our portfolio, the end-markets our companies serve are probably pretty consistent with how GDP breaks down across the economy.

When you are initially screening a specific opportunity, are there two or three things you consistently look at to decide whether it's an opportunity you want to pursue?

We usually start by looking at whether the company has true domain expertise that's embedded in the workflows of their products. In other words, does the company have an understanding of the vertical market it serves that's reflected in the product?

Then we think about whether it's mission-critical to businesses. Is it a "nice to have" or is it a "got to have?" To determine that, we'll look at the renewal rates or maintenance and support rates the company gets with its customers. For a software company, we're looking for something in the high 80s or 90+ percent renewal rate range. That's usually indicative of something that's fairly mission-critical to a business.

And then, depending upon the business the company is in, we look at whether the team has the ability to run a profitable business.

Given the stage of companies you're looking at, if there is no consistent ability to deliver to the bottom line, then it's probably not a business you're interested in.

Exactly. And then the last thing I'd say is at end of the day we partner with people, not businesses. There has to be good chemistry, high integrity people, people looking for a partner who can help them. We've had good success because we've partnered with good people. It sounds simple, but it's not.

Generally speaking, private equity firms bring focus and discipline

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that can really help businesses grow. What would you say Accel-KKR could bring to a company that might set you apart from other PE firms?

We have a singular focus on tech and tech-enabled services and we've been doing this for 20+ years. So, I think we do have a real understanding and expertise in the market. I also like to think we have a reputation for being good, honorable, high-integrity partners with our management teams.

And then related to that is the willingness and an interest in rolling up our sleeves and working with our portfolio companies to help them in a myriad ways. We are not passive observers; we are hands on people who want to lock arms with management teams to help them.

Lastly, I think given our experience, our relationships and networks can bring some fairly unique resources to bear for our partner companies.

Can you give a couple of examples of the kinds of networks you have access to?

A lot of our companies have an interest in becoming more global, going outside the U.S. We have a presence in Europe; we've done business in Asia; so, we can help them get global. Then if you look at the broader Accel-KKR family, some of the largest customers of our portfolio companies were relationships from Accel-KKR that we brought to bear and where we were able to get them C-level introductions. We've also brought in world-class board members through our network.

I'm sure you consider a lot of companies and therefore in some cases you don't end up making the investment. What are some of the things that cause you to walk away from an opportunity?

We won't compromise on our partner principle. So, if it's not a management team that is going to be enthusiastic about working with us and has a longstanding reputation for being high integrity folks, it won't matter how good the business is. So, I'd say that's number one.

With regard to the kinds of metrics around the business and what makes a good software business, we can usually ferret that out quickly given how long we've been doing this. So unless we hear something just completely contrary to what we've been told, we typically know early on about that.

What would dismiss something fairly quickly might be something simple. For example, they might not have a lot of domain expertise or a differentiated product or a competitive advantage. Those are the kinds of things that will probably make for a quick pass from us.

How about if you are fairly deep into a process and then you decide not to go ahead? It sounds like, in that situation, it would be because you discovered something in the diligence process that you just did not expect.

Yes, and I'm not suggesting that we might be misled but you don't always learn everything right away. And so we might in the discovery process learn something that gives us a different perspective on the business. I will tell you, it's rare that we come out of the first one or two weeks of doing work that our view changes.

What advice would you give to the CEO of a company who is interested in private equity versus a strategic buyer? Are there differences that matter?

I think there are meaningful differences. If an owner thinks they are ready to hit the beach, so-to-speak, then they are probably better to sell to a strategic because when a strategic owns the business they might not view the CEO as core and may be more open to replacing them. And so people tend to sell to strategics when they are ready to exit the business for good.

A good private equity partner is more appropriate when an owner wants to get some financial diversification but believes in the business and would like a second bite of the apple with the portion of ownership they are retaining. So, it's important that they pick a good partner.

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If a CEO decides that private equity is the way to go, what advice would you offer about how to present the company to a PE firm? How can they put their best foot forward?

Demonstrate knowledge of their business and their market. Have a clear and concise plan for where they want to take the business. Have a genuine interest and enthusiasm for working transparently with a partner.

Is there anything else you'd like to say that might be valuable to that CEO?

I'm not sure that entrepreneurs who've built good businesses realize that there are different options available to them, ways to achieve diversification and still run a business, to retain ownership and upside potential – in other words, have their cake and eat it too.

So, I think they might be surprised at the creative ways they can work with a private equity firm to meet their financial and their personal objectives.