Churchill Spotlight

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This week we speak with Jeff Drazan, Co-Founder, Bertram Capital

Bertram Capital is a private equity firm based in San Mateo, CA with $850 million of capital under management. They focus on investments in the lower end of the middle market.

On The Left: *First off, Jeff, how's business?*

Jeff Drazan: The firm is doing extremely well, thanks. We've been ranked in the top decile for our vintage by both Cambridge and Thompson Reuters. We're very proud of that.

OTL: *Congrats. Any recent activity that accounts for that?*

JD: We're about to have our first liquidity event. It's the sale of PDI (Power Distribution, Inc.) that we just announced is being acquired by Smiths Group. That's a business we bought four and a half years ago when they had revenues of $28 million. This year they'll do over $150 million.

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OTL: *What was the sale price?*

JD: Let's put it this way: this one transaction will return more than half our fund.

OTL: *Hard to beat that.*

JD: It perfectly encapsulates what we do in the lower middle market private equity community.

OTL: *If you were to reflect that in your corporate motto, what would it be?*

JD: We help our companies achieve their full potential.

OTL: *What are the key ingredients to that strategy?*

JD: Well, we have five elements – what we call at Bertram "High Five.'"

OTL: *Nice!*

JD: The first is "Enhance the management team." The second is "Teach them to in-source and out-source." Third, "Build barriers to entry using intellectual property and technology." Then, "Broaden channels of distribution", and finally, "Seek out strategic acquisitions."

OTL: *Could you give us an example of using those elements?*

JD: PDI was actually a perfect case. The company is the largest independent designer and manufacturer of mission-critical power distribution equipment. We knew we had a great management team – we kept all of them – but in order to take the company to the next level we added six new key members. Also, outsourcing components of our manufacturing to China was critical to maintain and improve our margins, so we helped the team execute on that.

OTL: *How about leveraging the Internet?*

JD: We have a few operating partners at Bertram who help us drive tech innovation. With their help PDI expanded its product line from three to seventeen during the four years of our ownership, and management filed twenty-one patents to protect the new markets they opened up.

OTL: *How about distribution?*

JD: There we tripled our sales force and focused on international revenues which accounted for a large share of the top-line growth over the last few years.

OTL: *And acquisitions?*

JD: We acquired two companies after our initial investment in PDI. One acquisition enabled us to vertically integrate and secure a relia-

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ble and cost effective supply of certain high-demand components and commodities. We also acquired a strong competitor on the West Coast that allowed us to broaden our geographic reach.

OTL: *Back to IT. Everyone talks about on-line stuff, but hard to execute and make money.*

JD: We've really broadened our IT capabilities with our new team of three programmers and three contractors. That'll probably grow to ten overall. A good example is our Supra footwear business. We built an e-commerce platform there from scratch. Practically overnight, we added 15% to our sales through this on-line effort. So now each of our portfolio companies has an ongoing project related to IT infrastructure for cost reduction as well as revenue enhancement.

OTL: *Is there any secret to executing those projects?*

JD: The key is attacking the problem with small teams of really bright, motivated and capable people, and then giving them the latitude to execute. That's the way to create value quickly.

OTL: *What's your view of the deal financing environment?*

JD: Because our deals are on the small side, we rely on lines of credit with two major banks to help us finance the acquisitions quickly. After that, we can take our time and pursue debt financing the old-fashioned way. So far, we've had no problem finding debt financing.

OTL: *Do you avoid auctions?*

JD: Of the twenty transactions we've closed, only four have been via auctions. The rest were privately negotiated. We don't necessarily avoid auctions, but we do concentrate our time on situations where we believe we have a differentiated viewpoint.

OTL: *So many sponsors tell us they avoid them. You wonder why they're so crowded.*

JD: Our strategy is to take $5 million Ebitda and quintuple it. So what we first pay for a company is less relevant than someone who buys a $20 million firm, and in seven years it's still $20 million.

OTL: *How's deal flow? Valuations?*

JD: We've reviewed 500 companies with Ebitda between $5 and $15 million over the last year. Prices are certainly increasing, but I think that's because of strategics – not private equity – bidding up properties. We've see them pay two to three extra turns relative to what we'll pay.

OTL: *I guess that's good, though, if you're a seller.*

JD: Yes. We found that to be the case for PDI. We only engaged strategics in the sales process and received excellent bids from all of them. It was a tight range.

OTL: *Are there sectors you like more than others?*

JD: About 20% of our portfolio is in the healthcare space. Like everyone, we seek proprietary, high-margin businesses who want to be consolidators in their niches. Ideally we'd like half of the growth to come organically, with the balance derived through acquisitions.

OTL: *And of course continuing to improve margins.*

JD: But you can't quintuple Ebitda from just operating efficiencies and have a buyer believe it's sustainable. It has to be top-line growth. That's why when we talk about IT projects; they aim to grow revenues, not just save money.

OTL: *I noticed on your website a portfolio company called Author Solutions.*

JD: Yes, it's that's a business that publishes 25,000 titles a year, which is more than anyone else. We have a catalog of 135,000 titles that we're in the process of digitizing. We believe we currently have the largest collection of electronic books anywhere. Of course, that catalog becomes incredibly valuable as the world moves increasingly to an e-book environment.

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OTL: *Any other growth areas there?*

JD: Actually we have some incredibly exciting initiatives in children's e-books. I can't go into too much detail yet, but think about education. You can create video interactivity, help with spelling and vocabulary – we've already implemented a coloring tool for the tots. Our CEO Kevin Weiss is an ex-president of McAfee, so he's obviously hugely experienced in the world of technology.

OTL: *How about your health care company, Sanare?*

JD: That's a company focused on reducing costs, and improving outcomes for diabetics. It's a roll-up of three businesses, collectively $120 million in revenues and 15% operating margins. Sanare provides a variety of medications, supplies and equipment directly to OEMs and retailers as well as education, health coaching, analytics for health plans.

Again, new IT initiatives have been critical to that company's success. When we bought the business, all three units did virtually everything on spread sheets. We changed that.

OTL: *Can you get a sense of the economy by looking at your portfolio's performance?*

JD: As a matter of fact, we own a business that acts as a barometer for the global economy. It manufactures seals for shipping containers. Virtually every consumer and industrial product has its logistical roots somewhere in those containers.

OTL: *Is it forecasting any hurricanes on the horizon?*

JD: Actually the outlook is pretty good. We're expecting much better than the 1.5% GDP the Administration is calling for. I wish naysayers would just focus on strengthening the elements of the economy doing well instead of trying to save those that can't stand on their own.

***OTL:** So why is everyone else so negative?*

JD: The media loves bad news. There are certainly plenty of excuses for bad performance – hurricanes, budget battles, you name it. But after a slow summer, when we saw some customers hit the "pause" button, we've seen a huge pick-up in orders in September.

I also think it's important to distinguish by market. For large and mega buyout funds investing in large corporates that are fully penetrated in the US, growth will be a challenge. Our focus in the lower middle market includes companies that are still immature and have large growth opportunities. They just need some help to execute on their potential. That's our specialty.

"Strategics hold the cards: when they're ready to buy, you better be ready to sell."

***OTL:** How are you telling your companies to respond strategically?*

JD: Well, for one thing we're not trimming inventories or conserving cash. We're telling our companies, "Go get more inventory, but make sure you negotiate good discounts." We're actually pretty lenient with our cash; we carry a little more working capital by design, but that's OK. Capital is cheap. The multiple that we get on those discounts and resulting incremental profitability at exit far outweighs the carrying cost of that capital during our ownership.

***OTL:** What's been your biggest surprise so far this year?*

JD: I guess it's how strategics have come on-line so aggressively. They cut expenses to the bone, and now have to add sales to generate earnings growth and meet investor expectations. The easiest option for them is to buy the sales growth by acquiring our businesses. They're being less rational than private equity! After all, they've got lots of cash and no leverage. That's a double-edged sword. Good when you're selling, bad when you're buying.

***OTL:** Is that a temporary phenomenon?*

JD: No. Strategics will drive M&A liquidity for the next ten years. They hold the cards: when they're ready to buy, you better be ready to sell. Otherwise they'll buy your competitor and muscle you around in the marketplace.

***OTL:** Of course, that doesn't mean they'll make smart acquisitions.*

JD: Correct. Look at Google. They've got the best brand, infinite capital, and the smartest people. They've gone through billions of dollars in acquisitions, thousands of ideas and internal projects, but only one – paid search – ever made money. Looks like they may have their second in Android, but the jury is still out on the profitability of giving away operating systems. Maybe that's just another loss leader to draw customers to paid search. Schmidt, Brin and Page are no dummies.

***OTL:** That must be frightening from a VC's perspective. Wonder why they can't make it work?*

JD: Well, that's the $64,000 question. It takes a lot of luck and timing, as well as smarts. But that's why we find the middle market so attractive. You can bring innovation to companies that have a strong foundation and are at an inflection point in their development. You can help the 'meat-and-potatoes' managers make great strides simply by applying some creative, but well-tested strategies. That's what our firm does, and it's working out pretty well.

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