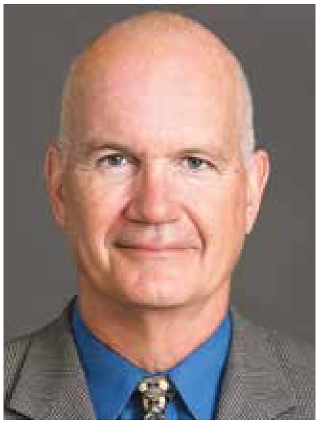
KEYNOTE INTERVIEW

Eyes on the prize





Technology deals have become intensely competitive, but there are still opportunities for operational improvement in complex situations, say CD&R's Stephen Shapiro, Russ Fradin and Jeff Hawn

The technology sector is booming as never before, driven by a need for investment that cuts across every business in every sector. We caught up with three executives in the technology services and software team at CD&R – financial partner Stephen Shapiro and operating partners Russ Fradin and Jeff Hawn – to find out where they see the most opportunity in a market with both high potential and high pricing.

Q How has CD&R's approach to tech investing evolved over time?

Stephen Shapiro: We have a long track record of investing in broader business services, and we decided to focus on technology-enabled services in 2016. We believed that technology was becoming a larger and very attractive opportunity because it was impacting every business in our portfolio.

CLAYTON, DUBILIER & RICE

Building dedicated technology coverage was a natural evolution of our strategy. We have so far made two mid to high growth investments in this sub-sector – technology consultancy Capco, which we recently exited, and insurance technology solutions business Tranzact, which we sold in 2019.

We have also invested in technology solutions integration company Sirius, which is a mature business with strong cashflow generation. We could also see opportunities in the software space, so we hired Jeff Hawn and Harsh Agarwal, a principal with significant software investing experience, to build out our platform last year.

Russ Fradin: We tend to approach technology-related investments in much the same way as we do other sectors: we look for businesses that we truly understand and where we see complexity and opportunities for operational improvement. Often these are assets or industries at inflection points where we can invest in the form of a corporate carve-out and/or partnership transaction. Tranzact is a good example here because it was a pre-eminent company in the direct-to-consumer space, but its technology needed to be invested in and strengthened. We worked with the team there to change the customer contact technology and acquired a search analytics firm. Overall, we helped make the business more effective and efficient – the company's growth rate increased from 12 percent when we bought it to 45 percent when we exited in 2019.

Jeff Hawn: As Stephen mentioned, I joined at the beginning of 2020 after having known the CD&R team for about five years. I was brought in to develop the firm's software investments from an operational standpoint. Since then, we've made an investment in Epicor, a leading global provider of industry-specific business software, and, more recently, in Cloudera, an enterprise data cloud company, which we expect to close later this year.

Q Where does ESG fit within operational improvements in technology businesses?

RF: Technology is key to the broader economy transitioning to an increased focus on ESG issues, from emissions and climate risk to data privacy and cybersecurity. However, I believe it is also vitally important at the company level, in a way that it didn't used to be even just five years ago. Today, our portfolio companies have more diverse boards, and they regularly measure diversity in their workforce. They are also measuring environmental impacts and finding ways to improve their footprints. Governance has also stepped up with an emphasis on transparency.

A lot of progress has been made, but there is still a long way to go. For example, while our portfolio companies are on track to reach our 2021 goal to have at least one woman and one person from an ethnic or racial minority on every board, that represents an interim goal, not the finish line. The diversity in our portfolio companies is not yet where we'd like it to be. We want our companies to be representative of the populations where they operate because we believe that makes for a better company. We also need to consider the societal impact of technology as part of our ESG integration – both at the firm level and portfolio company level. Technology tends to result in greater efficiency – and that's clearly positive. Yet it can also be highly disruptive and have an uneven impact on different stakeholders. We have to be cognizant of this.

Q To what extent would you say technology requires a different operational approach from other sectors?

Jeff Hawn: As operating partners, we are there to provide operational support and experience and our approach is broadly the same in technology-related investments and other sectors where we invest. We apply a player/coach model that allows management to do its job of running the company, while drawing on the experience of someone like me to help anticipate challenges and opportunities as the business grows and evolves.

Each company will have different operating needs, and I believe a supportive investor's role in operations is to focus on the fundamentals. You have to start with the basics, such as making great products and services and then move through to the detail of the value creation plan. I believe a good operating partner in any industry will help to define strategic priorities, inform human capital decisions, drive organizational effectiveness, and identify value creation initiatives.

RF: I agree – our operating model is supported by a deep roster of operating partners and advisers to our funds. I believe a strong operating partner is someone who brings deep experience in a sector gained through a successful career running major businesses in their respective sectors. However, there are particular levers we can pull in higher growth tech service and software businesses, including accelerating growth through investment in salesforce capacity and effectiveness, targeted investments to update or refresh product portfolio or development, M&A and cost discipline and margin expansion.

My experience happens to be in tech-related businesses and in direct sales, salesforce management in particular. In Sirius, a business we bought in 2019, for example, there are 300 salespeople and the business has increased productivity since we helped management identify and focus on the fastest growing sectors – healthcare and security. That is bringing real improvements to the business.

> *"Technology is key to the broader economy transitioning to an increased focus on ESG issues"*
>
> **RUSS FRADIN**

Q What would you say are the main challenges of investing in technology businesses?

JH: There is – and has always been – a war for talent in technology. I don't think that will ever go away. As a business, I believe you have to create an attractive environment in which to work and create the right opportunities for people to flourish.

SS: I agree – we see it in every portfolio company. And these companies are competing with the likes of Amazon and Google. You have to have a strong human capital strategy.

I think the other key challenge in technology investment is disruption risk. We always have to examine in detail whether there is the potential for disruption before investing – we do a lot of work on the quality of the product and keep a close eye on where venture capital money is flowing, for example, to see what's in the pipeline.

Q Technology businesses have seen multiples increase over recent times. How concerned are you about high valuations in the sector?

SS: Valuations have increased across the board, and this is especially true of technology, particularly since the pandemic started. This is partly driven by monetary policy and government intervention, which has lifted valuations in all sectors. In technology, however, I believe the higher valuations reflect the quality of growth outlook and the fact that the sector performed so well through the disruption of the pandemic. It can be challenging to make new investments when valuations are elevated, but I think it's still possible if you can be selective and prioritize the businesses where you can really add value and bring unique insights to the value creation plan.

RF: I believe it's also possible to mitigate high pricing by adopting a partnership approach, in which the seller retains a stake in the business. We did this with Capco, a subsidiary of parent FIS, a company I knew well because it bought SunGard, where I was CEO. We therefore knew that Capco's consulting focus didn't really fit well with FIS's strategy, which was centred around higher margin software.

When we struck the deal for Capco, FIS came in as partner and held on to a 40 percent stake. Under our ownership, Capco strengthened the management team so it could run as a standalone company, it broadened the scope of its consulting work, diversifying away from banking to include, for example, asset management and insurance. It also built its digital consulting from 10 percent of the business to around 40 percent when we exited. Through the holding period, Capco also made a series of acquisitions. I believe targeting under-appreciated businesses with complex transactions allows you to invest at more attractive valuations.

> *"There is – and has always been – a war for talent in technology"*
>
> **JEFF HAWN**

Q Where do you see further opportunity in the technology space over the next five to 10 years?

SS: We expect to be very active. We'll continue to target businesses where we have a specific angle, such as an intersection with other sectors we invest in. In Epicor, for example, we were able to leverage our expertise in other verticals – some of its customers were portfolio companies in our industrials vertical and so we could bring our industrials team into the due diligence to understand how customers used Epicor's system and what they got out of it.

I think there is a multi-decade opportunity to transform businesses through tech-enablement. Cloud adoption is another major theme – Bain, for example, predicts that around 80 percent of companies will be using hybrid cloud by 2030 – automation and digitization is also growing fast, accelerated by the pandemic, data and analytics will enable companies to gain competitive advantage, while security is an increasing focus area for companies as they become more digitized. ■