PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 001: HUNTING FOR VALUE IN MANUFACTURING & DISTRIBUTION

Featuring Branford Castle Partners

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

TODD KINNEY:

My name is Todd Kinney. I'm a director at BDO's private equity practice. Joining me today at BDO's Park Avenue's offices in New York City is John Castle, Managing Partner of New York City-based middle market private equity firm, Branford Castle Partners. John, thank you for joining me today.

JOHN CASTLE:

Thank you very much for having me, Todd. It's great to be here. We've had a long-time relationship with BDO. BDO's done a lot of great things with our fund and our portfolio companies, and it's always great to spend time with you.

TK: We certainly appreciate and value the relationship with Branford Castle, so thanks again. John, as you know, we're here today to discuss private equity investing in the manufacturing and distribution industry. Given that your firm invests in this industry, obviously among others, how would you describe your overall deal environment?

JC: Well, I think the old saying is, "May you live in interesting times." And I think it's fair to say that we live in interesting times. I think those who are deeply involved in the deal market these days know that valuation is quite an issue. The other day somebody said, "If you're buying a business, 10 times is the new 7 times." And that statement I think is absolutely right. There has been a significant escalation in valuations recently, and I think it's caught some people off guard.

To step back, Branford Castle is a lower middle market investor, and typically we focus on companies with about 2 to 15 million dollars in EBITDA. At that size range of company, while there are plenty of industries that we would find those heightened valuation levels, there are plenty of other industries for companies that size where you can still find great value. And that is our approach to investment. We still like to find companies where there's a value component to it.

JC: Beyond valuation, of course, as everybody knows, we have a new administration, and they, by themselves, keep things quite interesting. But if I were to speak to a few of the issues that make for a more difficult deal environment, or a better deal environment, depending on your investing perspective, of course the administration has tried to tackle some very large issues in very material ways, which creates significant amounts of uncertainty. Overhauling Obamacare in the healthcare sector, focusing on international trade and rewriting our trade deals, overhauling and rewriting our tax code are major issues for many different types of companies. And if you are the type of investor that relies on certainty to the investments that you're looking to make, you have to factor those into your equation, and you may

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decide not to move forward in certain companies that are affected by those initiatives. On the flip side, there are many speculators out there who think that they will have a proprietary view of how all of those will play out. And in those respects, you'd expect there to be certain investors to enjoy and/or love a period like this, where there's a lot going on.

TK: Well said, John.

The future of the industry looks interesting for sure, especially considering new technologies being developed, such as driverless technology. While it's still in its early stages, how do you think private equity investors and their portfolio companies can prepare for and adapt to this new technology?

JC: First of all, there have been people in the technology world that have been working on driverless cars forever. But for those of us who aren't involved in that world, I have found the rise of driverless cars to be somewhat surprising. In fact, I was thinking about this the other day. I don't think things like driverless cars were ever part of the science fiction future. If you think back to those science fiction movies, like Star Wars or Star Trek, or even shows like The Jetsons, they contemplated space pods or cars, or some derivation that flew. But there was always somebody in the cockpit, so to speak. Driverless cars, I don't think I've ever seen a program, a movie, or a television show that ever had that element to it. So, for some of us, I think that this, as I said earlier, this has somewhat come out of nowhere. And this is not something that I think a lot of us sort of thought would happen in the future, but here we are.

Just to be smart on the issue, I have taken rides in a couple of Teslas that have semi-autonomous features to them, and you can actually do that here in the New York area if you want to. And I have found the experience to be quite interesting, quite eye-opening.

I think if the technology industry can figure out all of the kinks in the technology, I think it could be quite interesting for consumers and for users to adopt the technology. But I do think that they have a long way to go to make things fully autonomous. And, in fact, I think my current view of the future would be that it would take a very long time for consumers to adapt to a purely autonomous world. I think that, for the next few decades at least, most of these cars will likely have a dual option, where a driver can flip it in to driverless mode when they want to, and then flip it back into a mode where they got to take the wheel. And I think there's a lot of applications for when they would want to do that.

But as a private equity investor, you have to at least nod that this is coming down the pipe. You have to position yourself to acknowledge a potential future reality. But, as of right now, from what I've seen, I don't think people have to be too alarmed by the driverless future. We do think there's a long, long tail to people being behind the wheel.

TK: Sure. Absolutely. Well, given that there's so much competition out there vying for assets in this high valuation environment, what can private equity firms do to differentiate themselves?

JC: Well, in Branford's case, we have a very long track record. If you take the number of deals that our professionals have been involved in, we've completed hundreds of transactions in a wide range of industries, so we think of ourselves as being a very reliable partner. In addition to that, we love to work with managers post-transaction. Two of our last three portfolio company CEOs have made between 30 to 45 times their rollover invested capital. Someone once joked that we should want to sell the business to ourselves so we can get that sort of upside. But, from our standpoint, we try to champion our professionalism, our longevity, the number of deals we've closed, and the fact that we work well with teams moving forward.

That having been said, in a high valuation environment, you have a few things that you can consider in terms of your approach. Number one, you can pay a higher price for the businesses and do the best you can to improve the company in various ways, and maybe you get the return. So that's the first thing. The second thing is, some people may decide to sit on the sidelines during this period, and I think that that is a perfectly reasonable approach. And then, the third thing, the approach that we've decided to take is to continue to look for new and innovative investment hypotheses in places where the crowd is not headed. We spent a good deal of this year thinking through those types of new hypotheses, and we have a number of them. We've got at least, at this early stage, a number of businesses that we're looking at quite closely that fit those new hypotheses.

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TK: Very good. Well, I think the BDO family knows and highly respects the Branford Castle brand, but what would you say separates your firm from the crowd?

JC: Some of the things that I may have mentioned. In the lower middle market, there's a number of investors that have gotten into the market recently. Again, we've been here for 30 years. In addition to our activities, Branford Castle is somewhat loosely affiliated with a larger market buyout firm by the name of Castle Harlan. They've also been around for 30 years. When you combine the expertise for those two organizations, you're really talking about a lower mid-market and mid-market powerhouse in terms of the best practices that it can bring to the businesses that it invests in.

TK: Fantastic. Well, thank you for your insights today, John. It's been a pleasure chatting with you.

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