Buyouts

By: Kirk Falconer
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NEWS & ANALYSIS

Carl Thoma: 'People are still in denial'

One of the founding fathers of private equity talks about his 50 years in the industry, software's resilience and why returns will invariably decline.

Carl Thoma is one of private equity's founding fathers. He was present at the industry's birth in the 1970s, taking his first job at First Chicago Equity Group. In 1980, he joined Stanley Golder in forming buyout shop Golder Thoma, the predecessor of GTCR.

Thoma is recognized as a pioneer of buy-and-build investing, a strategy that decades later is part of the toolkit of almost every PE firm. In 2008, he and Orlando Bravo married that approach with software buyouts in the launch of Thoma Bravo and helped grow the brand to become one of the market's largest.

Last year, Thoma Bravo secured more than $32.4 billion in fresh capital, including $24.3 billion for a 15th flagship vehicle.

In a rare interview, Thoma shared with Buyouts thoughts about his nearly 50-year career along with some pearls of wisdom about private equity then and now.

What in your view explains Thoma Bravo's rapid growth?

We ran Golder Thoma and GTCR as what I call a federation. You had half a dozen senior partners making their own investments and at year's end you tallied up the results and that was the firm's return. Fortunately, it was pretty good, so no complaints. Then when Orlando evolved into leadership of Thoma Bravo, we really had to be one firm, one focus, and not half a dozen people each doing their own thing.

Carl Thoma

If you get larger, you've got to create scale. You can't scale if you run a federation, but you can scale if you run a firm that focuses on turnover, culture, strategy, consistency and how you go about making investment decisions.

Software took an economic hit. Can it rebound?

Yes. Will people make as much money investing in software in the next 20 years as they have in the last 20? Probably not. But the same question can be asked of investing in real estate or the stock market.

Part of the secret sauce of software is it drives productivity and allows people to do things more efficiently and effectively. Software is like salt. It's a necessary ingredient to live. I don't think any of us could have ever predicted what technology – from chips to software to the internet – could do, hopefully, to make the world a better place and, for sure, a more productive world.

GPs have recently accelerated investing and fundraising. Are they now changing course?

Yes, but it's all relative to degree. Does it take 18 months to invest the fund instead of 12? Is the next fund going to be as big as the last one? I'm always cautious, so I guess I would say we might be at a peak. But that's easy to say when the stock market is down and we're getting ready to go into a recession.

Inflation and interest rates are higher than they used to be and beyond our control. To the extent you're using leverage, you have less free cashflow to invest in acquisitions and pay back debt. All these things will probably lead to a tempered pace, but maybe not as slow a pace as you might think.

Thoma Bravo is buying companies that are creating leading positions and have technology that's needed by a lot of customers. We've got some businesses growing 30-40 percent in the last quarter. Even though the economy is slowing down, their product is so critical to customers, they've got to have it.

Buyouts

Has the GP's role evolved since private equity's early days?

You have to be a smarter investor today. We jokingly said in the past, if you had money, that was the competitive advantage. Now everybody seems to have money.

If 10 people want to buy something, it's going to bring a higher price than if only two people want to buy it. Prices or valuations are starting to impact private equity's overall returns. There is no way around it because there are billions of dollars coming into our industry. Returns are going to trend down over time. That's just the law of economics, there's nothing we can do about it.

If people were making 25 percent a year on their money, maybe they're going to be making half that. But if the stock market is making five or six percent, it still looks pretty good.

For an old timer, it's hard to realize that you've just got to tolerate lower returns. One thing that gives us a little bit of a cushion is that the vast dollars globally are still in public equity and not private equity. So, we've still got that wind at our back.

Will GPs have to work harder to generate returns?

The reason we're entering into lower rates of return is instead of buying something at 14x earnings and selling it at 20x, you may now buy it at 13x or 14x, but you're probably going to sell it at 16x or 17x, not 20x. You're just going to see a moderation on how much value you can create, how fast.

I think we're going to see less windfalls. We won't work any harder because we're already working as hard as we can. We just won't get, as the expression goes, as many bluebirds flying in. But I was probably saying that 40 years ago too.

Along with challenges, will there be opportunities in 2023?

A little bit, but not as much as you might think because people are still in denial, they're still thinking their stocks will bounce back. As a seller, your feeling right now is, "My company is still growing, valuations are down, I don't really need the money, so I'm just going to kind of ride out the storm."

It's going to have to get worse before we see any real bargains. Or time is going to have to run to when somebody finally says the incremental return we get for holding this asset has dropped down to the point that maybe we should just take a lower price and recycle the money. But we're not there yet. I don't know whether that's six months from now or a year.

I think we're going to muddle through this. We may be going into a slower paced stock market, which is not the end of the world. It just puts a bigger premium on "don't overpay too much and make sure your companies are best-in-class."

How has buy-and-build investing developed over time?

It really started with us just sitting around saying, "How could we create more value for our investors?" And we kept seeing these opportunities in fragmented sectors.

We saw we could generate more profits in companies by getting the benefits of tuck-in acquisitions. It was just a great niche. You had leverage, you had sector knowledge, you had incrementally strong margins. We kept doing it because it kept working. We made a lot of money in cable television, in cellular, in bringing hospitals together.

Many sectors are now so consolidated that that opportunity no longer exists. You can't buy cable television companies now. There's nobody left to buy in cellular. I guess eventually that might happen in software, but I don't know whether that's 10 years from now or 30.

Initially, we didn't talk as much about operations. But now operational improvements are pretty critical because you've got to get that extra cashflow by running an efficient, growing business.

Buy-and-build started out as a mid-market function. Then we discovered the approach that works so effectively in the mid-market works in a larger market. But if you get deeper into the details, there are more synergies in a mid-market company than you can get in a larger company. Nowadays, when you look at the large software businesses we're buying, operational improvements play a bigger role than the synergies of acquisitions.

What was most rewarding about your 50 years in private equity?

I think for everybody that's successful in private equity, what gets them up in the morning is helping to build and grow companies, going to board meetings, and seeing people working hard and achieving results. It's not like the stock market, where you get up every morning to see whether your stock has gone up or down.

When I started out in the 1970s, with just a handful of people in private equity, we had what I call an investor mindset. We were going to buy this company, leverage it, maybe improve operations some and then sell it. Over time, our industry has evolved and now we're really owners, which takes on additional responsibilities. The buck stops with us. We can't sell our position if the company is not doing well, we have to fix it.

The key to private equity's phenomenal growth is that it has accumulated a number of participants who think like an owner. And when you think like an owner, you have a lot of pride in the company's products, the culture they're creating, their growth rate and the efficiency with which they do things.

Return on investments is like a sporting event, it's a way to keep score. But you don't play to keep score, you play to win. The secret of private equity is that sense of pride and ownership.

Orlando Bravo identifies you as a mentor. Who were yours?

There's no question Stan Golder was my mentor. It could also be somebody like Peter Brooke (founder of TA Associates and Advent International) or somebody like John Vogelstein (ex-president of Warburg Pincus). It can be peers like that who just show you respect.

The key to building capabilities in our industry is to ensure you don't destroy the person's investment ego or pride. You've got to coach them and mentor them to know they're going to make mistakes. But when they make mistakes, they learn from it. And Stan was just brilliant at that. That's what I tried to do with Orlando.

Nobody's going to be very successful in private equity if they don't make some mistakes. You ultimately have to have confidence to do investments. But you can't get gun shy. You can't be a great guard if you never shoot the basket, but no guard is going to hit 100 percent. You've got to learn to make calculated risks and focus on the easy shots, not the nearly impossible shots.