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Executive Perspective®

Unique Viewpoints from Industry Leaders

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Editor's Note: *Dun serves as the President and Chief Operating Officer of Columbia Partners, where he is responsible for day-to-day operations and the strategic growth of the firm. He also serves on the Management Committee and Executive Committee for Columbia Partners. With over 28 years of experience in the capital markets and in operating businesses, Dun has extensive experience in the banking, financial services, and operations industries. Dun began his career in the Foreign Service, served as an M&A banker and then as Chief Financial Officer for several significant IT companies, including one that he helped fund and grow from start-up to $100 million in revenues. He also served as a Corporate Vice President in charge of investor relations for a multi-billion dollar company. Dun holds a Bachelors of Arts degree in economics and German Literature from Lehigh University and a Masters of Business Administration from The Wharton School of the University of Pennsylvania.*

You have quite the history in the IT industry. Can you walk us through your early career and speak to how it informs your leadership role at Columbia Partners?

Leadership, when herding cats is more appropriate, is probably not the right phrase to use!

My interest came more from the financing side of the IT business. I identified, way back, having come out of the investment banking business in the early days of the leveraged buyout business, a company in Washington that was an orphan subsidiary. I went to the CEO and we tried to figure out how we could buy it from Honeywell, the parent. This was the government segment – the last vestige of the Honeywell computer business that they were unable to sell to the buyer of the commercial business, Groupe Bull, because of Bull's French ownership. We wanted to buy it as a standalone since it was highly profitable with tremendous cash flow. The cash flow resulted from the decline of the old mainframe business which – as it declined – threw off prodigius cash. So my interest was not so much technology but cash flow, and I thought this was a great candidate for a leveraged buyout if a reasonable price could be struck.

Our approach, which we had well-financed, prompted Honeywell to create a complicated structure that has been used subsequently by owners of defense and intel businesses, called a proxy arrangement, to allow Bull to buy the business. It was basically a trust, in which the national security asset was governed by a proxy agreement, with a number of luminary US directors on the board who were responsible fiduciaries for the French parent. So I ended up running that with the CEO; I was CFO.

The transaction was effectively a leveraged buyout, unfortunately not controlled by the CEO and me, but rather by Bull. We ended up arranging a massive term loan to do this from one of the local banks. It was the largest loan they had ever done, a $75 million loan, and it was the most profitable piece of business they had ever done. We paid it off within 18 months because the cash flow was so strong. It was a terrific business.

"The company was basically financed with commercial paper – on top of a rapidly changing technology cycle."

Unfortunately, we didn't own it! Ultimately, the challenge was figuring out how to replace declining hardware sales with services revenues fast enough, but as you could imagine, with a very asset-rich balance sheet and declining asset base, the cash generation was enormous. At the same time, we also had very lucrative service contracts, or managing software licensing fees, coming off these mainframes. It was a terrific business.

This is an age-old story in technology – everybody knows the life cycle. Wang Laboratories ended up acquiring the business in 1995, after Wang had gone through its own restructuring. Wang was a similar story but operating in hyperspace because of the enormous financial leverage – the company was basically financed with commercial paper – on top of a rapidly changing technology cycle. They had declared bankruptcy and wiped out the shareholders. None of the bondholders or commercial paper holders lost any money in that transaction; the shareholders bore the entire brunt.

Joe Tucci was Chairman and CEO and he had the same challenge as its hardware base ran off. There were huge contracts with the software licensing going forward and enormous cash flow, so the struggle was continually trying to find, "How do you back fill with declining revenues?" Through hard work, acquisition and a variety of deals, Joe did an excellent job building a software business and a pretty substantial services business, which was ultimately sold at substantial returns to the investors. Interestingly, Joe was very aggressive in capitalizing on a number of the 2,000-plus patents that Dr. Wang had had created within Wang Laboratories.

I started at the tail end of the mainframe business. It was really beginning to run off, and I think everybody is saying the same thing. Unisys certainly did. All the other big players in the business were seeing their revenue bases decline but the cash flows increase as the assets came on the balance sheet. So they were great cash generators, but at the end of the day, it became extremely hard to replace those very lucrative revenues with new revenues at anything even close to the same margins. That was sort of the late 90s when the world started catching on to the internet.

There were lots of opportunities to work for people who were doing rollups and strategic value creator strategies around the internet space. I worked for this company called Vista and we did a number of things there. Ultimately, it didn't work out for me and I don't think it worked out for GTCR either, but I think that leads to the lesson that you have to be in complete sync with your operating partner. I think that was the challenge at Vista; the CEO and I did not see eye to eye on the nature of things we should be buying, number one. Number two is the importance of integrating each of the units into a coherent whole. There were several really successful companies. Many rollups were not successful, of course – and the era certainly gave consolidation stories a bad name!

"Success in running IT businesses is highly dependent on operating philosophy."

Success in running IT businesses – particularly ones that involve expansion through acquisition – is highly dependent on operating philosophy; it's critical to make sure that everybody is totally aligned and that everybody you bring into the fold via an acquisition is totally aligned as well.

After the internet bubble popped, the landscape facing Columbia Partners was dramatically different. What was it like in 2002 when you started?

I put the two founders together in 1995. They started the business, and I knew these guys very well. One was running a fixed income business at one of the local banks, and the other was running the equity side at another one of the local banks. The equity guy had been the pension fund manager I picked to run our pension at HSFI, which was the old Honeywell Federal Systems business. He was a terrific guy. He made a lot of money for us and was a close personal friend over the years. He asked me in 2002 to come in because the investment management landscape had been decimated by the aftermath of the internet bubble and the complete collapse of valuations. Cisco went from a peak P/E of 229x in 2000 to a still generous 42x a year later. It trades at 21x today. Lots of managers who had done well in the runup did not fare so well in the collapse in pricing.

One of my challenges was assessing the internet portfolio of an insurance company which we oversaw for a client. They had made a couple of investments which had created extraordinary value – and we had to figure out how to capitalize on as much of it as we could. It was another interesting IT connection. The investment management challenge was pretty clear – anybody that was growth-oriented, equity management, had suffered dramatically in that 2001-2002 period. So the job coming in to Columbia Partners was just to help stabilize the asset management side and then grow.

"We are largely growth capital-focused."

One of the ways we started to grow was to expand beyond our traditional long-only stocks and bonds business by entering the private capital business. We were fortunate to identify a great team of experienced investors whom we brought in to make significant commitments to late-stage venture-backed companies. It's equity investing but by structuring it as senior debt – with warrants attached – we take a senior position in the capital structure so that in the event we need to, we can control the restructuring of the company. Ideally, the companies grow, get EBITDA positive and either refinance at lower rates to take us out, get sold or go public.

We just had a company in the portfolio go public at a very nice valuation and they will refinance us out, and we now have publicly traded position in this successful business. And of course, sometimes we do end up taking control – even then, that has worked well for us as we exert control and find a solution to capture value.

IT is one of the areas we're focused on. We've got a few other technology-related businesses, and we've done some things in the media and telecom space as well, only because that's in the expertise of the people we have.

The industry in the last few years is the complete opposite of a smoking ruin. But now, as expectations for interest rates come up, we see volatility. How do you continue to evolve Columbia Partners and the changing conditions?

Certainly, the underlying business has changed. Attractive IT investments are different today than they were just a few years ago. We are largely growth capital-focused. And we really look for opportunities where the investable company is doing something that will allow customers to improve, simplify, and accelerate the ways in which they pursue their businesses.

Certainly, hardware seems much less important in our own investing. Product strikes us extremely risky; since the capital required to keep the product fresh is daunting, the competition is relentless and the life cycles seem short. You really have to have some kind of differentiating service offering if you possibly can, and a service or software offering that enables people to change the way they do business. If it's a revolutionary product that allows people to streamline their operations or do something much more cost effectively than they were before, that becomes a very attractive, sticky kind of offering.

"Research shows that smaller funds generate higher returns."

We have also created a fund of funds to offer our institutional clients a way to participate in the private equity space. We have fully invested our first fund – making commitments to 30 underlying funds – spread across Venture, Growth Equity, Buyout and Mezzanine. We have focused on smaller funds in each category since the research shows that smaller funds generate higher returns. We are very pleased with performance of the fund – and we are now launched on raising Fund II. There is a heavy information technology focus in a number of our underlying fund investments.

How does changing cost of debt alter your calculations?

I don't think it affects us or our companies much because we are essentially equity investors – our direct investing is a substitute for venture capital. In return for a higher place in the capital structure, we are willing to reduce our targeted runs to well below what the equity community seeks. What has affected us, interestingly, been the large number of entrants into the lending marketplace. There's so much capital available, and many more competitors for good deals are willing to invest/lend at pricing, which is sometimes astoundingly aggressive.

How do you respond to the competition and differentiate yourself?

At the end of the day, of course, the price and structure of the capital is important. If the price differential is significant, we are just not going to compete. We have business targets we are trying to meet for investors. We respond to the market but try not to completely cave into it. So that's a challenge. But it's a matter of trying to get there first and trying to differentiate. A big differentiator for us is that we are patient capital, and we can prove it. We're not the first ones to pull the trigger to cause companies to go into restructuring mode, and we've got a record of working with our underlying investments to make sure they're successful over time.

"If you want to have a diversified portfolio, you need to be participating in the private equity markets."

Everybody says that, but fortunately, we can actually point to it. There's so much capital available that's pushing pricing down across the board for lenders/investors.

It will be interesting to see the impact on the underlying funds in our funds-to-funds investing. I don't think there is any consensus yet on how the traditional private equity funds are going to react to the fact that tax rates are down, reducing the attractiveness of debt and the capital structure. At the same time, we've got rates going up, so that will also bear watching.

Another critical development in the capital markets is the fact that the public markets are being hollowed out. We make a strong argument to new investors that the reason they should place some capital with us is because increasingly, if they want to have diversified portfolios, they have to be participating in the private capital markets. The Wilshire 5000 Index, which was created by Wilshire Associates in the mid-80s, was the largest publicly traded companies for which there was an active public market, and that is now down to 3,492 companies. So the capital markets, public capital markets, are increasingly focused on a more and more limited number of investment opportunities.

If you want to have a diversified portfolio and you are an institutional or large investor, you really need to be participating pretty heavily in the so-called alternative markets, the private equity markets.

Looking at the rest of 2018 and moving forward, in terms of your investment priorities, pure product is more problematic these days. What are the types of companies you are looking for (I.e. recurring revenue, cloud)? Do you have other metrics?

All of those are good. You certainly have to be aware. Increasingly, people don't want to own stuff; they want to rent it. In our own business, we own less and less, and are more and more reliant on people who can provide us access to the service on a recurring basis. So those are important characteristics.

The other one is that we look at the people we're about to invest in. Are they doing something which is going to change the way people do business? Is it nice to have or something that customers really have to have because it fundamentally frees them up to do other things with their time and their capital? I think those are very important criteria. We have several investments like that.

"We look at the people we're about to invest in."

What's a piece of advice someone gave you in your past that you'd like to pass along?

Before entering a deal or a business arrangement, make sure all the parties are clear about who brings what and what each side expects from the other. And then develop a clear operating plan with well-defined – and agreed-upon – metrics. Then execute and adjust as required. Seems pretty simple, but sadly, having learned the lesson several times, it is really important!