MILKEN INSTITUTE

CONVERSATIONS WITH MIKE MILKEN

Orlando Bravo

Co-founder and Managing Partner, Thoma Bravo

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Mike Milken: I'd like to start with the concept that, in many ways, we're all going to be judged for what we did during this pandemic to meet the needs of our citizens and fellow workers, but also those most in need. Talk to us for a few minutes about your family's response to the thousands of employees of the companies that you've invested in and how you saw this play out in society.

Orlando Bravo: Thank you, Mike so much for having me. I really, really appreciate it. It's a very, very complicated time. And this affects people very differently. I told the team, we will not judge anyone because we had some colleagues that wanted to get back to the office, and we had other colleagues that thought that engaging in any way was such risky behavior.

From the standpoint of society, you get to some point in your life when you realize that if you're not doing something, nobody else is, about a given problem or something that touches you personally. And with that, one of the things that we did at Thoma Bravo is we given the fact that we're in software and technology and our office is in San Francisco, we were one of the first to fund getting internet access and tablets in the hands of public-school students for a whole host of reasons, not only the pandemic, but also how those students can learn in the future through summer programs so they're not lost in the system. And that was pretty inspirational, especially for our younger colleagues who saw immediately react to this.

This interview has been lightly edited for clarity and readability.

And from a business standpoint, what do we do with employees? Is this a very interesting thing because no crisis is the same. And of course we had no idea that something like this could happen and we needed to cut costs very quickly at our companies because our philosophy is, in times of crisis it is better to be overly conservative than overly optimistic. So that's kind of Rule One. And Rule Two is in times of crisis, you have to be very hands on. So we realized that it was appropriate to cut costs. But see, we didn't do it by laying off people because we thought in this environment, it was too unfair for employees to be looking for work elsewhere where nobody could take an interview. It wasn't like the financial crisis where talented people could go out with some training and go on and fulfill their careers. So we had to do things a bit differently, and this is really still ongoing and we're learning through it.

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Before COVID-19 hit, we saw that more than 50% of people under 30 felt that may be socialism or communism might be a better system. And we can imagine how they might be feeling today. We saw that only about a quarter of people in America under 30 felt their life was going to be better than their parents. And so, there are a lot of challenges. And this year, the dual crisis of the COVID-19 pandemic and issues of injustice and inequality, how have you seen the potential for the financial community to better connect and better tell their story? Or how the free enterprise system can do a better job meeting those needs?

With the free enterprise system and the financial community and the private equity community that we're all part of, we're not doing a very good job. One of the things that has happened, and I'm involved in the Brown [University] Economics Research Center, is every a hundred years or so, some group of academics and politicians come together and they decide that the previous system, neoclassical system, is not good anymore, and we need a different system because it may have created a whole host of problems. And sure, there are some problems that exist that are not being solved by the current system; externalities related to the environment and other issues of inequality that will be addressed and should be addressed.

In Venice in the 1300s, there was a group of merchants, of entrepreneurs that decided that they could contribute in terms of moving merchandise for the feudal lords. And they would take a cut of the profits. If you move the merchandise, you received a big cut of the profits. And if you didn't, you would have a loss. And they started creating a lot of wealth. Doesn't it sound like private equity? Doesn't it sound like financial services, where if you move capital, where you do things, you can start creating wealth. Until there were becoming too wealthy and too powerful and being threatening to the incumbency, which was their own political system and their own feudal system. And they removed them and Venice stopped progressing. And now it's a beautiful place to go, but it's not the free enterprise system that we live in.

So one thing is really explaining what we do and what our industry's about and how it increases the standards of living by moving capital quicker, by chasing innovation, by taking risk, by being entrepreneurs. Three people in an office can do just great games in our system. But the other thing is leading by example. When you get to a certain point, you're going to be watched very carefully, and what you do has a big influence in how so many other young people behave. That is an individual sense of responsibility.

So Orlando, ancient companies and the world that you've been in, in software primarily have benefited. And other industries, cruise ships, airlines, hotels and restaurants have struggled. We have more and more people say we're going to have a K recovery. For some companies, the wind is to your back. And for some companies, the wind is blowing very strongly. I know your partner, Carl Toma was both a partner for you and a mentor, but how did you choose going into the software industry and the areas of your firm has specialized in? And how do you see the recovery affecting the businesses that you've invested in, and how do you see if you're going to change your approach? How has COVID-19 affected your thinking today?

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Two parts to that question. I got into it by first doing a lot of bad deals. I was given a lot of responsibility and authority at the beginning by Carl and I did three bad deals back-to-back and I almost was about to get fired. And he gave me another chance. We started looking at software companies and the, the pitch was simple. You can buy recurring revenues in software in the year 2000 cheaper than you could in almost any other recurring revenue category: media, cable, outdoor advertising, you name it. And while the companies were not making any money at the time, it's not as different as it is from today. We thought that we could hire operators and with 90% gross margins, we can have great cashflow businesses. But see the thing was in software. That's very relevant today. I remember the first deal we did. It was a software company that sold to small, mid market distributors, distributors of tile and electrical equipment, all kinds of districts that have about 5,000 customers.

Why would anybody invest in a distributor that has 3% EBITDA margins, highly competitive businesses when you can buy the software company that runs all their business warehouse and logistics, customer entry has recurring revenues and has 90% gross margins? Why would anybody do that? So, as we went along, we were able to build, build this business and continue specializing.

When the pandemic happened, it was about the third shock that we have seen software endure. On the first two ones, the recurring revenue stood tall and did very well; the businesses were very resilient. There were a lot of hedge fund blogs out there saying software is going to get destroyed. This SAS revenue with new, the recurring revenue is not as resilient as people think. People can turn it off very quickly. And, this is going to be a problem. We were nervous, but that did not make sense to us either. When you're so embedded in your customer's business, software has become their business. You cannot transact, analyze information, communicate, market to your customers without these core pieces of technology. And guess what happened? Our recurring revenue stream was really nearly untouched in the pandemic. Corporate customers paid their subscription software revenue, but they didn't pay rent. It was more stable than real estate.

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It's very interesting because there's something a lot deeper that's going on in the industry that partly explains the potential overvaluation of the whole space. For the first 30 years in software, the whole solutions that were being produced by these vendors were really targeted at improving the cost of materials, the cost of goods sold, improving that supply-chain process. When SAS and cloud computing really started, most of the solutions being provided by the new companies were to solve operational expense problems of businesses. These are 20 times as large, at least as their cost of materials. That's where the expensive labor is. That's where the complicated processes are. So, the industry is multiplying in size and at the same time becoming more embedded in the customer base.

Now, as to companies that trade for 50 times revenue, those are very difficult to understand and stand behind, but we do not think that the current valuation environment is anywhere near what it was during the dot-com bubble.

We've seen software companies go public this year. As a private investor, how do you see yourself investing with the public market willing to pay substantial multiples today for recurring revenue and software?

It's a difficult problem. Now we've been there before. And a lot of the stories that I said is the public markets realizing that and paying handsomely for it. There are two things though that have always remained the same in software since we started doing it 20 years ago. The first one is valuation inefficiencies; this space is characterized by gross over evaluations when companies are beating their quarterly estimates on revenue. And when they miss, even when they miss by very little, since they don't have any fundamental earnings to support any value, they crash. We have bought many businesses at times where their peak market cap was $20 billion, we bought them for a billion. There was a company the peak market cap was $17 billion, bought it for $700 million. I'm not saying we bought those companies cheap, but I'm saying there was something wrong in the values of it.

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So that's one piece. And we're not an index buyer. So all we need to do is three to four significant deals a year to continue our pace in a universe of tens of thousands of companies that continue to multiply based on the new solutions and the new capital that goes into the business.

But the second thing that has remained the same in software over all this time is operational inefficiency. When we started 20 years ago, the average EBITDA margin of a software company publicly traded was negative 5%. Today, the average margin of a SAS software company that's public – that's a trillion dollar market cap environment – is negative 3%. There has been no improvement in that over time, and therefore that provides an opportunity for private equity really to add shareholder value.

So, this year, we see the stock market going down 30% to 40% in a very short period of time, and then in another relatively short period of time, going to new highs, do your children ask you, 'Hey dad, what are you doing for a living? And what's happening in these financial markets?'

They do, you know, of course they laugh at me. They don't take me seriously; they do all that kind of stuff. So they keep me really grounded. And how I explained it to them what I do is … I always say it's very difficult to be good at more than one or two things. We know how to identify software companies that are really innovative, that are the true innovators. We're good at seeing that. And secondly, we're really good at running these companies in partnership with people. So, a lot of my conversations that they hear me on the phone with a colleague or with a CEO is all about operations. That's where I spend most of my time, and so does our team, versus in the financial markets doing more rapid transactions.

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So Orlando, I just want to give you a quote that was a while ago: 'I would have rather played at Wimbledon than become a successful financer investor.' Do you still feel that way today?

I definitely do. I was in a meeting with these great potential LP of ours, and there were three people on the call and towards the end, one of them said, can I ask you a personal question? I said, yeah, go ahead. And they asked me exactly that, and it took me one second to answer. I said, it's not even close. And I think he asked me, would you rather have won Wimbledon? I'm like, I would have rather just stepped on the court in Wimbledon than do all this. Now that's hard. This is easy compared to that.

So Orlando, I know you responded substantially when the hurricane hit your home of Puerto Rico and the devastation that occurred. When you go back to Puerto Rico today, and you see your enormous success and what's occurred over the past few decades, what do you tell your friends or people you knew that never left Puerto Rico or never took that trip that you did to Brown and Stanford and to building one of the great firms in the history of the investment market? What's the interaction with those individuals?

I've been really blessed and nothing has changed; our friendship is exactly the same. We talk about the same things, and they're as casual as they were, which I really, really appreciate. After the hurricane in Puerto Rico – about a day and a half after – that was my personal moment in philanthropy where I understood at that point for the first time, that if I didn't do anything about it, nobody else was going to. And that's where your organization is inspiring to me; when I understood it better, listening to the personal stories and how people got involved in the dramatic research and outcomes that have been produced, just because people did it. And I didn't think about philanthropy that way before. And then the specific one was my brother in Puerto Rico had their friend, a reporter, the day right after the hurricane. And that reporter was running through the island, calling him whenever there was a signal, to let him know what communities were really in trouble and why.

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And he got this call late at night saying that there was a community right next to the place I grew up in. It's called Lares; I grew up in [nearby] Maraguez. There was a shelter at 50 people that have two-day supply of food and water. That was it for me. I knew that nobody was going to go there. I know the central government of Puerto Rico was not going to go there. I knew it. I know the island really well. I know how things work. So, we have the resources and there was no nonprofit organization that I could call to try to help on that. So, we just went. We told them, tell the reporter we'll be there tomorrow. And we were able to actually go and make it. And there were no problems with the roads; you can make it. It was difficult. But it was the need for somebody that can actually do something about it.

Orlando, thank you for the call to action. I appreciate you joining us today. All the best and good health to you.

Thank you, Mike so much for having me.