INTEROFFICE MEMORANDUM

TO: DEVIN MATHEWS, PARKER GALE

FROM: JOHN P. MCCARTHY

SUBJECT: TWENTY GOOD QUESTIONS

DATE: MARCH 2, 2021

CC:

---

1. **Software as a Service (SaaS) is widely considered an attractive business model. Why?**

One word -- predictability. Business-to-Business SaaS companies are often paid annually in advance for their products (creating growing Deferred Revenue accounts on the balance sheet that help deliver steady revenue in the future) and many B2B SaaS companies often sell multi-year contracts with annual price increases built in so that's pretty sweet, too! And some of the best SaaS companies generate well over 100% net customer retention (by getting existing customers to buy more stuff each year, which is usually called upselling). So, all that compounds the predictable nature of the business model making it more predictable and, therefore, valuable than companies without these characteristics. I think investors like predictability more than anything and if you have predictability and growth watch out! Add to that 80% gross margins, low capex and high EBITDA-to-Cash Flow conversion and you have a recipe for sustained premium valuations.

2. **For the type of businesses you assess, do you view software as more of a product of more of a service?**

Software is a product. The "software as a service" moniker is inaccurate. The "service" part of that really means it is hosted in the cloud and requires limited IT resources at the customer, so the customers don't have to manage/maintain/upgrade it themselves. So, software is a product for our investment purposes.

3. **You seek to better commercialize "must have" software in growing markets. Your tag line is "Products that Matter, Cultures that Last". Why do these companies tend to need this type of help?**

Our tagline really lays out everything we do at ParkerGale . . . we look for products that solve hard problems for important customers. For us, that means B2B software products that are either vertical solutions (e.g., they do something very specific for the business user in a specific industry, something that a generic solution could not do) or infrastructure solutions (e.g., they solve a specific problem for IT users across – potentially – multiple industries). We look for companies owned by aging founders, who know an industry or

technology challenge well and solved it with software. Over the years, these founders have built a product that matters, though it is probably in need of some upgrades and modernization. Most aging founders, however, aren't so good when it comes to culture. Sure, they think they have a great culture, but when you peel back the often paternalistic, one-size-fits-all approach, you see the obvious problems that are limiting their growth prospects. There is no training, little personal and professional development. Decisions are made at the top and then trickle down through the organization. Communication is either non-existent or sporadic at best. Employees don't know how what they do all day fits into the overall strategy of the business. And there is either no plan for the organization or way too many plans – neither of which is good. The team at ParkerGale is confident in our ability to fix that, and we start from day one to try to get culture right by over-communication with employees, high transparency, visibility into the company's strategy and investment goals. And when we do, that establishes a lot of good will with employees who then stay longer, are happier and more productive, and it's the right thing to do which is the most important reason we do it.

4. **Any founder characteristics you tend to seek?**

Customer-obsessed, self-aware (as in they know it's time for them to depart), and not critical to the future success of the business. Most people think that if the founder leaves the company will suffer – that might be true of companies that have concentrated revenue from a handful of customers or are more service-driven than software. We avoid those situations, and we spend a lot of time in due diligence making sure that the founder's presence and continued employment is not critical to the success of our investment.

5. **Any favorite methods for sourcing investment ideas that are productive for you?**

The best way to source a good investment is to source a great executive who knows about a good investment you should pursue together. We spend more time meeting CEO candidates than we do meeting companies because every company we buy needs a CEO and the only companies we want to own are ones where we have a great CEO to back to run it, preferably someone who knows what he/she would do with the business before we ever own it. Of course, we also do deep dives into industries, and talk to bankers all the time, and go to conferences, and cold call target companies when we think we have an angle or a deep understanding of the industry in which they compete. We have also hosted a podcast for the last eight years that has caught on with a segment of the technology company world, so we get a lot of good ideas from people who listen to that and reach out to us because they like the sound of our voices.

6. **You seek a "great product market fit". What does this mean?**

We buy companies that already have found product-market fit. We don't take risks that the software doesn't work or is still seeking an audience. What this means is that the companies we pursue already have hundreds or thousands of customers who are using the software every day. We call those customers during our due diligence to verify our investment thesis and to find out what we can do better. Having product-market-fit means that the companies probably have good margins (gross profit and operating profit margins) which tells us their customers value what they are getting. And it means that they have high (enough) customer

retention rates (meaning that they are not losing customers every year). World class gross retention for our type of company is over 90% with net retention exceeding 100%. We can buy companies with lower retention rates if we feel like there are easy ways to increase retention though better customer success processes and/or straightforward product improvements we can make during the first eighteen months of our ownership.

7. **You seek to avoid venture capital, start-up investing. Why is this?**

VC or even taking minority stakes in a company is too risky for us because of the potential volatility across a portfolio of companies. We want product-market-fit. We need the software to work and be used by lots of customers. We also don't like the valuations start-ups receive compared to what you are getting in return. We think we can buy companies at a stage where the largest (risk adjusted) percentage value increase can happen in their lifetime which is post-start-up and pre-maturity. And we think we can help move the needle in our direction during that time because of our hands-on operating approach working alongside management.

8. **You seek control investments. Ever tempted to be a minority equity investor?**

To paraphrase Jimmy Carter "I have looked at many minority deals with lust. I have invested in minority deals in my heart many times." We have learned our lesson over the past 20+ years that our approach works best when we own control – we don't have to ask permission to do the operational things that we believe create value and there is no confusion about who owns the business, when it's time to sell, who is hired and fired, all that.

9. **You seek to have a price discovery conversation early in the bid process. Why is this?**

We generally acquire companies at below prevailing market multiples (mostly because we are buying companies that need improvements). While we don't have a rule for what we pay, we don't want to waste our time with sellers who are out of sync with our thinking on valuation. Now, that is often a sensitive dance you engage in with a seller – we don't want to insult people or act like we know better than them, but we do want to gauge if we are at least in the ballpark before we start doing a lot of work and spending money on due diligence. We regularly walk away from investments because price expectations are way off, and we are ok with that because we see enough deal each year to be picky.

10. **You have said, "When you do the same thing over and over you eventually get pretty good at it." What are some of the things you tend to implement across companies?**

We focus on four areas of to have an impact – Products, Talent, Sales, and Finance. We standardize financial reporting and sales activity/pipeline reporting. We run an executive alignment program to get the Executive Leadership Team (ELT) rallied around a long-term strategy as well as the key short-term tactical initiatives. We run a middle manager training program based on Daniel Goleman's research on emotional intelligence where the top dozen middle managers in our companies collaborate through six months of training and coaching on how to lead, how to be authentic at work, how to give feedback, how to manage their own energy, how to use situational leadership, as well as other topics we find important for

managers to master in growing companies. We give employees executive coaching to help them along the way and to work on their blind spots. We have standard ways of hiring and interviewing that we teach our companies. We run product strategy review meetings twice a year at each company so that the leadership is synced up with product development team on what products and enhancements we are building and why. We often help move technology platforms to the cloud with AWS or Microsoft Azure to improve performance and scalability. Recently, we have rolled out cyber security programs to help our companies harden their networks to reduce the likelihood of network breaches or damaging hacks. We often roll-out sales training programs so that our salespeople are using data and metrics in their selling and using the latest methods for engaging with customers and prospects (such as recording calls, role-playing, demo practice).

11. Does Amazon Web Services pose a systemic risk?

Does owning companies headquartered in the United States pose a systemic risk? If so, we'll be in great company if they both crash and burn.

12. Do you worry more or less about cloud security than you did a few years ago?

Significantly, more and we are getting better at helping our companies defend themselves. I don't worry much about competitors stealing our stuff to compete with us. I worry a lot about hackers getting control of our systems and holding us up for ransom. We foil dozens of plots a week at every company we own. It's an arms race and I worry all the time that we are falling behind but we spend a lot of money and work with very smart people to avoid anything catastrophic.

13. There are 360 public companies in the USA with market cap over $1 billion and negative earnings in 2020. Does this effect what you are trying to do?

And there are probably and equal number of private VC-backed unicorns with similar dynamics. Where it gets hard for us as buyout investors is when the VCs point their money cannon at one of our end-markets because then it is really hard for us to compete on a level playing field. VCs sometimes pursue "market capture" in a large, competitive space where one of their companies enters a market a very low price (losing vast sums of money) in hopes of capturing the market and raising prices later to achieve profitability (this rarely works by the way). We look for end-markets that are big enough for us to build a company worth $100-$300 million dollars but not so big that VCs will pour vast sums of money at trying to capture market share, and, in the process, ruin profit margins. This happened in the Financial Technology market ten years ago and is happening around consumer, cyber, and in some segments of healthcare technology now.

14. It is widely perceived that there is a shortage of software engineers. Is this true?

We don't experience this at our end of the market. We make pragmatic choices about the languages, databases, platforms and tools we use inside the portfolio. You don't want to be too cutting edge because then it is very hard to find enough competent programmers to build your stuff, but you can't be too old-school because then good programmers won't want to work on your stuff. We like Python, Java, C#, .Net, SQL, NoSQL, MongoDB,

MariaDB, AWS, Azure, and lots of other stuff that is not too hot but not too cold (meaning they are well-regarded, stable languages and platforms on which to build products). That way, we can offer exciting things for engineers to work on but not risk the company with untested technology or inexperienced development teams.

15. Why don't small and growing software businesses borrow money as opposed to raising new equity?

This might actually be more common recently. Lenders are just starting to get comfortable (quite comfortable) lending against recurring revenue rather than profits or assets. But most lenders are wary of lending to smaller, family-owned software companies without meaningful profits. The underwriting risk is too hard compared to a having a PE fund who can stand behind the loan in a PE-backed software company. However, as the lending market matures, there will likely be more products that a founder can access at $5 or $10 million in ARR that would help them avoid raising equity. Ten years ago, that founder would have needed $5 or $10 million of EBITDA before a lender would consider providing debt to a business with few assets to lend against. VC-backed companies have long had access to venture debt at very high interest rates (though much lower than the cost of VC equity).

16. What type of discussions do you tend to have with founders when you want to purchase a large piece of "their baby"?

This answer could be an entire book, but I'll try to keep it brief. Our brand, and what attracts founders to us, is that we are the exit for the founder. We are his/her retirement plan, their massive liquidity event. We don't have to convince them to sell us their baby, they come to us asking for us to buy it. But we do have lots of conversations with founders about what we plan to with the business after we buy it. One thing that always comes up is "are we going to change the name?" Which the answer is "it depends." Most of our type of founders are happy to get paid well for their business and walk away to start the next chapter of their lives.

17. What characteristics do you tend to see in Founders who can also be effective managers?

We don't back founders to run their companies after we cash them out. But, if we did, one characteristic is more important than all the others – self-awareness. Do they know what they are good at and what they aren't good at and are they willing to admit it to their management team so they can help fill in the gaps?

18. Do you tend to have specific buyers in mind for your investments?

Twenty years ago, we usually sold our companies to the obvious strategic buyer who needed a new, modern, rapidly growing acquisition to fill out their product portfolio. Now, there are so many financial buyers who like our type of software companies, we generally expect to sell our companies to bigger PE funds. This is great for management because they get paid out on our exit, roll over equity into the new investment, and get re-upped on their incentive equity by the new owner. However, before we buy a company, we still have a good sense of the potential strategic buyers who would be interested if we built the company a certain way.

19. Are there any advantages or disadvantages for Parker Gale being based in Chicago?

Huge advantages in my opinion. We are outside the vortex of west coast tech babble and east coast private equity bubble. We have an abundance of smart, hungry, and humble people to hire to work at our firm. We can get anywhere in the US on a direct flight. Work-life balance is expected here, and we value that more than most firms. Chicago is still the best city in America to eat in – high, low, and everything in between. The weather – what else are you going to do for eight months a year but work? Isn't that what our LPs want?

20. What are the costs and benefits of being a world renowned, global dominator of private equity podcasting?

The costs are minimal – though we pay a lot in t-shirt production and shipping costs. The benefits are numerous – we have not only met so many amazing, smart, and nice people around the world because of it, but also, it has given our talented team a platform to show their stuff and share their ideas with likeminded investors, operators, and PE practitioners. It also makes our team better for having to articulate their beliefs and it makes other investors better by learning from what we do and adding their own spin. Our goal was to "open source" PE and software company building and I think we have accomplished that over the past eight years.