MW Executive Perspective®

Unique Viewpoints from Industry Leaders

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John Bates

Partner and Founder of Potomac Equity Partners

Editor's Note: *John Bates is the founder and partner of Potomac Equity Partners, where he is responsible for day-to-day operations and the growth of the firm. With over 25 years of investment transaction experience, John has completed $100 billion worth of transactions in a wide range of industries. Prior to founding Potomac Equity, John held numerous titles such as Partner and member of the Investment Committee of Arlington Capital Partners and Vice President in the Mergers and Acquisitions Group at Lehman Brothers. He began his career as an analyst at Price Waterhouse. John holds a BA from Princeton University and an MBA from Wharton School of Business at the University of Pennsylvania.*

What was your vision when founding Potomac?

The vision was to partner with entrepreneur owned small and middle-market companies to help them grow their companies through organic initiatives and add-on acquisitions, serving as a sounding board to management. Creating these partnerships with entrepreneurs and management teams enables us to maximize the value creation for the benefit of all shareholders, including our owner-entrepreneurs, management, and investors.

You personally have a strong history in both the M&A world and the private equity sector. How does your past reflect what Potomac is today?

I had a background in both M&A and private equity, but when we created Potomac Equity, the focus was not just on the transactional aspects of the industry, but more importantly, on value creation opportunities post-investment. Value creation initiatives like new customer introductions and add-on acquisitions can materially change the growth trajectory of companies, and their value. For example, in our typical investment partnerships with our companies, we have made numerous introductions to potential customers, which have on several occasions become significant customers for our companies. We do leverage our M&A backgrounds and deal sourcing network as well. We have sourced proprietary add-on acquisitions for our companies at attractive valuations, that we then helped our management teams to successfully execute and close.

How does your background help you evaluate investment prospects? And what do you look for in a potential investment?

Some of it comes from looking at thousands of opportunities over the years in our priority sectors - business services, education and training, healthcare, and software and technology. This experience has helped us gain insight into industry and company attributes that appeal to us as investors. Even in cases where we are more cautious, we can structure the transaction appropriately to moderate the risk post-investment and create win-win scenarios with our management partners.

For new opportunities, we like companies that expect to continue their meaningful growth patterns, that have differentiated business models vis-à-vis their competitors, and have strong management teams. We’re typically more cautious of companies that have significant customer concentration. However, in certain situations, we can be more aggressive than the typical investment firm where our strong network of potential new customers can help reduce the customer concentration.

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Are there any potential pitfalls that you detect that founders or owner-operators are not aware are red flags for investors?
Most of the companies we invest in are in the $2-15 million operating profit range initially with strong operating margins. However, while they are not necessarily blind to this, many have historically developed one or two key customers that they began with and then scaled. They think, Gee, we've known this customer and they've been with us for years -- they'll continue to be with us in perpetuity. That’s not always the case. Some owners are more reluctant to acknowledge that long-term customers can also evolve and may at some point elect for a variety of reasons to churn off. That’s something that we’ve worked hard to evaluate as we make our investments – and with business owners, sometimes there is sensitivity around acknowledging that, which we do appreciate.

What are your primary sources of capital, and how does your fundraising approach differentiate you from other private equity peers?
We have a differentiated business model versus the typical private equity firm. Our primary source of capital for our investments are family offices, some of whom we have gotten to know over a 25-year period. Some of these family offices are recognized names, while others are private investors who want to maintain their privacy and confidentiality. These family offices have partnered with us as they seek opportunities to invest in small and medium-sized entrepreneur owned businesses. In many cases, the opportunities are similar to what the families owned when they originally built their wealth. As a result, we partner with these family offices not only for their capital,

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but just as importantly, to increase the network of relationships that we can tap to assist our companies in their growth strategies.

You've been on a number of boards personally. What level of board control or influence does Potomac desire in your portfolio companies?

We like to have a majority of the board seats of a company, although we look at control of a company as a collaborative effort. For that reason, we like to have on the board of a company members of management and independent outside directors who bring different areas of expertise than we might possess, and who can further assist the company in various areas and initiatives.

Interest rates rose through 2018 but are now holding steady. How does that affect Potomac, with your light leverage model?

We are proponents of less leverage for our companies, relative to the typical capital structure of other private equity firms. And so, with that strategy, our investments are generally less exposed to interest rate fluctuations. We prefer to achieve the returns that our investors desire through helping companies accelerate revenue and operational improvements, rather than financial engineering and maximizing the debt levels at a company. Operational improvements include making customer introductions like we referenced before, implementing a more aggressive sales and marketing strategy, or investing in new solutions and creating IP for our business. Also, with the reduced leverage of our companies, they are generally less exposed to market or company-specific hiccups. Therefore, we have incremental flexibility to pursue growth initiatives and respond to adverse conditions versus more leveraged companies.

Where do you see IT valuations at this point? Have we hit a peak, or is the sky the limit?

Boy, we wish we knew the answers to that. It's hard to time the markets, and we don't think ourselves as trying to do so at all. Certainly, the markets, and companies in general, are well-valued today compared to historical trends--but we're not market timers. Our goal is to research long-term industry trends and macro themes, and then pursue companies that can specifically target and exploit these trends and macros as part of an overall investment thesis.

MRR is something of a crown jewel for services companies today. Is there still a place for companies that don't focus on MRR?

Certainly, companies that have created meaningful amounts of MRR are highly perceived in the markets. But we believe there are plenty of opportunities for us to invest in companies that don't produce meaningful MRR or are working to transition in that direction. We have invested in a variety of companies that don't have MRR and engaged with a number of companies that are working hard to make a transition to more of a subscription MRR model. That's part of what intrigues us with what we do – are there ways that we can work with these management teams to help them make business model transitions, and therefore create long-term value? And we do that through our investments and working collaboratively with management teams.

Tell us about Orion. You recently sold the IT services company, and reportedly made 8x your investment on the transaction.
We were honored to be partnered with Orion and its entrepreneur owner and management team. We are extremely pleased to achieve the returns that we collectively did for the company, management, and our investors. It was a great partnership with them.

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What initially attracted you to the business?
Orion was well positioned for growth, and they had several existing Fortune 500 customers that could become referenceable accounts for other potential customers. We liked their entrepreneur owner and management team and felt that they would be good partners with us. We also believed that we could help the company transition from an app dev and staffing company, to one more focused on data and analytics.

Did you go into the Orion investment with a master plan? Or was it more of a dynamic, responsive process?
Like any of our investments, we do go into the investment with specific goals and strategies, developed in partnership with the entrepreneur owner and management. We memorialize this into a 100-day plan, and also a longer-term strategic plan. This process enables us to make sure everyone is on the same page about the investment thesis and what direction the company is heading post-investment. It's also a good chance for the management team and owner to evaluate us as a potential partner, and for us to evaluate them as part of our due diligence. And like any good plan, that plan can and will typically evolve over the four to six-year investment period.

This process helped our success in Orion. We needed to supplement the management team, so we helped source senior members of the team; we helped the team to make investments in the sales and marketing departments and refine the go-to-market strategy; we completed numerous customer introductions at the CIO or CTO level; and completed two add-on acquisitions that we sourced, financed and helped execute. And then the company made some additional investments in IP to help materially increase its overall gross and EBITDA margins.

How do you identify the next Orion?

We're hard to work on that today. To source potential transactions, we work with a variety of third parties, including deal brokers, lawyers, accountants, and consultants for deal flow. We also like to work with operating executives, who typically come from the sectors that we are targeting and have operational expertise and their own proprietary deal flow. We will partner with these operating executives, creating a symbiotic relationship as we pursue opportunities together.

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Are there any other things that you want to talk about when you seek companies and partners?

We always emphasize to company owners that they pick the right partner, where you have an overlapping strategy and mindset, and a collaborative dialogue as you explore the transaction and investment potential. Most owners have only one opportunity to make that decision of which partner to choose. If it is us, we are humbled and honored to be that company's partner and will work hard to build the partnership together.

Is there a piece of advice that you were given early in your career that's stuck with you or influenced you that you want to pass along?

Work hard, operate with integrity, treat others as you expect to be treated. And, of course, have some fun and laughs along the way!