An Insider's Take On Ultimate Software's $11 Billion Private Equity Takeover

These days, there’s a fair amount of criticism aimed at private equity investing and the trillions of dollars that have flown into the strategy recently. It percolates when investors get scared of pricey, debt-fueled takeovers, or a company like Toys “R” Us goes bankrupt, or asset maneuvering as with Caesars and Sears, which appeared to deprive other investors.

But there are a few realities about the PE boom: Endowments, pension funds, sovereign wealth investors and even high-net-worth individuals continue adding money to the industry because it has performed well for them. This, of course, is the crux of PE pitches to limited partners and even the public shareholders that own a piece of firms like Blackstone, Apollo, Carlyle and KKR. Meanwhile, company after company, such as Whole Foods or Panera Bread, say “good riddance” to public stock markets on their way out the door. Rarely does the discussion of PE’s growing influence over financial markets go beyond obvious critiques, industry marketing tropes or self-serving excuses from management teams blaming public stockholders for their own issues.

So it was revealing when an insider at Ultimate Software recently offered up an explanation behind the wildly successful H.R.-on-the-cloud company’s sale to a private equity firm, which went well beyond tired arguments about the industry. In February, Ultimate Software was sold to Hellman & Friedman for $11 billion, or $331.50 a share. During its two-decade run on public markets, Ultimate rose 33-fold and grew into a company with well over $1 billion in annual revenues and adjusted profits of beyond $250 million. Along the way, it was generous to rank-and-file employees and most definitely C-suite executives, and successfully navigated the tumult of 2008 and subsequent growth scares. It even weathered criticisms from shareholders over executive compensation and accounting questions raised by activist short sellers.

Ultimate’s reason for going private, this insider said, wasn’t because public markets are unfriendly and broken, or that investors have become overly myopic. Though the insider did touch on some of those concerns. Simply, Ultimate decided to sell to Hellman & Friedman because it’s at the mature stage of its life as a company where it can’t report the growth that had made it a blue-chip tech stock. And yet Ultimate was hesitant to sacrifice its future growth opportunities in the spirit of amping up profits for shareholders or returning capital through dividends. For Ultimate, going private was a way to do well for shareholders and be allowed to run a business at slowing growth rates that could continue to invest and win added share of a valuable HR software economic pie.

In a town hall for Ultimate employees, the firm’s chief technology officer Adam Rogers made the argument. The speech was found in a securities filing the other day and tweeted by @LennyIce. My read on the speech is that Rogers is simply arguing there are times when it makes sense for a firm to be public or private, and that different capital structures work at different stages in a company's life cycle. Because it comes from a seller with a record of success, it holds more weight than a PE pitch deck that might make the same point. Also, private markets are now so flush with cash, take-private deals don't necessarily fit the old mold of LBOs. Thus not every deal will look like Caesars or Toys "R" Us. There's a growing stable of PE firms like Vista, Thoma Bravo, Permira, and apparently Hellman, that can tolerate growth-minded deals without tangible assets to lever up. For Ultimate, that kind of capital made all the difference.

Rather than butcher Rogers' idea, it is presented in full below:

Transcript From PDIS All Team Meeting (Excerpt) Adam Rogers February 20, 2019

There was this news that came out a couple of weeks ago that maybe made you question if our strategy had changed. I am going to tell you it has not. You've had about two weeks or so to process this. I'll tell you unequivocally, this is a good thing. It's a really good thing. It's going to allow us to continue to focus on building a business that can last.

You know we are normally, and naturally, very transparent about everything, including something like this. I need to read this part: the transaction is subject to stockholder vote and must go through the regulatory procedures. We're excited about sharing the rest of it with you as we get through this process, which will happen, probably in the next sixty days.

This might give you a little different perspective. Hypothetically, let's say you want to start a company. You have a great idea. So, you have this idea and you think people will really love it. You think people are going to buy it and it is going to make billions of dollars. What is the first thing you have to do? It's going to be to raise money. You raise money from good friends and family.

Then you look at your new checking account for your business and you say this is awesome, I'm never going to need money again. I have everything I need to start this great idea and live happily ever after. What happens next? You run out of money and you have to raise more money. No one ever thinks they are going to need more money. Almost every founder realizes they have to get more money. But that is OK. So now you have more money and more people that you owe and more people that work for you.

Then you think this could really work. People really like the stuff that we're doing and that's great. That's great. But every Friday or every other Friday that rolls around, you think, "Oh my gosh I better have enough money to pay my people". You have to pay your people, and you think this could be something people really love , but oh, my goodness. Like, I never realized how expensive it was to invest in, you know, R&D, to invest in sales and marketing. And you're like, this could really work if only you had more money.

So now you sit there and go, okay well, now what? One option, which is actually a really good option. If you're at the right phase in your company is to go public. So, what happens when you go public? IPO, initial public offering, gives you cash. All of your aunts, uncles, sisters, brothers, friends who invested in you now have public shares of your company they can track on the ticker, every single day. Everyone's happy, your employees now have stock too. You have this cash that, you know, you can use to grow, because you're probably not making money yet, but you can use that cash. It gives you a long enough runway so *you can get to the point where you can feed yourself and you can make money. That's great. And now things are good. Like, life is great. You're growing, and companies in this stage, early stages, grow thirty to forty percent of your top line revenue. So, you're growing thirty or forty percent a year and when you do that, Wall Street loves that.*

So, what they do is reward you with a high multiple, which is really just a multiple of something. So, let's just say revenue. So, if you have a million dollars in revenue, and because of your growth, they think you're ten times your revenue. You are a ten-million-dollar value and that's what your stock price reflects. Then it is two hundred million. Then you are worth a billion. And so on. So that's awesome. This is great, but then you do that for about a decade or so, and then you realize, you know, to grow thirty percent from $1M to $1.3M, I just need three hundred thousand dollars in new sales. To go from $1B to $1.3B, you need three hundred million dollars in new sales in one year. It gets really hard.

So what is happening, you see the growth starting to decline and if you can pull off fifteen or eighteen percent growth at that size, it is incredibly impressive, and completely uninteresting to Wall Street. Guess what? Now the reality of Wall Street sets in. If you're not growing at a certain rate, then Wall Street says, well, then you better be making a whole lot of money. So now you're a company and you're growing at a rate of about 15 percent, 18 percent.

Now every single dollar that I want to go spend, I have to figure out, I've got to make a decision. Do I want to spend money on R&D, sales and marketing? Or do I do what Wall Street asked me to do, which is to make more money? Where do I put that next dollar? And it's a hard thing to grapple with and it's really hard when you think about it. Well, I really believe that. Hypothetically, this company has a much longer runway to continue to grow because if you want to do that, your're a little bit stuck with this balance.

Then you say, okay, there is another option, you can go private. If you can go private, there's two things I believe that are really important. So, first, you have to find someone who has a few billion dollars lying around, which is not an easy find. And you have to buy back all your public shares. Then secondly, ideally find somebody who really believes in your culture, believes in your business and believes in you as a team, so that you can keep running your company, just run it privately.

And that's kind of where we are today. This is what we announced on February 4th. Because if you can do those two things, obviously find the money and then find it with a partner who believes in you and believes in what you can do long term. And that's ideal. That is what we announced on the 4th. We are going to work with a Private Equity firm.

I have been talking to a lot of people about this. People hear private equity, and they get really nervous, right? They are wary of private equity because, historically, private equity companies have looked for really distressed companies that were poorly run. And then they ran, a standard playbook that was basically to spend all the money in sales and take all the expense out of the company.

Maybe they didn't realize that there's a new breed of private equity out there today, called growth equity. And this is what growth equity firms believe. Growth Equity firms invest in well-run, growing businesses with proven business models and solid management teams looking to continue driving the business. They look for businesses just like ours to do this very thing. So it's exciting. It really is. This is the type of partner that we're looking for.

So now you are all getting really quiet and serious. I thought now may be the perfect time to give you a little bit of a view of what will it feel like, what does it feel like to work for a private company versus a public company? And I decided that it's been a long time since I wrote code but I know some of the terms, so I thought I'd do some engineering terms since I have a lot of the "dev" team here.

You will spot that I underlined the engineering terms. So, when you're public, you have loosely, coupled commitments to thousands of relatively anonymous shareholder. This is just how it is. When you're public, you don't really know who your investors are, you just do stuff and then they vote by buying or selling your stock and so you don't really get...it is loosely coupled. When you are private, you have names, smart reasonable investors that have skin in the game and they share the commitments that you make. It's that simple.

For the second one, <u>I/O throttling</u> of big bets/ investments to shareholders. This is kind of what I said before, which is, when you don't know who your shareholders are and you are a public company, you have to be careful what you say. You kind of throttle the information you give people as investors. And therefore, when you do something, great, they think you're a genius and when you do something wrong, they think you are an idiot, why would you do that?

Versus when you're private, there's nothing you can't say. You can tell your investors anything. Not only that, the private investors are savvy with their networks. They can help in lots of different situations with lots of different decisions and they have a ton of experience that you can lean on and rely on. So you make these big bets together. And that's a great feeling.

Round robin scheduling pressure to create value. All this says that some of my friends, or some of your friends bought at ten dollars a share and they're like, they don't care what happens. And then some of your friends, or family, might have bought at three hundred dollars. They just come in at different times, obviously, they have different views of the world. In private equity, all the investors came in at the same time and at the same price. And they have the same timeline.

High sample rate of our results. We have to do quarterly read outs, Wall Street earnings calls. I think about this one like my kids. When they were little, we would drive up to Orlando and every five minutes the question was: "Are we there yet?" Every quarter, it is twelve short weeks and they want to know what happened.

The alternative to that in a private world is long term view with increased responsibility and accountability. I want to be really, really clear. We don't get a free pass. The quarterly cadence was just sort of how public companies operate. It is true in a private world, part of the reason that you look to do something that is because if you want to make a big bet, that's, you know, twelve, eighteen, twenty-four, thirty-six months away, you have buy-in and flexibility to do that.

But guess what? When you do that, that means that without quarterly check-ins, like that, what you can typically do with wall street, it actually increases our responsibility. It makes accountability even higher, which, I mean, quite frankly, I say that so that you kind of hear it, but that's awesome. We would welcome that. Billy Jean said it best. Pressure is a privilege. You know when you're under that kind of pressure, it is because you're onto something really big and you have a really huge potential.

So, that's when the pressure is there, pressure is a privilege. So, we welcome that and we thrive on it. So that is precisely what we're up to. And I'm really excited.

https://www.forbesmiddleeast.com/an-insiders-take-on-ultimate-softwares-11-billion-private-equity-takeover