

## **PRIVATE EQUITY PROFESSIONAL DIGEST**

An Interview with John Castle

October 2011

### *1. What is the last book you read?*

I have been rereading a bunch of books. David Galula's "Counterinsurgency Warfare;" Mao Zedong, "Guerrilla Warfare;" Gary Bernstein, "Jawbreaker," which is about our attack on Afghanistan in 2003 and how the CIA took Afghanistan at the time. They are all interesting.

If our leaders read these books, it would change the way they approach war, where they go and how they do it. I have read all three books over the last decade, but I decided to reread them and it reaffirmed my view that as a nation we are misguided. If we recognized the thinking of these people, including Mao Zedong, we would have a better understanding of how to fight guerrillas and others who are dangerous to our country.

### *2. What words do you live by?*

It can be said in different ways. Matthew 7 verse 12, "Do unto others as you would have them do to you." Treat people like you want to be treated. That's my guiding philosophy in terms of what I do, and it goes beyond that. You need to be trustworthy and have integrity. All of those things are part of the equation.

### *3. What's your favorite part of the job?*

I like building companies. I like growing businesses. I feel that most companies are better after they have been with us than they were when they came to us. They employ more people and are in a position to make a stronger contribution to our global economy and their local economy. Their employees are more secure, as well. The probability of things going well for employees is greater when they work for a strong and growing company.

### *4. What would you be doing if you weren't in private equity?*

I grew up in a family where there were many businessmen. Both my grandfathers had several businesses and so did my dad. I went to MIT and studied Physics and Economics but I knew I would be in business. If I wasn't in private equity, I would own several businesses and would be growing them.

### *5. What is the biggest misconception about the private equity industry?*

The biggest misconception is that every time the banks get in trouble and the country gets into economic difficulties, the press blames it on the private equity industry. The fact is it never has been private equity that created our economic crises and recessions. During the 2008 and 2009 period, the number of dollars lost by banks because of private equity is really, really small – a very modest amount. Real estate is what got the banks in trouble. Most recently it was the single-family housing market. In earlier times it was commercial real estate and office buildings.

### *6. What is the biggest change the private equity industry will see in the near or not-so-near future?*

Let's look at 10 to 20 years from now. The biggest change will be that corporations and, in some cases, states are going away from having traditional pension plans. They will offer more 401(k) plans, so defined-benefit plans are going away. A huge portion of private equity that has come in over the last three or four decades has come from defined-benefit plans seeking high returns on their money to insure they could meet those pension benefits.

In the U.S., businesses haven't come up with a mechanism to have a defined-contribution plan and have private equity involved. Defined-

contribution plans are in marketable securities, not in private equity; therefore, the number of dollars available for commitment to private equity in the future is going to be dramatically reduced and a large number of pension programs aren't going to make contributions to private equity the way they used to. On a longer-term basis the number of dollars invested in private equity could be down dramatically unless there are changes in the institutional structure of the Defined Contribution Plan.

A logical solution would be for people who can invest in defined-contribution plans to put an amount into private equity, but it's not institutionalized now. It would be ideal for a 30 year-old person putting money into a 401(k) to be able to diversify into marketable securities, fixed income, real estate and private equity, but we aren't there yet.

*7. What sectors do you think are interesting for private equity investment now, why?*

Private equity investing has not been done from the top-looking-down view at our firm. The great investments we have made were serendipitous and bubbled up, as opposed to someone saying environmental or energy looks good. We focus on a large number of transactions and hope that we will occasionally find a nugget of gold and make money. We know there's a likelihood some sectors will have above-average growth, but we are looking more for specific opportunities than global opportunities. We have found things all over when we wouldn't have expected it.

Our investment in Austar United Communications was a good example. The company provided satellite and cable service to Eastern Australia. We typically don't invest in media because those companies usually trade at high multiples. But Austar's parent had financial difficulty and was in Chapter 11 in the Southern District of New York. We used our Australian affiliate CHAMP to do the Australian due diligence and we were here to work the bankruptcy. We bought the company for 16 cents per share and sold it for \$1.10 — making about seven times on our money. It was surprising because it was in a sector we thought

we couldn't play in. Austar had 10 television networks including the Sport's and The Weather channels. It's a good example of things working out fortuitously. And we got involved in the Austar transaction because one of our team members went to church with the CFO of the company. He happened to be bemoaning the circumstances of the company to our team member, and we used it to our advantage.

*8. Is it better to have a good management team with a bad company or a good company with a bad management team?*

A good business with an average management team: it will work out. If you have a great management team and crummy business it's amazing how often the business will humiliate the team.

*9. When you are looking at a new investment what are the three most important things that you are looking for?*

First, a good company with an established, defensible position; then, reasonable growth prospects and a reasonable purchase price. If you buy at a good price, you have a good chance of things working out. Under seven times EBITDA we consider to be a good price. Under four times there may be reason why the company's so cheap.

*10. Does proprietary deal flow exist? And if yes, how does Castle Harlan pursue proprietary deals?*

I do think there is proprietary deal flow. There are a lot of reasons you get proprietary deal flow — inside knowledge, you know the business or you worked with the principals before or went to school with them, or they live next door. When you get into deals with billions of dollars, investment bankers are usually all over it, but lower than that there are proprietary deals.

*11. The current recession began in December 2007. The recovery has been tough and protracted. Where do you think things are headed?*

We have been saying we don't think the economy is robust for some time. We are closer to the real economy than the policy makers in Washington. We have 18 companies in our

portfolio, and we look at the order rates for those companies every week. Based on that, we have a real sense of what is going on in the economy. And we don't think things are getting better.

Packaging material businesses and restaurants are coincident economic indicators. If salesmen have a good week they may go out for dinner. During a difficult period, they may have macaroni & cheese on Friday night. A large portion of the population - the people whose net worth is driven by their house - is suffering. The economy continues to be weak.

*12. Do you keep a short list of senior debt/mezzanine providers? If yes, how does somebody get on that list?*

I wouldn't call it a short list, but we have a list of providers that we go to. The interesting part is that we have raised about \$1 billion of debt in the last year and none of the money has come from a traditional bank, like a JPMorgan, Bank of America or Citibank. Once in a while we got an asset-based loan with Wells Fargo. We more often get money from GE Capital and lenders like that. Hedge funds are also a place where a great deal of money came from. The commercial banks say they are lending, but my sense is they aren't.

In the last couple of days I read something that says 60% of business loans requested by private businesses are being turned down. If the bank turns down the company, it doesn't add the plant or buy the new equipment. When you have an environment where the banks are not participating it's hard to have robust growth.

*13. Everyone uses benchmarks when evaluating new deals. For instance, some investors might say that a value added distributor should have gross margins above 20%; a manufacturer should have gross margins above 40%. Do you have any simple benchmarks that you use when evaluating new deals?*

We look at the company's market share, what kind of leadership position it has and its defendable niches. It's very clear that if the company has substantial gross margins they have these qualities and you're probably in good shape. You have to also make sure you are paying the right price and can grow the company. If it's growing by five percent a year you want to try to grow it by 10% a year.

*14. You're an interesting guy outside of work. You've sailed around the world, flew a plane to the South Pole, do you have anything on the horizon?*

In my 42-foot boat I have circumnavigated the Earth, twice crossed the Pacific and gone to the North Pole and South Pole in a small plane. I have crossed the United States in my small inflatable boat going from New York harbor to the mouth of the Columbia River via the Hudson River, Erie Canal, Allegheny, Ohio, Mississippi, Missouri, Snake, and Columbia Rivers and I am always looking for new places to explore.

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About John Castle

John K. Castle is chairman and chief executive officer of Castle Harlan and a member of the Executive Committee of CHAMP, an affiliate of Castle Harlan. Mr. Castle is also chairman of Castle Connolly Medical and is chairman and chief executive officer of Branford Castle, a holding company. Immediately prior to forming Castle Harlan, Mr. Castle was president and chief executive of Donaldson, Lufkin & Jenrette, one of the nation's leading investment banking firms. Mr. Castle is a board member of Morton's Restaurant Group, Perkins & Marie Callender's and various private equity companies. He also served as a director of the Equitable Life Assurance Society of the U.S.



Mr. Castle is a Life Member of the Corporation of the Massachusetts Institute of Technology. Previously, he had served for 22 years as a trustee of New York Medical College, including 11 of those years as chairman of the board. He is a member of the board of the Whitehead Institute for Biomedical Research, and was founding chairman of the Whitehead Board of Associates. He is also a member of The New York Presbyterian Hospital Board of Trustees and has served on various visiting committees at Harvard University, including the Harvard Business School.

Mr. Castle received his Bachelor's degree from the Massachusetts Institute of Technology, his M.B.A. as a Baker Scholar with High Distinction from Harvard, and has two Honorary Doctorate Degrees of Humane Letters.

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