VISTA POINT ADVISORS

The Founder's Guide to Private Equity

As the private equity universe has multiplied and diversified over the past decade, certain prevailing PE personas now characterize the investor universe. To better understand buyer behaviors during negotiations and post close, founders will want to know the intentions and tactics of their prospective acquirers.

With nearly 7,000 active private equity firms, each promoting a unique strategy or investment edge, the asset class can hardly be characterized as a monolith. Bain & Co., in its most recent private equity report, documented that the industry has indeed become more diverse over the past ten years, as the proportion of "classic" buyout funds increasingly shrinks, giving way to specialist strategies comprised of hyper-focused subsector funds, growth managers, ESG offerings, and long-hold funds, among other flavors of focus and facility. Yet to entrepreneurs and founders, particularly those in software and tech, it can be hard to tell one shop from the next.

To be sure, the strategies of most sponsors, even when they're different, will revolve around the same return drivers, although specific components may be accentuated or de-emphasized. Generally, most prospective buyers will be seeking value at entry (ie, they all want a deal); most will incorporate leverage, rationalizing that financial pressures instill management discipline; and most will also tout their operational capabilities to enhance value post close. One consideration most buyers leave out of their initial introductions, is that approximately three quarters of private equity firms bring in external management to serve as CEO at some point after the deal.

All sellers want to maximize value as part of any sale process (obviously!). But most founders, when they're selling their business, will have more nuanced considerations. Many, for instance, are seeking a partner who can provide capital and resources to help their business grow. A cultural fit, in these scenarios, is sometimes more critical than the purchase price. Others may recognize the most valuable path will come from getting a "second bite" of the apple – investing in growth and then selling the business again a few years down the road. Sellers should recognize this opportunity may

not be available if they're pushed out in favor of external candidates. Whatever the ultimate goal, the makeup and track record of the sponsor matters. And founders can benefit from better understanding both how investors aim to deliver returns to their limited partners ("LPs") and which tactics they'll deploy to tilt the odds in their favor.

Make no mistake, institutional investors gravitate to fund managers able to demonstrate persistent returns – across their holdings, over multiple funds, and at different points in the credit and economic cycle. And beyond just historic performance, LPs increasingly focus on process and strategy to ensure returns are repeatable and not dependent on macro developments, one charismatic rainmaker, or other idiosyncratic factors. In fact, the most attractive general partners, from the perspective of LPs, will have a consistent and repeatable strategy that translates into an investment edge.

However, for founders going through their very first sale – and encountering PE for the first time – it can be challenging to understand how one approach may or may not align to their own goals. To help founders read between the lines, there are a few distinct private equity personas sellers should always keep in mind even if they're not initially evident. What follows isn't necessarily an exhaustive taxonomy of the PE universe, but we seek to outline and characterize some of the prevailing investor types that founders will encounter in a typical sale process.

The Playbook Players

In technology and software, in particular, PE firms espousing a "playbook" approach to value creation have become a force in the middle market. From the perspective of founders, though, the "playbook" strategy often feels more like a one-size-fits-all approach that can seem very prescriptive to those that have built their business based on their own vision and through intuition.

As it relates to performance, it can be hard to argue with the results. Many of the most successful firms utilizing a playbook strategy have achieved top-quartile (or better) returns for their investors, aided by digital transformation trends that are very much aligned to precise initiatives outlined in their respective playbooks. However, from a CEO's point of view, these playbooks can seem constraining post close. It's not uncommon that in hindsight many will equate the experience to trying to squeeze a square peg into a round hole.

For instance, as it relates to capital allocation decisions or other operational initiatives, there's little, if any, room for debate. To operators, it can seem like a check-the-box punch list versus the decision-maker role they previously assumed. For founders purely focused on the value of their rollover equity, the ends may justify the means, but for those looking to impart their own fingerprint on the business or seeking a more collaborative approach, the PE playbook can become a source of contention over time.

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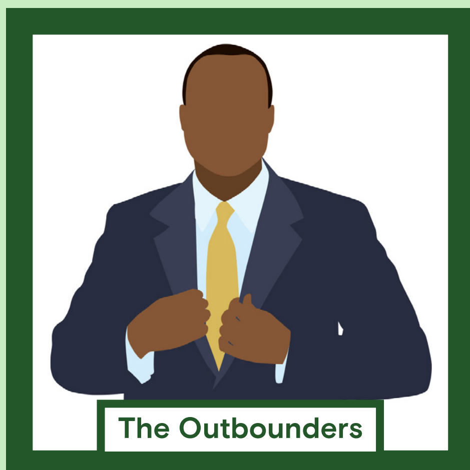
Tipping their hands:

The playbook players don't necessarily hide the fact that they're coming in with a roadmap for growth. The initial personality test, however, may be one sign for sellers that they're dealing with this type of firm (and can mark an early exit for founders). Other giveaways include an intense focus on specific metrics and KPIs, whether they seem appropriate or not for the actual business or end market.

The Outbounders

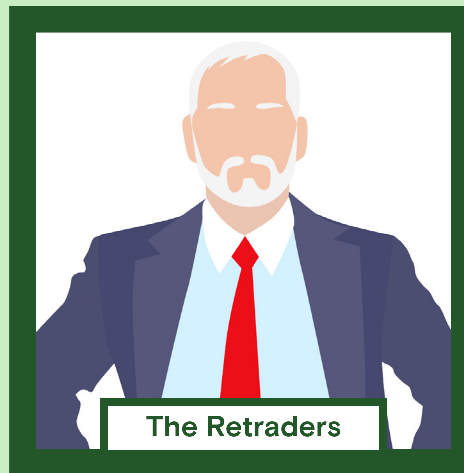
Since the earliest days of the asset class, GPs have touted their ability to transact outside of formal auctions, the implication being that through avoiding a competitive process they'll be able to secure value at entry. This is no small feat for LPs in such a rich valuation environment. While true proprietary deals are extremely rare in tech today, sponsors do indeed keep track (and report to their investors) the number of deals secured outside of a formal auction. It may not even translate into value, but LPs do look kindly on sponsors able to regularly pre-empt a sale process.

There are a couple of different ways, however, sponsors will seek to gain an inside track. Increasingly, for instance, many have established outbound sourcing efforts centered around cold-calling CEOs to initiate new relationships. They'll also tap into their networks for an introduction or a "warmer" lead when possible. For executives who may be at the early stages of a sale, these efforts can accelerate a process. For the financial sponsors, it's effectively a numbers game, and wide nets can indeed yield big fish. Many CEOs, however, begin to view these efforts as intrusive and distracting over time, particularly as inbound inquiries multiply as the company grows.



Tipping their hands:

It's not just the influx of 8am phone calls and unsolicited IOIs, the timing can also be conspicuous. Certain milestones – from employee count to inclusion in the Inc. 1000 — tend to attract even more PE attention. Advisors can often run interference and serve as a valued middle-man to distinguish the inquiries with substance.



The Dreaded Re-traders

Founders, when they begin a sale process, fully expect a negotiation with buyers, and PE fund managers who regularly outperform their benchmarks don't do so by consistently over-paying for assets. Where this focus on entry value can raise a red flag is when buyers are less than forthright in their initial interest. Enter the "re-traders."

It's not uncommon for certain firms to pre-empt a wider auction by submitting an initial bid that far surpasses any other competing offers. On occasion, sophisticated buyers do recognize opportunities others miss, and are willing to pay up to pursue a compelling investment thesis.

Others, however, have developed a reputation for submitting an initial outsized bid to gain exclusivity, but then chip away at the premium on the term sheet through "unforeseen" discoveries during due diligence.

Tipping their hands:

Often the easiest to identify, re-traders are marked by seasoned buyers, with teams of analysts and operating partners, willing to submit a term sheet or talk about their conviction to close before even a perfunctory level of due diligence has been completed. Any diligence that has been done is generally not of the third-party kind (e.g. lawyers, accountants, tax, IP), or diligence that shows deep levels of commitment, since re-traders would then have to spend actual money.

Tipping their hands:

Don't underestimate the ability of GPs to get up to speed quickly in a given segment, but initially founders may find themselves explaining basic market drivers far more than they would with true specialists in a given market.

The Generalists

In the middle market, generalists probably comprise the bulk of the financial sponsor universe even if the total proportion of "classic" buyout shops is shrinking as the total pie grows. Still, most tech CEOs and founders have had little if any exposure. That's changing as generalists increasingly tread into tech and software, areas previously perceived to be too risky and incompatible with traditional LBOs in which cash flows are earmarked to pay off debt rather than re-invest in R&D.

Again, it can be hard to generalize (no pun in intended), but often these firms are looking to deploy capital over a wide swath of potential targets, across multiple industries, usually with a very narrow team of decision makers. As a result, they're often looking for very clean transactions before they'll meaningfully engage with a target. And it's not uncommon for deals to fall apart due to questions or discomfort over technology.

For some founders, the generalists can provide a compelling alternative. In some cases, the sponsors will lean heavily on management to help them navigate unfamiliar terrain. They'll view these investments as an opportunity to gain experience in a specific segment and leverage their management teams to build a presence in a niche.

In other cases, however, the generalists may not be equipped to orchestrate a bold growth strategy. For instance, if a sponsor has never helped a company transition from selling perpetual licenses to adopting a SaaS-driven sales model, they may overlook the risks involved, the timeline required, or the capital investment needed to get it right.

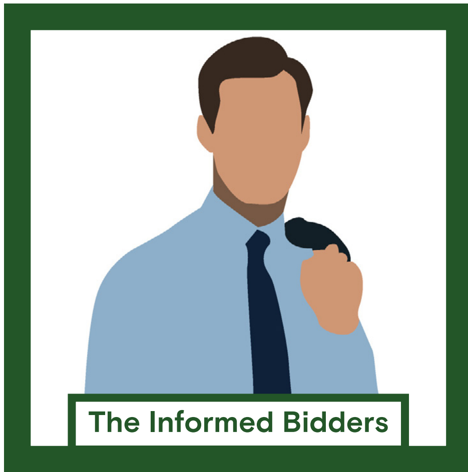
The VC All-Stars

There are some obvious distinctions between traditional private equity buyers and venture capitalists. One of the more subtle differences, albeit critical to founders, is in how the two prospective investor types manage their portfolios. PE sponsors, for instance, expect to generate a return on every deal they back, whereas VCs may be willing to lose money on most of their investments so long as one becomes a unicorn and shoulders the bulk of the fund's total returns. Said another way, PE is looking for singles and doubles, whereas VCs are swinging for the fences, aiming at 100x+ returns or bust.

To be sure, founders, can be enchanted by the name-brand venture capitalists whose reputations often precede them. They may even hear first-person anecdotes about Mark Zuckerberg or dealings with the Paypal Mafia before they hit it big. But whether a VC provides the best path for sellers often depends on the scope of the market opportunity for the target company. Unless the business can realistically grow to become a $500 million plus revenue company, founders should question if venture capital represents the best path for either immediate or longer-term payoffs. As such, founders should ask what true liquidity will look like under a range of different scenarios and timelines.

Tipping their hands:

Founders may be surprised to find VC investors are far less interested in company fundamentals than the market opportunity in front of the business. Worse, they may be turned off by structural protections, ranging from liquidation preferences and anti-dilution provisions to investor consent rights, which can create mis-alignment down the road.



The Informed Bidders

In such a crowded field, certain characteristics can resonate with founders when all else is equal and even, on occasion, when it isn't. The best partners for many of the founders we work with tend to embrace a thesis-driven approach.

This often means senior partners are coming to management meetings with an exhaustive point of view around how a business can grow, threats to be aware of, or other observations that demonstrate a deep familiarity with a given market. This informational advantage often translates into "precision" bids. Investors well versed on an opportunity will be able to safely navigate risks others don't recognize and be aggressive at times when they spot latent growth catalysts others overlook.

Tipping their hands:

The biggest giveaway is that they generally mean what they say, which creates a consistency that allows prospective investors to build a rapport and trust with founders at the jump, translating into alignment and performance post close.

Distinguishing between the different archetypes

Each category of financial sponsor – as well as those that may reside somewhere in between — can bring considerable value to a business in the right circumstances. But depending on the goals of founders post close, the outcomes after the sale can diverge spectacularly depending on the buyer and their specific approach to generate returns.

Historically, it's been very black and white. Founders could choose between a VC funding, a sale to a financial sponsor or a more complete exit through sale to a strategic. As they grew, an IPO might provide another alternative. Still, the diversity in the buyer universe today speaks to the maturation of the asset class and growth of the private equity ecosystem over time.

The upshot is that founders today generally have more options at their disposal to not only attract the best bids, but ultimately the best long-term partners. However, prospective sellers will want to keep in mind that timing matters. The earlier a founder can engage with an advisor, the better they'll be able to navigate and choose from such a disparate buyer universe. Moreover, staging can also make a considerable difference. Specialist advisors, who are intimately familiar with the tech landscape, better understand what appeals to specific investor types and can help position companies to attract the most appealing long-term partners.

It's against this backdrop that the value of a sell-side advisor won't always be measured in sale multiples; it will be measured in the ability of entrepreneurs to choose their own destiny and find a buyer aligned to their own vision.

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