# SMALL TECH BUYOUTS – THE FOURTH EXIT OPTION

A perspective on the changing exit landscape for venture-backed businesses

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## INTRODUCTION

We believe we are witnessing the dawn of a new wave of emerging, well-positioned small tech buyout funds, those with less than $750 million of committed capital, targeting a sizable and expanding greenfield opportunity – specifically, venture-backed technology companies. Historically, venture investors exited their investments through an IPO or strategic M&A, and over the last decade it has also become commonplace to sell shares in the secondary market to generate liquidity, a trend we initially pinpointed in 2008 (*Venture Capital Secondary Funds – The Third Exit Option*). However, a fourth exit option has emerged in the venture capital market, with almost 20% of all venture-backed business exiting to buyout funds according to Pitchbook.[1]

The proliferation of the SaaS model, which lends itself well to a buyout structure, has been a key driver in the emergence of many of these new funds. SaaS is by no means a new paradigm – venture funds began investing in the space in earnest more than 15 years ago – however, we are now at a point where many early SaaS businesses have achieved suitable scale, with stable, predictable revenue growth and expanding EBITDA, a profile that naturally appeals to potential financial acquirers. While many opportunities have been created by the maturation of the SaaS business model, over time similar trends should emerge in other maturing segments that include technology infrastructure, healthcare technology, and internet-based businesses.

Lending further weight is the growing prevalence of larger and larger multi-billion-dollar buyout funds which have created a void in the market that smaller buyout funds are filling. As these "mega-funds" have scaled, they have directed significant capital toward larger deal sizes and later-stage companies. While the shift has benefited some larger tech companies, the current growth paths for smaller and more niche businesses are too limited to garner sufficient attention from many of the existing buyout operators.

Traditional exit prospects for small tech companies have also abated over the last several years as the annual number of venture-backed acquisitions has declined. From 2014 to 2017, for instance, acquisition volume fell by 21%.[2] Strategic acquirers, meanwhile, have been held back by relatively rich valuations or have found themselves busy integrating prior acquisitions. But these seemingly adverse

[1] Pitchbook: 2017 Annual VC Liquidity Report
[2] Pitchbook: 2017 Annual VC Liquidity Report

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developments, however, do not mean it is a case of "game over" for small tech companies. On the contrary, tech buyout firms have been stepping in to fill the void.

This evolving landscape represents a significant opportunity for investors. By our estimate, there are more than 1,000 venture-backed software companies that have not raised capital in more than eight years and are ripe for a private equity (PE) exit. Because many of the buyout behemoths are focused on opportunities elsewhere, this has created openings for specialized funds targeting smaller tech companies.

Indeed, there are a number of emerging managers seeking to capitalize on these developments who are well positioned to succeed. Experienced software investors have tended to outperform peers with broader mandates, and it is this profile of investor behind many of the small tech buyout firm launches. Furthermore, emerging managers in the space have historically produced greater total-value-to-paid-in (TVPI) multiples in initial funds than in follow-on efforts. We believe these funds together with the prospect of being able to co-invest alongside these emerging managers as they raise capital, provides a compelling opportunity to generate attractive returns for LPs.

**MARKET OVERVIEW**

As noted earlier, venture-backed companies are remaining private longer. Since the 1990s, the time to IPO for venture-backed companies has continued to increase; according to Pitchbook[3], the median time from founding to IPO is now over 10 years. While the IPO window opened in late-2017 and appears to remain open, activity continues to lag 2014 levels. Meanwhile, the number of new unicorns continues to outpace IPOs, with some of the biggest names (e.g., Uber, Airbnb) yet to exit.

The trend of companies staying private longer will likely only continue, primarily because of shifting market dynamics. While venture funds of all stages have raised an abundance of capital, the amounts raised among late-stage funds are especially striking. Softbank's $100 billion Vision Fund, Sequoia's new $8 billion fund, and many other billion-dollar-plus funds can readily write checks that exceed nine figures, affording many larger enterprises an IPO alternative.

Moreover, a thriving secondary market will allow, and may even encourage, private companies to remain private. Secondary deals have become increasingly commonplace, with many later-stage rounds

[3] Pitchbook: 2017 US PE & VC IPO Trends Report

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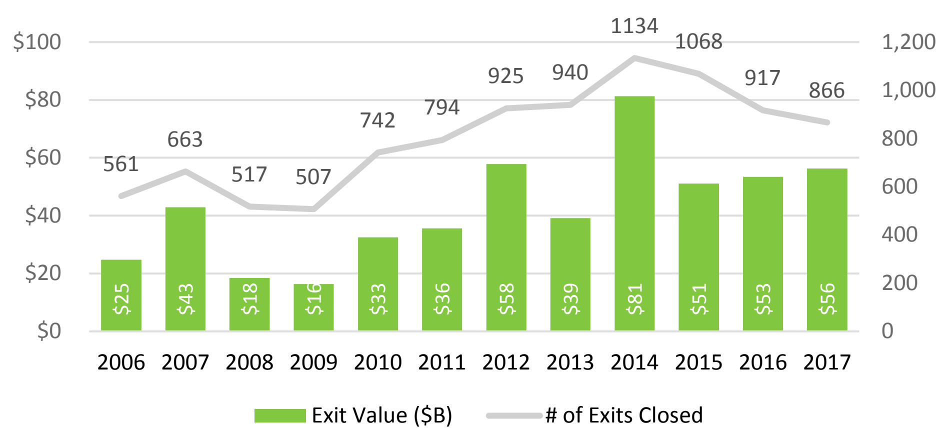
incorporating elements that offer executives, long-time employees, and early investors IPO-type liquidity. Such transactions also enable management to provide certain stakeholders with the flexibility to exit their positions while also affording their company the ability to remain private.

These structural changes aren't the only factors altering the landscape. As highlighted earlier, M&A exits have been harder to come by for many venture-backed companies, with such transactions declining in recent years.[4] Following a spike in 2014, venture-backed acquisitions fell steadily through the end of 2017, likely due to acquirers' efforts to integrate prior acquisitions and an increased focus by larger corporations, in particular, on promoting in-house technologies and innovation.

Against this backdrop, buyouts have become an increasingly important exit pathway for VC investors; the share of such transactions nearly doubled from 9.8% in 2006 to 18.5% of all completed exists in 2017. Several factors likely account for the shift, including the growing maturity of venture-backed companies, buyout investors' increasing familiarity with technology and software business models, and the growth in capital being raised by buyout funds.

*North American & European VC-backed acquisition activity[4]*




[4] Pitchbook: 2017 Annual VC Liquidity Report

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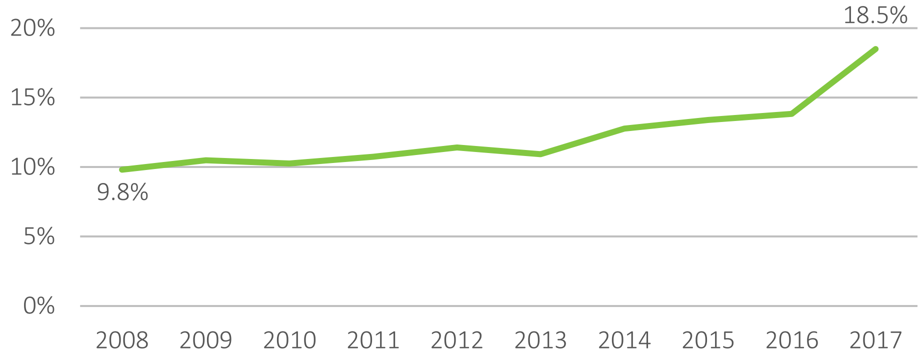
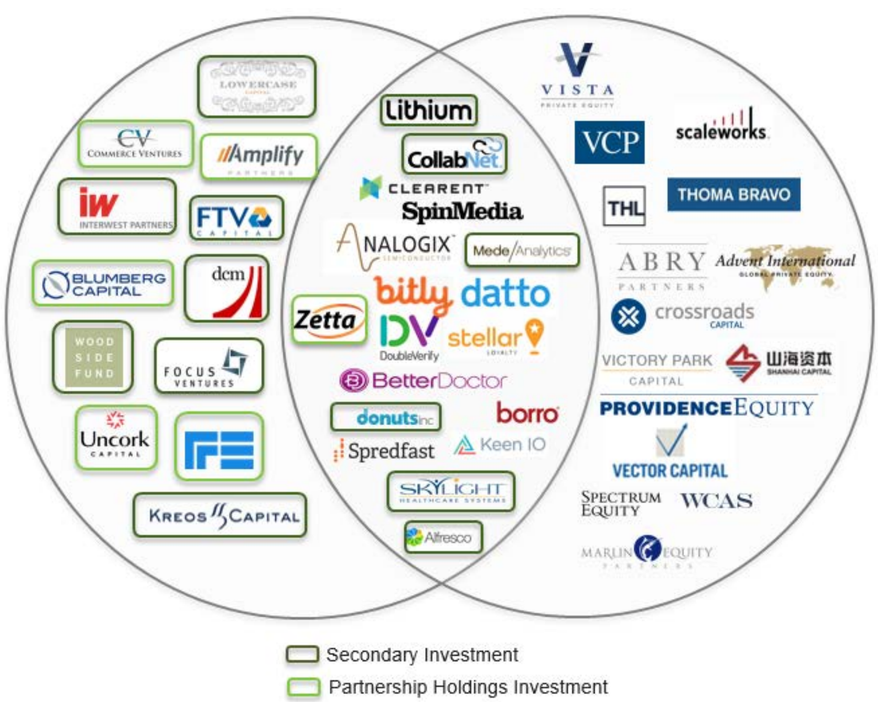
*Buyout % of Total North American & European VC-Backed Exits[4]*




We have seen this trend unfold first-hand across our universe of portfolio companies, as well as through those held by the venture funds where we are LPs. In aggregate, our funds have seen 20+ exits to buyout firms over the past three years. Many of the exits to-date have been in SaaS companies, as the business model lends itself well to private equity, and the history of venture investment in that model has created a number of attractive targets. We explore the SaaS dynamic further here, but anticipate many other venture segments to experience a similar exit trend going forward.

*Example Buyout Exits Across Industry Ventures Platform (2015-Present)*




Source: Pitchbook

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**A BRIEF HISTORY OF SAAS**

The term Software-as-a-Service (SaaS) was coined by the Software & Information Industry Association in 2000, but similar business models have been in use for nearly 60 years. In the 1960s, for instance, many companies, especially small and medium-sized enterprises (SMEs), paid to access mainframes on a time-shared basis. By the 1980s and 1990s, circumstances had changed. The advent of the personal computer industry and other technology innovations enabled firms to provide employees with their own hardware and host on-premise software products.

However, along with the ubiquitous increase in company-owned technology came the rise of "bloatware" – nonessential add-on features and capabilities that gobbled up precious storage space. Consequently, IT departments began looking for better ways to satisfy software resource needs, which led to the rise of the application service provider (ASP) industry, a precursor to SaaS. In the late-1990s and early-2000s, these ASP vendors sold their offerings over the cloud on a "pay-as-you-go" basis.

Eventually, the ASP industry ran into significant scalability issues that SaaS businesses were able to overcome. As virtualization technology improved and became more mainstream throughout the 2000s, SaaS businesses capitalized on those advances using multi-tenant infrastructure models. This allowed them to accommodate demand more efficiently than ASPs, which often hosted multiple instances of third-party applications for each client.

The SaaS industry really began to take off at the turn of the Millennium, when Salesforce was established and Concur – which many consider the first of the genre – pivoted to a full-scale SaaS model. Nowadays, the segment is well-established and expanding at an impressive pace. According to, Gartner, the worldwide SaaS market grew from an estimated $10 billion in 2010[5] to $73.6 billion in 2018, a seven-fold increase, and is expected to reach $117 billion by 2021. [6] Even with that, SaaS is expected to be less than half of total application software spending.

**THE SAAS OPPORTUNITY**

Increasingly, customers and other stakeholders agree that SaaS offers several advantages over on-premise solutions. For example, SaaS has lower upfront costs and is cheaper to implement than locally-installed software. IT departments also find it easy to administer, with updates and patch management

[5] https://www.gartner.com/newsroom/id/1739214
[6] https://www.gartner.com/newsroom/id/3871416

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dealt with via the cloud. Finally, this approach facilitates global accessibility for a distributed and mobile workforce.

Investors, in particular, see the model as attractive because well-run SaaS companies can grow with limited infusions of capital. Amid a widespread decline in storage prices, increases in computing power, and the advent of Amazon Web Services (AWS) and other cloud platform services and providers, the costs of starting, operating and scaling a SaaS business have fallen dramatically.

Moreover, an expanding and increasingly mature market means that the business model is now well understood by private and public investors alike. The first major SaaS companies went public more than ten years ago – Salesforce and NetSuite launched IPOs in 2004 and 2007, respectively – and the universe of publicly-traded SaaS companies, which includes some of the world's largest enterprises by market capitalization, amounts to more than 50.

That said, there are a considerable number of privately-owned SaaS companies. Venture funds have been investing in the space for almost 20 years now, and many of the early venture funds have continued to operate well beyond their original 10-year terms. Over time, these funds have been left with solid SaaS portfolio companies – oftentimes, they represent a residual holding alongside a fund's major value driver.

SaaS companies, with their subscription models, inherently take time to reach scale, which may mean that while they are older venture investments, they still may only have $10M-$50M in recurring revenue at time of exit.

In addition, while these SaaS companies may have decent scale, breakeven or better cash flow, and no debt, they typically are only growing revenues at a modest pace (e.g., 20%). Since they are unlikely to reaccelerate growth to the 50-100%-plus range that venture investors are increasingly looking for, they are not large enough to make a noteworthy impact on fund-level returns, even after a successful sale.

For example, a $10 million ARR company exiting at a 4x revenue multiple will generate proceeds of $40 million, which will hardly move the NAV needle for a venture fund with a 10% ownership stake. Not surprisingly, many of the fund managers that hold such interests may be less-than-motivated to invest additional time or resources to achieve a larger exit in the future, opting instead to create immediate liquidity for their LPs.

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But that doesn't necessarily mean the opportunity is limited. The SaaS approach, with its basically stable and predictable cash flows and ability to scale in a fairly capital-efficient manner, lends itself well to a buyout model. Bolstered by low-single-digit churn rates, high lifetime-revenue-streams-per-user, and low customer acquisition costs, these technology companies have much to offer for acquirers employing leverage when making acquisitions.

In addition, software businesses have historically generated relatively high EBITDA – the largest among them have 25-35% EBITDA margins – suggesting that smaller SaaS businesses generating more modest results have inherent prospects for margin improvement as they increase in size.

**EMERGENCE OF TECH BUYOUT FUNDS**

In response to these favorable market dynamics, new tech buyout funds are emerging, targeting companies that have not (yet) achieved critical mass. Indeed, the larger buyout specialists in this segment have experienced remarkable growth in a relatively short period of time. After raising $822.5 million for its Fund IX in 2009, for instance, Thoma Bravo closed Fund XIII seven years later at $7.6 billion. Others that have achieved similar successes include Vista Equity, which has garnered $11 billion in commitments for its seventh fund, Francisco Partners, Accel-KKR, Marlin Equity and Vector Capital. We have watched these firms grow over time, and believe the small end of the market defined as sub $100M tech buyout deals is a very compelling part of the market to focus on for new emerging funds. Not only can these funds roll-up smaller companies into a larger entity, generating synergies in operations, finance, sales and development, they can also acquire and sell these smaller companies to large buyout fund portfolio companies as add-on acquisitions.

Many of the emerging managers are employing opportunistic approaches that heighten the potential for accelerated paybacks and larger returns on capital. We have seen, for example, small tech buyout funds reaccelerate growth at older, formerly venture-backed businesses and then execute dividend recap strategies that enabled them to cover their acquisition costs and produce incremental returns. In doing so, we believe, they also provide liquidity to their owners that is somewhat immune to the vagaries of the stock market.

Similar to what we predicted in the venture market with small venture fund proliferation (*The Venture Capital Rebound*), we believe an emerging group of small tech buyout funds will generate outperformance to their investors.

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## SMALL TECH BUYOUT AND THE GREENFIELD OPPORTUNITY

These emerging managers are well placed to capitalize on an array of growing tech opportunities. Aside from having a larger opportunity set available to them amid the rise of mega funds, which are increasingly focused on deploying capital at a larger scale than before, they are engaging with sellers who are, by our observation, more motivated than in the past.

BCG, for example, expects that venture funds will exit 900 or so late-stage investments to private equity or corporate acquirers through 2021.[7] We estimate that there are currently over 300 SaaS businesses and 1,000 software businesses still held in VC portfolios that have not raised capital in eight or more years,[8] as well as thousands of bootstrapped software businesses that were launched during the last twenty years – various sources peg the SaaS ecosystem at more than 10,000 companies – it suggests that attractive opportunities are ripe for the picking.[9]

But the benefits do not just flow one way. Prospective targets also stand to gain from a new investor. We believe buyouts can inject fresh energy into these companies, especially those residing in older venture funds where investors have become fatigued or are simply not as focused as they once were.

In addition, new investors often implement best practices aimed at helping companies to exit within a three-to-five-year time frame. They may be more willing to recommend and press for changes that improve business models and enhance value, including transitioning to SaaS (for companies still operating with an on-premise model), upgrading sales and marketing efforts, implementing new pricing initiatives, refocusing product and service offerings, and engaging in more efficient software development.

## FIRST-TIMERS OUTPERFORM

A new wave of buyout funds is emerging to address this opportunity set. As of March 2017, the median internal rate of return (IRR) for first-time PE funds with vintages between 2012 and 2014 was 17.1%[10], a

[7] BCG: Cracking the Code in Private Equity Software Deals, May 2017
[8] Data from Pitchbook and CrunchBase Pro for SaaS and Software companies that last raised capital between 2000 and 2010
[9] https://thesaasreport.com/saas/
[10] Based on 18 global first time funds during 2012-2014 through March 31, 2017

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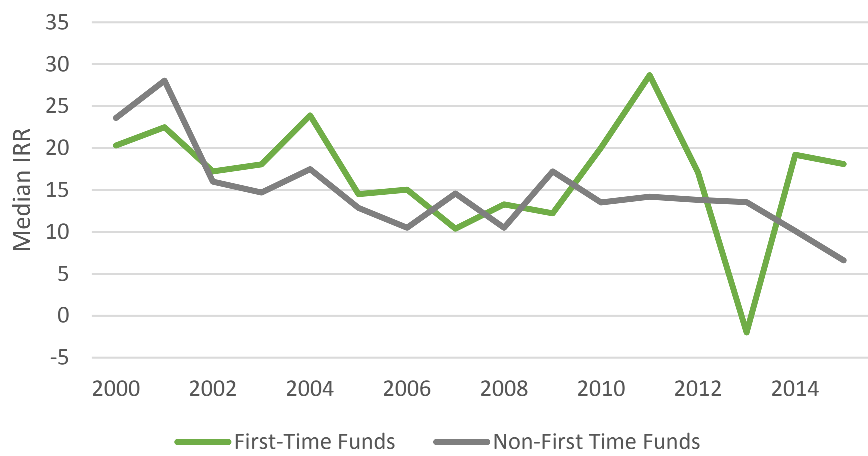
sharp contrast to the 10.8% produced by follow-on funds[11]. At 1.40x, the former's TVPI was also higher than the latter's 1.19x.[12]

*Small Buyout Returns (2000-2014 Vintages)*[12]




There are various reasons why emerging managers have historically fared better than their established peers. Among other things, we believe, they tend to pursue niche or otherwise distinct strategies that are often overlooked by long-time investors. More importantly, they are likely to have large amounts of personal capital invested in their funds, which provides motivational alignment with their LPs.

For software investing, in particular, expertise has also proved to be an advantage. A BCG analysis found that serial software investors – those who have been involved in 10 or more such deals – produced a median IRR that was 15 percentage points higher than that of investors targeting other industries, while experienced software investors – for whom these sorts of deals represented at least 20% of their respective totals – outperformed by 20 percentage points. In the case of opportunistic investors who are less knowledgeable about the space, their relative outperformance was only two percentage points.[13]

This upsurge of talented managers is somewhat akin to the wave that unfolded in the late-1990s and early-2000s, which eventually led to the creation of several of today's top-tier firms. In fact, we believe the current landscape may offer even greater potential than before, mainly because many of today's

[11] First-time and follow-on funds returns data for the 2012-2014 vintages (both IRRs and cash-on-cash multiples) include paper gains that are not yet realized
[12] Pitchbook: Q4 2017 Private Equity Analyst Note: Feels Like the First Time
[13] BCG: Cracking the Code in Private Equity Software Deals, May 2017

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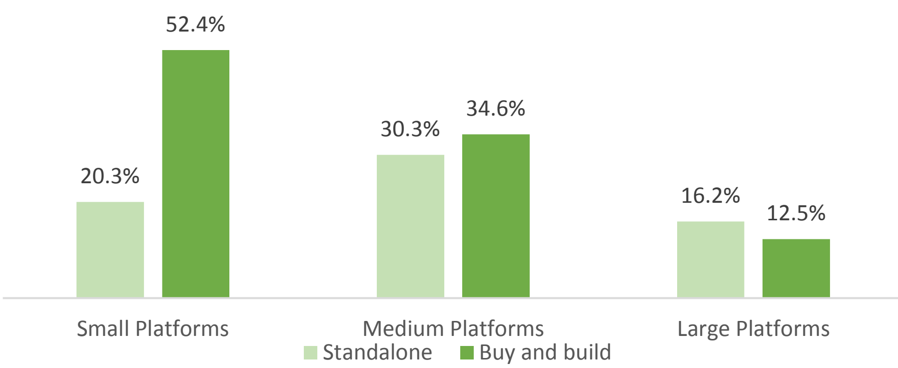
software-focused funds, spurred by a multitude of factors, are spinning out of marquee operators such as Silver Lake, Vista, TA and others.

At the same time, limited partners are more open to investing in first-time funds. A 2016 Preqin survey revealed that more than half of LPs would invest or consider investing in such a fund, up 13 percentage points from 2013, and that 11% would invest in spin-off firms versus 6% three years earlier.[14] Coupled with a robust private equity fundraising environment, this suggests that the path of least resistance for the smaller players is up.

**THE BENEFITS OF BEING SMALL**

At Industry Ventures, we have more than 10 years of experience investing into small venture funds. During that time, we have found that while most M&A exits tend to be modest, they can generate attractive returns for managers that are not dependent on hitting home runs. We believe there is a similar dynamic which applies to small buyout funds, which are mainly focusing on underbanked tech businesses with relatively subdued multiples. The markets for these businesses tend to be fragmented, creating ripe opportunities to pursue "buy and build strategies," which have often proved particularly successful for smaller players.[15] Furthermore, these underserved businesses appear to be acquirable at more attractive multiples than their larger peers.

*Deal IRR by Company Platform Size*[15]
*(Small Platform <$70M EV; Medium $70-$290M EV; Large >$290M)*




[14] Preqin Special Report: Making the Case For First Time Funds, November 2016
[15] BCG: How Private Equity Firms Fuel Next-Level Value Creation, February 2016

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We believe that the smaller buyout funds (<$750M in committed capital) will see success in exits in a similar vein to their small venture fund counterparts. These smaller funds typically invest $20-$100M per deal with 10-12 positions in their fund. By investing into smaller companies, these funds can realize successful exits at much lower enterprise values (EVs) than larger peers, which opens up a wider array of exit pathways for their portfolio companies. In specific terms, buyout-to-buyout activity is expected to increase, especially given the large amount of capital that has been raised by middle-market and large buyout firms. These smaller companies may also be acquired by strategics, as they represent a more accessible acquisition for a wider swath of companies. In select cases, these portfolio companies may even go public.

**THE ROLE OF THE CO-INVEST**

Oftentimes, first-time fundraising efforts can prove difficult for GPs, who may be restricted by previous firms from retaining track-records and, hence, may find it difficult to prove to potential LPs their ability to access compelling deal flow. That said, this chicken-and-egg challenge can promulgate unique co-investment opportunities for investors, especially in cases where GPs are aiming to warehouse deals prior to closing their initial funds.

Limited partners have been co-investing alongside GPs with increasing regularity, with more than half of all LPs actively or opportunistically doing so. [16] In fact, more than a fifth of all buyouts involve LP co-investment. LPs are increasingly interested in concentrating their exposure in top-performing portfolio companies, and can do so through co-investments with favorable economics.

For LPs and emerging managers, in particular, co-investments tend to be mutually beneficial: LPs can develop deeper relationships with GPs, while GPs can capitalize on deal flow that they might not otherwise access. Furthermore, 80% of co-investment returns have historically outpaced their respective fund returns.[16]

[16] Preqin: Investor Survey, September 2015

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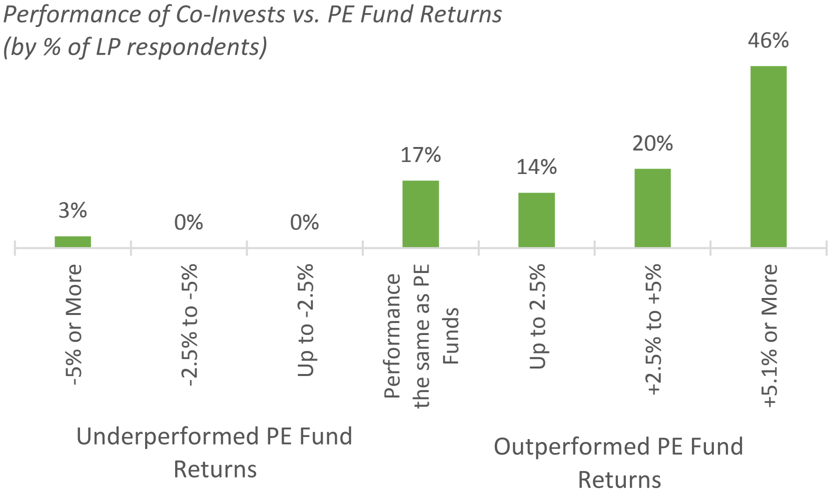
*Performance of Co-Invests vs. PE Fund Returns*
*(by % of LP respondents)*




**CONCLUSION**

Over the next decade, we expect that there will be a growing number of tech buyout funds that target niche tech markets capitalizing on opportunities to acquire controlling positions in venture-backed companies. SaaS is just the tip of the iceberg; over time, new funds will likely broaden their horizons to include technology infrastructure and services, healthcare technology, and internet-based businesses. In an environment where companies are remaining private for longer and existing venture funds are extending well beyond their 10 year terms, we believe buyouts will become increasingly commonplace for smaller venture-backed technology companies as a viable path to exit.

We believe emerging tech buyout funds are well positioned to drive attractive returns. Historically, software-focused buyout funds have outperformed and the deeply experienced managers launching the next generation of funds will be no exception. As the mega-buyout funds continue to grow in size, the competition for smaller companies will remain limited, leaving more opportunities on the table for smaller, nimbler rivals.

We believe that LPs who have the risk tolerance to back new managers and co-invest alongside them will be rewarded. These managers are often more tightly aligned with LPs, as they are focused on building a compelling track record and driving meaningful exits especially in inaugural deals – creating even more attractive co-invest opportunities. Co-invests not only help LPs better understand the GPs approach to diligence, but also a way to drive further exposure to the manager in a value-added way.

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