

# Buyouts

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## NEWS & ANALYSIS

# Slow and steady still wins for growth equity

Investors who got ahead of their skis are facing a 'reckoning' in the tech sector.

**W**ith the Nasdaq's pre-bear-market high now nine months in the past, private technology companies are feeling the weight of lowered public valuations. For growth equity investors, which set a record for fundraising last year with more than \$100 billion of inflows, deteriorating conditions have exposed a sharp distinction in the market – “a very firm and dark line between profitable companies and unprofitable ones,” in the words of Jim Quagliaroli, co-founder of Silversmith Capital Partners.

Managers say growth investing is moving away from a venture-like approach and back to fundamentals.

### Heads in the cloud

“It used to be that people had forgotten about profitability altogether, just ignored it,” says Robert (Tre) Sayle, partner at Thoma Bravo and leader of the firm's growth platform. “It had an almost non-registrable correlation to the stock price or valuation. Now there is value being put on having a profitable business model, but more importantly being able to grow profitably. If you can do both, you're going to be a superstar.”

The mania for growth goes back three to five years, to when cloud-based applications overcame concerns around scalability and security, spurring huge opportunity for many software-as-a-service companies. Sayle recalls the sentiment: “We haven't seen growth like this in years, not since the late nineties.’ People got really excited and exuberant to pour capital

into these really interesting companies.”

The ensuing influx “upended a lot of business models,” says Dave Welsh, partner and global head of tech growth at KKR. “Instead of thoughtfully investing, companies just started spending money on customer acquisitions and growth, and it's hard when you get in this mode of ‘growth at all costs’ to bring that back down without upending the company.”

“Operating efficiency, profitability and cashflow matter,” explains Matt Hobart, co-managing partner of TPG Growth. “That's why we've constantly focused on investing in profitable businesses and skewed more toward control growth buyouts than our peers.” He says that more than 70 percent of investments out of TPG's Growth V fund are EBITDA profitable.

Inflation, rising interest rates and the invasion of one resource-rich country by another seem to have answered the longstanding question of when the good times would end. High-growth, speculative assets were the first to get hit. For “companies that were spending tens or even hundreds of millions in advance of revenue, there's been a reckoning,” says Quagliaroli, “and I think there will continue to be.” But even “in the early innings” of what could prove an extended downturn, “in both the public and the private markets we are starting to see a level of differentiation, that not all tech is created equal. Some of this over the short term is going to be painful for a lot of folks, but over the mid- and long-term, it's hopefully healthy for the tech ecosystem.”

KKR's Welsh identifies “a very stark contrast” on the sponsor side as well. Some hedge and crossover funds invested “by their own admission in a high-velocity model: as much capital in as many companies in as short a time as they could.”

These funds, looking to raise money when institutions were willing to give it to them, backed “hundreds of businesses in a single year,” says Welsh. Some are likely in the unusual position of “having to figure out what exactly is in their portfolio at this point.” By contrast, KKR's team kept to its regular pace of six to 10 investments per year, typically spending three to four years getting to know a company before writing a check.

“There were so many firms that were coming back every 18 months, or even every year, and a lot of institutional investors got caught up in that,” Welsh says. “I think there has been a recognition that that was probably a mistake. Investing consistently across cycles has always been the best way to do things.”

Quagliaroli adds family offices to the category of investors without established presences in tech who joined the “extreme bullishness,” as rounds up to Series G sought to sustain valuations or gain access to public markets. “When you're burning huge sources of cash, you're appropriately focused on trying to find the next funding,” he says.

Now that public comps have cratered and the IPO window is closed, “it's going to be very difficult for those management teams. [They] don't have the luxury of

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thinking for the long-term or in a strategic direction.”

Silversmith targets “capital-efficient businesses,” meaning break-even or better, with cashflows typically in the millions or tens of millions. The firm continues to invest “aggressively” in sales, marketing and R&D, Quagliaroli says, and many of its portfolio companies are still hiring. “But we’re not pushing companies to grow at rates two or three times their ordinary course, [which] puts in jeopardy their capital structure.”

While tech and healthcare – Silversmith’s two verticals – have historically been strong end markets, caution among buyers could slow demand.

Silversmith has had no trouble fundraising: its fourth vehicle, launched in May, reached a first and final close in July on \$1.25 billion. “We’ve been very direct with [LPs] that we certainly don’t feel any urgency,” Quagliaroli explains. “We have the luxury of being very patient, and so the motivation to raise Fund IV was that we needed capacity. We don’t try to time markets.”

## Unlocking transactions

For Thoma Bravo, which started doing more minority growth investing around 18 months ago, the recent volatility has led not to a radical shift on valuations but rather a reorientation of focus.

“We’re actually paying as-high multiples – or close to it – today as we were six, seven months ago,” says Robert Sayle,



“and the reason is that we’ve really doubled down.” Rather than “close up shop and say we’re not going to invest until Q4,” the firm decided to “go back home,” seeking category leaders in the markets it knows well.

Those sectors include security, modern data stack or infrastructure, vertical market software and fintech. Unlike during the global financial crisis, customers haven’t slashed their technology budgets, though “of course that’s always on the table,” Sayle says.

As the public-to-private lag elapses, says TPG’s Hobart, “we expect to see more and more private companies accept the valuation reset in the coming quarters – and as a result, seek liquidity or growth capital at more reasonable values.” He adds that investors and companies will be open to different kinds of deals, including

PIPEs, growth buyouts and structured growth rounds.

“There’s a bit of a tug of war going on” over fair value, says Welsh. “Investors with new capital are pointing to the market environment and current multiples and saying, ‘This is the way we have to value businesses now, because it’s the reality of where we sit today.’ Companies and existing investors try to point backwards at recent multiples and say, ‘Maybe this current downward shift is temporary, we don’t want to take money at the lowest part of a cycle.’”

The two sides may soon come to terms. “Companies are starting to realize that this isn’t something temporary,” Welsh says. “My guess is you’ll start to see deal activity pick up a bit in the second half, after the summer slowdown, as some of that valuation gap closes.” ■