Private Equity Done Differently

WITH MARK STRAUCH

JUNE 2022

Mark Strauch is a Founding Partner at Alpine Investors and Chairman of Alpine SG, the firm's vertical SaaS aggregation platform. Prior to Alpine, Mark served as CEO of EDC, a financial technology company that was acquired in 2011. Previously, he served as CEO of Business Engine, a venture-backed software company that was acquired in 2007.

Listen to the episode at
www.SaaShimi.cloud

Aznaur Midov (AM): Mark, thank you very much for being on SaaShimi. You are a founding partner at Alpine, and we are obviously going to be talking about the firm and private equity in general. But why don't we start with your career path to where you currently are?

Mark Strauch (MS): Aznaur, first, it's a pleasure to be here. As you said, I'm one of the founding partners at Alpine, a private equity firm in San Francisco. And I've been in Silicon Valley for well, 30 years now. I started in consulting, did a stint in banking, and then ended up running a few companies, one of which was an Alpine-backed company. That's how I got to know the firm in the early days and then joined as one of the founding partners. And here I am today.

AM: When someone asks you what's unique about Alpine, how do you answer?

MS: Starting with basics: Alpine was founded 20 years ago; we are on our eighth fund. We have about $6 billion in assets under the management. But I think the more interesting piece is what we're known for, and one of the unique things about our firm is our emphasis on talent. Our view is that remarkable investment outcomes come from exceptional leadership.

Many years ago, we began building two programs that would become the main expression of our philosophy on talent, the CEO-in-Residence, and the CEO-in-Training programs. And the idea there was, “What could happen if we infused our companies with leaders who we call high attribute leaders who are aligned on our values, trained in our growth playbook? And, what could that unlock for our companies?” Fast forward to today, it’s probably been the biggest underpinning of our success as investors and business builders.

AM: Can you tell me a bit more about the CEO-in-Training program?

MS: Yeah, absolutely. Maybe just to rewind to the philosophy and then to the program. Peter Thiel, one of the founders of PayPal, is fond of asking a question in interviews: "What's one thing that you believe in that the rest of the world disagrees with you on?” And I love that question. We've answered that question in Alpine in the context of leadership talent. And basically, the rest of the world has generally hired based on track record – what you've accomplished, what you've done. And we agree that a track record is essential and correlated with success. People who have won will probably generally continue to win. But I think what we believe, even more, is that something else is actually causal for that success. We call that “attributes” your personal characteristics, like, will to win, humility, or grit. And so we spent time really geeking out on this and tried to develop a way to assess and ascertain those characteristics, which are pretty subjective things and as data-driven away as we could.

The result was, “What if we created an equivalent of a residency for being a doctor, but for being a CEO?” And that's really what the CEO-in-Training program is. We hire exceptional high attribute people from the top business schools. Then they get matched into one of our companies at a very senior level where they're mentored by a kind of “been there, done that” CEO. As a result, they also get in-depth training and hard and soft leadership skills. They are in kind of the YPO cohort in our own talent community with other CEOs. So, the learning is very intentional and very rapid.

It was just like a glimmer in our eyes seven or eight years ago, and fast forward to today; it's amazing. We've become the number one sought-after job at Harvard, Stanford, and Kellogg business schools. We never imagined it would be that successful, but we're humbled by that. And I think the market wanted what we're trying to provide.

AM: Is it because you create the shortest path to a CEO position for this graduate?

MS: I think that's part of it. We believe in betting on people before the rest of the world is ready to make that bet. So that's probably true. I do think it's more than that, though. It's not just the timing or the duration. It's just also the idea of how intentional we're trying to be. Like, what if you really wanted to say, “what does great leadership look like?” We invest in recurring revenue software and services businesses, so what exactly is that, from a track record standpoint and an attribute standpoint? And what if you went about intentionally building that in these amazing, high-potential people who have everything to prove to the world and who are ready to get after it?

It turns out that it's an enormously untapped sort of market making of the talent that's out there and wants the ball, so to speak. And then the companies who covet that talent, but perhaps on their own, couldn't access that as readily as Alpine, putting those two pieces together. So it's been amazing, and it continues to be something that just compounds, and we're very happy with it.

AM: Let's talk about the profiles of companies you typically invest in. What's the vertical, how big is the ARR, and maybe some other metrics you typically want to see?

MS: On the software side, we covet what has become known as the Rule of 40: companies growing at least 20% to 30% per year while operating at 20% to 30% earnings margins. These are businesses that used to have 80%+ gross margins. And then, if you think about the leading indicators for businesses like this, you look at metrics like Net Revenue Retention at or above 100%. Because that usually is a marker for a company that's developed a highly defensible, competitive moat.

And so, we found a deep reservoir of companies that fit that profile in vertical SaaS. I think that's been our main go-to area. In terms of the size, it's an extensive range. So we have a terrific down-market buy-and-build solution for a business growing 80% to 100%. But it's only $2-$5 million of ARR, on the one hand. And then, on the larger end, we'll make platform investments and software companies at or above $100 million in ARR. So it's a big range. It is primarily vertical software rather than horizontal. And then mainly, it's application software. We've done some infrastructure and cyber, but vertical SaaS has been our big sweet spot.

AM: Why not cyber and infrastructure? What's different about those spaces?

MS: Well, I think cyber and infrastructure are super interesting areas. But we're fond of quoting Bruce Lee, the paragon of business school intelligence. His quote is, "I don't fear the man who has 10,000 kicks. I fear the man who has one kick, practiced 10,000 times." And so, I suppose we just believe in the power of focus, and so vertical SaaS is our one kick. We do other things too.

But the other thing I want to say about vertical SaaS is we believe that about seven or eight years ago, there was a new cohort of companies which we thought of as SaaS 2.0, which were very different than the first generation of SaaS businesses. And they differed in a few conspicuous respects. One, they weren't venture-backed; they were bootstrapped. Two, they weren't in Silicon Valley; they were everywhere. Three, they weren't horizontal. They were decidedly in vertical niches that serve a very homogeneous set of customers with very tailored solutions to the workflow of that vertical.

Many of these businesses were the Rule of 40 at a pretty young age, so we thought, "Wow, this is interesting." We leaned into that, and that's how we created one of our biggest and most successful portfolio investments, ASG, the company that we founded and built from the ground up five years ago. It's the largest software company in Alpine's portfolio. And it's a holding company that has completed nearly 50 acquisitions across ten different vertical markets in the last five years. And for each of those verticals were buy-and-build over the long haul.

The idea of ASG is there has emerged the SaaS 2.0 cohort of companies that are very interesting, bootstrapped, and vertical. But these businesses could really benefit from some specialized subject matter expertise in areas like tech, sales and marketing, and M&A to sort of accelerate their growth from level 1 to level 10. And so ASG has become the destination of record for those types of businesses where the growth can be incubated. There's a dedicated team of subject matter experts in each of those areas that I mentioned, and we make them available to these companies. And although they are in different verticals, they face, in many ways, the same challenges.

AM: Is it fair to say that when you buy a company, you look at whether it's a bootstrapped smaller company that goes to ASG or a well-established one that goes to Alpine's main funds?

MS: I think that's a good shorthand. But what I would want to add is an asterisk to that. Let's say you are in ASG, and the business has $60-$80 million of ARR, and say, within behavioral health software. If another opportunity comes, which is a $100 million ARR acquisition within the same vertical, the absolute right place for that is to go is into ASG. So it's not purely a size distinction. We are a strategic buyer, we know the landscape, so it is not uncommon for add-on acquisitions to be bigger than the starting investment.

AM: The readers probably think that ASG reminds them of Constellation Software. How is it different?

MS: Well, we've admired Constellation Software, so whoever would be tempted to draw that parallels is not wrong, in the sense that Constellation, as you know, has become a very successful publicly traded business on the Toronto Exchange, aggregating subscale software companies.

I think where we have tried to go in a slightly different direction with ASG is we are looking at really growth-oriented businesses, as opposed to sometimes somewhat more mature, lower growth businesses that Constellation focuses on; at least that's our perception. And we're also really SaaS only, so we are not interested in legacy on-prem license models for ASG. So I think that there's a “growthier” feel to it. And we want to be a long-term home for these growthier SaaS businesses in similar ways to what Constellation did.

AM: Public SaaS companies have gone through a significant correction recently. How did it affect with valuations of private SaaS firms?

MS: Well, there wasn't as significant a correction, but there was a little bit of it. You know, many private equity firms want to own businesses with the characteristics that I have described. So these businesses on the private side are in high demand, and they typically trade in the 5x –10x ARR.

On the public side, you'll see multiples of ARR, even higher than that, as you know. And so one of the things we look at is the private company discount between the public and the private valuations. The nominal percent of the discount is less important, but the movements in that discount are fairly interesting. And so, when the market traded up over the last 12 months prior to the recent correction, that private company discount, or if you like, public company premium, expanded fairly dramatically. That sometimes creates unrealistic expectations of private sellers who feel entitled to those valuations. And since that correction you refer to, that discount has come down. Usually, when that discount comes down, there's more deal-making and the velocity of M&A in the private markets increases.

It's definitely a competitive world out there. We can talk for hours on the subject of valuation, but I think if you look over the 30 years that I've been in software, that's really the entire history of the application software industry. You see these companies trading at high valuations, not all of them, but many just prevailing over the long-term. It's because they are mission-critical to their customers, have recurring revenue, and are capable of being durable and high-margin growing businesses. They ultimately end up producing earnings at a high level. And so when you impute sort of the earnings multiple a few years into your deal, it's like, "Wow, it's actually, very reasonable." But they're eye-popping to start with; there's no question about that.

AM: As you mentioned, there are quite a few private equity players in the SaaS market: there are specialized funds and generalist funds with dedicated teams. How do you compete with them? What do you offer that they don't?

MS: Well, we have respect for all of the players that are out there. I get asked that question a lot, and I always give a horribly underwhelming answer to it, which I will apologize for in advance. But I guess the best way to answer this we try not to compete with other private equity funds. And I don't mean to be flippant about that; I think there's something important to point out underneath.

Probably 95% to 99% of private equity firms out there are looking for the same thing – they are interested in backing continuing management. And for a good reason. There are a lot of good management teams out there, and it's certainly easier to carry on with the existing team than to bring in new talent. But we've taken a different path because we have become very clear on the fact that there is a large market of businesses that, for whatever reason, don't come with continuing management: they aren't suited to that, there's a life change or a founder who's technical but wants to really be the CTO or whatever it may be, or it's the carve-out. In which case, we are sort of fishing in an entirely different pond. We are looking for businesses that are a little bit the photo negative, at least from a leadership standpoint, of many other private equity funds.

I think that's a big part of where we begin. We source aggressively, as do many funds, and utilize all of the traditional channels you would expect. We are over-indexed in direct, heavily researched outreach sourcing. We also have referral programs and engagements with parties to which we can't provide success fees in the event they bring deals to us on an exclusive basis. And really, what we're trying to do is play a different game to the degree we can by hunting in a different place, number one. And then number two, providing a different solution. Yes, it's a private equity, and so I suppose that's the same. But what we try to provide, certainly with ASG, is a very different proposition. And I think providing ongoing leadership talent is something that many of these companies really value. That's like putting jet fuel in their tank.

AM: You mentioned direct outreach. Do you mean that somebody at Alpine is calling every single company you found in some database that might possibly be on sale?

MS: Well, even better, the ones that are not for sale. I think the name of the game in private equity is more and more; you really need to be a strategic buyer, which is to say, if you're coming to the table, as "Hey, I'm a private equity firm, and I'm not in the space. You're an interesting company. I'd like to buy you, and you're for sale." You're kind of facing 20 other firms saying the exact same thing.

There are many smart people in private equity, and I think people know that you have to be a strategic buyer someway or somehow. I think part of that is just picking a less populated strategy; that's level one. And then, level two is having a toolkit of value-add and post-close that maybe other companies don't necessarily have.

AM: Makes sense. When I looked at ASG's website, there was something called ASG Finder, which caught my attention. From my understanding, anyone can go in there, enter the name of the company's website, the revenue number, etc., and if you like the company, and I can make an introduction, you'd reward me with $25K to $400K. Did I get it right?

MS: Yeah, I mean, I think this is an example of what we were just talking about. Obviously, if you're going to be in the majority buyout market, investing in these businesses is a very deep undertaking. There's a lot of research and work to ensure the investment is right. But so much of your success ends up being the shots on goal. Did you get opportunities to meet companies you really want to meet?

And so, ASG Finder is a program aimed at the top of the funnel. And it's an example of several programs we have to access the long tail of interesting companies that may be a little bit off the radar and provide people an incentive to introduce us. Of course, it's on us to underwrite the diligence and persuade the seller that we're a terrific partner and home for the business. But we'll take care of all that. So we don't need the referring party to do much, but we do need to know about the company in the first place.

AM: To be clear, that program was not just for brokers; it's actually for individuals as well, right? Somebody reading this interview may have a friend who has a SaaS company, and all they need to do is convince them to sell. Is it fair?

MS: That's right.

AM: Ok, everyone should get on it! So, what's the typical acquisition process, from sourcing to diligence and to the closing?

MS: Well, it varies a lot, as you might imagine, depending on the situation. One way to answer it is what we don't want to do. And what we don't want to do is fall prey to what can very easily happen in private equity, which is a treadmill of processing a lot of deals. Let’s say you have 12 deals on your radar, and you are sort of cranking through the early days' assessment of those deals, so you are giving one-twelfth of your time to each of those 12 things. That is about as uninspiring as that sounds, not just for you as a private equity firm. But what if you were the seller, and that's what you are getting? No, thank you.

One of the big things that we did was what we call “sprint pass.” And “sprint pass” is a philosophy that says if, say, five key assumptions that really matter in underwriting this business turns out to be true, we sprint. This is a deal we'd want to do, and this is a company we'd like to help build. So we staff a team, build on our expert understanding of that market, and get going – sprint. So, we're sprinting after the ones we think have potential and just passing early on ones we imagined couldn't get there from here. There will be a little bit of loss in the system, maybe from a false negative pass. But the power of the true positives via the sprint really overwhelms that. It overcompensates for that. It's been something that we have emphasized.

The other thing we've emphasized in our process is fit and relationships. We are the opposite of transactional. I mean, on the one hand, private equity has come of age as a transactional, short-horizon asset class, but we're sort of endeavoring to be the opposite of that. We believe that life is short, but relationships are long, and selling your business or part of your business is like inviting someone into your living room. It's personal. It's about treating people right and honoring the legacy of how the business has been successful in the past and then also introducing how it can grow to reach even new levels of success.

So, on the one hand, investing is a highly quantitative and financially sophisticated thing. On the other hand, it's the social studies of fit. I think sprint pass, relationships, and fit are a big thing for us. And certainly in software, technology, and customer diligence, as you would imagine, is a massive area on which we spend a lot of time.

AM: How long is that process?

MS: Well, it varies. Like many others, we want to move as quickly as we can to position ourselves properly. So we'll get deals done within 30 days, sometimes even less. But, you know, many firms talk about that from a marketing standpoint. I would say the average transaction probably, from start to close, takes about 60 days.

AM: Makes sense. So private equity is known for putting debt on companies. Do Alpine and ASG structure deals similarly?

MS: It’s pretty similar. Whether it's Alpine or ASG, we're looking for the same basic profile we refer to, right? Recurring revenue and growing profitable the Rule of 40, competitive mode, high net revenue retention. And then, we are believers in the power of the capital structure to drive the right decision-making, like we believe that sometimes there is a false trade-off between growth and profit. We think sometimes you can have your cake and eat it too. And if you really are a good choice maker about what you choose not to do, what products you choose not to build, and so on.

So at Alpine and ASG, we'll try to structure deals with debt, but not too much. Because the last thing you want to do with high growth, high total addressable market, high vitality company is tying its hands behind its back from a free cash flow standpoint because you're paying off too much debt instead of plowing back into some growth areas. So we are very cognizant of that. I don't know that we always get it right because you can't be perfect. But I would say we are sort of moderate in our use of capital structure and that, by and large, it's similar across Alpine and ASG.

AM: You've been an operator for a long time before becoming an investor. Do you miss anything about operations? And did you learn something as an investor that you didn't know as an operator, and vice versa?

MS: I get asked this question a lot. I can say with high conviction that knowing what I know now as an investor would have made me a better operator. And I do believe the reverse is also true that having been a CEO and understanding how to build enterprise selling models and how to actually go about building teams, I think it has benefited me as an investor. I don't think that's a necessary path. Of course, many people don't follow that path.

For me, it's good. I like being bilingual between the sort of investing and diligence, which is a slow thinking modality, and business building, which is a faster thinking modality that you would have as a CEO. That was a very geeky way to say it so let me decode that and say it in English. The CEOs probably make thousands of decisions a year. I never stopped to measure it, but it's a remarkable rate of choice-making over and over and over again. And as an investor, I would be doing my job well if I made four really good decisions a year, but they were really good, highly reasoned, and careful.

And so, I have enjoyed the context switching between the two. It will be for others to decide how good I am at that, but I've learned a lot on both sides. And what I would say to people is, if you have an opportunity to experience both sides, you should; there's no one path. But it's definitely made me more sympathetic to the challenges of founders and CEOs who grow businesses and what they're up against. It's not a spreadsheet. It's a super carbon-based difficult real-life thing.

AM: You mentioned that you often acquire bootstrapped companies that are not set up correctly. What are some common mistakes these companies make? What do you tend to fix more often?

MS: Well, I might frame it a little bit differently than that, in the sense that we're not investing in businesses that need fixing, per se. They are not broken. They are healthy. They are growing businesses. These CEOs and founders we encounter are remarkably clever and skilled people. But if the question is more around where we typically invest in time and time again, I think it is invariably in two main areas. One is the team and talent. So we are very much believers that it's who, not what. And so, making sure that early in our hold, we have a team that is on fire with its mission, crystal clear in its priorities, and has the capital and runway to do its thing and grow. That's where we are hiring people; we are bringing in leadership talent to augment the team, et cetera. That's the thing one that almost invariably we're doing.

And then the thing two is, we love add-on M&A. I mean, who doesn't? When you can make add-on acquisitions and create a step function in organic growth, it's a beautiful thing. The perils there are that it can be hard, especially in software, and people can get it wrong. But we spend a lot of time leaning into day one, building out, target add-on, you know, roadmaps and really bringing to bear our playbook on how to integrate M&A, how to be high speed and low drag with it, and what you choose to integrate when you buy a company.

So, those would be the two biggest areas that we focused on. If I had to pick a third, it would be sales and marketing – we typically add headcount. And the companies we buy have proven customer acquisition economics, so we want to hit the “more” button.

AM: Got it. And you're a chairman of ASG, right?

MS: Yes.

AM: So I looked at the website. There is a portfolio of companies, the subsidiaries of ASG, and each has its own CEO. I'm guessing a lot of times, CEOs are either from CEO-in-Training or CEO-in-Residents.

MS: Yes.

AM: But then ASG has its own CEO. What are the dynamics between them? What type of decision does each of them make?

MS: Well, one of the underlying philosophies is that ASG is sort of a team of teams, and Alpine is like that, too. We believe in the power of distributed decision-making, subject to certain parameters. And so, empowerment is a vibrant core value of Alpine and ASG. The way we've set it up is Steve Reardon is, the CEO of ASG. And together with Steve at the holding company, we have an executive team: a COO, a CFO, a Head of M&A, and a Chief Technology Officer. And we also have a Holdco team working with that leadership group.

Their job is the overall health and happiness of the businesses and the leaders we have back to run those businesses. The way we think about it is the CEO of the operating company is the CEO, period. There is no matrixed, hybrid structure that would create confusion and disempower leaders. And if you think about it, if your thesis was talent, and you wanted to recruit these amazing high attribute leaders – the last thing you would want to do is to clip their wings.

But having said that, having done 50 of these vertical SaaS deals, we have so much pattern recognition when it comes to common challenges. So, picture the leadership team of ASG providing enormous accelerant based on the patterns we've seen, advice, governance, assistance, and connecting to subject matter experts on the Holdco team – that's really their role. We think of ASG as an enterprise that needs to become a $10-$20 billion company someday. So there's a lot to do to build a business like that. And that's the focus of the Holdco team.

AM: That's interesting. This actually answers my next question. If you think ASG would be that big, is there a plan to take it public one day?

MS: Well, it's an interesting question that we've spent time considering. Indeed, when myself and my two co-founders started the business five years ago, it was our view that we would take it public and that this would be the best way to create this sustainable long-term home for these vertical SaaS businesses. But life is what happens when you're making other plans, as they say.

So, we went down that path, were having great success, and were really pleased with ASGs growth. And a few years into it, we realized that the opportunity for micro-aggregation in each of these verticals was very profound. It was bigger than we thought. And so when you become a strategic buyer in legal tech, behavioral health, or hospitality software, you end up really zooming in, in a big way in those markets, and then you become a student of the game of all the businesses that are out there, and the different nuances of their strategies, and so on.

And so we realized that we could build really big and important, $50-$100 million ARR vertical SaaS businesses inside of ASG. And so we realized that we could build really big and important, $50-$100 million ARR vertical SaaS businesses inside of ASG. And then that liberates each of the verticals to describe its own path. Maybe we should hold this vertical for 16 years, perhaps this one is a four-year hold, and it's time to exit. Or this one has a certain set of strategic buyers, whereas the other one has a different set of potential buyers. And so, I think where we are now is building ASG as a single company, but recognizing that each vertical may have its own outcome of some shape or form with its own timing that makes sense.

AM: And there is no pressure from investors to cash out, right?

MS: Well, no. What I would say is I think investors today are really getting more sophisticated about the different ways that you can create some liquidity for managers and even some liquidity options for the limited partners and still hold an asset and keep going. So we have done, in a few cases continuation vehicles, where we give our investors the opportunity to cash out if they so wish, roll over, or status quo. And they love that because it puts the power in their hands to do what they wish and what is best for their portfolio.

And they also love it because we are able to create an outcome that creates liquidity for those who need it and then keep going and holding the business. After all, we can do so much more in these markets. So I think there are more and more alternative ways to separate the outright exit decision from liquidity. And I think that has been a positive for LPs and GPs, and it's been positive for the companies we've done that with.

AM: Mark, thank you for being on SaaShimi.