Growth Investing in SaaS

WITH STEVE WOLFE

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Aznaur Midov (AM): Steve, thank you very much for being on the podcast.

Steve Wolfe (SW): Thank you for having me. I'm really excited to meet you and to meet your audience.

AM: We'll be speaking about Growth investing in SaaS companies. But first, perhaps you could say a few words about yourself and Growth Street Partners.

SW: I'm one of the two co-founders of Growth Street. My co-founder is Nate Grossman. We'd worked together at a much larger growth equity firm before starting Growth Street. And I always think that the story of how we named Growth Street is an interesting way to tell people about the firm and to tell people about our focus.

We wanted to call ourselves Rally Partners when we first started the firm. And the reason it should be evident to anyone that's looked at our website. We love ping-pong. We played ping-pong all the time, and we would rally with each other, and we said, "Hey, geez, when we rally, number one, we think of lots of good ideas. And number two, you're kind of independently accountable, but you're dependent on each other."

You know, it's a little bit competitive, but you're having fun, and you are both getting better. And we were like, "Rally Partners, great name, and the story's amazing." There's Rally Ventures, so we couldn't do that.

So we quickly came up with Growth Street Partners. It originates from the idea that Growth Street does not invest in the country's major tech centers. We don't invest in San Francisco, New York, or Boston. And that we're not investing in Sand Hill Road, we're not investing on Wall Street, we are not even investing on Main Street. We are investing on Growth Street. And Growth Street is a street or two off of Main Street in these second and third-tier cities in the US and Canada. And on Growth Street, the rent is lower, so you are putting more of your money back into the growth of the business. The founders are from the industry, so they live the problem their business now solves, and they are "learn-it-alls," not "know-it-alls."

In Silicon Valley, New York, or Boston, many of the founders of these firms have never lived the problem their business now solves. They saw something, and they said, "I can do it better." That's OK. You can actually build amazing businesses or disrupt industries with that approach. The founders we are partnering with have lived in the industry, love the industry, love the customers, and have seen something that they can make fundamentally better.

And those folks are really humble. They're lifelong learners. And when we partner with them, they're looking for help; they're looking for a true partner to help them grow their business. That's the ethos of Growth Street – we try to invest in a meaningful minority percentage in these businesses so that we can be a sounding board to the entrepreneur but not affirmatively have control over anything.

We acknowledge that with the type of investment we are making, "Hey, Mr. and Mrs. Entrepreneur, you know your industry and your customers better than we do. Frankly, you know it better than anyone. But we know B2B scaling, and we think we know it pretty darn well." So if we can marry those two things, if we can really respect the skills, background, and experience that we each bring to the table, then we can build something really special.

AM: Growth Street is a growth fund. Could you please explain how growth funds are different from VC or PE funds?

SW: Typically, when we invest in a company, they already have something working. They've got \$1–\$3 million in revenue, but they haven't quite figured out how to scale it. So when we invest \$3 to \$12 million, maybe 60% of the dollars are going on the balance sheet, and we're using those dollars to help scale their business.

So investing in their team or the Go-To-Market efforts would be slightly different from the Venture world, where they are still trying to figure out how to get something to work. It is also different than the Private Equity world, where something would have already gotten to scale. Presumably, it would already have some operating leverage where it is generating EBITDA, and it can use that to generate the returns. For us, growth equals returns.

AM: We spoke about Growth Street structure prior to the podcast, and I found it quite interesting. Could you please say a few words about it?

SW: The way that we think about Growth Street is in three main functions. Like most firms, we have investment and operation teams, but we also have what we would think of as a product team. On the investment team, we are doing investment research and trying to figure out what markets we want to invest in, what kind of companies, whether the company is good or we can help it, et cetera, just like most growth equity firms. Same thing with the operations team, where we are trying to figure out how we can help the companies.

The product piece is really important, though. Most Growth Equity firms out there have historically hired armies of cold callers. So the kids will complete a couple of years of investment banking, come into the industry, and cold-call every company under the sun trying to break into them.

In the software world, we would call those BDRs or SDRs. And what they're trying to do is set appointments for vice presidents. Then, if the vice president gets on the phone, they do a demo of the growth equity firm. And if that all well, they will pass them on to the partner. When we started Growth Street, we said, "Hey, wait a second, we're a B2B business, just like our portfolio companies are." And these companies leave digital footprints; companies do, and the entrepreneurs do. We can learn a lot about these companies before we ever speak to them, and that means we can know who to call when to call them, and what to talk to them about.

What it really means is that if we use software and technology to make it such that we can "shoot fish in a barrel." Then we can reallocate our internal resources, and we can say, "Wait a second, instead of spending our resources on convincing the entrepreneur to work with us, we can spend more of our time figuring out which investments to make and how we can help the entrepreneurs."

So in the traditional growth equity model, the pie chart of time might be 50% – 70% devoted to sourcing. At Growth Street, we try to shrink that as much as possible to allocate the pie chart more to operational support and select the best opportunities. The way that we can do that is by investing in our proprietary software.

We hired many offshore developers to pick up on that digital footprint and gather all these attributes about these potential targets. Then, we integrate that software into third-party best-of-breed, Go-To-Market software. And the really cool part about our process is that once we get an entrepreneur really interested in us and we are really interested in them, we'll actually demo our software to them. We will show them exactly how we found them, what attributes we picked up on, how we scored them, and how we move them through our own funnel. And we'll say, "Hey, Mr. and Mrs. Entrepreneur, you can't use our software because it's built for our industry. But these best practices are what we will bring to you to help you scale your business."

AM: That sounds like a pretty valuable piece of software. Any plans to sell a subscription?

SW: Well, the way that I think about it is that it's really just a fancy filtering software. It would never be valuable as a third-party commercially available solution. But for us, it's really valuable. We target relatively small companies, like 10 to 50 employees, $1 to $5 million of ARR, and there are tons of those companies.

If you think about the market in the shape of a pyramid, we're targeting companies at the base of that pyramid. The reason why the pyramid is so wide is because it's really hard to get really big. But what it means for us is that we could spend all day, every day, talking to companies that will never move up the pyramid. And so, what we are doing with the software is just filtering out the ones that don't meet our criteria.

AM: What do you look for in these companies, both qualitatively and quantitatively? Perhaps, there are specific metrics outside of revenue size?

SW: We look for a few different things. The first is, as I said before, that we really care about a Founder-Market fit. We feel like it is a proxy for a product-market fit. So if a founder has lived the problem her business now solves, that says lots of great things about the business.

From a financial metrics perspective, we are looking for businesses at their early inflection point: generating $1 to $5 million of ARR, growing nicely, getting lots of customers, and no customer concentration. They are at/or approaching breakeven, growing quickly without investing in their Go-To-Market. And we can figure out a lot of that stuff without ever talking to them.

The last thing that we look for, which comes a little later in our process, but is really important, is companies where we think Growth Street, in particular, can help them grow more efficiently. If we can't add value to those businesses, we can't stretch on valuation. We can't bridge the value gap with an entrepreneur.

But if we think that our specific skills, specific experience, and our team can help that company get to that inflection point, we can find a really nice match and meet or exceed the founder's expectations.

AM: Can you quantify some of these characteristics? Are you looking for revenue growth of 30%, 50%, or something different?

SW: It depends. And I know you probably hate that answer.

AM: I do.

SW: At the low end of the range, companies doing a $1 million of ARR need to be growing pretty fast – close to 100% year over year. At the higher end of the range, at the $5 million level, they can be growing ~30%. The growth and ARR are really telling us, relative to the amount of capital they have raised, how good that Product-Market fit is.

So if we have a founder from the industry, we've got a Founder-Market fit. And then, we have got financial metrics that show that the business can grow without that much capital. It can be pretty capital-efficient, so we feel like we've really got something.

AM: Does churn ever come to play?

SW: Absolutely. We think about it like most investors – gross churn, customer churn, and net churn. And like my last answer, though, entrepreneurs ask me, "What's a good retention rate or a bad churn percentage." And again, it depends. Because our job at Growth Street is to uncover the good core business, if you will.

Sometimes, you can find a business that naturally just on its own has 90%+ gross retention and 100%+ net retention, and you are really just a momentum investor. You are giving them money just to fuel the fire. Sometimes, core business in there, they've got a $3 million ARR business and $2 million of it has that 90%+ gross and 120% net retention.

But there's another $1 million where they sell to a customer that is too small or not the right fit for them for whatever reason. And that's the value add where we can come in and say, "Hey, Mr. and Mrs. Entrepreneur, this $2 million business is amazing. Let's double down on that. And let's just stop to that $1 million business that doesn't quite fit your ideal customer profile. Let's not commission our salespeople; let's not target our marketing to them; let's just stop that. So the churn or retention question is always a little bit nuanced.

AM: How else do you guys add value besides refocusing a company on the right segment?

SW: I kind of want to double click on the focus and the segmentation. Usually, what we find in the space we invest in, where the companies are relatively early in their development and have been around for 5 or 10 years – they haven't figured out how to scale yet. So the entrepreneurs running those businesses tend to want to take customers and revenue from wherever they can get it.

Because they are bootstrapped and don't have a lot of capital on their balance sheet, they are willing to take that small customer, or that customer that doesn't quite meet the criteria that they otherwise would say is their best customer. We take that conversation and that topic really seriously. We think about how we can segment your customers, how we can segment your market to get to what your true ideal customer is, and then how we can double down on that.

And then, all the other pieces of help that we bring to the table come from that. That's the foundational piece of our value add. So we'll work on that segmentation that'll help us understand how to structure our sales, marketing, and customer success organizations.

It might also tell us that this segment of the market or our customer base is interested in buying this second or third module. And then we can start to think about how to help them sell more to the same customer over time.

AM: VC funds typically don't have an operations team. PE funds usually do have one. You mentioned you have one too. What exactly do they do?

SW: Again, in the size of companies that we invest in, whether you are on the investment team or the operations team, the lines are really blurry. We have a dedicated operations team, but the handoffs between the investment and operations teams and the demarcation lines are not very stark. When we are thinking about making an investment, we are doing a lot of the analysis that I just talked about what we are getting, their customers' files, all sorts of financial data about those customers, and qualitative attributes tied to all that.

We are running all sorts of numbers to figure out if it's a good potential investment for us. But that analysis is exactly the analysis that the operations team is doing in collaboration with the investment team to figure out how we're really going to help them.

Because when we're evaluating the new investment, we might find that, "Oh, these small customers or these small prospects are not a good fit for us." So then, the operations team is saying, "Well, yeah. How are we going to make sure that we stop talking to, engaging with, and selling those customers that aren't going to be good fits for us?" And that's very much an operational decision that the investment team wouldn't necessarily be an expert in. It's a bit different than if you were at a large private equity firm, where the line between the investment and operations teams is much more stark.

AM: I'm assuming your operations team includes former executives of SaaS businesses with multiple exits. Is it fair?

SW: That's a great question. When most firms think about operations teams, they usually think about operating partners. They think about the people that you just described, which are the executives that were at a large SaaS company that had a very successful exit. Usually, the CEO, CFO, or somebody in the C-suite.

On the other hand, we are really looking to provide execution capacity to the firms in which we are making investments. And so, the people that we have on our operations team are doing just that. Yes, they have worked at SaaS companies before, and they have worked in consulting roles, but they will roll up their sleeves and actually do the stuff that I just described.

They are not doing monthly or quarterly calls giving advice. They are running the analyses that I talked about before, and they're helping implement the programs that will effectuate the outcomes that we talked about.

AM: Let's talk about the valuations of SaaS companies.

What do you currently see in the market?

SW: You know, over the course of my career investing in SaaS companies, the multiples, other than maybe a few months of deviation, have done nothing but go up. When I first started looking at SaaS businesses, 3x revenues was a big multiple. Nowadays, if you look at the public markets, they are 15x or 20x revenues.

In the growth equity world, the multiples have also gone up. And I would say during COVID, it's been uninterrupted. The world, if it hadn't already woken up to the subscription model before COVID, it certainly has now. Nobody wants to be selling widgets in the COVID world. They want to have subscriptions with long-term contracts and high gross margins. And as a result, there's been a flood of capital into the SaaS world. And you've seen multiples just go up.

For us, based on where we are investing with businesses that generate $1-$5 million of ARR, that got something that's working but haven't quite figured out how to scale it, we are seeing meaningful discounts to the public markets, but still really robust valuations.

AM: I'm assuming the growth rate is a primary driver of the revenue multiple paid for a company. How do those multiples change when growth increases let's say, from 30% to 60%?

SW: The relationship between growth rate and revenue multiple is not linear. A multiple paid for a 30% growth rate, and a 90% growth rate is not 3x. So it wouldn't be 2x and 6x ARR. The faster you're growing, the more your multiple is going to go up. And really, all investors are doing is trying to predict what the revenue growth rate is going to be in three to five years.

When they're trying to figure out the valuation in their models, they're saying, "OK, I invest today. In three to five years, what's this thing going to be growing at?" The very shorthand for figuring that out is (i) your current growth rate; (ii) the size of your addressable market. If you have a high current growth rate and a large addressable market, you will presumably have a higher future expected growth rate. So the valuation is going to be really high.

At Growth Street, we don't want just to be momentum investors. We don't want just to invest when those two things are present and give money for money's sake. We'd like to find opportunities where the current growth rate isn't as high as a founder would want it to be. Or, the addressable market isn't as big as some investors would want it to be. But we have some differentiated views or ways that can help the entrepreneur to impact those things.

So if we increase the retention rate or do X, Y, or Z to increase the chances of the growth rate in three to five years to be higher, that's great, right? Or if we think we can sell a second or third module to the existing customers, that increases our sales efficiency, but it also increases our TAM. Because now, we get more revenue per customer. If you just multiply the number of total potential prospects by the total potential revenue we could get from them, our TAM goes up.

For Growth Street and our entrepreneurs to be really successful, we want to pay a fair price for those businesses that maybe aren't perfect on day one. They don't have super high growth rates and super large TAMs. But we can help them increase both of those things, which will make them a bigger and faster-growing company, increasing their valuation and the revenue multiple that we would apply to them. And when we're thinking about selling, that revenue multiple would be much higher.

AM: What's your take on Rule of 40?

SW: Rule of 40 is kind of funny for us because the businesses are not generating EBITDA; certainly not on a GAAP basis. But hopefully, the growth rates are north of 40%, so technically, we make investments in the Rule of 40 companies. When we are exiting the businesses, I just talked about that, growth rate in three to five years, these companies are definitely Rule of 40 companies.

If you look at the best public SaaS companies, they're Rule of 60, 70, and 80 companies. That's our goal – having businesses that we are exiting that are growing 40% – 60%+, and are generating a little bit of EBITDA.

AM: Did you say you hold investments for three to five years?

SW: At Growth Street, we say we make investments for two to six years. Every time I say that entrepreneurs and our investors say two years. And the reason why we say two to six years is because on the low end (two years), these businesses can become strategically relevant, and there can be strategic interest early.

And that moment in time is more perishable than entrepreneurs or investors want to admit. The CEO of the acquirer or the principal/partner at that growth equity or private equity firm may have some reason why they are interested at that moment. And that moment may not last, and you need to take it really seriously. Therefore, sometimes you can have opportunities where you have to think about doing something earlier than you otherwise would. On the high end of that range, the six years, we just include that because we can't invest forever.

However, we've invested in a business called, Visual Lease, which is a lease management and lease accounting SaaS business. It grew very fast after we first invested, and we sold a piece of the business to Spectrum Equity about 1.5 years into our investment, which did a couple of things.

Number one, it put capital on the balance sheet to help that business continue to grow. But number two allowed us to take a much longer view of the investment. Because we weren't under pressure to think about when we needed to exit the investment, we could hold on to that business for another five years. Who knows?

AM: Who do you typically sell to, Strategics, PE firms, or maybe larger growth investors?

SW: That's another thing that's changed over the last decade. Now, when we look at a new investment opportunity, we are thinking about what this exit is going to look like. If we don't see a larger software business owned by a growth equity or private equity firm, we start asking ourselves questions about that market. Why isn't there somebody? Because there are so many firms and there is so much capital now that almost every end market, every vertical within the software has a large software business that's backed by a private equity firm.

So maybe, a third to a half of the time, we would expect the businesses to get sold to either a private equity firm or a portfolio company of a private equity firm. And then, the balance would probably be strategics. And that percentage has been going nothing but up in terms of the percentage sold to private equity firms or firms that private equity firms back.

AM: I've noticed that more and more large PE and VC funds are adding growth strategies. How do you compete with them?

SW: Yes. So my co-founder and I came from a larger growth equity firm, and we noticed that all the firms are raising larger and larger pools of capital and are trying to make larger and larger investments. I agree with you that the very large private equity firms have probably started growth equity practices, but also, the growth equity businesses have largely moved upmarket.

And we started Growth Street to focus on this kind of early growth capital space, where the entrepreneur has something that's working, but they haven't quite figured out how to scale it. We can make a meaningful minority investment and help them grow to the point where they can get to all of that capital that you've just talked about.

The number of firms that are just above us, with $500+ million funds, has done nothing but grow over the last 10 years. They are all looking for good SaaS businesses with high growth rates and high retention rates. And hopefully, our portfolio will be those companies, and there'll be many opportunities for them to either invest behind or acquire.

AM: Does it ever happen that entrepreneurs themselves reach out to Growth Street to raise funds? And if so, what do they typically need to prepare for the process?

SW: Most of the time, we're doing outbound to these entrepreneurs. So you know, maybe 70% or 80% of our opportunities are coming from our outbound efforts; 20% or 30% are coming from inbound through channel partners or through referrals, and we track that religiously.

From a smooth process perspective, the best founders are the ones who are already really diligently tracking all contracts. There are contract files, they are already looking at every single one of their customers and tracking all of their financial and qualitative attributes. And they are starting to figure out that customers that look like this are better for me, while the customers that look like this are not as good for me. And we can really take that to the next level.

The founders where the due diligence process is more challenging are the ones who haven't started to think about that, where they are just taking in customers and revenue wherever they can get it.

AM: What's the typical time period between your first meeting the founder and actually investing in the company?

SW: It's an interesting question. Given the stage where we are investing, the biggest risk that we take and the biggest risk the founders take is a "key person risk." If we invest in a business that's doing $2 million of ARR and the founder comes from the industry, they really understand the customer and the end market, making them invaluable to the product and the business. If that founder got hit by a bus, we are in trouble. Similarly, if the founder took investment from Growth Street and Nate, I or somebody on our team got hit by a bus, that founder would be in trouble in many respects. So we are actually trying to talk to entrepreneurs when they are not ready to take the investment or don't want to take the investment.

If the sales cycle is really short, the key person risk is really elevated. So, we can't get to a valuation that makes sense for the entrepreneur. The entrepreneurs' valuation expectations are also really high because they don't trust us. And so, you never get to a transaction that works for everyone. But if you spend time getting to know each other, then all of a sudden, the valuation expectations come together, and you can have something that really works.

So we want to talk to companies early, get to know them and their businesses, and then make an investment when it feels right on both sides. And what's been really interesting recently, and I know this wasn't exactly your question, but in COVID, one way to anticipate that due diligence would be a really hard thing. But ironically, it's been a lot easier. Because with Zoom, we can actually see into the entrepreneur's home.

Before COVID, my co-founder and I used to have one exercise prior to making an investment. We would close our eyes and imagine how the founder treated their spouse, children, neighbors, and pets. It was just a thought exercise to try figuring out what kind of partner that entrepreneur is going to be after we invest.

And now, in COVID, we see the spouse come into the Zoom and say hello. And we get a window into their personal lives that we never got before. Previously, we got, I don't know the proper term, like the dress rehearsal? Like, they put on their costume, went into their office, sat in their conference room, and put on a play for us for four hours.

And now, you can't put on a play. The doorbell rings, and you either yell at somebody to go get it, or you say, "Excuse me, I need to put the Zoom on pause for a second while I go get it." And you learn about how these people treat their family members and how they treat other people. And it's been incredibly insightful. I don't think we'll ever go back to the old world as a result.

AM: That's interesting. COVID has changed a lot of things. I actually wanted to step back for a second. You mentioned that there has to be a fit between you and the founder. When you sell the company, do you look for the same fit? Or is it mostly maximization of the return that drives the decision?

SW: I hate being the "it depends" guy, but it does depend, right? If we are selling 100% of a business, then valuation is critically important. I guess it's kind of obvious, right? If we're selling 20% – 40% of a company, other factors come into play. Can they help us increase the value of the piece of the business that we are still going to own? Will they be able to work with this entrepreneur in a constructive way to help them be more successful?

And on that continuum, valuation becomes more or less important. Think of it, we, kind of in a very self-serving way at Growth Street, talk to entrepreneurs when we are trying to make an investment, and we make this exact argument to them. And we say, "Listen, we want to buy a meaningful minority stake of the business. You are still going to control the business. So think carefully about whether we are the right partner for you. Think carefully about whether we can add the kind of value you want because that's way more important than the 1% – 3% of dilution that a change in valuation makes vs if we weren't buying all of the business."

I mean, they shouldn't care (other than their legacy) about anything else besides valuation.

AM: Have you ever been in a position where you wanted to sell the business, but the founder didn't like the buyer?

SW: No. And I should be knocking on wood like crazy. But we have an expression at Growth Street that we disagree initially but always agree in the end. And we want to build a firm where that's part of our culture. We might disagree with an entrepreneur on day one or at the beginning of a process about whether we should sell all of the company or a piece or sell to buyer A or buyer B. But at the end of the day, we agree.

And if we make that a fundamental part of our culture, then knock-on-wood, we are not going to have that terrible scenario that you described, where they say, "I would never sell to that person," and we say, "Gosh, you got to sell to that person…." That's a really bad place to be.

AM: You spoke about the founders you look for, so maybe you could provide a few examples from your current portfolio.

SW: I'll give you an example or two. One guy, Tim Ballantyne, founded a business called Suralink. It's an audit workflow SaaS business for CPA firms. Tim was an auditor and then a financial controller, and he literally lived the problem that his company now solves. And when he talks about his industry, no one knows it better. And we can help enable him with capital, with all this stuff, and help him grow faster.

Another one of our founding partners is Deb Muller. She is the founder of a company called HR Acuity. It's a SaaS business that sells investigation management and employee relations management software. What that really means is, you work at a big company, and there is an employee issue, to be a bit crass, somebody grabbed someone at a holiday party. In the older days, that would be resolved with an email and basically swept under the rug. But Deb has built software to make sure that all of these incidents are handled in a timely manner, professionally, confidentially, and fairly. All of this is possible because she had that job at Honeywell and Dun & Bradstreet.

And so, when we partner with her and give her capital and give her the resources, the sky is the limit. And the most fun part about partnering with entrepreneurs like that is that when we make our investment of, call it $3 to $12 million in exchange for that meaningful minority stake, that investment is not an estate planning event for them. They are not putting away $10s of millions and saying, "Geez, I'm rich now. I don't need to work hard."

This is truly a growth equity investment to help them accelerate growth and to get to that estate planning event later. If we can do it, we get friends for life, right? And one of the ways that we judge ourselves is by an internal KPI – how many of the founders we invested in became limited partners in our fund. And if they are investors in Growth Street, that means they have had a really successful outcome, they really like us, they really trust us, and they want to be a partner with us for the next 10 plus years.

AM: So how many of them are limited partners?

SW: I should have known the number exactly off the top of my head. But both of the companies that have had liquidity events are investors in the fund. Some of the founders that we worked with prior to starting Growth Street are also investors. A couple of the others who have not had liquidity events are investors too.

AM: Steve, thank you very much for the interview.