PitchBook

VC-to-PE Buyouts: Adapting the PE Playbook

Why PE firms are sourcing directly from VC portfolios

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Key takeaways

- PE buyouts of VC-backed companies are growing in prominence, often undertaken by a group of GPs specializing in software buyouts. Between 2000 and 2019, the number of VC-to-PE buyouts grew at a CAGR of 18.1%, compared to overall buyouts' 9.5% growth over the same time period.

- Founders and shareholders of VC-backed companies see PE as an increasingly viable exit strategy. In fact, nearly one-fifth (19.2%) of US VC exits in 2019 occurred via buyout, compared to less than 5% in the early 2000s. Going forward, founders and shareholders of VC-backed companies will become more comfortable with PE buyers, especially as PE firms alter and adapt the PE playbook to effectively leverage and profit from later-stage, quickly growing VC-backed companies.

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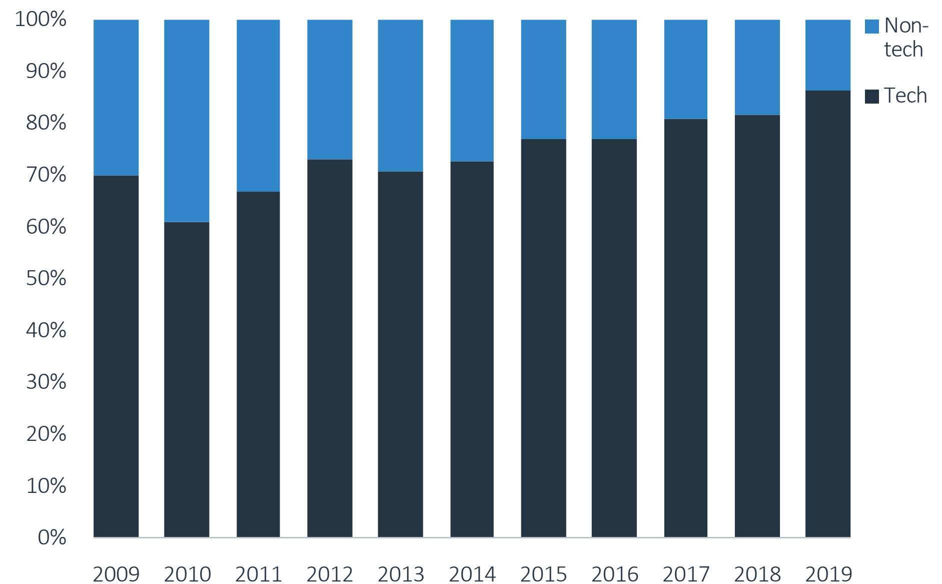
Introduction

The proliferation of PE buyouts of VC-backed companies (referred to here as VC-to-PE buyouts) stems from PE firms seeking earlier exposure to tech companies that are often staying private for longer. While PE firms may not be specifically pursuing investment in VC-backed companies, the growing overlap between buyout barons and tech entrepreneurs appears here to stay. VC-to-PE buyouts not only account for a rising percentage of PE deals, but also of VC exits. Between 2000 and 2019, the number of VC-to-PE buyouts has grown at a CAGR of 18.1%, compared to overall buyouts at 9.5%. During that time, PE buyouts went from accounting for 2.4% of VC exits to 19.2%. While a variety of different types of companies can be (and have been) VC-backed, the bulk (86.3%) are tech companies. This note focuses on PE buyouts of VC-backed tech companies, many of which could be described as software-as-a-service (SaaS) businesses.

Proportion of VC-to-PE buyouts in the tech sector

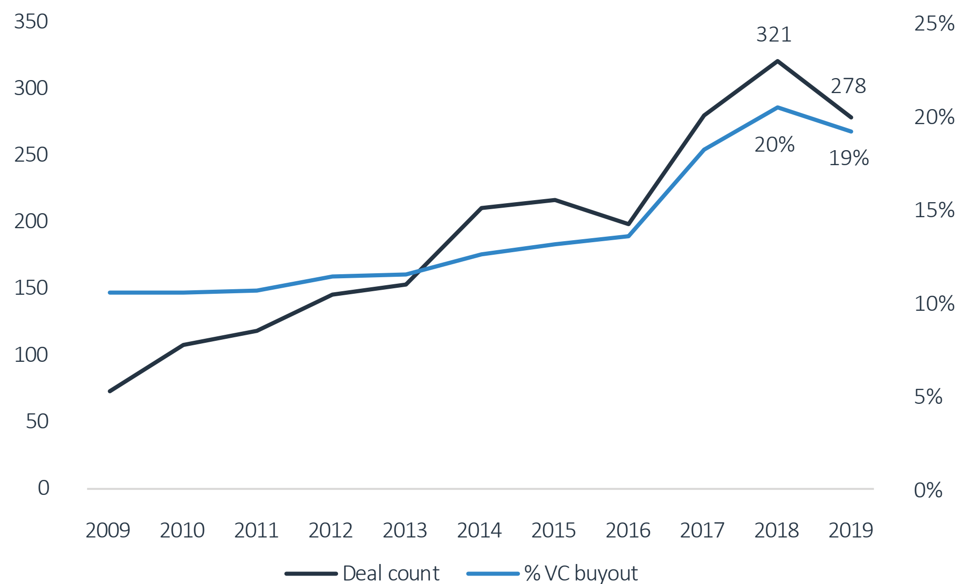


Source: PitchBook | **Geography:** North America and Europe
*As of December 31, 2019
Note: Tech refers to the entire information technology sector and associated verticals.

Financial sponsors find the high-growth profile of many VC-backed companies attractive because GPs can no longer count on financial engineering alone to drive returns; they instead increasingly rely on top-line growth and operational improvements. The SaaS business model, which enables

scalability and stability, meshes well with all buyout strategies. PE firms specializing in software buyouts often act like strategic acquirers and increasingly outbid them for high-growth VC-backed companies. Furthermore, many VC-backed companies present a differentiated return profile that tends to outperform other buyout types.

Buyouts (#) as a proportion of all VC exits

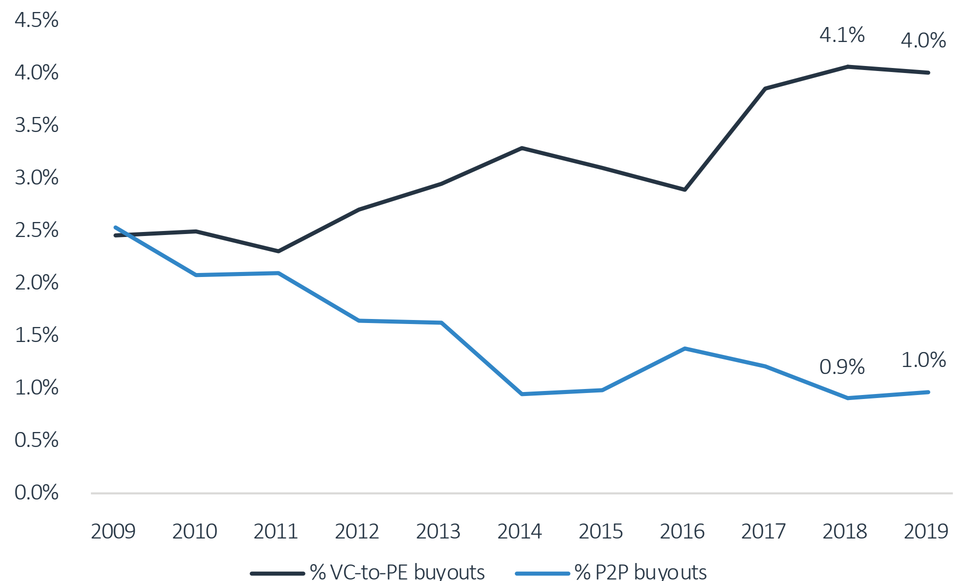


Source: PitchBook | **Geography:** North America and Europe
*As of December 31, 2019

Private capital availability

An overabundance of capital in private markets and low interest rates have allowed private companies to readily access funding and borrow at historically low rates. This has led to a new crop of VC-backed acquisition targets that are more mature—in terms of revenues, headcount and valuations—than in past decades. Indeed, the median VC-backed company acquired in a buyout is about a decade old, compared to around seven and a half years old pre-financial crisis. Therefore, while it was previously more common for PE firms to source technology investments from public markets, they can now go straight to the source. Most VC-backed companies skip the public offering altogether. VC-to-PE buyouts comprise over 4% of all buyouts, whereas PE take-privates (formerly VC-backed and otherwise) account for 0.97%, a reversal from the past. We expect to see a continuation of this trend going forward.

Proportion of VC-to-PE buyouts (#) and P2P buyouts (#) compared to all buyouts



Source: PitchBook | **Geography:** North America and Europe
*As of December 31, 2019

VC-to-PE buyouts are also becoming more common due to tech-focused PE firms having more dry powder and raising larger funds. Tech-focused PE funds have often outperformed non-tech funds, causing LPs to allocate to the space hand over fist. In turn, these tech-focused GPs have raised record sums of capital. Thoma Bravo and Vista Equity each raised funds above the $10 billion mark in 2019. This alone should drive VC-to-PE buyouts into 2020 and beyond. Additionally, non-tech-focused GPs—including Bain Capital, KKR and the Carlyle Group—have set up tech-focused funds that are likely to pursue VC-backed companies in similar numbers. Some of these firms are buyout specialists, while others are primarily growth equity firms which participate in buyouts of companies with growth characteristics.

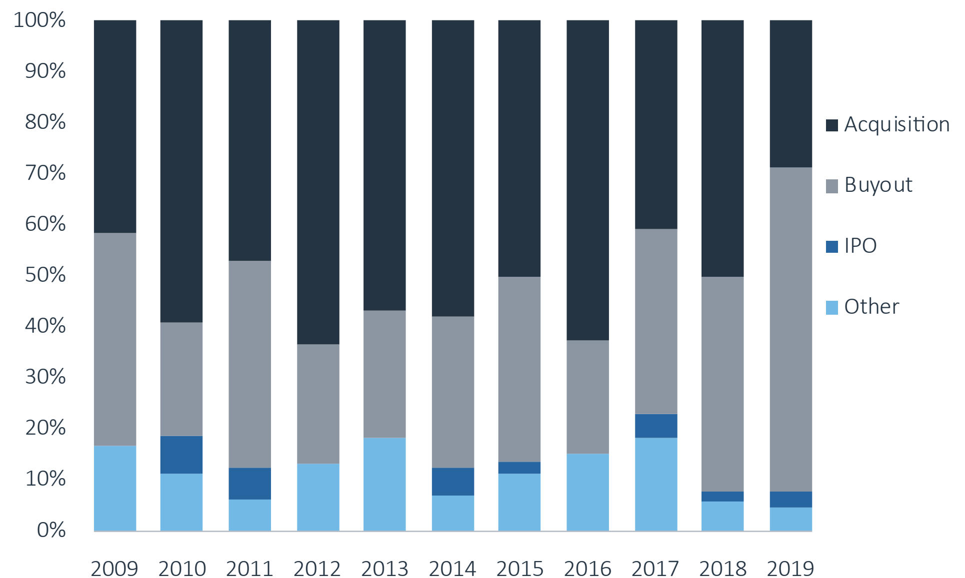
As PE firms more broadly exhibit a mounting interest in tech investing, GPs have sought out tech companies from several sources, including other GPs' portfolios. Because of this, previously VC-backed companies often have multiple rounds of PE ownership. Once a startup has been acquired by a PE firm, they are more likely to be subsequently sold to another PE firm, as opposed to publically list or be strategically acquired. In 2019, 63.6% of PE portfolio companies acquired via a VC-to-PE buyout exited via a secondary buyout (i.e. sold to another financial sponsor). This proportion has risen substantially in recent years and sits comfortably above the figure we observed across the broader PE exit market (around 50%).

Top firms investing in VC-to-PE buyouts (2000-2019)

Investor name	Tech deals (#)	Non-tech deals (#)
Vista Equity Partners	66	0
TA Associates Management	40	4
Providence Equity Partners	40	2
Thoma Bravo	37	0
Insight Partners	34	1
Francisco Partners	31	1
Silver Lake Management	29	0
Kohlberg Kravis Roberts	26	9
The Carlyle Group	25	7
Warburg Pincus	25	6

Source: PitchBook | **Geography:** North America and Europe
*As of December 31, 2019

PE exits (#) of formerly VC-backed companies by type



Source: PitchBook | **Geography:** North America and Europe
*As of December 31, 2019
Note: "Other" includes bankruptcies, out-of-business and undetermined situations.

Buyer and seller considerations

Buyside

Myriad factors underlie the VC-to-PE buyout trend. An influx of capital has pushed prices higher in PE's traditional, lower-growth industries, making outperformance more difficult in the process. This has lured many GPs into the tech space, where the (often organic) high growth and promise of outsized returns can offset

generally elevated buyout valuations. In this typically low-growth environment, investors are willing to pay up for tech companies with these types of robust return profiles.

The potential drawbacks of public markets are widely known, and PE firms have key advantages over corporates when it comes to acquiring VC-backed companies. PE firms are structured to easily facilitate the dealmaking process, which contrasts with the slower pace of corporate acquisitions. While a corporate acquisition regularly requires approval from multiples sources—including the corporate development team, C-suite executives, shareholders and more—a PE acquisition generally only needs the investment team's approval. Furthermore, changes in capital market dynamics, poor earnings, departures of key executives, recent acquisitions, or lack of shareholder approval can all inhibit or delay dealmaking for corporate acquirers, but generally don't hinder buyout firms in the same way.

Sell side

Compared to corporate ownership, selling to PE has certain advantages. Although PE firms are often the highest bidder—the primary consideration for most VCs—selling to a financial sponsor may be a more attractive exit route even if the headline acquisition price is not the highest. PE firms can appeal to founders and management with a "best of both worlds" solution: partial liquidity while maintaining some upside. Under PE ownership, founders and managers can continue building their company as a private entity and work toward another exit at a multiple of the company's current valuation. In buyouts, founders and executive management can often roll over a portion their equity from the target company into the new entity in lieu of cash returns. This benefits the PE firm by reducing outlay costs. Additionally, by allowing management to hold a sizable equity stake, GPs also help to align their respective incentives. This contrasts with corporate ownership where a company is typically folded into a larger (often public) entity and the founders and management generally no longer have an equity stake in their former company.

The changing PE playbook

In the pursuit of quickly growing VC-backed companies, PE firms have developed several key advantages to outbid strategic acquirers and appear more attractive than an IPO. Today, every serious PE firm has developed an operations shop (op-shop) focused on boosting top-line growth. This contrasts with prior PE

strategies that relied more heavily on cost cutting and financial engineering. The most prominent tech-focused buyout firms, Vista Equity Partners, Thoma Bravo and Silver Lake Partners, all have in-house operations teams that explicitly focus on building technology companies. Vista takes this a step further; executives across their portfolio companies will meet regularly in order to trade tips on strategy and share best practices, allowing them to reap the rewards from economies of scale. To be a serious competitor in the space, sector specific op-shops are a requirement. As generalist firms, such as Carlyle, enter the tech-focused mix, they too have had to build out tech-specific teams.

GPs can also quickly drive top-line growth by integrating add-on companies and cross-selling and/or boosting the company's offerings. Often, PE firms will streamline operations and properly incentivize sales teams. While this is a key part of the broader PE playbook, PE firms can more swiftly make changes with tech companies due to the unique scalability of software. While some methods of value creation are industry-agnostic, there are some levers PE firms frequently pull that are specific to software. Experienced PE investors in software often improve operations through cloud/SaaS integration, sales and pricing initiatives, sophisticated software engineering and productization.[1] Top-line growth is of paramount importance because markets generally value software companies on revenue multiples.

Looking forward

VC-backed companies are highly sought after because of their potential for growth. To PE firms, buyouts of VC-backed companies represent a way to maintain mid-double-digit returns, while for VC-backed companies and founders, they can be a lucrative exit option with additional upside potential. We expect these deals to continue proliferating as tech-focused PE funds multiply and spend down dry powder. Further, many later-stage VC funds will seek nontraditional liquidity options amid public-market pushback on unicorn valuations. Going forward, we hope to explore a more in-depth analysis of the specific value-creation levers used to improve these companies.

1: "Cracking the Code in Private Equity Software Deals," BCG, Michael Brigl, et. al., May 16, 2017.