

Five features every successful investment shares

Growing businesses that haven't worked with private equity before are often nervous about raising investment. They worry their new investors will want to take over, or to run the business solely to deliver a short-term return.

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Above all, they often have a relatively limited idea what private equity investors might be looking for in a potential investment. The truth is that the best private equity backers are very supportive - they provide a wealth of experience and advice in addition to capital investment. But to get the relationship off to a strong start, it's crucial everyone is on the same page.

At Gresham House Ventures, there are five attributes we always look for in a potential new investee business.

A differentiated product or service

There's no such thing as a brand-new product or service - almost everything is an iteration of something that has gone before. But to succeed, businesses do need to give customers a compelling reason to come to them rather than to a competitor. Management teams are often proud of the products and services they've built - but lack the self-awareness to see that other businesses offer something almost identical.

The best businesses, by contrast, position themselves carefully in the markets they serve. For example, Gresham House invested in Connect

Childcare, a SaaS platform offering nursery administration services as well as an app for parents and nurseries to communicate with each other in the UK. It is the market leader and only business in its sector offering a sophisticated platform that can manage a large number of nurseries, who operate within in the same nursery group. It also had 14 of the top 25 nursery groups in the country. All its rivals concentrated on the smaller end of the market with a more “plug and play” solution.

Industry tailwinds

Businesses need to have the right product or service, but they also need to have it at the right time. In other words, the broader economic, commercial, or strategic backdrop needs to be supportive.

In a recession, say, does your business sell a must-have product or service, or is it discretionary spending for customers? Are you well-placed from an environmental, social and governance (ESG) perspective?

Regulatory change is a good example of a tailwind that can offer businesses particularly strong support. Gresham House’s investment in ActiveNav is a case in point; it developed a platform that identifies unstructured data in organisations and manages the ongoing governance of this data to serve a market that has been scrambling for solutions since the introduction of the General Data Protection Regulation (GDPR) and subsequent privacy legislation.

Strong management team

Track record matters because people learn from their mistakes. Strong management teams typically consist of people who’ve built businesses in the past - and, at times, seen them fail. They have experience of what works and what doesn’t at different times in the cycle. And they know how to build the right teams to maximise their chances of success.

That's not to say every management team has to be stuffed full of industry veterans - private equity can, and does, play an important role in providing investee companies access to support, and management teams should welcome opportunities to listen and learn. But with experience comes wisdom.

For example, when Gresham House invested in media business IPV, one key selling point was its CEO Mark Fagan, who had previously worked with a string of successful start-up and scale-up businesses. He has gone on to build a strong team around him and they continue to make strides in their industry, while others struggle to gain traction.

KPIs - hard numbers matter

Every management team naturally wants to talk up their business's performance, so it is important to have agreed benchmarks through which that performance can be scrutinised with objectivity.

These key performance indicators (KPIs) provide a continuous read-out of how the business is progressing; they also offer a quick scorecard against which investors can assess companies according to their own criteria.

At Gresham House, we look at the scores on a number of specific KPIs with a keen interest. In the SaaS sector, we're particularly looking for annual recurring revenues of more than £1mn - and ideally between £2mn and £3mn; we favour business which are break even or have a clear pathway to profitability; we look for high customer retention rates, typically above 95%; we focus on businesses with annual contract values that are higher than £20,000 (rising to £50,000 or even £100,000 with enterprise clients); and we like to see gross profit margins above 75%.

Alignment of interest

The question of alignment is the most subjective of our five key features, but one of the most important. Essentially, we want to work with businesses where the management team is motivated by the same aspiration as us - to grow the business over time in such a way that all stakeholders can look forward to attractive returns.

When we meet potential investee companies, the discussion about valuation is often revealing.

Management teams understandably want to achieve a strong valuation for their business, but when they are unrealistic about what the company is worth - often making assumptions about performance that will be almost impossible to realise - it's a red flag.

What management see as a good return can differ vastly from what investors see - driving possible misalignment. Starting a relationship with expectations out of kilter increases the potential for conflict later on, so good communication on this point is absolutely vital.

Rowan Grobler is investment director at *Gresham House Ventures*.