commonfund private equity

Seeking Alpha in A World of Private Equity Beta

A Commonfund Forum Spotlight

From left to right: Mark Hoeing, In Seon Hwang and Fred Sturgis

Deep sector expertise is a differentiator in the pursuit of alpha-like private equity returns.

Commonfund Forum 2024 convened a Forum Spotlight panel to discuss growth equity and middle market private equity viewed through the lens of sector/industry specialist managers who concentrate deep expertise on opportunities overlooked by large- and mega-cap managers. The panelists were In Seon Hwang, Managing Partner, Ascend Partners, and Fred Sturgis, Managing Director, Resurgens Technology Partners. The exchange was moderated by Mark Hoeing, President and CEO, CF Private Equity.

Mark Hoeing: We believe that over the past 15 to 20 years private equity has migrated, similar to public equities, into a world of private equity beta and private equity alpha. The beta component of private equity is represented by the generalist, large- and mega-cap managers. Private equity alpha is closer to managers generating potential outsize returns relative to the public markets and these firms are often founded and built on deep sector and industry expertise.

We have two such specialists with us today to explore this notion of generating alpha within the larger world of private equity beta. To start, let me introduce In Seon Hwang and Fred Sturgis. In Seon, tell us about Ascend.

In Seon Hwang: We started Ascend Capital Partners in late 2019/early 2020. Our first fund was a $570 million fund focused very specifically on underserved and vulnerable communities. Especially in the U.S. this is a massive portion of the population where there are outsized disease states relative to the access and affordability of quality health care. The question we asked is, how do we take what private equity is good at and address this problem? To us, that's understanding opportunity, allocating capital, and creating value for our investors aligned with great problem solvers and getting capital flowing into these communities.

If you're going to invest in these communities, you need more than just money. It's more difficult than private equity generally. You have to build your firm differently and that comes about by accessing operating clinical technology resources. We very much believe that if you bring all of that to bear, not only can you deliver top-tier private equity returns, but you should also have a meaningful impact on the communities that you're serving.

Hoeing: Fred, give us an overview of your background and strategy and your launch of Resurgens Technology.

Fred Sturgis: We're a small buyout firm focused on software. I've been in the private equity industry for 23 years, most recently at Accel-KKR where I was responsible for the firm's small buyout strategy. We formed Resurgens in 2016 and raised a $200 million first fund followed by a $500 million second fund. The reason for a focused firm is that at bigger, multi-strategy firms it's difficult to invest the time and resources to really know the smaller end of the market. So, we have a concentrated strategy as software specialists, but we invest across the spectrum without focusing on any particular vertical.

Hoeing: Perhaps we could delve one layer deeper into sector specialization and why, In Seon, you chose your health care concentration.

Hwang: We focus on multi-site physician groups—think of 100 doctors in 30 locations. We stay away from what I consider to be the generic end of the market, including dentistry, veterinary and physical therapy, that represent the more retail-like consumer product side. Those also tend to be more competitive, and the value creation levers are less obvious.

Our focus is on the deeper, more complex areas of the market especially around primary care and multi-specialty care, really understanding patients' holistic, continuous need for health care and proactively keeping patients healthy instead of waiting until they get sick. Almost every deal we've done has been with the founding physicians and a practice of maybe 100 doctors, $100 million in revenue and $10 million of EBITDA. Almost always they have outgrown their ability to manage the practice. So, these are good doctors, they care about their community and run good clinical operations, but the complexity of this business is not linear. What if the practice adds 100 doctors, 200? Complexity compounds and excellent doctors can be overwhelmed. What we're able to do is come in and anticipate the systems and processes needed when you add doctors. And these practices deliver higher quality care and become more productive than they could on their own.

Hoeing: Can you bring that alive with a particular case? There's a good one in your track record prior to fund one.

Hwang: I went to college and became friends with a fellow who became a doctor, and he created a company called CityMD. If you're a New Yorker, you know what CityMD is. As Starbucks is to coffee, CityMD is to health care in New York. When I was at my previous firm, we invested in CityMD at a valuation of $600 million. They had about 60 medical offices around the city. In two years, we exceeded our five-year case. We sold the company five years after investment for $9 billion—a phenomenal outcome for a non-technology deal. We were serving about 3 million

patient visits a year. To manage the volume, we invested in data layers, so we knew exactly how many cardiology, neurology, endocrinology, or urology referrals we were getting. When we acquired a cardiology group or urology group, we knew exactly what we could plug in and where we could create value while better serving the patient and saving money for the insurance companies or the government in ways that these doctors independently could not do.

This is a relatively simple insight, but very hard to do. And we've been able to replicate it across multiple communities and multiple, very different patient populations in ways that unlock value such that we can buy these independent doctor groups for 5X their EBITDA, which becomes 1X EBITDA relatively quickly.

Hoeing: That's a great example. We tracked CityMD in our other portfolios for many years. If I had to summarize your sector expertise from my perspective, I would say you're experts at building the structure to help overall practice management and help doctors be doctors and deliver the kind of results that insurance companies and the government are looking for, which is track the patient through the life cycle and improve efficacy, outcomes and the patient experience. This is a mega-trend that is agnostic to the business cycle as well as the capital market cycle.

Fred, let's move to the world of software. You're not focused on specific vertical end markets. What you're looking for are special situations at the inflection point in a company's growth cycle. Tell us more about it, please.

Sturgis: We point ourselves toward founder-owned and operated companies and offer a buyout style transaction. These are good companies owned and operated by industry participants who generally identified a niche problem and built a software product to solve it. They've probably been at it for 10 or 15-plus years and they're looking for liquidity. We're generally not backing people who came out of MIT or Stanford. We're not typically the right partner for businesses that are growing 50 percent a year. But if you're a 15 or 20 percent grower that's a great starting point because if there's one thing that's universal it's that these businesses are all under-managed and oftentimes fairly dramatically.

So, we are bottom-up investors prepared to build a talented team, often replacing the founder as CEO. It's not like we're sacking the founder—we want them to reinvest in the business and to play a role in the company going forward, if that's what they prefer. What we're saying is let us manage the company and the stake that you've retained will be worth a lot more. These founders don't really want to run the company so having a professional management team is attractive because they are not going to scale the business without it.

Hoeing: Give us an example of a portfolio company.

Sturgis: In our first fund we invested in a company called OfficeSpace, which developed an interesting space management software product. It functions like a visual rendering of your floor plan and allows you to plan your space, manage moves, book desks and rooms, check-in visitors and deliveries, and see who's in the office. This was pre-COVID interestingly, November of 2019. We sourced it through a smaller investment banker we had known for a long time.

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>
> *– In Seon Hwang, Ascend Partners*

The two co-founders wanted to sell to a sponsor and be part of a platform but didn't want to run the business. For our part, we wanted to take a controlling interest, install a management team, and run the business for growth. This was an $8 million revenue company, and a unique factor is that the co-founders had moved the entire business to Costa Rica for the lifestyle. There was no U.S.-based operation. We had to build an entire management team in the U. S. and contributed one of our people to the business as the head of product strategy.

Fast forward two years, this company had a really interesting COVID bump. Vista Equity Partners came in and recapped the business at a very significant mark-up for Resurgens. We took out almost half our money and left half in, retaining a 25 percent share and a seat on the board with Vista. The co-founders sold another half of their retained interest and made more money on the second bite of the apple than they did when they sold their controlling stake to Resurgens. That's the makings of a great partnership.

Hoeing: At your firm how do you think about new hires, new sectors, operating expertise versus purely investment professionals?

Sturgis: We have about 35 people now, half operating professionals and half investment professionals like me. One thing I've learned is how to look at complex situations and non-trivial deals. That's important because if your team is too small you subconsciously point yourself at situations that are more predictable because you need a high batting average. Some of the most interesting deals at the smaller end of the market are not easy to get done. The first deal in our second fund we had under exclusivity for 14 months—we watched the company a long time, which, of course, is a better way to really know a business. On the operating side we have people focused on strategy, product development, sales, marketing and general management.

Hoeing: If I had to articulate Resurgens' strategy, I would say it's a sector expert team looking for companies that never wanted to take venture capital. So, what Fred and his team are looking for are those entrepreneurs who built a business, got it to a certain scale and then recognized they needed help to continue growing. They see a period in their lives when they can bring in new management leadership and roll 40 percent, maybe 50 percent, on their stake. And these entrepreneurs actually validate whether Fred and his team are any good by talking to 10 to 15 different firms.

Hwang: There are so many similarities to Fred's in our approach even though we're in different sectors. Everything we've invested in has been a founder-owned, founder-led practice. They're doing well, but very often they don't know what they don't know. We tend to be the first institutional capital. Therefore, you have to overbuild your operating team. We have about 15 people on the core investment side but 50 people on the operational side.

In health care it helps to look at how the Center for Medicare and Medicaid Services measures quality scores. It's a simple five-point system but there are a lot of things that go into it—like 18,000 diagnostic codes that collapse into 90 different disease states and measures that collapse into a five-point score. It's things like this that overwhelm doctors. Being at three stars is average but five stars makes a difference not only on revenue and margin but also in patient care and outcomes. It keeps people out of the Operating Room or the Emergency Room. When we come in most practices are right around the three stars average, meaning 50 percent of your patients and 50 percent of your doctors are doing what they should be in terms of annual checkups, your blood sugar, mammograms, colonoscopy and so forth. What we do with our teams, systems and processes is take that to about 85 to 90 percent of our patients getting higher quality care.

The other interesting stat is the average American doctor spends two to four hours a day in their office not seeing patients. It's all insurance paperwork, medical malpractice … you're running a small business. It's the worst use of their time, they hate it and so they make mistakes. And the ROI on taking those administrative activities away from them and doing it better with cheaper resources and technology allows doctors to spend more time with patients.

Hoeing: We have a sense for the specialized nature of what each of these firms focuses on, and the attractions of sector specialization. It's really at the front end of the company building curve.

So, what are the risks? How are those risks mitigated? In your case, In Seon, we're talking about doctor practice

management. How do you think about risk when you invest and what do you do to mitigate those risks?

Hwang: There are risks but we've been fortunate. In our first seven deals we used no leverage and in our eighth deal, which represented $400 million in revenue, $90 million of EBITDA and 98 percent EBITDA to cash flow conversion growing north of 20 percent a year under long-term recurring contracts it would be easy to lever that business six, seven times but we only levered it one time. So, we try to take leverage risk off the table. Instead, we've structured our investments so that everything has a 13 – 15 percent preferred rate of return. So, we basically lock in what looks like second quartile or median returns as our downside case.

With doctor groups the thing that I worry about the most is making them wealthy and losing them to retirement or they become lower quality, less productive doctors. That's why we don't do 100 percent buyouts. We usually do 51 to 70 percent buyouts with full governance control. Even when we have less than 50 percent economic ownership, we have very disproportionate governance to make sure that we can exercise our governance rights.

Hoeing: How about from your perspective, Fred? How do you think about small companies growing quickly? How do you mitigate risk?

Sturgis: It's some of the same things. Software businesses are entirely recurring revenue now for all intents and purposes. Right? When we started the firm, we thought we would be able to do some business model transitions from license to maintenance to SaaS (Software As A Service). Now it's just completely disappeared, and our businesses are 90 percent-plus recurring revenue and 100 percent-plus net customer retention. So, essentially, 100 percent of every dollar comes back every year without selling any new customers. And the businesses are highly diversified. These are niche businesses that are attacking market segments that are usually not big enough to be interesting to venture capital firms. They're insulated to a degree just based on what they do and how niche they are. Same thing from a leverage standpoint—we're putting debt on these businesses but only something like 25 to 30 percent. We've never had a business decline in revenue, much less get anywhere near to having a difficult conversation with a lender.

Hoeing: We've been through a rapid rise in interest rates and we at CF Private Equity, probably like many here in the audience, have been waiting for the cycle to turn. We had 15 years of up and to the right metrics but that changed in the last two years. Now we emphasize or over-index our investment strategy toward low levered or no levered strategies. We like this part of the market because you're investing in fundamental growth and not levering the business. The rise in interest rates, of course, stems from inflation so let's talk about that a bit. In Seon, how has inflation affected your businesses and how do you manage it?

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Hwang: About 50 to 60 percent plus of our cost structure is wages—physicians, nurses, billing and coding people, call center people. Without a doubt, that is the biggest

factor over the last two years that we've had to deal with. To overcome this, for us it has meant two or three big layers, the biggest of which is revenue growth. Most of our portfolio companies have more than doubled revenues since we made our investment. Second is the quality improvements that we've been able to secure over a remarkably short period of time and we do get paid by the government on about 50 percent of those savings. Those are very high margin dollars that for us have overcome the cost escalation. But you need to have those value creation arrows in your quiver so you can make a difference right out of the gate. The last part is avoiding the leverage component because if we had levered to the degree of others all our EBITDA would have gone towards debt service, not toward financing growth. That's the playbook that has worked really well for us.

Hoeing: Fred, we'll turn to you with a similar question. When I think about inflation it puts a lot of pressure on the earnings power of large corporate customers. And they have debt service that's going up along with higher interest rates. It only increases the need to outsource to small, nimble private companies that can solve problems more effectively.

Sturgis: Our cost structure is about 80 percent wages. Software companies are people, essentially. But to your point, Mark, one of the big levers we have is being the recipient of larger corporations' outsourcing dollars. That's a big reason we're in business. Pricing is another factor in our favor. The companies that we invest in have almost never raised prices prior to our involvement, which is kind of shocking, right? I mean cumulatively they've invested perhaps tens of millions of dollars and never once raised pricing. Or maybe they're satisfied raising prices at 2 percent, 3 percent a year. So, there's a lot of pent-up opportunity for us to raise prices. In the last 12 to 18 months, we've passed along price increases of up to 10 or 15 percent. We have a business right now that by acquiring companies and repackaging the products is beginning to pass along 30 percent aggregate price increases.

Hoeing: Gentlemen, our time is up. I want to thank you both for sharing insights into both the financial and operational sides of your investment models and the opportunities to pursue alpha in smaller buyouts and growth equity.

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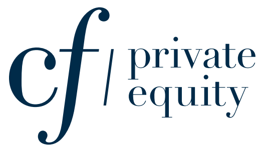

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