



Back to the Basics of Private Equity Investing

The Evolution of Private Equity

In the early stages of the private equity industry, investors were often operating professionals who had successfully built their own businesses. These venture capitalists leveraged their own experience by rolling up their sleeves and working with their young portfolio companies to help them grow and develop. While technology and other high-growth industries have always been favorites of the venture capital community, some venture capitalists also invested in more mundane businesses when there was a compelling opportunity to generate high returns.

The leveraged buyout industry emerged as a new private equity class in the 1980s. Buyout professionals focused their attention towards the amount of debt financing they could utilize to leverage the acquisition of their portfolio companies. The buyout industry flourished throughout the 1980s and 1990s, driven primarily by the availability of “cash-flow” based debt financing and the expansion of valuation multiples.

Today, the venture capital segment of private equity focuses almost exclusively on high-growth industries such as information technology and life sciences, and generally invests in companies at the very earliest stages of their development. The enormous returns that can be realized by a few “winners” in a portfolio dwarf the losses that occur on the “losers”, allowing for positive overall returns. Therefore, this model dictates that VCs focus their energies on high-risk, high-return prospects – not on less-risky, slower-growth companies.

Conversely, buyout firms seek to acquire large, established companies with stable cash flows, enabling them to raise sufficient debt financing to help generate their targeted investment returns. The larger the company and the more stable the cash flows, the better. The buyout world’s increasing appetite for larger deals is evidenced by the dramatic growth in \$1 billion plus

size funds. According to *Venture Economics*, 205 buyout funds with commitments in excess of \$1 billion were raised from 1997 to 2003. From 1984 to 1996, only 45 such funds were raised.

Active buyout funds, defined as those that raised investor capital from 1999 through 2003, raised an average of approximately \$540 million per fund (*Venture Economics*). This translates into minimum investment sizes of \$20 million to \$50 million in order to deploy the fund's capital efficiently, which equates to companies with revenues of at least \$50 million, and generally greater than \$100 million. By comparison, private equity transactions focused on "small market" companies, defined as those generating revenues less than \$50 million, typically require equity of only \$2 million to \$10 million.

While this evolution in private equity bodes well for promising technology start-ups targeted by venture capital firms, and larger companies with revenues of at least \$50 million targeted by buyout firms, it has created a dearth of equity capital available to established, non-tech companies with revenues below \$50 million. This is an interesting dynamic, given that there are 220,000 businesses in the US with revenues between \$5 million and \$50 million, and only 26,000 businesses with revenue greater than \$50 million (*US Census Bureau*).

The lack of attention paid by the private equity world to this large segment of our nation's economy further results in less operating expertise being available to guide these companies. Interestingly enough, small market companies derive far greater benefits from active operating guidance than their larger peers, which can lead to higher financial returns to their investors.

The interesting paradox is that while small non-tech companies are generally ignored by most of the private equity world, investments in this segment consistently outperform other private equity classes by a wide margin. The proof is irrefutable. Based upon a report published by *The Hewitt Investment Group*, deals in the small segment of the buyout market returned approximately 25% annually to their investors over a 20 year horizon. These consistently high returns compare very favorably to the 15% returns earned in venture capital, and are double the returns of the buyout industry taken as a whole (approximately 12%) over the same period.

The Genesis of Fundamental Capital – Getting Back to the Basics

Fundamental Capital was created to get back to the basics embodied in the early stages of the private equity industry. More specifically, making investments in small growth companies and then actively working with them to expand their business profitably. The firm is comprised of 21 founding investors and 12 operating partners who share the vision that small growth companies make excellent investments when they are nurtured and advised by CEOs who are experience in building their own businesses.

Fundamental Capital was founded by Kevin Keenley, who like many of its investors, brings both a private equity and operating perspective to Fundamental Capital's investments. Other prominent financial investors include Dan Lufkin (founder of investment bank DLJ), Pacific Community Ventures (an investment firm and non-profit promoting the growth of low to moderate income jobs), and Bob Puette (former President of Apple USA, Centigram Communications, NetFrame and former Cisco board member).

Augmenting the experience of the firm's private equity oriented investors is a team of operating partners. These operating partners are CEOs who are experienced in managing and successfully growing businesses in a wide range of industries. Collectively, this pool of talent addresses the myriad operating issues confronting a growing business. Areas of expertise include organizational structure, business development, operating efficiency, corporate finance, expansion plan implementation, and strategic acquisition integration, to name a few.

The firm's founding investors were inspired by the desire to address two pervasive problems confronting small market businesses:

1. The lack of investment capital interested in either growing or acquiring their businesses.
2. The need for hands-on strategic and operating guidance to help management teams manage their growth profitably.

Meeting the Capital Needs of the Small Market

As venture capitalists direct their energies toward promising start-ups and high-growth industries, and buyout firms seek larger companies to acquire, small market companies face a difficult task in attracting capital. Bank loans are tied to the collateral of the business, and lenders are unwilling to loan more risky “growth” capital. Strategic buyers tend to focus on larger companies as acquisition candidates, thereby limiting the avenues available to small company owners looking to sell their businesses.

Fundamental Capital is looking to fill this void by focusing solely on growth companies that have reached an “inflection point” – a point in time when they require capital and guidance to grow their business to significantly greater levels of revenue and profitability. While investing in these situations carries with it a significant amount of risk, the financial return dynamics are compelling.

Small companies have greater growth prospects than their larger peers, and significant opportunities to benefit from the operating leverage created by spreading their fixed costs over an expanding revenue base. These companies also receive a significant increase in the valuation multiples applied to their operating profits as they become larger and more sustainable.

Small company investments also require a lot of work. Many would argue that these investments require as much time to manage – if not more – than larger deals. The founding investors of Fundamental Capital agree; it is precisely this required commitment to help navigate the success of the small market company that fuels their passion for this segment of the private equity market.

Expertise to Make Good Companies Great

Executives in small, fast-growing businesses need help. They jump from one fire to the next and often lack the time or resources to devote to strategic opportunities which can take their business to the next level. The strategic and operating guidance provided by Fundamental Capital helps to shoulder the burden of these over-stretched, under-staffed management teams.

The key ingredient in Fundamental Capital’s ability to ensure the success of its portfolio companies is its team of operating partners. While investing in small growth companies is not a

new strategy, the utilization of a large team of CEOs to work with the companies differentiates Fundamental Capital from other private equity firms in this space.

In order to qualify as an operating partner, executives must have successfully run a business with revenues less than \$100 million at some point during their careers. Most of these CEOs also benefit from executive positions at larger firms as well; providing management teams with the experience necessary to design best-practice processes to prepare for the challenges of taking their business to new levels. Fundamental Capital's core group of operating partners are supplemented by a network of over 100 CEOs who are available to work with portfolio companies based upon their functional and industry expertise.

Fundamental Capital believes that only a CEO who has built a business from the ground up can truly appreciate the day-to-day and long-term challenges a small market company faces. There is no substitute for experience.

The Future of Fundamental Capital

The private equity industry is an increasingly valuable contributor to the success and prosperity of the U.S. economy. However, both the venture capital and buyout segments of the industry have matured and firms now need to rethink their investment models and codify the differentiation they can offer their portfolio companies. Simply providing capital is not enough. The prevalence of capital and the extraordinary growth of competing firms has, and will continue to, drive down the expected returns for those in the industry that do not adapt.

Fundamental Capital is poised to generate exceptional returns for its investors, and to add tremendous value to small market businesses that are starved for capital and strategic guidance. This market has consistently outperformed other sectors of the private equity industry, and Fundamental Capital believes that the combination of its investing acumen and operating expertise positions the firm to be the industry leader in its niche.

Fundamental Capital's approach to private equity investing is not revolutionary - it is simply getting back to the basics.