MERITAGE

How the Traction Fund Defines Growth Equity

A simple web-based search reveals that Growth Equity is defined differently by many different organizations. For example, the National Venture Capital Association includes it as a subset of venture capital, characterized as "the final part of the venture investment life cycle." Others, including a highly regarded fund-of-funds manager, define Growth Equity as a unique category: the third leg of a Venture Capital/ Private Equity/Growth Equity stool. Interestingly, a number of firms that describe their investment stage as Growth Equity define it simply as attaining a certain level of EBITDA. The level varies among firms with some at $5 million, others at $10 million and some even at $20 million-plus. Some practitioners include smaller buy-outs as part of Growth Equity; others do not. What some have labeled Consolidation Plays is included in some definitions, while some define late-stage venture as Growth Equity. At TF Investors, LLC ("TF" or the "Fund"), we believe growth equity is an investing discipline that is separate and distinct from venture capital and leveraged buyouts. This means that we seek high return with mitigated risks.

Risk-Based Definition of Growth Equity

Given these alternate definitions of Growth Equity, we thought it might be constructive to define what Growth Equity means to the TF. Although we will use EBITDA attainment as a shorthand definition, as the Fund will only invest in EBITDA-positive companies, in our experience, EBITDA attainment does not fully define Growth Equity. For TF, Growth Equity centers on the discipline of risk evaluation and mitigation. Rather than accept the long-standing investment allocation choice between high-risk/high-reward and low-risk/low-reward (both acceptable investment practices), we firmly believe that mitigated-risk/high-reward is a more desirable and also highly achievable investment outcome.

The Seven Entrepreneurial Risks

Every business enterprise faces seven entrepreneurial risks. Of these seven risks, we believe all can be meaningfully mitigated. Growth Equity opportunities of interest to the Fund are either successfully mitigating or have successfully mitigated these risks. Interestingly, Execution Risk is the one risk that many investors underestimate at their peril. Therefore, let's start there.

Execution Risk

Many investors believe Execution Risk can never be fully mitigated, suggesting it remains in play regardless of the size or age of an enterprise. For many years, we believed this as well... until we discovered the Entrepreneurial Operating System®, or EOS®.

> "Every company has an operating system, whether it has a name or not. That system is the way a company organizes all of its human energy. It's the way that the people in the organization meet, solve problems, plan, prioritize, follow processes, communicate, measure, structure, clarify roles, lead, and manage."

At its simplest, EOS® is a complete system of simple concepts and practical tools which ultimately leads to a healthy, focused organization that makes continual progress toward the organization's vision. The result: Execution Risk is mitigated by companies professionally implementing EOS, which is why the Fund will only invest in companies running on EOS®.

The other six risks are:

Market Risk
Importantly, TF seeks companies that are addressing large and growing markets. This is in contrast to a venture capital investment focus on new or emerging markets. When a new or emerging market is effectively exploited, extraordinary returns are possible; however, there is considerable risk that capital is lost when investments are "too early" from a market perspective. Therefore, the Fund seeks proven markets and emerging leaders within those markets. Further, we vastly prefer participating in a growing market versus trying to grow by taking market share from competitors.

Product or Service Risk
At the Growth Equity stage, forecasted growth should not depend upon introduction of a new product or service. We will invest the Fund in businesses with products or services that customers have already purchased, often repeatedly. When a company touts a new growth product, we consider that a "start-up within an established firm." Therefore, we tend to attribute little value to a new product until it has demonstrable effectiveness, usefulness and marketplace acceptance

Management Risk
The real estate mantra of "location, location, location" translates to "management, management, management" in the private capital world. At the Growth Equity stage, the management team, though perhaps not fully complete, must be comprised of executives/entrepreneurs who have a track record of success. The company must be on the path of achieving 100% Right People in the Right Seats (EOS® tells us how to accomplish this). Proven management talent attracts other proven managers. This contrasts to the venture capital investment model, in which many executives and entrepreneurs are as yet unproven. Unproven management risk is not acceptable to the TF investment model.

Business Model Risk
Business model risk can mean different things to different people. From TF's perspective, we believe that a company at the Growth Equity stage must have a proven business model. By this we mean that revenues exceed expenses, thus creating a profitable business. In addition to investing in real businesses with real revenues and real EBITDA, we evaluate how a product or service is sold. For example, there is a significant business model difference between selling hardware and selling Infrastructure as a Service; a significant difference between selling software or Software as a Service. Furthermore, how the company delivers its product or service, including its sales or distribution channels, is particularly relevant. In venture capital, there are examples of pre-revenue companies being sold at staggering valuations, yet those examples are few and far between. There are also numerous examples of companies raising significant venture capital prior to having a proven business model. At TF, this is not the case. Growth Equity is based on the simple premise that capital is used to finance growth or to facilitate ownership transfers, in proven business models, not to develop a business model. Importantly, this means that a Growth Equity opportunity should not be over-leveraged. Beyond a certain point, leverage impedes growth.

Regulatory Risk

Many investors are blind to the regulation risks of a business. We are not talking about routine OSHA or ECOC issues, for example, but about issues that can jeopardize the underpinnings of a business model. Regulatory agencies such as FDA, FCC and FAA are obvious areas of regulation concern because they can interject sweeping industry changes. Simply stated, though we cannot mitigate Regulatory Risk itself, we must consider and pragmatically mitigate our investment exposure to it.

Capital Risk

The final risk that can be mitigated is Capital Risk. The function of the Growth Equity investor is to mitigate this risk by virtue of its capital, plus the capital provided by the investment syndicate that it forms. Typically, an investment from TF and its syndicate partners mitigates this risk. For a company, the source of capital can also be a risk. For companies running on EOS®, having a capital partner that understands EOS® is a major advantage. Also, in virtually all of its investments, TF will offer co-investment opportunities to its Limited Partners, greatly expanding the capital available.