Buyouts

December 2021 • buyoutsinsider.com

PLUS
Investors unite under value-based care

Guided by the light

How Diversis Capital evolved from independent sponsor to fund manager

Co-founders Kevin Ma and Ron Nayot

Cover story

Guided by the light

Cover story

Founders Kevin Ma and Ron Nayot transformed Diversis Capital from being an independent sponsor into a fund manager. It was an eye-opening, sometimes punishing voyage for the software investors. By Eamon Murphy

PHOTOGRAPHY: LAURA TILLINGHAST

Cover story

Back when Ron Nayot and Kevin Ma started Diversis Capital in 2013, there was still an element of novelty regarding the status of independent sponsors. "People would confuse you with a search fund or investment bankers or the like," Ma recalls. Management teams wanted to talk to investors, "not guys like [us] who [were] passing the hat around." In short, there was a bit of a stigma.

Diversis now has more than $1 billion of assets under management, and recently announced the close of its second fund, having raised $675 million in three months. The Los Angeles-based firm, which makes control investments in lower mid-market software and technology companies, surpassed a $500 million target and far outstripped its first institutional pool of $255 million, raised in 2019.

But Nayot and Ma remain marked by six years of struggle as deal-by-deal investors; says the former: "Whenever you build something from scratch and you don't have the resources and you struggle through it and you make it to the other end, I think it gives you a lot of perspective."

Threading the needle, deal-by-deal

"Our goal was to find deals that were proprietary, off the beaten path," Nayot says. "We were a solution provider for a broken process or a more difficult deal to get done." A broad auction process, by contrast, presented a disadvantage, "unless you're going to pay more than everyone else, and that's also problematic. That's how we were able to get around that stigma."

The firm's first realization, and "what changed the game for Diversis," was a label and artwork software provider called BLUE Software, acquired in late 2014. "That was a carveout of a public company, and [an] independent process run by the corporation," Nayot says. Diversis got wind of the opportunity, which had gone overlooked by the market, "and really ingratiated ourselves with the management team, with the corporation, and really built a partnership."

But being a fundless sponsor meant going above and beyond to prove themselves. "It took us about six months of courting the general manager of that division, showing we were credible and knew exactly what to do," Ma recalls. "That whole process took a year, year-and-a-half." When it came time to pitch the board, the corporation was acquired by another public company, necessitating an additional round of persuasion.

Matters were no less complicated on the LP side. There were around 30 investors, and late in the game one of the larger ones reduced their exposure. "It left us scrambling to fill that gap," Ma says. If it was a challenge to "look credible when you had a chunk of the equity fall out," the difficulties didn't end with closing the deal. There was also the matter of doing add-on acquisitions with so many LPs, who didn't all put in pro rata. "It takes more time, more stress, late nights agonizing over how you're going to get things done," Ma says. That's the nature of working deal-by-deal: "It felt like threading the needle every time."

Diversis sold BLUE, after two add-ons, in July 2018. "If we prove ourselves," Nayot recalls thinking, "it will be easier and easier to raise money, so why do we need a fund?" But "as time went on, regardless of the returns we were making, it was still very challenging to convince people of a deal that was maybe slightly different than a deal we'd done before."

Diversis also lost a few larger deals for lack of capital. "There's this bitter, haunting pain that follows you when that happens," Ma says. "What could have been.

"I think we've reached the tail-end of being an independent sponsor," he recalls thinking after an especially agonizing near miss, which became "a tremendous return" for someone else. It was time, in Nayot's words, "to make our own decisions and control our own destiny."

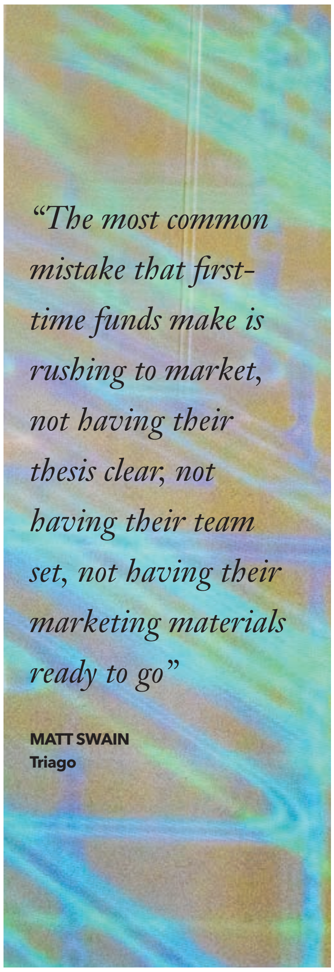
The pair had partnered with a mixed group of LPs, including large family offices, finance professionals, some funds of funds, and endowments with programs targeting independent sponsors. "We had a couple institutions that were very stable and believed more in the Diversis name, rather than looking at the actual deal itself," says Nayot. "Effectively we formulated a path to becoming a quasi-fund," without the controls, having to call capital, etc.

But they didn't have the discretion that a blind-pool fund would bestow, to invest as they wanted. And of course, with a fund, "people will take you a lot more seriously when you walk into the room and say, 'I want to buy your company,'" Ma says.

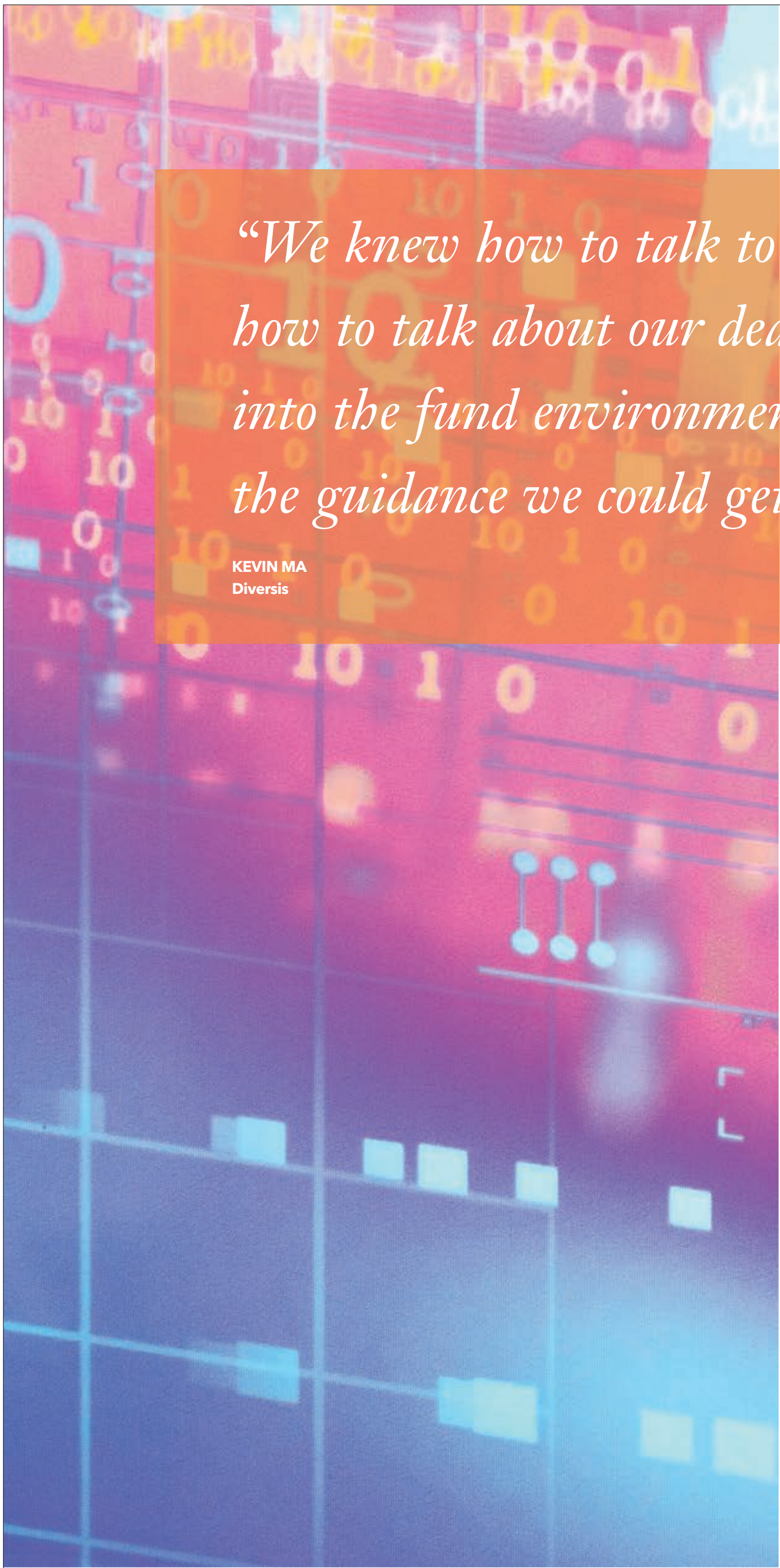
One of the first steps they took was hiring Evercore as their placement agent. "We knew how to talk to LPs, we knew how to talk about our deals," says Ma. But "going into the fund environment, we needed all the guidance we could get." While some family offices and institutions that were able to invest in a fund carried over, other existing LPs were focused solely on independent sponsors.

"What surprised me was the amount of investors we ended up speaking to," says Nayot. But all those meetings paid off when Fund I reached its hard-cap in just six months.

"If there's a silver lining to being an independent sponsor," says Ma, who seems to have enjoyed it less than Nayot, "it's that it lends itself to a fundraise process that's transparent and quick. People trust you." Unlike spinouts from large firms, where "most of the track record is hidden




$1bn
Amount of assets Diversis now has under management



> *"We knew how to talk to LPs, we knew how to talk about our deals. [But] going into the fund environment, we needed all the guidance we could get"*
>
> **KEVIN MA**
> **Diversis**

behind layers of hierarchy," deal-by-deal investors can develop "a level of trust with the LPs which is really deep."

And a comprehensive history can withstand the occasional stumble, with Ma summarizing what a potential investor might say to him and Nayot as a result: "Everybody makes mistakes, but man, you guys really do what you say you're going to do."

Getting close to the asset

Problems with early investments can even be a positive from the perspective of a potential partner, according to Richard Wiltshire, managing director at PA Capital and leader of the firm's co-investment team. "The best experiences for us in this area have been in situations where we've made an investment alongside an independent sponsor and it hasn't gone as planned from the start," he explains. "And we've had the ability to see the team work with the management team through a challenging time, because inevitably in investing that happens.

"With every year that goes by where we don't have a regular recession or a crisis like we had [in 2007-08], you distance yourself from individuals that have actually gone through that as senior investment professionals. That period of time, and being able to manage through that, is critical in our opinion to what makes a GP successful over the long run.

"It's always part of the criteria and checklist we go through when we're evaluating a fund. Have they gone through adversity like that? And a lot of new groups haven't," Wiltshire says.

Wiltshire's team uses co-investment in part as a means of "riding shotgun" with a manager, seeking "the ability to gain comfort to committing to a first-time fund, particularly as part of a first close, where we can be most impactful to the GP." He says he's seen better investment results overall from managers with whom the firm has partnered early.

And as the market becomes increasingly competitive, the timing of relationships matters even more. "The most successful independent sponsors these days can become capacity-strained when they're raising their first pool of capital, particularly if it's consistent with the size [of the deals] that they've been executing on successfully. We want to make sure that we're early in terms of the development of the relationship and our ability to gain conviction."

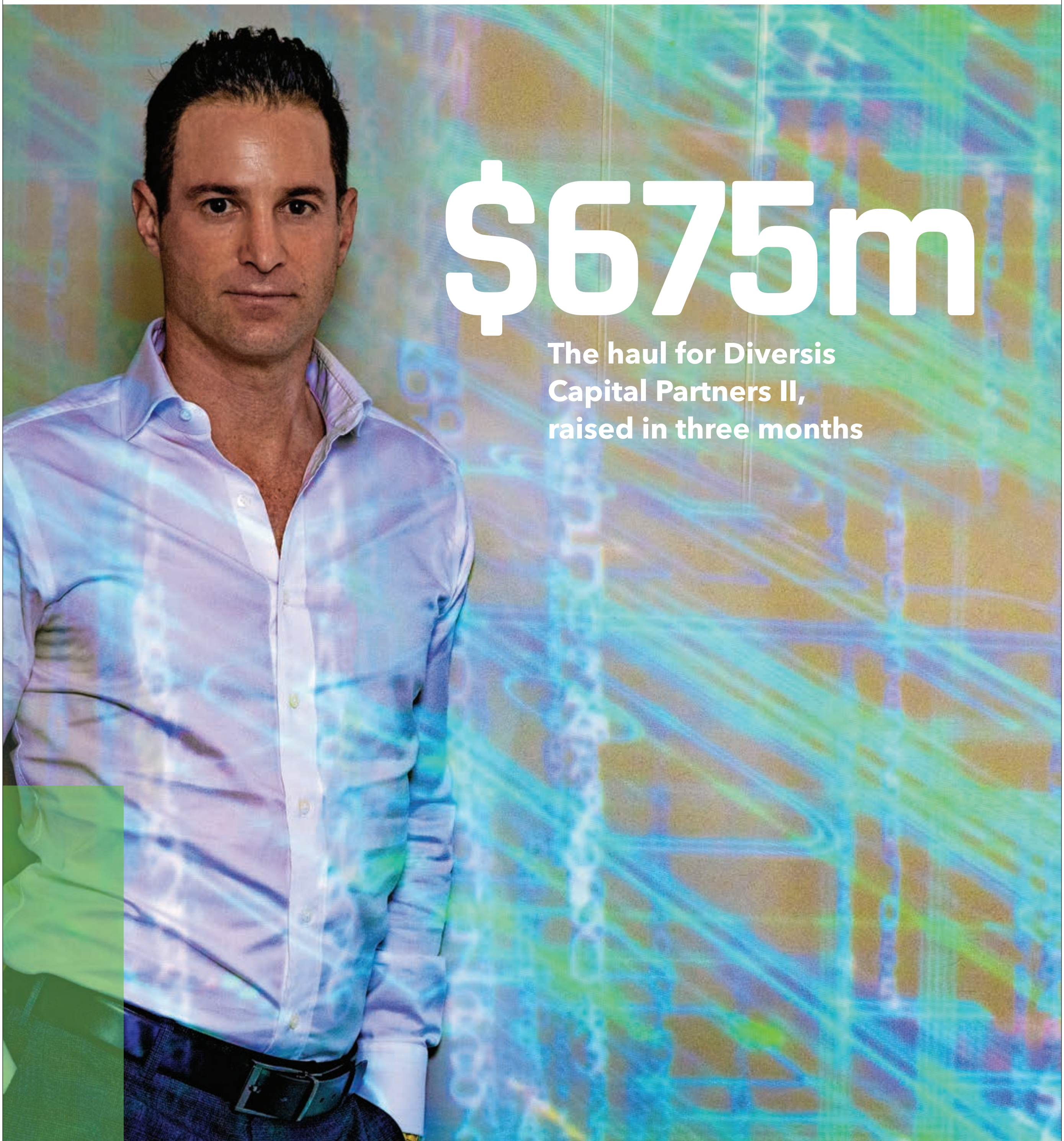
When a deal-by-deal investor enters the world of the funded, as Wiltshire says the best ones inevitably do, that transition carries challenges.

"It takes away what we would consider to be one of the benefits and even advantages of being an independent sponsor in the first place, which is they don't have a committed pool of capital to invest," he says. "With no IRR clock ticking, being patient is not punitive. At times, we get the sense that new groups feel pressure to invest once they've raised a fund, so they often overpay for companies."

Funds are being raised more quickly these days, "and GPs are in our opinion raising too much capital for the strategy and for the experience that they have," Wiltshire says. PA tries to mitigate this

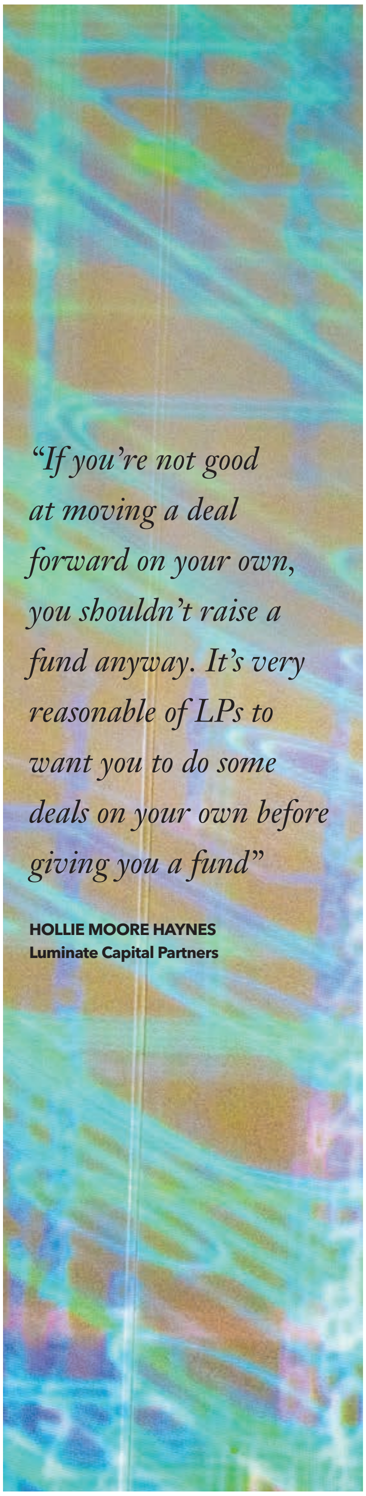
"Our goal was to find deals that were proprietary, off the beaten path. We were a solution provider for a broken process or a more difficult deal to get done"

RON NAYOT
Diversis



$675m

The haul for Diversis Capital Partners II, raised in three months



"If you're not good at moving a deal forward on your own, you shouldn't raise a fund anyway. It's very reasonable of LPs to want you to do some deals on your own before giving you a fund"

HOLLIE MOORE HAYNES
Luminate Capital Partners

Going Institutional

'Institutional investors are a different stakeholder and a different audience than a management team,' says Bart Molloy, managing director at placement agent Monument Group.

"Often these [independent sponsor] groups have really prepared how to sell themselves to a management team, but they need to know that an institutional investor has different drivers and different priorities, and to be able to be thoughtful and answer those questions."

That includes "transparent and honest assessment of lessons learned in those situations that didn't go perfectly," Malloy says. "One of the most additive things in a meeting with prospective investors is to say, 'We didn't get this right and we've learned and changed in how deep we go in our forensic accounting,' just as one example." One important topic to cover that might not come up in front of a management team is making hard decisions if changes need to be made at the executive level of a portfolio company, "doing that in the right way but being able not to wait too long."

Molloy says clients who have made the transition well have provided investors with clarity on what they intend to do once they've invested in a company: "The deal-by-deal experience really is a positive in terms of people evaluating and understanding that there has to be a plan for real value improving going into an investment." Independent sponsors have had to make that case again and again. And they "often have a strict sense of downside protection. They know that they can't have a couple of deals go sideways and still go back to the same folks to raise that next deal. Those battle scars are very effective."

But managers have to keep in mind that an institutional fund is different. It can be helpful to explain "why a certain investment was one size, where maybe it could have been larger with a committed fund." And Molloy cautions "funds come with different administrative aspects, in terms of reporting and disclosure. So, trying to be upfront and tactical about setting yourself up to be an institutional fund I think pays off in the long run," which could mean, for instance, taking on the expense of a full-time CFO.

"The most common mistake that first-time funds make is rushing to market, not having their thesis clear, not having their team set, not having their marketing materials ready to go," says Matt Swain, managing partner at Triago.

The key for independent sponsors is "having a real focus," explains Molloy, "because institutional investors have their own portfolio and they want to understand, is this manager going to be additive, complementary, or overlapping with the exposure they have?"

risk with intensive diligence around sourcing networks.

"And we tend to like to align our first commitment to a first-time fund around the date of an initial investment in the fund. So, we know what the first asset in the fund is going to be and we've had a chance to underwrite it, so it's not a total blind pool."

"Any time you have assets that can go into that first-time fund," says Matt Swain, managing partner at placement agent and advisory firm Triago, "that's a great shortcut both to get the interest and attention of senior LPs and to have a quicker fundraise. That could be via a first-time fund that's been seeded with what were originally deal-by-deal investments or it could be done through a continuation vehicle for an existing direct deal. In the latter case, you might be providing liquidity to non-institutional investors and bringing in institutional LPs looking for identifiable assets."

Swain says institutional investors are looking more and more at both first-time funds and direct deals; endowments and foundations that previously were uninterested now want to be kept in the loop on dealflow. "You're starting to see participation out of E&Fs and single-asset participation vehicles, which traditionally were more secondary funds and family offices," Swain explains. "Potentially a next step for them would be these direct deals, part of a thesis of getting close to the asset and having more fee mitigants."

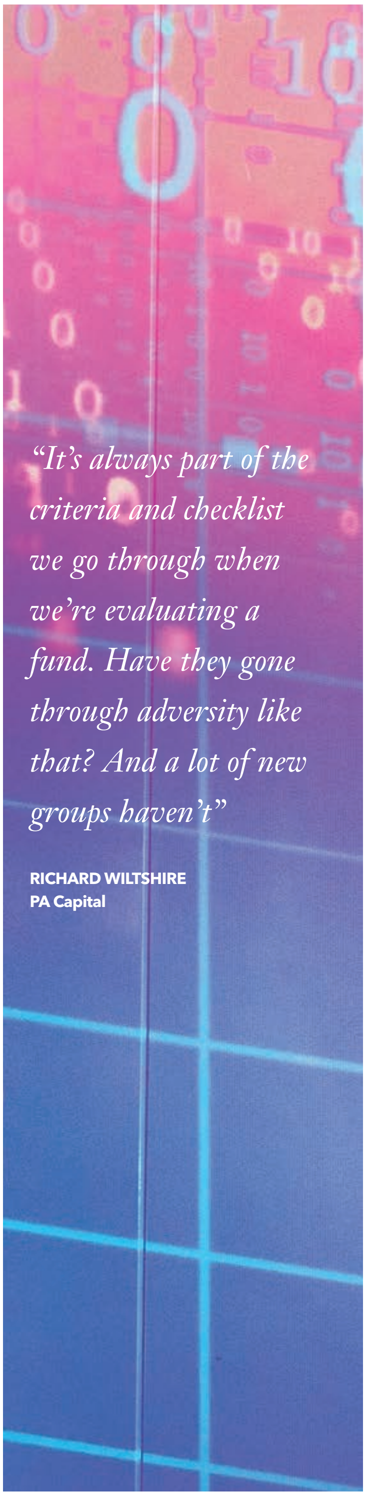
Making 'yes' easy

The experience of Hollie Moore Haynes, founder of Luminate Capital Partners, illustrates the apparent paradox confronting an emerging manager, and one possible solution. A veteran of Silver Lake Partners, Haynes launched her firm in 2015 with legal attribution, money in the bank and strong references, "and I still couldn't raise a fund," she says. "People just don't believe you. Luckily I figured it out within a few months that we just had to stop trying to raise a fund and do deals."

Haynes calls it "a chicken-and-egg situation: you can't do a deal without money, and you can't get money without a deal."

She eventually found one through her operating partner, who knew a CEO looking to carve out his software business from a company owned by Berkshire Hathaway. "Amazingly he had a price negotiated with the parent, he just didn't know anybody in the deal business except us," Haynes recalls. "Part of the deal business is serendipity sometimes."

With $400,000 of her own money for legal and accounting work, a loan from Wells Fargo, participation from the management team (who mortgaged their houses), and investments from founders and senior executives at her old firm, Haynes closed the deal. She took no fees, though her operating partner got some cash compensation. And she insisted on an unorthodox compensation scheme: "I will take a 10 percent carry if we do less than a double, [but] I want a 30 percent carry with a full catchup if we do more than a triple." (That ability to ratchet up carry returns is "truly a strong benefit" of being an independent sponsor, says Ma. "Everything else is much harder.")



"It's always part of the criteria and checklist we go through when we're evaluating a fund. Have they gone through adversity like that? And a lot of new groups haven't"

RICHARD WILTSHIRE
PA Capital

Luminate sold the business 13 months later to TA Associates for a nearly 9x return. "Which is why I'm not in the deal-by-deal business anymore," Haynes says, "because then people were willing to invest in a fund."

Haynes seeded Luminate's inaugural pool with commitments from family office investors in her second deal. Half of a $25 million check would go towards a minority interest in the target company, free of fees or carry, with the other half going into the fund. In this way she secured a $50 million first close. "The theme of this being, make it easy for people to say yes," Haynes explains. "We were very much aligned."

Fund I ultimately raised $265 million, closing above its $200 million target in late 2016. In all, the process took around two years, although once Haynes hired the placement agent Moelis & Company it was only another three months.

"I think everybody who tries to start a new firm should just assume that they're in the deal-by-deal business out of the gate," Haynes says, "because doing some initial deals will massively increase the probability they can raise a new fund.

"If you're not good at moving a deal forward on your own, you shouldn't raise a fund anyway. It's very reasonable of LPs to want you to do some deals on your own before giving you a fund." ■