PERMANENT
EQUITY

How to Build without Buying

It feels like we say this a lot: small businesses don't stay small on purpose. And it's true. Companies want to grow. Every record translates to a reason to celebrate. An improving market position, larger profits, and more optionality are good, too.

So how does a company grow?

The Traditional Private Equity Answer: Buy & Build

Traditional private equity offers one primary answer on how to grow: they'll invest in you (known as a "platform investment"), and then they'll open their checkbook and go buy other things to add on to you (known as an "add-on" or "bolt-on"):

Your Earnings + Company B's Earnings + Company C's Earnings = More Earnings (assuming all these companies are profitable)

With more earnings (and likely cost-cutting through "synergies"), the private equity firm will then look to sell the bigger entity to a bigger firm for more money. And then the bigger firm will go shopping again. Assuming things go well, the story repeats again every 3 to 7 years until going public or becoming part of a conglomerate.

If you're an owner – especially a founder – you know how difficult it has been to grow independently (and usually incrementally). You have the heartburn and wrinkles earned through navigating the internal pace of progress and changes in the competitive landscape and bad hires and more. On a personal level, writing large checks for something you didn't build and don't know probably seemed uncomfortably close to betting the farm. So letting someone else take the lead on such a strategy probably sounds appealing.

What's the issue with growth through acquisition? Maybe nothing. But like lots of elements of traditional private equity, the fact that there's a default answer doesn't mean it's the right answer. No business is perfect, including one that you buy and then try to integrate into your own. Baggage tends to accompany any purchased earnings. And the theory on why the

business could be complementary may be wrong. Available research says 70% to 90% of mergers and acquisitions fail, so history can't offer you a ringing endorsement either.

In short, growth through acquisition is one way to grow, but it is not the only way to grow. And within Permanent Equity's family of companies, most operators have opted not to pursue it as a dominant strategy. Here's why:

Growth without Goals

We invest in companies that are already successful without us. This means not only are they not in distress, but they already have loyal clients, pricing power, and a compelling market position. Most, though, focus on one to three offerings, which we think of as the core. And unless the core value proposition isn't durable (a reason we may not invest), our first priority is to preserve and strengthen the core (see Rule #1: Do No Harm for more). But almost every team also has ambition to grow to the "next level."

This means that early conversations with owners and operators naturally trend to the topic of growing without goals, a foundational piece of our firm's long-term approach. This foundation requires a shared belief in continuous improvement and a common understanding of three ingredients to developing any growth strategy: reality, resources, and return.

Reality: This discussion starts with a series of questions: Where are we? What can and do we control? Where do we want to go? What's standing in our way? What are we willing to risk in the process?

Honesty is the most critical piece of this discussion. Dreaming is fun (and sometimes constructive), but progress is most frequently made through regular check-ins on what's working, what's not, and where we need more information.

Resources: Most small businesses don't have a ton of slack; everyone has a full plate all the time. So change, especially related to building something new, means you either need more or different resources (or a reorganization of existing resources) or something could go very, very wrong.

Existing resource allocation is another regular topic with management teams. Example questions include: Where could process improvement or automation free up talent for new or more things? Where are we understaffed, naturally limiting existing offerings? Solving these types of issues early increases everyone's awareness and confidence about how equipped the team will be to realize growth going forward.

Return: Why should an organization take risks and do more? Most people

answer: to grow. But there is an important qualifier to add, and that's to grow profitably. Why would a team want to do more work for worse margins?

There is, of course, nuance to this, and a key factor is time. Sometimes margins will have to dip short term to grow long term. And something that is expected to improve earnings by 20% this year versus something that will do it over 5 years are of different value to the organization's finite resources.

While forecasts can never be precise, building a shared understanding on pace, feedback loops, and milestones allows everyone involved to understand why the effort is being made, what our opportunity costs are, and how and when we intend to measure progress.

Throughout these discussions, most management teams end up with a years-long list of ways to grow, with growth through acquisition on the list, but probably not at the top. Generally, we end up with a combination of the following groups:

- One-time projects, oftentimes related to gaining resource capacity
- Development of complementary products or services
- Solutions for improved quality, pricing and/or sourcing control
- Major reinvestment or overhauls

This is also where we can lean into our approach. Operating with 30-year funds, we are afforded the opportunity to grow in ways that aren't even an option for others. Most notably, we always keep a running list that answers the question: What can we invest in today that may take 5-10 years to come to fruition, but would fundamentally change the trajectory of the business?

Knowing they have time and options, operators within Permanent Equity, especially those with some traditional private equity experience, often prioritize their growth initiatives with a balance between things that can make notable change short-term and those that will have long-term payoffs. And that's exactly what we want.

And then we circle back to reality, resources, and return to figure out how many engines we want to jumpstart, and who is going to do the work.

How to Grow

If you're not buying earnings via acquisition, how do you grow? Here are examples that have been successful among our companies:

Invest: Think of growth investments as expanding resources to increase capabilities and/or capacity, oftentimes requiring an upfront cost. Examples include:

Growth Hires: Again, small teams are often lean, and it can be tempting to limit payroll costs as the company grows. However, adding new roles may introduce valuable skill sets or create opportunities for exponential scaling within a department through reorganization.

New Equipment/Technology: Installed systems are sunk cost, so it's natural to try to get as much value as possible out of them before upgrading. However, there have been advancements in the past decade, especially in software and network management. Whether a service-based or product-based company, sometimes an upgrade can "next level" operations.

Supply Chain: Small organizations often have small supply chains. The past few years have taught us all the pitfalls of 1:1 supply chain relationships… basically being at the mercy of suppliers. Redundancy and diversification mean optionality in crises and increased capacity for growth.

Sell: Think of growth sales initiatives as adding strategic variations on what has worked well historically in order to build a bigger sales funnel.

Business Development Strategies: Most businesses want a bigger sales effort, but headcount doesn't generally solve the problem. The common story is that a sales rainmaker holds all the relationships, and everyone else ever hired just kind of flounders in comparison. But nurturing one-to-one relationships is likely only one of many potential BD approaches. It's often worthwhile for management to map how they and industry peers have successfully generated business historically (including customer retention strategies), prioritize the list, and determine what skill sets and personalities are required for those they want to pursue. And then dedicate resources accordingly.

Marketing: In our experience, being an expert resource in a specific industry does not make you excellent in marketing your expertise. Whether a rudimentary upgrade to a website or an advanced targeting program, spending money to find potential customers can build the funnel… if equipped with the appropriate team and tools.

Pricing: Pricing strategies are an undervalued playground for growing a company. This doesn't equate to gouging existing clients until they leave. What it often means is experimentation on variant pricing, including prices based on scale, bundling, tiered service levels, and more.

Invent: Think of invention growth initiatives as solving for customer needs and requests that you are not actively fulfilling (or not fully solving for):

R&D: Like marketing, R&D can feel like a black hole, especially if there's little muscle memory internally on how to do it successfully. But inventing solutions that expand your offering set can deepen existing relationships and originate new ones. And there are multiple ways to approach R&D.

Offering Mix: If an organization has been selling the same offering mix for decades, sometimes there can be growth opportunities in an internal reshuffling and/or through external partnerships. This may make bundling, referenced above under pricing, more relevant, along with other things.

Who Does the Work?

Whether an add-on acquisition or an organic growth initiative, someone has to do the work. It's exceedingly rare that an investor can hand you growth on a silver platter.

In traditional private equity buy and build plays, the answer is often: "Figure it out," along with a detailed spreadsheet of expected cost cuts to implement in the process.

At Permanent Equity, we plan together, and then divide and conquer. Practically, the planning results in prioritization and a discussion of available resources. For initiatives that require specific expertise not yet on staff, someone on the management team or at Permanent Equity may take the lead in sourcing. For projects that the company will benefit from but doesn't need long-term expertise in (e.g., sourcing add-on candidates, recruiting a CFO), someone at Permanent Equity takes the lead. And for plans that aspire to be part of the core operations at the company, the management team takes the lead.

Inevitably, things will not go exactly as planned, and then we'll circle back to the conversation on reality, resources, and return to levelset again. And in that process, we aim to continuously improve, with that intermittently-to-consistently translating into meaningful growth.