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A Recipe For Growth Equity Investing In A Slow M&A Market

By **Carl Marcellino** (May 7, 2024, 5:24 PM EDT)


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As a deal attorney I enjoy negotiating complex deal terms, similar to mixing together a good recipe. In another life, I would have been a chef and during the current downturn in mergers and acquisitions, here's one of my favorite recipes:

- Take one part high interest rates.
- Mix it well with one part higher-than-desired inflation.
- Let that sit for a few fiscal quarters.
- Then add two parts of longer-than-expected hold periods and one part desire to put capital to work.
- Stir in a healthy amount of valuation assumptions set during a different market.
- Let that simmer for about six to 12 months.
- Then add a pinch of a presidential election uncertainty.

And with that you have a great recipe for growth equity investing. Not exactly my grandmother's Sunday gravy, but she still would have been proud.

My career started during the dot-com boom of the early 2000s, through the Great Recession of 2008-2009, the economic expansion that followed, COVID-19, and now our current post-pandemic malaise. Throughout each downturn in lending activity, as M&A slowed and seemingly came to a halt, some mix of the above ingredients have been available, and in the kitchens of private equity firms and corporates emerged a greater appreciation for growth equity investing.

Data from McKinsey & Co. shows that growth equity fundraising touched $132 billion globally in 2021, which remains the highest amount recorded to date.

According to GrowthCap Advisory there are over 400 asset managers that identify themselves as growth equity firms.

To compare, fundraising across the entire private equity industry was less than $200 billion in 2010, according to a report from The Wall Street Journal, and growth equity fundraising wasn't even tracked by conventional sources.

So what has led to the growth of growth equity, and why is the current macroeconomic environment creating such an appetite?

The theory is that by taking a minority position with some structured downside protection, growth equity investors can put money to work at higher valuations than they otherwise might be comfortable taking a control position in.

And founders and owners can raise funds at valuations that are acceptable without giving up too much of their companies, all while still providing needed sources of secondary capital for existing legacy investors that are otherwise interested in monetizing their positions.

In other words, it's win-win: The investors invest, the companies grow and legacy investors get liquidity. Really, it's win-win-win.

In the last two years, we haven't seen as much growth in growth equity as prior cycles where the above recipe could be applied. In fact, the McKinsey global private markets review for 2023 and to date note that private equity deal volumes across the board have declined during this time.

While the ingredients for growth equity investing are there, investors have other available opportunities. Most notable among them are the recent prevalence of continuation funds and related transactions.

These transactions have been able to provide private equity firms with a much-needed refresh on their capital commitments without having to borrow more or sell attractive assets that otherwise have a lot of upside potential, and at the same time provide exits for legacy investors at acceptable valuations.

Such investments have kept a number of investors busy in the slower transactional market, and they can recapitalize businesses in a more holistic way that minority investments cannot always do.

That said, not every company is already private equity-backed and not every business is large enough to justify the costs of such a transaction. For those businesses and investors, the above recipe for growth equity investing might be just the meal ticket.

And the market is following suit. In recent months, we have started to see an uptick in growth equity in a variety of sectors, including tech, food and beverage, financial services, healthcare, and infrastructure.

Notable deals from the past three months include:

- On April 11, HighLevel Inc. announced a minority growth investment from General Atlantic for an undisclosed amount.

- On April 9, Platform Science announced a growth investment for $125 million from an investor group, including Activant Capital and BDT and MSD Partners.

- On April 8, Buyer's Edge Platform announced a $425 million growth investment from a consortium led by Atlantic Park, and which included Blackstone and Morgan Stanley funds.

- On April 2, The Rawlings Group announced a growth investment from New Mountain Capital LLC.

- On April 1, Castleford Capital announced a growth investment in Rebound Medical Systems Corp. for an undisclosed amount.

- On Feb. 29, Insurcomm Inc. announced a majority growth investment from Summit Partners for an undisclosed amount.

- On Feb. 21, digital transformation software and services firm Trianz announced a major growth equity investment from Capital Square Partners, for an undisclosed amount.

- On Feb. 14, Blackstone announced that Blackstone Growth and affiliated funds made a growth equity investment in 7 Brew Coffee.

These kinds of deals do not typically use venture-backed investment structures. We are well beyond the various simple agreements for future equity and National Venture Capital Association forms. As useful as those can be as a starting point, today's growth deals are negotiated to meet the specific needs of each situation.

Growth equity investing in the last several years is about highly structured investments tailored to a bespoke set of circumstances. There is no market.

This is not a cut-and-paste exercise for documentation. Rather, the growth equity investments being served up in today's dining rooms are highly negotiated, designed to meet the appetite of the companies raising the capital and the investors providing it.

To be clear, it's private equity at its best — addressing needs of businesses and investors to spur growth in an economic environment that otherwise would have limited it. Again, it's win-win-win.

Here are some examples of typical growth capital terms that are different than venture capital.

Preferred Stock and Subordinated Notes

Structured investing usually means just that — investing in a new place in the capital structure, usually ahead of common stock, but behind bank debt.

Growth equity isn't always equity, as it often comes in form of convertible notes or similar securities, but it's intended to have equity-like returns, more than mezzanine lending or other forms of credit. Do common investments still happen? Sure, but usually with a healthy mix of other bells and whistles.

Minimum Return

While many have gotten used to little or no real dividend on invested capital in the last several years — thank you venture capital investors — growth equity investors still expect some minimum return on their investment.

This can take the form of an accruing dividend or interest rate — the old school approach — a multiple on a liquidation preference, or some other required minimum payoff in the event of an exit, or even just limiting the ability of the company to do deals at lower valuations.

Investors often will structure the return so that it goes down over time — in other words, to insure against a quick exit at a lower-than-expected valuation, but it can also be pure downside protection. Not every growth equity investment has the concept of a minimum return, but it often finds its way in some way.

Exit Rights

Exit rights too can take many forms and are highly fact-specific — some investors seek the ability to be redeemed, to force a sale or initial public offering, or just to pursue a secondary trade; some seek a combination of these.

Which approach will often vary depending on the existing investor group and founders involved. Some founders prefer the freedom to take out new investors, so redemption rights are fine.

Others don't want that overhang, but are perfectly willing to be pushed into a launching a sales process or seek some recapitalization. When these rights kick in will often depend on the maturity of the business. It is usually somewhere in the four- to seven-year mark — not the shortest hold period, but still well within the realm of reasonableness, particularly when coupled with structure and other rights.

Board Seats

Any significant minority investor in a private company is going to expect board seats. How many is always a debate. Some investors focus on getting a number of seats commensurate with their investment, but others will seek one or two, recognizing the right answer sometimes is just being convincing in the boardroom, not having the most people talking.

We also often see new investors seek to increase independent representation on the board, which can have strategic benefits and also provide more diversity, discipline and oversight.

Governance

Many growth deals start and stop with the governance rights sought by the new investors. This can be a trap for private equity investors, and in particular control investors who are seeking to participate in minority deals, as they often have a harder time accepting that the management team can overrule them.

Venture investors seek consensus in the boardroom, but growth investors seek influence. That said, the answer is not a long list of veto rights. Growth equity investors seek the veto rights that they need, after considering what other influence they have — through structure, return, exit rights, etc.

What Else?

Other growth equity deal terms really depend on the facts and circumstances, and this is really where the meal — I mean deal, obviously — can shine. Many growth equity deals include concepts similar to venture investments — co-sale, tagalong rights on founder or keyholder sales, preemptive rights on future issuances, information rights and registration rights.

Some investors negotiate for a right of first refusal to lead future financings or subsequent secondary sales. Others may pursue other limitations on transfers or the ability to enforce certain rights that majority investors may be conflicted on — e.g., management call options, etc.

In exchange, growth equity investors will often agree to restrictions that venture investors never would — lock-ups or other limited restrictions on transfer for some minimum period of time.

What is ultimately included in any growth equity investment is often dictated by what makes sense. That be scary a thought for some, but for a savvy investor, it can be the difference between getting a good deal done, and sitting on their hands, waiting for the financial markets and M&A to bounce back.

The wonderful thing is that the complexity of this recipe means — like any good Italian dish — there is not just one way to make this dish great. Here are few pointers for new chefs seeking to give this recipe a try.

Ask for What You Need

There is a saying that if you don't ask for it, you'll never get it. That applies in a lot of M&A negotiations, but it is not the best approach when you are negotiating a growth equity investment.

Founders and existing investors want to know that their new investor is going to be smart, focused and productive. If you ask for everything, you're not presenting as any of those things. Best play is to focus your asks. Keep some things in your pocket to negotiate, but stay focused.

Focus on the Economics Initially, if Possible

Many growth equity investments start with a term sheet. As a general rule, it is very easy to negotiate economic terms in a term sheet, but it is very hard for a minority investor to negotiate governance in a term sheet. It happens, of course, but an investor's bargaining power is the lowest when negotiating the term sheet, particularly in a competitive process.

As a result, investors are often pressed to drop asks that they otherwise could have gotten, just to get the company to agree to move forward. If those asks aren't important, then so be it, but in many cases, they are, just not priorities.

Best practice would be to identify the board seats wanted, note some key veto and rights that are fundamental to the investment, and then indicate additional terms are to be mutually agreed. This of course isn't always possible, but if it is, investors will absolutely benefit.

Recognize You Are Not in Control

Another governance point, but an important one: Many private equity firms and corporates that are doing growth equity investing are used to taking control positions, and they have a hard time recognizing that they may get overruled — or may not even get consulted — on certain matters.

Investors that ask for pages and pages of veto rights, whether they are taking a 5%, 20% or 40% position in the company, do not win. That never leaves a good taste in any founder's mouth. Focus instead on the rights you absolutely want and need based on the investment thesis. That's it.

Focus Your Diligence

In control deals, acquirers will say they are being targeted, but they still do broad-based diligence that takes time and costs a significant amount. This is not the wrong approach, as any exposure of the target is going to be the acquiror's exposure following the closing. In growth equity investments, it should be a very different calculation.

As noted, the investment normally has been structured with downside protection, and the ultimate exposure of any issue to your investment is diluted as a result of being in the minority. Accordingly, investors can and should be targeted in their diligence.

Set a plan at the beginning focused on material exposures that truly impact valuation. Thinking that way will help you get the transaction done, but also in a more costly, efficient manner.

Speed Will Benefit You

This is obvious, I know. Still worth saying though. Private buyouts can move quickly, but often don't. Growth equity investments can move quickly, and really should. If the economic deal is struck and the diligence is targeted, the negotiation of the definitive documentation should not take long.

While speed should never be prioritized over doing the work, it goes without saying, that being nimble and able to move quickly will only increase the chance to get a deal done.

The bottom line is that the recipe for growth equity investing tastes best in an economic environment where these deals can thrive, where parties are willing to be more creative to find solutions that work best for the given situation — and that's where we are right now.

Conclusion

The various mixes of rights and obligations all come together differently depending on a number of factors — who controls the target, how likely is the controller to seek an exit, when did the existing investors buy in, the maturity of the business, the use of proceeds, the pro forma ownership of new money, how competitive is the process and so on.

Structured growth equity investments are highly negotiated — and they are at their best and most successful if they can admit that what's market is not what happened the last time, but instead what makes sense in this market, for this business, raising capital at this time. Certainly not the recipe for your parents' venture capital investing.

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Disclosure: In the recent deals mentioned, the author represented Activant, and Ropes & Gray represented New Mountain Capital and Morgan Stanley.