

## How Growth Equity Investors Can Adapt To Tougher Times

By Alese Bagdol, Brian McPeake and Jared Spitalnick

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There has been no shortage of limited partner allocations to the growth equity asset class over the last decade.

The attractiveness of growth equity's risk-return profile — occupying the space between venture capital and private equity buyouts — and its exposure to investments in some of the fastest-growing and most defensible private companies has attracted a range of investors, each with distinct philosophies.

### Rising Challenges of Growth Equity

Over the last decade, competition for the highest quality growth assets surged, driven by the attractiveness of the businesses seeking capital and by a favorable macroeconomic context in which dry powder far exceeded opportunities for deployment. Headline valuations continued to climb as a result.

Combined with the growing number of investors willing to make large investments in later-stage private companies entering the segment, downward pressure continued to be applied to the underwriting of return hurdles.

While the driving forces of growth equity's success — companies delaying listing on public markets, the digitization of economies and lack of dependency on debt markets for funding, among others — ensure that this investment category is here to stay, it should come as no surprise that some of the deal terms that paid off during the longest bull market in history are now up for reconsideration as markets experience turbulence.

There has been a notable increase in investor-friendly terms — a trend that, according to PitchBook Data Inc.'s late-stage venture capital deal terms indicator, was also reflected in the broader market in this year's second quarter for the first time since the third quarter of 2020.[1]

It is therefore those sponsors who are able to offer flexibility to create a win-win scenario for themselves and founders alike — while also protecting their downside risk — that are successfully navigating the current market uncertainties.



Alese Bagdol



Brian McPeake



Jared Spitalnick

In the new macroeconomic environment characterized by a slump in public equities, rising interest rates and high rates of inflation, we are seeing more pressure on — and disagreement over — exit projections and valuations.

In this year's second quarter the average deal value of growth equity transactions declined by 28% compared to the first quarter, but remained just above the 5-year historical average.[2]

As a way to smooth out price discovery, some investors and founders are seeking to implement return and exit structures that enable funds to meet valuation asks rather than pursue down rounds, which held steady in this year's second quarter.[3]

These structures preserve downside protection for investors, while ultimately rewarding founders in the event that their original valuations and growth aspirations are realized.

### ***Structuring in the New Environment***

In response to the current environment, we have observed increased use — or consideration — of the following investment terms, as market uncertainty takes hold and growth equity funds adjust their strategies.

#### *Liquidation Preferences*

Growth investors are seeking a combination of higher priority payment rights compared to other preferred stockholders in the case of a liquidity event, higher minimum-return multiples on their investments before distributions to other stakeholders, and the ability to share in any additional upside, either on a capped or unlimited basis — i.e., participating preferred shares.

#### *Accruing Dividends*

While already common in middle-market buyout deals, more growth investors are negotiating rights to cumulative dividends — typically calculated as a percentage of capital invested. This can act as a minimum return on investment at liquidation in a downside scenario, or as additional upside where returns are modest but often phasing out at higher returns — e.g., two to three times return.

#### *Valuation Adjustment Mechanisms*

Growth investors are also favoring mechanisms that enable them to increase their ownership percentage in a company — through an upward adjustment to the conversion rate of preferred shares — if certain preagreed performance metrics are not met.

This structure allows an investor to meet a company's ask on initial valuation, but also provides protection to the investor in the event that performance does not play out as forecasted.

#### *Redemption Rights and Forced-Sale Provision*

There is increasing demand for provisions that enable growth investors to require companies to repurchase their shares in the future or force a sale, if the investment is not growing at rates that generate sufficient returns or if exit timelines, and therefore liquidity, are delayed.

Additional rights, such as an increase to the accruing dividend rate or rights that allow the investor to control the board in the event a sale or repurchase cannot be implemented, may also spring into effect.

#### *Option for Additional Investment*

The use of an additional investment option that gives an investor a right to provide additional capital in the future — at a negotiated or fixed price — in addition to the investment at closing, has drawn less scrutiny from companies in this market and can become very valuable to a growth investor when markets stabilize or if the current outlook proves unduly pessimistic.

This wait-and-see approach gives a growth investor time to understand and respond to how the market is evolving before providing additional capital, including the option to dollar cost average down if the business outperforms relative to projections.

#### *Inclusion of Additional Preferred Stock Protective Provisions*

While use of preferred stockholder approval rights are quite common, some growth investors are looking to include preferred stockholder approval rights over more operational functions related to cash management, such as approval rights over annual budgets and capital expenditures in excess of the board approved budget.

We anticipate that structured deal terms will be a continuing feature of growth equity deals, as new structured funds enter the market to provide further capital; investors continue to deploy dry powder, albeit at a slower pace; and the public markets remain closed as a viable exit option.

The challenge, however, for growth investors and their legal advisers will be knowing when to maintain the benefits afforded by structure and when to reset valuations entirely.

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*Alese Bagdol, Brian McPeake and Jared Spitalnick are partners at Goodwin Procter LLP.*

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[1] Source: PitchBook US Valuation VC report, Q2 2022.

[2] Source: PitchBook data; Goodwin analysis.

[3] Source: PitchBook US Valuation VC report, Q2 2022.