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GROWTH EQUITY – THE CROSSROADS SECTOR COMES TO THE FORE

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John LeClaire, Anthony McCusker and Michael Kendall, Goodwin Procter LLP

The private equity industry historically has been divided into two principal sectors – venture capital and buyouts. While pioneers like TA Associates, Summit Partners and General Atlantic have produced handsome returns for their investors by focusing on the "growth equity" sector that exists somewhere between these two, for many years growth equity has not received consistent attention as a separate asset class. Notably, Thompson Reuters, one of the leading media outlets covering alternative assets, has for years published *Venture Capital Journal* and *Buyouts*. There is no *"Growth Equity Journal"* – yet.

In the past decade or so, and with an increasing level of velocity, growth equity has received substantially more attention and focus as a discrete sector of private equity. An ever-growing number of firms, many with very different historic roots, converge in this sector in search of what the growth equity pioneers originally sought – superior returns by investing in profitable companies with more growth potential than mature companies and lower risk of capital loss than investing in start ups. The signs of this convergence are abundant.

In 2004, for example, buyouts comprised 51% of all U.S. private equity transactions. In 2012, buyouts had declined to 31% of all U.S. private equity transactions, with growth equity and portfolio company add on transactions accounting for the difference, according to Merrill Datasite[1].

During this period the number of private equity funds focusing in whole or in part on growth equity increased. Firms that historically specialized in growth equity, continued to do so. From the buyout end of the market, firms like Carlyle, KKR, Goldman Sachs, TPG, Blackstone and Silver Lake moved down market to launch growth equity funds or comparable investment operations as a complement to their larger LBO businesses. From the early-stage end of the market, venture capital firms such as Sequoia, TCV, Accel, Austin Ventures, North Bridge Venture Partners, Polaris and General Catalyst sought to move up market, expanding their investment mandates and writing larger checks in growth equity deals. Since the economic meltdown of 2008, growth in the U.S. and world economies has been hard to find but ardently sought. The growth equity sector has expanded as an increasing number of investors scour it in search of growing companies.

Most recently, reflecting the growing importance and size of the growth equity sector, the National Venture Capital Association ("NVCA") launched a new initiative focused on growth equity, the "NVCA Growth Equity Group". In doing so, the NVCA staked its claim that growth equity rightfully belongs in the venture capital universe. Stated Summit Partners' Bruce Evans, head of the Growth Equity Group, "Venture capitalists create and grow companies and growth equity firms do the grow part."

GROWTH EQUITY DEFINED.

While the roster of member firms comprising the NVCA's growth equity group is likely to include firms with a robust list of successful buyouts, it is understandable that many private equity firms and the NVCA wish to identify themselves with the growth equity sector. Who can dislike growth? And there are worse alternatives – for example, to be identified with companies that don't grow, companies that are over leveraged, companies that export jobs, companies that pay too many fees to their

[1] Merrill Datasite, Pitchbook 2013 Annual Private Equity Breakdowns, p. 7.

private equity sponsors, and companies beset by the other caricatures that commonly form certain public (or at least political) perceptions of private equity investing. But what is growth equity exactly, and who is properly called a growth equity investor?

At one level, the concept of "growth equity" can be defined so broadly as to be meaningless. After all, every private equity and/or venture capital deal involves equity and the expectation that the enterprise in which the investment is made will grow. So defined, every private equity and venture capital investor is a growth equity investor, and the NVCA would need a huge venue for meetings of the members of its new group.

It is possible, though, to identify certain characteristics that differentiate growth equity from venture capital and buyouts, or at least certain types of buyouts. Most growth equity investments involve acquisitions of minority interests in profitable, growing and usually substantial companies. Sometimes the new equity is used as expansion capital, but many growth equity investments also involve some degree of liquidity and retention of substantial equity stakes by existing owners. These may involve the use of a (usually) modest amount of leverage to enhance returns. Liquidity, leverage and size differentiate most growth equity investments from venture capital transactions.

Some growth equity investments involve acquisitions of majority stakes. These transactions usually involve companies with a base of existing investors, such as founders, employees and venture capital and other private equity investor(s), who sell a stake to a larger investor who they believe can lead the next phase of the company's growth. In situations where the company is owned by founders – a family for example – the growth equity investment may be the first institutional capital in the company. In these so-called growth buyout transactions, the sellers typically retain active involvement in the business, at the management level in the case of entrepreneur/owners and at the board level in the case of institutional investors. To use the language of growth equity firms, these transactions offer company owners liquidity, validation of value and credibility, help in reaching scale, and a "second bite at the apple" when the company is ultimately sold[2].

While growth equity is somewhat hard to define quantitatively, certain themes are common. Most importantly, growth equity involves, as growth equity pioneer Kevin Landry of TA Associates has put it, "selling money to people who don't need it." The right touch, the ability to add value and skill at acting like a partner and not as an overlord are critical, whether the investment is for a minority stake or (perhaps even more critically) a majority stake. Growth equity investing is more complex than venture capital investing, often vastly so, as it involves companies with operating histories, international operations, complex capitalization tables and tax planning challenges and opportunities. While growth equity transactions usually have the complexity of buyout transactions, approaching them with a buyout investor's mentality tends to lower an investor's success rate in landing and closing deals.

Outside the U.S., venture capital historically has been more prevalent in emerging markets such as those in Asia while buyouts have been more the norm in Western Europe. But as venture firms have grown in Asia, and as traditional buyout firms have found limited opportunities for growth through LBO transactions in Western Europe, both groups have converged on growth equity transactions in these markets. In Asia, Sequoia's investments into Alibaba Group and the theater chain company Wanda reflect this trend, as does KKR and Bain taking significant minority stakes in Chinese banks, insurance and retail companies.

[2]Some commentators have adopted a more limited definition of growth equity, suggesting that capital provided by growth equity investors is designed to facilitate the target company's accelerated growth by expanding operations, entering new markets or consummating strategic acquisitions. So defined, minority interests, targets with limited or no free cash flow and minimal or no funded debt are the hallmarks of growth equity deals. See Stewart, Growth Equity, The Intersection of Venture Capital and Control Buyouts, in *PE Hub*. This article adopts a more expansive definition of growth equity.

KKR for example launched a dedicated China Growth Fund ($1bn fund size), the objective of which is to support established, yet fast-growing Chinese companies across sectors with capital and operational capabilities to accelerate and professionalize their growth. Investments include VATS Liquor (China's leading liquor store chain) and Rudong Automobile Group (China's largest car services chain), which are both benefitting from KKR's support in their national store roll-outs.

In Europe, the supply of both growth and venture capital is scarcer than in the U.S. with fewer players focused on these market segments and risk aversion of European funds being generally higher than that of their U.S. peers. Since equity capital markets are moreover not a particularly liquid exit route for European growth companies and their founders, growth equity funds could therefore historically find attractive investment opportunities. Examples include TA's investment into Fotolia in 2009 or Insight Partners' investment into Photobox in 2011. Over the last two years, some larger funds have also moved into the growth equity space, due to the attractive risk-return trade-offs as well as overall lower levels of competition by other funds.

While "traditional" growth equity firms are generally hands-off in their investment style and have limited experience with debt instruments, buyout funds like KKR use their operational capabilities and their ability to raise debt to help growth companies with their internationalization, with the consolidation of fragmented sectors or simply with the professionalization of their organizations. This deeper level of institutional involvement is often attractive for European entrepreneurs, who face smaller local markets in Europe and are therefore reliant on internationalization or consolidation to drive international growth. A recent example includes KKR's 2009 investment into BMG alongside Bertelsmann, the German media conglomerate. In that transaction, KKR, which owned a 51% stake in the joint venture, supported BMG with capital and operational resources in a roll-up of the fragmented music publishing space. Through 6 larger acquisitions over three years, the company grew into the largest global independent music publisher with more than one million copyrights. KKR successfully sold its 51% stake to Bertelsmann in March 2013.

TOWARD MORE UNIFORM STANDARDS.

The blurry boundaries of the growth equity market inevitably lead to confusion in the market place. In venture capital, valuation methodologies and metrics are reasonably well known, and advances such as the NVCA's standard forms for early stage "alphabet" rounds ensure that transaction processes are smooth. Experienced market participants know what the general rules and parameters are; little time is wasted on tangents. Similarly, the past several decades of buyout transactions have produced investment bankers, lawyers, investors and business executives who can follow relatively clear guidelines and norms established by market experience, the SEC and other regulators and the courts in the areas of valuation, process, terms and the like. The American Bar Association's periodic publication of data on terms in private M&A deals based on surveys of actual transactions has further advanced the efficiency and transparency of the market.

In growth equity, by contrast, transactions can sometimes seem to take place in an environment resembling the Wild West, where anything can and sometimes does occur. Here, transactions have not been publicized and analyzed with anywhere near the degree of detail that classic buyout or VC transactions are. There is also generally a lower level of shared understanding by transaction parties, which is sometimes a product of investors coming to the table from very different backgrounds.

Pricing is one example where sector confusion may arise. In venture capital, an investor's valuation reflects all of a company's existing equity (including vested and unvested incentive equity for employees), plus a pool of authorized but unissued equity for future incentive equity grants that will be needed to propel growth. The investor's valuation is not diluted by these awards, and there is no adjustment or credit given for the exercise price of options. In a buyout, vested options are included in determining the selling price per share and the exercise price of options is credited to the common equity, as the transaction

is a terminal event. In growth equity transactions, positions can vary on this issue, with issuers and their current owners occasionally arguing for buyout-like treatment, which is more favorable to the existing investors. More commonly, however, pricing in growth equity transactions reflects the methodology used in venture investments.

Investor protections are a second area where confusion often arises. Generally, a growth equity investor is joining a company at a much higher valuation than prior investors. Such an investor has a legitimate interest in assuring that a liquidity transaction that produces a gain for existing investors but a loss or a minimal gain for the growth equity investor does not occur without its approval. In many cases, especially those involving rapidly-growing companies in frothy markets, growth equity investors may agree to a lesser set of blocking rights than a venture capital investor, sometimes as the price of admission to an attractive company, even to the point in some cases of making investments in common stock with limited contractual protections. Especially in Asian transactions, where contractual rights and enforcement mechanisms are less certain, selecting the right management team, and developing and maintaining relationships with the team, are viewed by some investors as more effective ways of achieving a successful exit for all parties than elaborate contractual protections alone.

A third area in which widely variable results can occur involves indemnification. In venture deals, it has been customary to have a set of representations that simply survive closing. In a buyout, by contrast, market participants are very familiar with the minuet-like discussion (or slam dance in some cases) of escrows, caps, baskets and time limits (and an ever expanding list of additional provisions) that are designed to apportion liability for known and unknown problems and limit the sellers' exposure in the absence of fraud. Where does a growth equity deal involving both an element of capital infusion and an element of liquidity fit? Which of these frameworks is most appropriate? Or perhaps neither?

A recent survey of over 60 growth equity deals closed in the past several years conducted by the Goodwin Procter Private Equity and Technology Companies Groups offers guidance on market outcomes for indemnity provisions in such transactions. The survey found, among other things, that:

- Over one-third of all transactions had venture-style indemnification, having neither a limitation on the survival period of the representations and warranties, nor a cap less than the full purchase price.
- Indemnification caps as a percentage of the investor's check size in deals that had caps were significantly higher than comparable caps in M&A transactions as a percentage of acquisition price.
- Indemnification liability closely followed the proceeds, i.e., when shareholders received liquidity they were generally responsible for some or all of the indemnification obligations.
- A meaningful portion of deals included indemnification terms unique to growth equity, such as adjusting an investor's ownership percentage as a remedy for loss in lieu of a cash payment.

CONCLUSION.

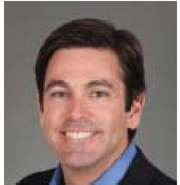
There is of course no single "correct" answer or approach for all aspects of growth equity deals. Relative leverage, location, sector, the amount of dollars taken off the table by the existing stockholders, and the personalities of the parties all matter.

As growth equity matures into a better defined sector of private equity, we expect that a more universally understood set of terms and understandings will evolve along with it. Early practitioners of growth equity may of course miss the anything goes nature of a sector involving so many participants coming from so many different backgrounds as the sector matures and gains more visibility. Growth equity has been around for some time, but better predictability and transparency as it comes to the fore can only help promote growth, by providing greater clarity and more predictability.

ABOUT THE AUTHORS

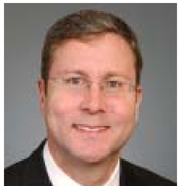
John LeClaire
617.570.1144 | jleclaire@goodwinprocter.com

John LeClaire is a co-founder and the chair of the firm's nationally ranked Private Equity Group and a member of its Technology Companies Group. Goodwin Procter's Private Equity Group serves leading private equity firms and growth companies operating in the U.S., Europe and Asia. Mr. LeClaire's practice focuses on private equity transactions and relationships with growth companies.



Anthony McCusker
650.752.3267 | amccusker@goodwinprocter.com

Anthony McCusker, a partner and co-chair of the firm's Technology Companies Practice, specializes in all areas of corporate, securities and partnership laws, with a primary focus on the formation and financing of emerging growth companies. Mr. McCusker serves as Chair of Goodwin Procter's Silicon Valley office and is a member of the firm's Executive Committee.



Michael Kendall
617.570.1765 | mkendall@goodwinprocter.com

Michael Kendall, a partner in the firm's Private Equity and Technology Companies Groups, focuses his corporate finance and securities practice on private equity and venture capital transactions, mergers and acquisitions, public securities offerings and representing emerging growth companies.

ABOUT OUR GROWTH EQUITY PRACTICE

Goodwin Procter's industry-leading Growth Equity Practice offers a blend of sector and stage experience for companies and investors. More expert at handling complex, large-scale transactions than typical venture capital law firms and more adept at working in entrepreneurial growth situations than buyout law firms, Goodwin Procter offers unique expertise in the growth equity sector.

ADDITIONAL RESOURCES

While there are numerous publicly-available studies of market terms in buyouts and strategic M&A transactions, until now there has been no published data reporting on deal terms of minority growth equity investment transactions.

Goodwin Procter has prepared a study to help advance the discussion of what is "market" for terms in minority growth deals, focusing specifically on indemnification terms because, in our experience, it is in this area that growth equity deals differ most from venture capital transactions, buyouts and other M&A deals.

For a copy of Goodwin Procter's 2013 Growth Equity Indemnity Study and to view a webinar discussing the findings of this survey, please visit http://www.goodwinprocter.com/Practices/Private-Equity.aspx.