Growth Equity: The Intersection of Venture Capital and Control Buyouts

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Growth equity (or growth capital) resides on the continuum of private equity investing at the intersection of venture capital and control buyouts. Growth capital is designed to facilitate the target company's accelerated growth through expanding operations, entering new markets, or consummating strategic acquisitions. We've put together a high-level overview of growth equity transactions, as well as a more in-depth discussion of redemption rights in these deals.

From the private equity investor's perspective, there are several key distinctions between growth capital and venture capital, including:

VENTURE CAPITAL	GROWTH EQUITY
Invest in early stage operating companies with unproven business models	Invest in mature operating companies with proven business models
Invest in multiple early stage companies within an industry/sector	Invest in the (perceived) market leader within an industry/sector
Investment theses underwritten on substantial revenue growth projections	Investment theses underwritten on defined plan to achieve profitability potential
Invest in companies with undefined future capital requirements	Limited or no future capital requirements to achieve profitability potential

Similarly, from the private equity investor's perspective, there are several key distinctions between growth capital and control buyouts:

CONTROL BUYOUTS	GROWTH EQUITY
Invest in a controlling (or exclusive) equity position	Invest in a minority equity position
Invest in highly profitable operating companies with consistent free cash flow	Invest in operating companies with limited or no free cash flow
Often employ debt financing to leverage the investment	Invest in operating companies with minimal or no funded debt
Invest at point where revenue and profitability are projected to grow steadily	Invest at inflection point where growth capital can fuel substantial revenue and profitability growth

From the target company's perspective, growth capital is often the preferred source of financing based on the company's financial profile and operational characteristics. For example, the fact that the company has limited or no free cash flow may cause buyout investors to undervalue the company on an EBITDA multiple or similar valuation basis. The lack of free cash flow also makes it difficult for the company to obtain debt financing. Similarly, the company's mature business plan may cause venture capital investors to undervalue the company on a projected revenue growth basis.

A company that finds itself in this position may turn to growth capital as a way to achieve its revenue and profitability potential. If that company has an articulable path to achieving profitability potential (upside opportunity) and is willing to agree to appropriate investor "protective provisions" (downside protection), investors may view a growth equity infusion as a compelling investment opportunity.

Deal Characteristics

Growth equity terms are deal-specific. Depending on several key metrics, such as operating history, financial performance, addressable market, and capitalization, a growth equity investment may be documented very similarly to a traditional, late-stage venture capital financing. Alternatively, in some growth equity transactions, such as a controlling-interest equity recapitalization with a founder rollover, the transaction may be documented very similarly to a traditional control buyout. That said, many growth equity investments share the following key characteristics:

CHARACTERISTIC	DESCRIPTION	OTHER TRANSACTIONS WITH SIMILAR TERMS
Senior Preferred Security	Investor acquires a newly-created preferred security representing a minority of the fully-diluted capitalization of the issuer	Venture capital
	Preference in liquidation to all other outstanding equity interests	Venture capital, control buyout with an equity incentive plan, or equity recapitalization with a minority equity rollover
Director Designation Rights	Director designation rights "commensurate" with investment, taking into account fully-diluted ownership and preferred security	Investments across private equity continuum
Protective Provisions	Appropriate "protective provisions" designed to provide effective operational control over significant matters	Debt financing and "club deals" in buyout transactions
Redemption Rights	Redemption (put) rights designed to create liquidity upon triggering events	Debt financing and PIPE transactions

On the protective provisions referenced above, these provisions are structured to give the investor consent rights on debt and equity transactions, M&A transactions, tax/accounting policy changes, deviations from budget/business plan, hiring/firing of key employees, and other significant operational activities. In addition to the rights, preferences, and privileges noted above, the investor also typically obtains other rights appropriate for the size and scope of the transaction and the lifecycle of the issuer, such as tag-along rights, limited drag-along rights, and registration rights.

Redemption Rights

The remainder of this article focuses on investor redemption (put) rights in growth equity transactions. In evaluating investor redemption rights, there are three principal considerations: (1) redemption triggers; (2) redemption value and sources of funds; and (3) remedies for defaulted redemption.

The most common "triggers" for the growth equity investor's right to compel the issuer to redeem its stock are:

- *Time* – Similar to investor redemption rights in PIPE transactions, this redemption trigger is typically set at 60-66 months after the original issuance date.
- *Performance Milestones* – Typically benchmarked against the investment thesis or management case, defined revenue or profitability growth, customer wins, etc., and may be tested multiple times during the life of the investment.
- *Covenant Default* – Similar to "events of default" in debt financings, this redemption trigger is based on the issuer's failure to satisfy defined covenants – usually financial covenants.

The most significant considerations in evaluating redemption value and sources of funds are:

- *Defining "Redemption Value"* – Upon exercise of its redemption rights, the investor's equity interest is redeemable at a pre-negotiated "redemption value". The redemption value is often set at (1) the original issuance price plus an accruing preferred return, (2) a multiple of the original issuance price, (3) the then-fair market value of the equity interest, or (4) a "higher of" combination of some or all of the foregoing.
- *Sources of Funds* – Subject to applicable statutory and common law limitations on redeeming stock, the issuer must comply with contractual requirements to effect the redemption and/or undertake a liquidity-generating process. For Delaware entities, statutory limitations include the "surplus" and "capital impairment" rules. Furthermore, an entity is generally prohibited by common law from effecting a redemption that would render it insolvent. In any redemption scenario, applicable surplus and capital impairment rules and solvency limitations should be analyzed thoroughly with counsel and financial advisors. Growth equity investors often also obtain contractual requirements that the issuer (1) use all "legally available funds", (2) undertake a "forced sale" of other capital raising transaction (discussed below), (3) issue a promissory note for the redemption value, and/or (4) use all other available means in order to effect a required redemption.

Investors will often negotiate for some or all of the redemption default remedies discussed below:

- *"Springing Board"* – This remedy permits the investor to designate a majority of the issuer's board of directors. Among other things, this enables the investor-controlled board to pursue a liquidity-generating transaction and modify the issuer's management team.
- *Forced Sale* – This remedy permits the investor to compel the issuer to consummate a liquidity-generating transaction or undertake a process to do so. Liquidity-generating transactions may include a sale of the company, incurring debt, raising additional equity, or undertaking similar transactions designed to get the issuer sufficient cash to satisfy its redemption obligation while remaining solvent.
- *Modified Economic Rights* – This remedy may include various "springing" or modified economic rights designed to mirror the economic detriment the investor suffers from the defaulted redemption. Modified economic rights may include, among others things, warrants, stock dividends, or default interest rate on preferred investment, etc.

Takeaway

Growth equity investing is not as well-known as traditional venture capital or control buyout investing. However, when properly sourced, diligenced, negotiated, and executed, growth capital can represent a lower risk-adjusted cost of capital for the investor when compared with traditional private equity investments. Similarly, by attracting cost-effective capital and a sophisticated and seasoned (but not controlling) partner, growth capital often represents an attractive financing source for companies poised to accelerate their revenue and profitability growth.

This article represents only a high-level overview of certain characteristics of growth equity transactions. As is always the case in private equity investing or in considering partnering with a private equity investor, it is important to engage legal, tax and other appropriate advisors early in the process. Engaging the proper advisors – and working collaboratively throughout the process – significantly increases the likelihood of a successful outcome.

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