GROWTH EQUITY 3

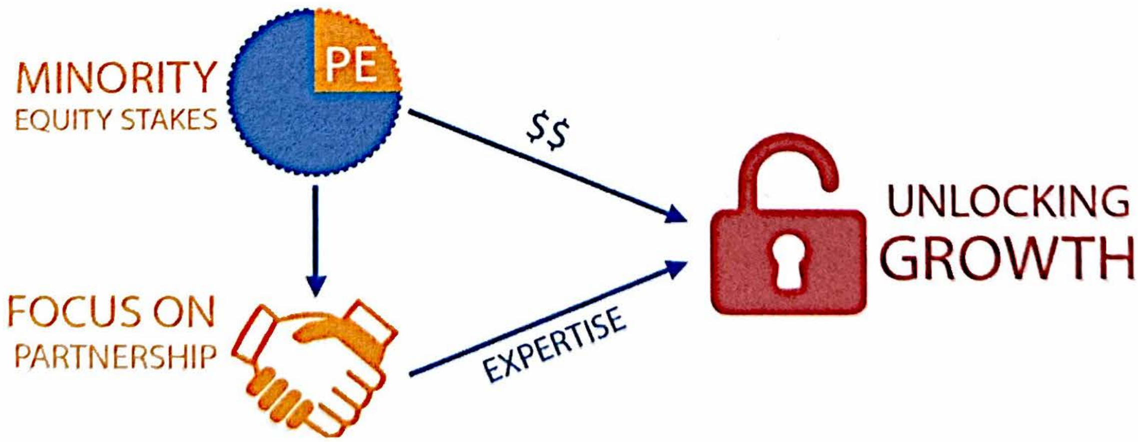
Growth equity funds occupy the space between (and thus complement) venture and buyout investing, providing fast-growing but established businesses with funds and support for a transformational leap in their development. Growth equity accounts for the largest number of private equity (PE) deals executed in emerging markets. In addition, following the global financial crisis, growth equity investments have gained fresh momentum in developed markets, as they provided an avenue to deploy capital at a time when debt markets were closed.

This chapter explores the strategy's defining traits, describes the attributes of its target companies and the unique characteristics of the growth equity investment process. We conclude with a closer look at some of the minority shareholder rights sought by growth equity investors.

GROWTH EQUITY DEFINED

Growth equity funds invest in fast-growing businesses (which have moved beyond the start-up stage) in exchange for a minority equity stake. Given the lack of control, a strong working relationship and trust-based partnership between the investors, existing owners, and management are required to achieve the desired outcome: advancing the company to a new stage of development. These dynamics are shown in Exhibit 3.1.

Exhibit 3.1 Defining Characteristics of Growth Equity



MINORITY EQUITY STAKES: Growth equity investments are usually made in exchange for a minority equity stake; strategic and operational control of the company will remain with its existing business owners. A growth equity fund's stake in a business typically consists predominantly of newly issued shares, although a portion of funding may be used to provide an exit for existing business owners. Only a small subset of growth equity deals results in the PE firm acquiring more than 50% of a company's equity and benefiting from the ensuing majority shareholder rights. In these instances, the key aspect differentiating growth equity from control buyouts is the active role both founders and management teams retain in the company.

The minority equity position of an incoming PE investor shapes all aspects of the investment process, from deal structuring and operational decision-making during the holding period, to the course of action at exit. From the outset, it is important for minority investors to understand the motivations of the majority shareholders and ensure they are aligned with the fund's investment thesis, its base case scenario for expansion and its plans for change. Still, focusing on an agreed-upon plan and executing the necessary changes can prove quite challenging from a minority position, even with a good working relationship and appropriate minority shareholder rights in place.

FOCUS ON PARTNERSHIP: In an ideal scenario, owners, existing management and new investors will form a successful partnership contributing complementary skills that help obtain superior operating results at the portfolio company. Growth equity investors bring financial acumen to the table, in particular experience in optimizing capital structures, in buying and selling businesses, and familiarity with capital markets and the initial public offering (IPO) process. In addition, they often have a broad network in both commercial and financial circles and experience in creating corporate governance structures in line with global best practices. Overall, their skillset can be an effective complement to the operating knowledge and local networks developed by owners and management.

As growth equity does not primarily provide liquidity to the owners, the economic interests of both parties are well aligned. Furthermore, it may be in the PE firm's best interest to keep the existing management in place and in control, as they have a working knowledge of the operating business and its markets. A growth equity investment will therefore often be minimally disruptive to the operating dynamics of a business, since existing relationships between owners, management, suppliers, customers and other stakeholders are maintained.

To ensure a smooth working relationship, both parties need to agree on growth and development targets and align their interests from the start. A clear understanding of the culture and approach to business at both the PE firm and the target company can help manage expectations and set realistic rules of engagement for both parties. PE investors and existing company owners must each carefully select partners that complement their individual investment and management styles. For example, a hands-on active investor may be best advised to avoid investing in a "closed" family business, and a passive investor might not be the right partner for a business with urgent restructuring needs.

UNLOCKING GROWTH: Growth equity funds invest in established businesses with proven business models and attractive future prospects for expansion. Portfolio companies often operate in expanding economies, in sectors exceeding a country's average national growth, or in industries ripe for disruption. A growth equity fund's capital, its industry and operational know-how can provide a company with the resources to unlock latent potential, improve profitability and enable accelerated growth.

The capital invested by a growth equity fund is typically used for two purposes:

- To fund specific, value-accretive projects at the portfolio company. Growth equity firms often employ a bench of operating partners who can help define these projects and drive the value creation process. Incoming funds may be used, for example, to realize international expansion plans, develop a new product line, fund working capital to reach scale, expand existing facilities, or consolidate a fragmented industry through roll-up acquisitions. Companies should select their preferred growth equity partner from a group of suitors based on their experience in driving the specific initiatives needed to maximize value creation.

- To provide liquidity to the current owners and founders and help simplify its shareholding structure. The latter can help reduce the complexity of economic claims on a company and significantly simplify the governance process. The new investor may, for example, replace a number of venture capital (VC) investors from earlier investment rounds in a successful start-up or step into the shoes of a group of family members in a family-owned business.

Creating Value through Genuine Partnerships

By J. Frank Brown, Managing Director and Chief Operating Officer, General Atlantic

Partnership is a frequently overlooked cornerstone of successful growth equity investing. Many fast-growing businesses are at an inflection point in their development, in need of a candid, patient, and strategic partner to help them manage and accelerate their growth by seizing new opportunities, mitigating risks, and preparing to scale their business models. The most important aspect of any partnership is the alignment of interests; if an investor and investee work together to build a successful company that is designed to scale and grow—the holy grail of growth investing—both will be successful.

In order to unlock maximum value and drive superior returns, an investor needs to build a genuine partnership with entrepreneurs by using a relationship-focused approach founded on an alignment of interests. But what makes a partnership genuine? What components are needed to maximize the success of a growth investment?

- Transparency and mutual understanding. With fast-growing companies, there needs to be agreement on a host of factors related to a company's current and potential future growth trajectory, including: how fast the company can grow, how it will expand, what capital is needed for that to happen, who is the optimal management team to lead that growth, and much more. In our experience, people are the most important factor determining a company's success, which means having the right leadership and employees in place as quickly as possible is critical.
- A short- and long-term plan. The investor and company management team also need to agree on a plan for the first year of the investment, as well as a longer-term plan, including how to prepare the company for its next phase of growth in the coming decade. Is the company going to expand to other markets, and to other products or services? How will the business need to grow in terms of its employees and management team? What capabilities are needed that don't currently exist at the company and does it have the right in-house talent to lead those capabilities effectively?
- Ongoing engagement. An investor needs to remain engaged over the lifecycle of the investment, with the investment team continuing to work hand in hand

with the portfolio company over the entire period of ownership, instead of passing off responsibility once the deal has closed. They should connect the portfolio company to the impactful advice, relationships, and resources it needs to enable and sustain growth. One of the most important roles of a growth investor is serving as a sounding board to entrepreneurs, offering guidance and best practices in all aspects of the business, including human capital, revenue generation, and operational excellence. To do this effectively, an investor needs to build and leverage a global network of relationships to help growing companies draw from best practices across industries and regions, and build a world-class leadership team and board that will help them scale.

- A structure-reinforcing partnership. A growth equity firm's investing structure should be geared toward alignment with its portfolio companies. For example, we generally invest in common stock with a simple liquidation preference that provides protection without overly structured provisions. To engrain an ethos of partnership and collaboration in a firm, investment teams need to be incentivized to add value and harvest gains, not put money in the ground. For example, our collective team represents the single largest commitment in our capital base. Our team members put their own money into every deal that we do, creating the ultimate alignment of interests. This motivates everyone to help build a successful enterprise from the time we finalize negotiations with a company and fund the capital until the time we exit the investment.
- Engagement across geographies. If a growth equity firm has a global footprint, the optimal incentive structure will rally team members around the globe to help a company unlock value and drive growth across geographies—critical for the many growth companies that rank global expansion as one of their chief objectives. While many global private equity firms have separate geographic funds with separate economics, motivating their investment teams to focus solely on deals within their region, at General Atlantic, we channel our communal focus on global growth equity. We have a unique global carry pool so team members benefit—and thus are ready and willing to help a portfolio company succeed—regardless of where a deal is done and who does it.

By building a transparent, aligned, and enduring partnership with a rapidly growing business, a growth equity investor is in a unique position to serve as a steady co-pilot, helping it stay on course and rise to new heights—and, by doing so, generate value and maximize returns.

GROWTH EQUITY TARGETS

Growth equity funds invest predominantly in three types of businesses: late-stage venture capital-backed companies, mature small and medium-sized enterprises (SMEs), and spin-offs from large corporations. These companies typically have high capital expenditure and increased working capital requirements to sustain their growth trajectory. Their investment requirements leave little free cash flow to service debt and the scale of company operations often inhibits their ability to tap public equity markets. As a result, an infusion of PE growth equity can be an attractive way to fund incremental growth. We explore the three types of target companies below.

LATE-STAGE VENTURE-BACKED: Growth equity is a crucial ingredient for VC-backed companies that have established a successful business model, claimed a defensible market position and reached profitability in their steady-state operations. Having arrived at this stage, these post-revenue and post-profit companies require access to deeper pools of capital to scale their activities and execute secondary or tertiary growth strategies. Thus, engaging with a growth equity fund clearly marks the transition from a start-up to a robust, sustainable business. Like VC funds, growth equity funds may continue to deploy capital into these companies over several rounds of investment and may over time establish a path to a controlling stake.

MATURE SMEs: Mature businesses with a unique competitive advantage and attractive development prospects offer perfect opportunities for growth equity investment. These companies often possess a strong market position with a well-recognized brand and a solid network. Investments from a growth equity fund frequently represent the firm's first and only engagement with a financial investor. As SMEs are in many cases family businesses or entrepreneur owned and controlled, a minority investment allows these owner/managers to maintain control of the board and the company's day-to-day operations. This differs from a successful late-stage VC-backed company, where founding entrepreneurs have typically given up significant equity and governance rights in earlier fundraising rounds.

SPIN-OFFs: Growth equity investors at times target divisions of large corporations that are well positioned for divestment or spinoff. In these instances, a corporation will typically retain control of the division initially but add capital and know-how from the PE investor to spark growth and pave the way for a smooth handover to a new investor (including public market) when the corporation eventually decides to step out. These targets are often inadequately resourced from a funding and talent perspective and thus offer greater upside under a new ownership and governance structure outside the parent entity.

Box 3.1

GROWTH EQUITY IN EMERGING MARKETS

As mentioned earlier, one aspect of growth equity investment is its prevalence in emerging markets. Observers of PE are often surprised to note that more than three-quarters of the PE deals in emerging markets are minority investments into mature SMEs. The reason: the majority of attractive companies that have thrived during the rapid economic development in these markets are family-owned businesses, still managed and controlled by the first or second generation of families. These founders are often reluctant to give up control of their company. Yet, after decades of rapid growth the foundations of these businesses are often lacking and governance structures are in need of a revamp. An experienced growth equity fund can help reform and professionalize the board, bring in experienced senior and middle management and help the firm think through suitable levers to ensure success for future generations.

THE GROWTH EQUITY INVESTMENT PROCESS
UNIQUE ELEMENTS

The typical growth equity investment process is distinct from other forms of PE investing. From deal sourcing to value creation to exit, understanding the needs of a growth company requires a specific skillset.

DEAL SOURCING AND DUE DILIGENCE

Identifying targets for growth equity funds can be a challenge: minority investment opportunities in mature SMEs are less intermediated than control deals and the most attractive target companies rarely seek an infusion of capital from external investors. Sourcing growth equity deals therefore requires a strong proprietary network; it can take years to build a relationship with company owners, argue the case for investment and eventually consummate a deal. Often these businesses do not explicitly need capital to maintain their current operating model, shifting the onus to the growth equity investor to open doors and convince company owners of the opportunities that an infusion of external capital can unlock.

Once a suitable target is identified, the lack of robust monitoring and reporting structures at many growth equity targets can introduce a significant information gap between existing owners and new investors, placing PE firms at a disadvantage during due diligence, valuation and negotiations. For investments in highly visible late-stage VC-backed companies, the challenge is slightly different: competition from multiple growth equity funds can accelerate the capital-raising process, but require investors to make decisions quickly with incomplete information, and accept valuations or terms driven by competitive dynamics or market momentum.

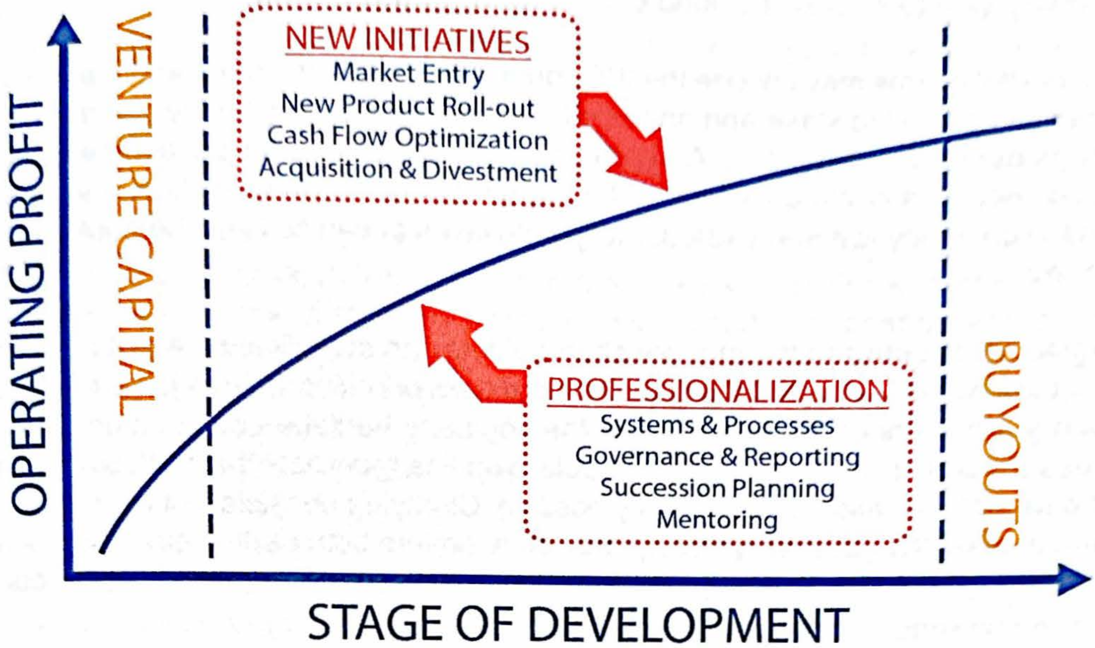
Negotiating growth equity deals can be particularly challenging given the presence of strong entrepreneurs and founders, as decisions often hinge on non-economic interests that may be difficult to identify for an outside party. The pre-investment phase is nevertheless the time when PE investors have the best chance of shaping a company's strategy by convincing management of its expertise and influencing shareholding terms given their position as prospective new capital providers.

Finalizing and executing growth equity deals is typically easier than in more complex buyout transactions; the lack of leverage and the smaller number of parties involved makes negotiation, information gathering, vetting of documentation, and closing the deal significantly easier.

VALUE CREATION

Whether a mature SME, a VC-backed company or a corporate spin-off, growth equity portfolio companies share similar levers for value creation. As growth equity investors rarely employ debt to magnify returns on their equity stake, their focus will be on driving change at the operating company (through strategic, operational and

Exhibit 3.2 Value Creation in Growth Equity



financial initiatives), or professionalization and governance optimization, as shown in Exhibit 3.2[1]

Professionalizing governance and business processes provides the necessary backbone to execute value creation initiatives. Given the initially lean set-up of VC-backed companies and the resource constraints in SMEs, many of the structures and processes governing their business operations and decision-making have previously been implemented in an ad-hoc fashion. Therefore, improving reporting structures and information flow, and professionalizing the management of both human resources and capital is essential for these companies to consolidate their advantage and enable the next stage of growth. PE investors can add value by mentoring current management and identifying blue-chip talent to help with succession planning. In addition to the PE firm's network, the presence of a new and committed shareholder sends a strong signal to the market, which may attract talent to the company.

When working with owner-operators, PE investors must be realistic about the number of changes they can implement during the holding period. While contractual rights can reassure and protect the investor's interests, the ability to execute controversial restructuring and cost-cutting plans will likely be constrained by the fund's minority equity position.

EXIT

Similar to most PE investors, growth equity funds will target to exit their investments within three to seven years. While the company may have grown in line with the business plan, finding a buyer willing to step into the shoes of a minority shareholder can be difficult. At times, the majority owner may exit alongside the growth equity fund, providing a viable acquisition target to strategic investors, who usually require a control stake in a business; however, these cases are the exception rather than the

1. Please refer to Chapter 13 Operational Value Creation for further insights into the tools used by PE firms to improve their portfolio companies during the holding period.

rule. More likely, the growth equity stake will be sold on its own, for instance via a secondary sale to another PE fund or a buyback by the entrepreneur.

Large portfolio firms may choose the IPO route, allowing on the one hand the owner to maintain a controlling stake and on the other hand the PE investors to sell down their holdings during or after listing. A similar mechanism applies for private investments in public equity, a common structure for growth equity funds in certain jurisdictions; given the company is already listed, the growth investor can sell into the public market upon exit.

Disagreements between the multiple shareholders can complicate the exit process. A mismatch in valuation expectations or non-economic priorities such as job preservation for family members or the protection of the company heritage can confound the exit process. In addition, a PE firm may be unable to optimally prepare the portfolio company for the sale of its stake from a minority position. Clarifying possible exit avenues early on and drafting the necessary documentation to ensure both parties are aware of and aligned with future plans are important to mitigate these risks and reduce conflicts.

MINORITY SHAREHOLDER RIGHTS

To mitigate the risk associated with minority ownership, growth equity investors negotiate explicit shareholder rights to monitor their investee firms, influence company proceedings, and preempt or mitigate potential conflicts of interest with the majority shareholder. Explicit rights and safeguards are included to ensure that the investor's interests are clearly expressed and aligned with those of the company's owners. Contractual provisions may be included to enable enforcement; they are negotiated as early as the submission of a letter of interest or term sheet and later formalized in an amended company's shareholder agreement post-investment.[2] Exhibit 3.3 shows some of the mitigating contractual safeguards employed by minority investors.

A jurisdiction's regulatory code and its established case law provide an important safety net for minority shareholders to mitigate the risk of unfair treatment, or ensure the enforcement of their rights. The investor may petition a court, stating that majority shareholders have run the company in a manner unfairly prejudicial to the minority shareholder; examples include not sharing financial information in a timely manner, dealing with associated companies on a non-arm's length basis or

Exhibit 3.3 Minority Shareholding Dynamics

2. For further details on the process and documentation of PE transactions please refer to Chapter 10 Transaction Documentation.

gross incompetence of senior management (or a family member). The court may then ask the controlling shareholder to refrain from certain activities, authorize civil proceedings or order the minority stake to be acquired by the controlling shareholder.

OPERATING CONTROL: The governance terms associated with growth equity investments vary widely, but typically include representation on a portfolio company's board of directors and certain negative control and approval rights. Growth equity investors may also seek voting rights disproportionate to their ownership share to strengthen their ability to execute strategic and operational change and prepare the company for a successful exit. Negative control and approval rights provide growth equity investors with control over decisions related to operating and capital budgets, C-level executive changes, mergers and acquisitions and divestment activity, new borrowing and equity issuance, divergence from strategic plans, and expansion into new business lines. Information rights ensure that accounts and advanced notice of important corporate actions are disseminated in a timely fashion. Overall, these contractual provisions provide growth equity investors only with the means to block company activities detrimental to their interest, underscoring the importance of developing a productive working relationship with business owners to drive value creation.

MANAGEMENT INCENTIVES: Given their limited operating control, growth investors strive to boost alignment with management through financial incentives. A management share or option plan tied to key operating and financial metrics will focus the manager's attention on growing the business in line with investor's goals. Ideally, shares should only vest upon exit of the PE fund to match the investor's time horizon. An incentive plan will often constitute a requirement to attract higher-caliber talent to professionalize management and drive the next phase of growth in the company.

LIQUIDITY: As minority investors, growth equity funds lack the voting rights to force the hand of majority owners at exit time. Some of the contractual provisions that protect their interests include put options that allow a fund to sell its stake back to the controlling shareholders at a predetermined minimum price or, in the case of severely missed performance targets, the ability to initiate a liquidity event such as an IPO. They may also include drag-along rights that enable the investor to force the remaining shareholders to participate in the sale of the business.

CLOSING

Growth equity has developed into a recognized strategy within the PE industry. In many instances and particularly in developing markets, where businesses are often owned and managed by the first or second generation of families, minority investors are much sought after, especially when they come with relevant industry expertise and the ability to open doors to new (overseas) markets. Given their reliance on strong partnerships and cooperation with the founding families, it is no surprise that successful PE firms take specific care to develop lasting relationships and a solid reputation with the business communities at large. In the day and age of ample dry powder, it is no secret that even traditional buyout funds have expanded their investment strategy to include minority investments in order to deploy capital in a timely manner.

KEY LEARNING POINTS

- **Growth equity funds invest in fast-growing, established companies in return for a minority equity share and make a concerted effort to establish a solid partnership with all company stakeholders (especially majority owners).**
- **Beyond capital, growth equity funds offer hands-on involvement with their portfolio companies to assist with business development, professionalization and expansion.**
- **Minority protection rights are crucial for growth investors especially with regards to achieving a successful future exit.**

RELEVANT CASE STUDIES

from *Private Equity in Action—Case Studies from Developed and Emerging Markets*

Case #7: Siraj Capital: Investing in SMEs in the Middle East

Case #8: Private Equity in Emerging Markets: Can Operating Advantage Boost Value in Exits?

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