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Financing With Growth Equity

Equity capital could be an alternative for financing a rapidly growing business.

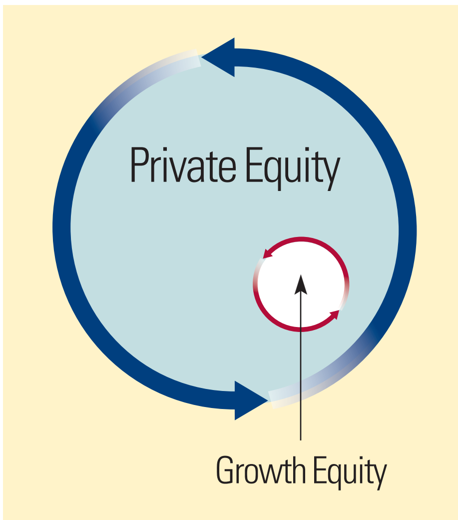
by Michael J. Black

The relationship between the passage of time and increase in business value does not follow a smooth curve. At certain times in the evolution of a business, the next step can result in an outsized change in the value of the business. Expansion of a product to a different channel of distribution, the creation of a new manufacturing plant, or any number of strategic initiatives might deliver the next breakthrough. Taking advantage of those value-creation opportunities typically comes with some additional risk, either operational or execution risk or, because such opportunities almost always require the investment of additional capital, financial risk. It is at this inflection point that growth equity can be used to raise the business to the next level.

Appropriately, business owners look first to their lowest cost of capital source, the company's banks or senior lenders. Most lenders seek to fund incremental growth, but may shy away from funding sizable new growth initiatives, particularly those that require outsized investment with uncertain timing for the realization of cash flow from that investment.

Mezzanine (subordinated) debt offers another source of capital if senior debt is approaching its reasonable limit. Although expensive, the potentially high returns on capital at this stage of the company's development generally justify the cost of mezzanine. Some owners may understandably resist coupling financial leverage together with the execution risk of the strategic initiative given the myriad of uncertainties in the business outlook. Therefore, if the level and timing of cash flow from the growth opportunity is uncertain, the prudent alternative might be equity capital, which does not have contractually scheduled calls on cash flow.

Growth equity is a specialized subset of the trillion-dollar private equity market. In addition to private equity, investors might include wealthy families or foundations. The parameters of growth equity vary considerably depending upon the desired use of proceeds and the capital provider's industry, size, and structure preferences. Typically, but not always, growth equity takes the form of a minority investment, with the majority (again, not necessarily all) of the capital going into the business. The central tenet in a growth capital investment is that the funds unlock latent growth potential, creating a sustainable stream of incremental cash flows that increase the value of the enterprise.



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If an opportunity exists to create incremental enterprise value (expected returns > the cost of capital), and taking on more debt is not available or is not appropriate, business owners should consider joining forces with a growth capital investor in order to execute the plan. Matching the growth investor with the appropriate company situation involves several considerations, the most important of which we address briefly here.

USE OF PROCEEDS

Growth equity investors generally target their investments to achieve the business growth initiative, not to generate liquidity for selling shareholders. In fact, growth capital investors typically require that some portion of current owners'/managers' capital remain at risk. That being said, some investors make the case that by freeing the entrepreneur (or inactive shareholder) from fear of wealth loss, business prospects improve through pursuit of prudent (if slightly more risky) growth opportunities. In all cases, a need must exist for capital to address new markets, targeted acquisitions, facility expansions, or similar strategic uses.

STRUCTURE

Growth equity investors act more like financing sources than owners, therefore their objective is not to "take over the reins." The most common investment by a growth equity investor takes some form of preferred minority equity. Typical terms include:

- The new money occupies a priority position in the capital structure relative to the common equity owners;
- The new investor is granted rights to a priority return, typically in the range of 6-8% that accrue if cash flow is inadequate to pay on a current basis.
- Although granted certain preferences, the new equity converts to common for all "economic" events.

A smaller group of growth equity investors invest in control positions, and some acquire entire companies. No set formula or standard terms exist for these securities and most investors customize the specific solution to accommodate the particular situation.

CORPORATE GOVERNANCE

Business owners must also seek agreement on company governance and what decisions must have the consent of investors. The minority growth investor trades receipt of a priority position and a preferred return for limited influence over the conduct of the business. Although they do not intend to control the board of directors, minority investors require certain controls on major corporate decisions such as:

- Operating and capital budgets,
- C-level executive changes,
- C-level compensation,
- Mergers and acquisitions,
- Divestiture of assets,
- Borrowing money beyond specified

(continued p.2)

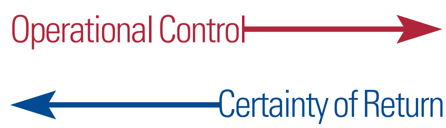
limitations
- Material capital expenditures
- Divergence from strategic plans and/or expansion into new lines of business.

These decisions generally require the approval of the minority investor (if there is an otherwise affirmative vote among the majority investors). Investors do not want these provisions to dominate the nature of the relationship, but put them in place to protect the integrity of the business.

EXIT DYNAMICS

Growth capital investors, like all institutional investors have a contractual responsibility to return capital and profits to their limited partners in a specified time period. As a result, minority investors require a "certain" exit plan. Typically, this takes the form of a put feature triggered by the passage of time and/or by a serious deterioration in business performance. The value of the securities subject to the put is often at fair market value determined by a third-party appraiser or may be specified by a formula based on performance. As a practical matter, investors and owners almost always decide together on the timing and type of exit event regardless of contractual obligations.

In addition to the economic and structural issues identified above, matching a particular company or situation with the appropriate growth investor also involves a compatibility of styles, a similar investment horizon, a like-minded culture for making decisions, and an alignment of risk tolerance. Partnership



dynamics permeate all aspects of the investment. The role of the financial partner impacts the specific structure of the investment. Required involvement ranges from an inactive or passive investor that simply observes at board meetings to partners with significant operating expertise that will weigh in on strategic and operating decisions. Generally, the more influence the growth investor has on operational matters, the lesser need for certainty of return. All parties must concur on the desired level of partnership to establish the bedrock for success of any growth investment.

Successfully employing growth capital rests on the ability to match the field of potential investors to appropriate company situations. The culture and desired use of funds by existing owners must synchronize with the level of partnership and appetite of the financial investor. While this requires a high degree of understanding and a close working relationship between existing owners and a new investor, a healthy partnership results in funds being deployed to the betterment of the company's prospects. Once these prospects are realized and monetized, the owners collectively benefit from the creation of increased economic output and the corresponding higher company valuation. Owners who finance expansion opportunities with growth equity must weigh the loss of total and absolute control against the potential benefit of a much larger and more valuable enterprise. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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