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Will Pearce is a partner and William Tong is counsel at Davis Polk & Wardwell London LLP. Mr Pearce can be contacted on +44 (0)20 741 81448 or by email: will.pearce@davispolk.com. Mr Tong can be contacted on +44 (0)20 741 81089 or by email: william.tong@davispolk.com.

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Growth equity minority investments

BY WILL PEARCE AND WILLIAM TONG

Minority investments by private equity (PE) firms (in contrast to venture capital (VC) firms) used to be uncommon. However, in the competitive M&A landscape of recent years, we have increasingly seen PE firms acquire non-controlling stakes in targets where existing shareholders retain control. Specifically, growth equity investment – the intersection between VC investment and PE buyouts – where PE funds invest in established businesses with significant growth prospects predominantly through minority stakes, has grown significantly in the last 10 years.

Preqin has estimated that growth equity as a segment of the private capital industry has more than doubled its size since 2016 and has grown to almost $920bn at the end of March 2021. Inflexion has also publicly noted that in 2021, the portion of minority investing has risen to 18 percent of total PE value (the highest ever), and it accounted for 25 percent of Inflexion's deals in 2021. It is therefore unsurprising that PE firms are launching more and more dedicated growth equity funds to make such investments.

Why do PE firms make growth equity investments?

In a busy M&A environment with competitive auction processes as the default means to sell a company, opportunities for PE firms to make investments are limited and often come at a high cost. Growth equity offers a different path for PE to deploy its 'dry powder' as it does not normally involve auctions and the investment cost would not include a control premium. As the amounts at stake are not as high as that for a buyout, such investments often do not involve any debt financing, which means that they can proceed even if debt markets are shut.

While returns from such investments tend not to be as high as successful venture capital investments (relative to investment amounts), the risk profile for an investor is lower, as these companies are often mature but still fast-growing companies. In other words, this is a distinct investment class with its own return and risk profile, which can be appealing to limited partners looking to diversify their portfolios. PE firms can also use a minority investment to competitively position themselves for a future opportunity to take control of the target.

Why do existing shareholders accept growth equity investments?

Businesses targeted by growth equity funds tend to be founder-controlled or family-owned businesses. Accepting growth equity investments allows them to retain control but at the same time obtain growth capital and PE expertise and credibility for the next stage of their business trajectory, perhaps for an eventual sale or initial public offering (IPO). For example, they may be interested in expanding into a new jurisdiction, and funding from an investor that can share its contacts in that jurisdiction would help accelerate this process. Such investments may also provide them with a liquidity event to allow them to realise a portion of their stake in the target.

Key issues in investment documentation

For a PE firm taking a minority stake, negotiations will invariably focus on the quantum of any return on capital, mechanisms to control their exit and other appropriate minority protections. Whether they succeed in this is often dependent on the size of their shareholdings and the specific expertise they offer to the existing shareholders.

Preferred equity

Growth equity investments are often made through voting preferred equity. Preferred equity shares are generally entitled to dividends accruing at a fixed annual rate on the investment amount on a compounding basis, paid to the investor before dividends can be paid to other shareholders. Dividends may be paid in cash or shares as a payment in kind. The latter is helpful for the issuing company as it may not have cash available at all times for dividend payments.

On a return of capital (including through a winding up) or an exit event such as a control sale, such shares would rank junior to debt but would rank senior to the other classes of shares. Specifically, the investor would be entitled to a preference amount ranking ahead of the other shareholders for such events (which would include any accrued but unpaid dividends). The investor may be able to negotiate for a multiple of its investment amount as the preference amount for such situations but as a minimum, the preference amount would be the investment amount itself.

Such shares would, at the investor's election, be convertible into ordinary shares on a pre-agreed conversion ratio subject to adjustments in relation to any consolidation, sub-division or other share capital events. This would give the investor the ability to participate in the upside where such conversion would result in the investor receiving an amount higher than what it would have received if it had held on to its preferred equity. The company and controlling shareholders often push for the automatic conversion of such shares into ordinary shares upon the occurrence of certain liquidity events (such as an IPO of the company or the control sale) in order to facilitate implementation of such events.

For companies incorporated in England and Wales, while investors and controlling shareholders have considerable flexibility to design the features of preferred equity, these features will need to comply with English corporate law; for example, the company must have sufficient distributable reserves before dividends can be paid to the investor. There are also certain requirements that the company has to comply with under the Companies Act 2006 before it can convert the preferred equity into ordinary shares or redeem or buy back shares from the investors.

Exit rights

For control investments, PE funds are usually able to determine unilaterally the timing and nature of their exit. However, as PE minority investors do not control the target by virtue of their shareholdings, they will want clearly defined contractual mechanisms for their exit. In contrast, VC firms do not typically ask for such mechanisms as their investment thesis assumes a larger number of failed investments with a few 'home runs' to generate the returns for the fund.

As a minimum, tag rights will be available to these investors to allow them to sell their shares to a third-party acquirer of shares from the controlling shareholders. Typically, such rights will be for all of the investor's shares if it is a control sale and for a proportionate number of their shares if it is a minority sale by the controlling shareholders.

In addition, investors will often ask for a put right, i.e., the right to require the company to redeem or buy back or the controlling shareholders to acquire its shares after a period of time (normally five to 10 years following their investment). If they are willing to accept a put right in principle, the controlling shareholders will often ask for the company to be subject to such rights so that they do not have to (at least directly) finance such acquisition.

The controlling shareholders (but not the minority investor) will have drag rights, i.e., the right to require the minority shareholder to sell its shares to a third-party acquirer. The investor will want to limit such rights to situations where it is a change of control and only after a specific timeframe.

For the sale of their shares under a put right or a drag, the minority investor will often ask for a minimum return amount (usually calculated by reference to a minimum internal rate of return or a multiple of invested capital) as downside protection.

Separately, the minority investor may ask for a general obligation on the shareholders to initiate an exit (such as a sale process or an IPO) for the company after a specific timeframe (usually after three to five years following investment and before a put right can be triggered). Depending on the size of its shareholding, it may push for the right to do so unilaterally. The put right would then be used as an exit right of last resort for the investor where the company is unable to consummate such exit event.

Existing shareholders will want to limit the PE minority investor's ability to exit the company in particular by selling its shares to a third party. They will often ask for a lock up period during which the minority investor cannot transfer its shares other than to its affiliates, restrictions on the investor selling its shares to a competitor or rights of first offer and refusal for any sale of the investor's shares. The minority investor will ask for such restrictions to apply equally to the existing shareholders.

Anti-dilution rights

PE minority investors will want to make sure that they have protections against dilution. This is often achieved through pre-emption rights to participate in new share issuances on a pro rata basis or veto rights over new share issuances. Existing shareholders would often push for exceptions to such pre-emption rights, for example where equity funding is needed by the company to remedy a default by the company under its financing arrangements (which is often coupled with a catch up right for the minority investor to subscribe for shares to maintain its proportionate shareholding) or for management incentive plan issuances (which will be subject to a cap – a percentage of the company's share capital on a fully diluted basis).

Board and observer rights

The right to appoint at least a director or an observer to the board is crucial to a PE minority investor as this is an important source of information as to how their investment is performing and what lies ahead for the company.

Typically, PE minority investors will be able to appoint one director to the target's board where they have above 5 percent of the company's share capital. For larger minority investments, i.e., between 25 percent and 49 percent, they are normally able to get a number of directors that corresponds to their proportionate shareholdings in the company. Regardless of the size of the minority shareholding, investors will also ask for the ability to appoint a board observer.

Reserved matters

As minority investors are often unable to pass shareholders resolutions on their own (although they may be able to block special resolutions if their shareholdings are above the requisite thresholds under applicable law) and they will not control the board, it is important that they negotiate for veto rights on certain reserved matters to protect their investment.

A distinction is normally drawn between fundamental matters and operational matters. Fundamental matters are matters that have an impact on the value or structure of the investor's investment (such as amendments to the company's constitutional documents, variation of share rights, issuance of shares and changing the nature of the business, or winding up the group). Operational matters are matters that go toward the conduct of the target's business, such as the adoption or amendment of business plans and budgets, increases in capital expenditure, incurrence of debt (usually subject to a leverage ratio threshold), acquisition or disposals of subsidiaries and assets, litigation or the appointment of key employees such as the chief executive or chief financial officer.

The list of reserved matters that a PE minority investor would be able to ask for successfully would often depend on the size of its minority shareholding. PE minority investors will have veto rights over fundamental matters and the higher their percentage shareholdings, the more operational matters over which they would have veto rights. ■

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