KEYNOTE INTERVIEW

Fertile ground for growth equity

Falling valuations and increasing emphasis on efficient and sustainable growth by private companies are likely to make conditions ripe for growth capital investing, say Adams Street Partners' Robin Murray, Tom Bremner and Fred Wang

Q How is the macroeconomic environment impacting the supply of capital in the growth equity market?

Fred Wang: Some later entrants, including public markets hedge funds, have retrenched. This is partly due to capital constraints and partly because they are seeing more interesting opportunities on the public markets on a relative basis. A huge amount of capital has poured into this space in recent years. That trend is now reversing.

We are also seeing a slowdown in corporate venture, with some big names starting to pull back. The renewed emphasis on capital efficiency and profitability is leading some large corporates to revisit their investment strategies.

Established growth capital investors that have formed the backbone of this space for many years are also raising less capital. This is partly because deal activity has slowed, and fewer new funds are being raised. When funds are launched, of course, the fundraising environment is more challenging. The flip side is that a lot of dry powder remains, and good companies continue to see plenty of demand. Companies at the margins will be impacted the most.

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Q How much demand are you seeing for growth capital and what is driving that?

FW: Companies are still burning capital and the need for growth capital remains, even with adjusted business models. The emphasis on the efficient use of capital and on reaching profitability earlier should ease demand in the medium term. Many companies also raised a great deal of money in recent years, often well in advance of needing

it, so some are trying to wait this period out.

But companies continue queuing up to go public and the IPO market is largely shut. Additional capital will be required to keep funding these businesses until the situation changes. Some platform companies are also seeing this period of dislocation as an opportunity to acquire competitors or players in adjacent markets. In many cases this will require additional capital.

Q What impact is this shift in supply/demand dynamics having on valuations and the nature of transactions?

FW: Valuations are coming down. As growth capital investors, we look to public markets adjustments as an indicator for growth company valuations. Companies have been waiting out the market to avoid valuation markdowns, either to avert negative public sentiment or the impact on employee options.

But they can only wait so long. As they return, there will be some valuation capitulation and, in other cases, we will see structure come into these rounds. For example, investors may provide warrant coverage that lowers the cost of the investment without showing up in the price per share. We are also seeing preferred returns that guarantee a minimum return for the investor or that compensate the investor if the valuation at IPO is lower than for the current round.

These are a variety of structures to adjust for value displacement and I expect we will see even more.

Q Has the emphasis of your due diligence changed in the context of the macro environment?

Tom Bremner: While the overall scope of our due diligence has not changed, we are putting more emphasis on certain aspects of the process. In some cases, we also need to redefine good versus great versus best-in-class. For example, we have always been highly focused on sales efficiency and the ratio of lifetime value-to-customer acquisition cost. A few years ago, we considered a lifetime value-to-customer acquisition cost ratio of three to five to be good, five to seven to be great, and anything over seven to be best-in-class. But rising rates and a slower economy have lowered the return on sales and marketing efforts. Today, we think that a ratio of two to three is good, three to five is great, and more than five is best-in-class.

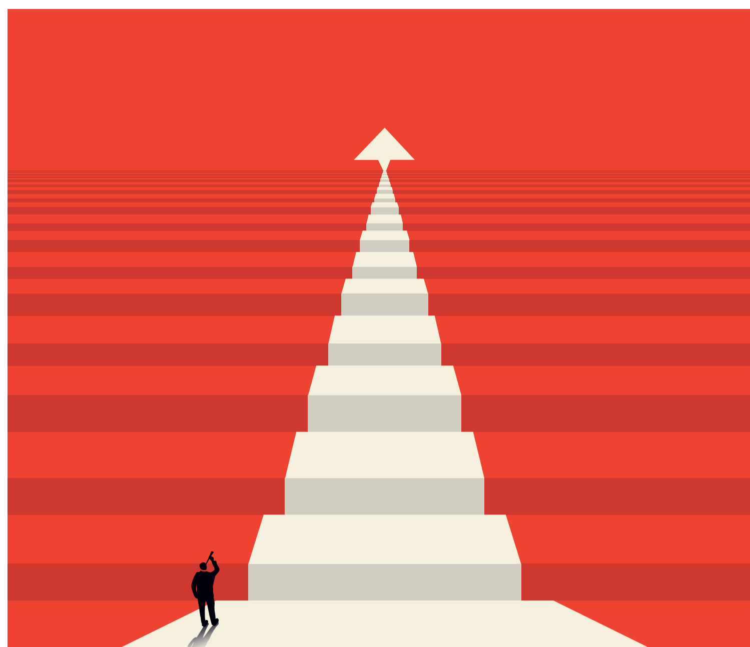
Understanding a company's true differentiation is critical now that we are no longer in an environment where rising tides are lifting all boats. Identifying companies and entrepreneurs that can demonstrate durable growth from true innovation versus me-too products is a focus.

Like many businesses, we are sharpening our focus on future financing risk. We evaluate capital needs beyond the current round and then assess the company's reliance on capital markets, both debt and equity, as it gets cash-flow positive and can control its own destiny.

Q Taking the current environment into account, why do you believe growth capital is attractive for LPs today?

Robin Murray: Downturns can make it easier for entrepreneurs to build businesses. There is less competition for customers, talent, office space, etc. The one real downside is that equity is now more expensive. From an investor's point of view, obviously the best time to invest is when valuations are low.

I have been a venture capital investor for 25 years and I believe we are entering a phenomenal couple of years in which to invest.



Q How is portfolio management being affected by today's more testing conditions?

Robin Murray: Our portfolio companies face many challenges today. In particular, the deteriorating macro environment is making it harder to acquire new customers, and existing customers

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ROBIN MURRAY

are not necessarily renewing. The financing environment further exacerbates the operational challenges.

Our role is to help companies to operate in this new environment, which requires a different approach to what made these companies successful 18 months ago. Above everything else, survival is critical. The aim is to emerge stronger and more efficient from this period.

Q Which sectors do you deem to be particularly attractive right now?

TB: Healthtech is interesting, and we are spending a great deal of time on value-based care. There are companies in our portfolio that are focused on treating the whole person as opposed to a particular condition. Aligning incentives to improve health outcomes, while driving significant cost savings, is obviously important in today's environment.

Cybersecurity continues to be a high priority. We are seeing fewer budget cuts there than in other areas. Most companies are pushing for supplier consolidation, and platform companies offering a full suite are better positioned than point solution providers.

For the fintech or application software sectors we are focused on solutions that serve the CFO's office. Scenario planning, budgeting, cash forecasting, accounts receivable, accounts payable and payment tools solutions are all critical as enterprises shift their focus towards efficiency and profitability.

Q Conversely, are there sectors that you are steering clear of?

TB: More so than ever, we are focused on solutions that are 'must haves' and not 'nice to haves'. Solutions must offer a clear return on investment or are so deeply used within organisations that the cost of switching is prohibitive.

We are avoiding anything that is too capital intensive or hardware orientated, such as biotech or medical devices businesses that require expensive trials before commercialising products.

Companies that serve end markets that have been hit hard by covid or the recent inflation and interest rate trends are also being avoided. An example that comes to mind are companies that sell into health systems and were battered by covid. Many are now being negatively impacted by the inflationary effects of labour demands.

Commercial and residential real estate is another area. The hybrid work environment is reducing demand for commercial real estate, while interest rates are affecting the residential market. In fintech, we are avoiding challenger banks given uncertainty in the banking sector and the potential for future regulatory changes.

Q How would you describe the exit market for growth capital companies?

RM: In a word, challenging. A healthy exit market for growth capital companies requires a healthy IPO market. That does not exist today and has not for the best part of 18 months. A healthy IPO market supports premium multiples for M&A, which is the way that most growth capital companies tend to exit.

A comparable period to today's IPO market was after the dotcom crash, when the markets contracted for a couple of years. If the past is a guide, the market may reopen in the second half of this year or early next year. That will likely be the critical piece to changing exit dynamics.

But the exit environment does not impact new investment decisions given the long hold periods in this asset class. We do not use the muted multiples of today just as we did not use frothy multiples from a couple of years ago. Our approach to doing deals has not changed. ■

Robin Murray is a partner and head of growth equity investments at Adams Street Partners, and Tom Bremner and Fred Wang are partners on the firm's growth equity team

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