



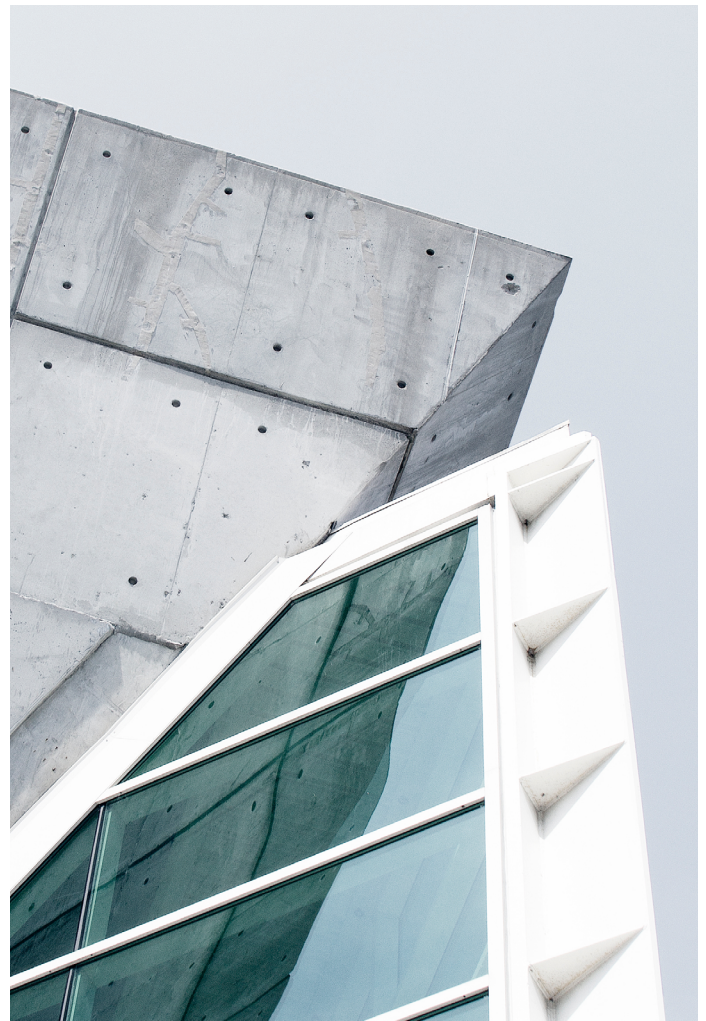
CHOOSING THE BEST INVESTMENT STRUCTURE

When a company reaches a certain scale, a common question is whether and how to raise capital from investors. This opportunity can arise from a number of milestones: a desire to accelerate growth; a need for operational expertise; a founder who wants to liquidate; or a need to fund acquisitions. Whatever the catalyst, taking on an outside investor might be the best option for a business owner to realize future success.

For established companies that have successfully navigated initial raises from venture capitalists, the next phase of financing can be particularly challenging. Many companies find themselves choosing between a minority, growth equity raise and a majority, private equity buyout. It's essential that business owners understand both the advantages and consequences that each investment structure can have on their business.

EXAMINING INVESTORS

Recognizing the different motivators behind minority and majority investors is important. Minority investors (e.g., growth equity firms) typically operate in a high risk/high reward capacity, in which a single investment can return an entire fund or multiples beyond. Their strategy is to hunt for “home runs,” and they often push the companies that they invest in to pursue higher-risk strategies that they hope can generate an outsized financial return. On the other hand, majority investment partners (e.g., private equity firms) typically operate on a lower risk/lower variability strategy, where each investment makes up a smaller return in the overall fund. However, the returns are usually more consistent and predictable. To continue the baseball analogy, these investors focus on helping achieve “doubles” or “triples” for as many of their portfolio companies as



possible. It's important to evaluate these backgrounds to ensure expectations are aligned from the start.

MINORITY INVESTMENTS

When a company raises capital from a minority investor, it receives primary capital, which provides cash for the balance sheet to fund the company's growth. Sometimes a minority investor will provide

secondary capital, which provides liquidity for existing shareholders. Pure secondary capital is harder to raise in minority investments because new investors expect existing shareholders to continue to have a material stake in the business going forward.

Both primary and secondary capital will dilute (bring down the ownership percentage) of existing shares if existing investors don't invest alongside new investors; however, there are two significant advantages to a minority raise. The first is that a minority raise often commands a higher valuation because it comes with downside protections for the new investor (see below). Another key advantage is that existing shareholders will continue to maintain operational and financial control in the company. If a founder has never raised institutional capital before, the appeal of maintaining control at a higher valuation can be a significant advantage, but it can come at a cost. Here are some considerations:

1. Onerous Conditions

It's essential to understand that various investors offer different preferences that affect how much of a company's proceeds they collect during a liquidation or exit event. For instance, investors might propose a participating preferred stock, wherein upon liquidation or exit, they would first receive their investment back dollar-for-dollar and then receive a percentage of the remaining proceeds relative to their ownership along with dividends that compound over time. Not only does this provide downside protection to the new investor, but it also meaningfully increases their returns at the expense of other shareholders. As a result, these types of structures lead to misaligned incentives and payouts between preferred shareholders (new minority investors) and common shareholders (founders and original shareholders). Also, blocking rights on future sale/capital raises, approval rights, and mandatory redemption can reduce the likelihood of a founder walking away with a positive financial outcome, even if an exit is positive for investors. For this reason, a higher valuation can't be taken at face value if it comes with preferences or other onerous conditions.

2. Lack of Operational Value

A higher risk/higher reward situation means that minority investors are often less incentivized to add operational value—in which an investor provides business expertise and strategic guidance—to investments. With a broad range of investments and less percentage ownership at stake, there is less of an incentive to nurture each company's leadership for success. This investment structure may also produce increased pressure



on the founder and management teams to achieve higher outcomes.

3. Higher Inherent Risk

With a single investment that could return multiples on a fund, minority investors can accept losses on several investments in their portfolio. As a result, growth investors tend to make bigger bets on their investments and are willing to make high-stake decisions, hoping for a big payout. These decisions may not be in the company's best interest and create a risky environment for founders and stakeholders. Raising a round of growth equity can often lead to the need for future rounds of capital, a result of high stakes decisions causing further dilution for common shareholders.

MAJORITY INVESTMENTS

Majority investments provide secondary capital, which gives existing owners liquidity as the new investor needs to purchase a high enough percentage to own a majority of the shares. This investment

structure can range anywhere from 51% ownership, where existing shareholders “roll over” part of their stake, to 100% ownership, where existing shareholders cash out entirely. The biggest driver to rolling over shares is the ability to participate in the upside created by the new investor. With majority investments, one of the key advantages for existing shareholders is that they can derisk their investment by receiving partial liquidity, while still participating in the company’s future upside potential.

Another key differentiator and advantage to a majority investment is the operational value that some investment firms provide. With a majority stake in the company, an investor is incentivized to prioritize the business’ strategic growth and ensures its operational approach is aligned with the business strategy from the start of the relationship. When a firm is more focused on a company’s long-term success, intellectual capital—such as expertise in hiring the right talent and scaling into new market verticals—provides exposure to outside expertise and best practices.

However, because majority investors have a lower appetite for risk and are providing more liquidity to existing shareholders (thereby derisking their original investment) the initial funding valuation is often lower. Additionally, many founders may be wary of relinquishing legal control of their companies to an investor. However, with the right firm and partnership model, the founder will be instrumental to strategic decision-making and the manager of daily operations. Since not all majority investors are created equal, it’s critical for founders to spend time getting to know how various firms operate. Ensuring clear alignment on goals will help founders avoid any surprises after the deal closes.

“FOR BUSINESS OWNERS, IT COMES
DOWN TO YOUR TOLERANCE FOR
RISK AND DESIRE FOR OPERATIONAL
EXPERTISE TO ACHIEVE YOUR
DESIRED OUTCOME.”

Another consideration before securing a majority investment is whether the investor’s track record is in line with company expectations. A successful investor will have an extensive history of guiding company growth and an array of best practices at their disposal. The firm’s intellectual capital based on these experiences can provide value to any company looking to scale.

CHOOSING THE RIGHT PATH

While there is no formula for determining which course of action to take when securing capital, it’s important that business owners think about their long-term growth strategically. The right partnership



will take a company to new heights and will help it expand into growth areas that would have been impossible without the capital and expertise that the investor provides; the wrong partnership can take a company in the wrong direction and destroy value.

Many offers can seem similar on the surface, so it's important to understand an investor's strategy and motivation before proceeding with a partnership. No matter what stage of revenue a company is in or what the founders aim for, the next phase of growth will likely require a very different approach from what it took to get to its current phase. Having the right information about the kinds of capital partnerships that are available is the first step in accelerating the growth of a business, and it can often be the beginning of a new era for a company.

MINORITY INVESTMENTS

ADVANTAGES

- Higher initial valuation
- Founders retain legal control
- Provides capital for growth

DISADVANTAGES

- Often comes with onerous conditions and terms
- Lack of alignment of incentives between new investors and founders
- Limited or no operational value add

MAJORITY INVESTMENTS

ADVANTAGES

- De-risks and provides liquidity while still participating in upside
- With the right investors, substantial operational value add
- Alignment of business incentives between founders and investors

DISADVANTAGES

- Owners have smaller financial stake in the business
- Lower initial valuation
- Founders relinquish legal control

READ MORE INSIGHTS FROM VISTA

401 Congress Avenue, Suite 3100, Austin, TX 78701
512.730.2400
Vista@VistaEquityPartners.com
VistaEquityPartners.com

The content of this document is for general, informational purposes. Neither Vista Equity Partners Management, nor any of its affiliates (collectively, "Vista"), makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein. Under no circumstances should the information presented be considered an offer to sell, or a solicitation to buy, any security. Such offer or solicitation may only be made pursuant to the current offering documents for the relevant Vista Fund (the "Fund") which may only be provided to accredited investors and qualified purchasers as defined under the Securities Act of 1933 and the Investment Company Act of 1940. While the information provided is believed to be accurate and reliable, Vista, its affiliates, advisors, and employees make no express warranty as to its completeness or accuracy. ©2019 Vista