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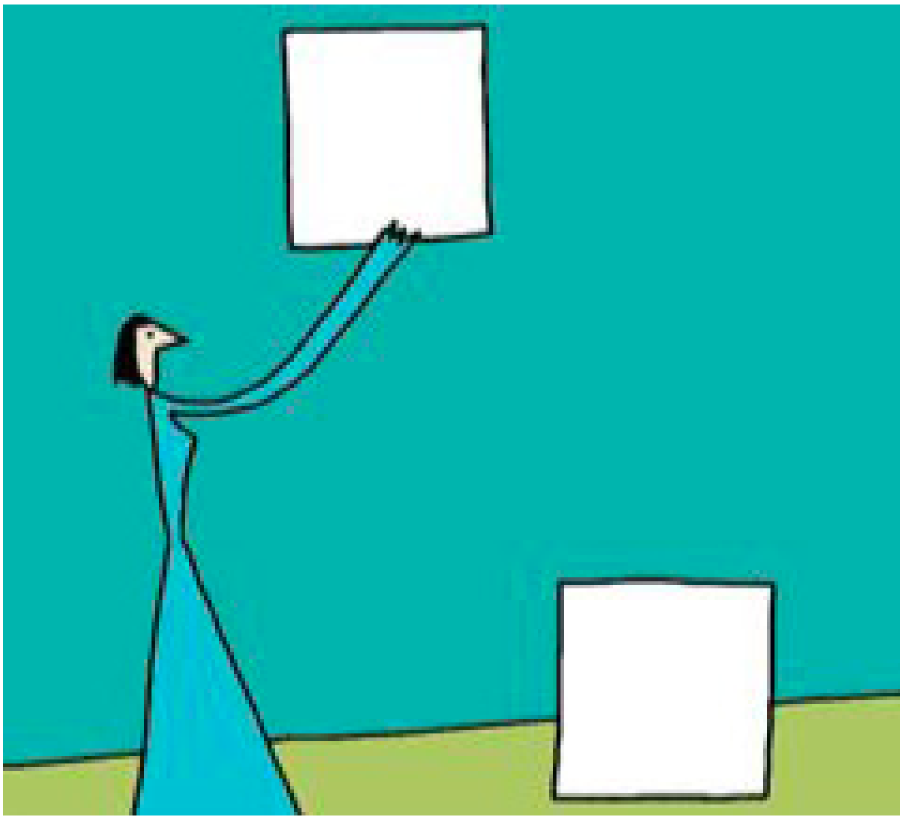
Ideas and Resources - Whitepaper

Secondary Growth Equity Transactions



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Secondary Growth Equity Transactions

Secondary growth equity transactions are a useful and increasingly common financing mechanism for founders of technology businesses.

A secondary growth equity transaction is one where an investor acquires shares from existing shareholders (with or without the addition of primary capital).

There are a number of situations in which a secondary investment from a growth equity firm can unlock value or solve challenges facing founder-led businesses.

At Kennet Partners, we have undertaken a number of secondary growth equity transactions which have enabled businesses to capitalise on market opportunities with a shareholder base that is better aligned with the needs of the business.

Below we list some of the key types of secondary growth equity transactions and examples of investments that we have made in each category.

Co-Founder Departures

One of the most common reasons for a founder-led business to undertake a secondary transaction is that one or more co-founders who are no longer active in the business seek to sell some or all of their shares.

It is not uncommon for founders to move in different directions and rather than being forced to sell the company or live in disharmony, the shares of a departed (or departing) founder can be sold to a new investor.

The sale of shares to a growth equity firm enables the remaining founder(s) to continue to develop the business and the departing founder to exit.

The continuing founders are not diluted in the transaction and the company gains the benefit of an experienced institutional investor who can help develop the business.

Kennet's secondary investments in online video advertising network, goviral (goviral.com) (acquired by AOL) and healthcare data collection business, WorldOne (worldone.com) are examples of transactions that were crystallised by co-founder departures.

Personal Wealth Diversification

As a company's value grows, the value of the founders' shares account for an increasingly high proportion of their personal net worth.

This level of portfolio concentration in a single asset can cause founders to become risk averse, as they seek to preserve, rather than maximise, the value of their asset .

An option for founders who seek a degree of liquidity to de-risk but still wish to continue to develop their business is to sell a portion of their shares to a new investor. This enables the founder to achieve a "mini-exit".

With the benefit of an experienced partner, the founders can aggressively grow their business with the comfort that all is not at risk.

Part of Kennet's investment in internet performance marketing business Next Performance (nextperformance.com) was used to acquire shares from founders.

Acquisition of Shares from Early Investors

Companies can take years to build and early investors such as angels, VC funds, and friends and family may seek liquidity before the company achieves a final exit. A growth equity firm can acquire shares from early investors providing a full or partial exit for those investors.

Additionally founders may wish to simplify the shareholder structure, by for example, replacing a large group of individual shareholders with a single institutional investor.

Through such a transaction the shareholder base is realigned to meet the needs of the business.

An example is Kennet's acquisition of a majority stake in cloud security vendor Prolexic (prolexic.com).

Growth Buy-Out

Where founders or owners seek to realise significant liquidity, a growth equity firm can acquire a majority stake in their company.

Often the founder(s) will retain a minority stake in the business and continue to contribute to the company's development by managing the company, remaining on the board of directors, and/or providing strategic guidance.

Kennet's investments in online lead generation provider AcademixDirect (academixdirect.com) and server load balancer appliance vendor Kemp Technologies (kemptechnologies.com) are examples of growth buy-out transactions.

Combining Primary and Secondary Investments

Depending on the nature of the market opportunity, it may be beneficial to combine a secondary growth equity transaction with a primary capital injection to accelerate the growth of a business.

If the company is likely to raise primary capital at some point in the future, it can be efficient to do so at the time the secondary transaction is undertaken. Most of Kennet's secondary growth equity transactions have included a component of primary capital to strengthen the company's balance sheet.

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Next steps

If you feel that a secondary growth equity transaction may be appropriate for your business, consider the following factors in choosing a partner:

- Will the growth equity firm actively contribute and dedicate time to the business?
- Is the firm experienced in the area of growth equity?
- Does the firm have experience building companies that are similar to yours?
- Is there a good personality fit with the individuals involved?

About the author

Hillel Zidel

Hillel works closely with the founders and managers of technology companies to exploit growth opportunities such as addressing new market segments and geographies. Hillel is currently a board member of online performance marketing services provider Next Performance.

Hillel joined Kennet as a Director from ETV Capital, where he undertook numerous transactions providing hybrid debt and equity-based capital to technology companies across Europe & the US. Prior to this Hillel worked as a Management Consultant at KPMG, advising clients on strategic, performance management and regulatory issues. Earlier, Hillel worked in Corporate Development at two internet businesses in South Africa.

Hillel is a CFA Charterholder. He holds a Bachelors Degree in Law from the University of South Africa, an Honours Degree in Economics and a Masters Degree in Economics (cum laude) from the University of Johannesburg.

Kennet invests in entrepreneurial technology businesses to help them take the next big jump in growth

We're an experienced growth equity investor with a long track record of building global market leaders and achieving high-value exits.

Since 1997 we have invested over $400 million in companies in Europe and the US.

As a growth equity investor, Kennet focuses on companies that have proven commercial success and are now ready for the next phase of growth.

The companies we invest in do not need money to survive. They have options. But the right investment from the right partner can help them keep ahead of their markets, expand internationally, ramp up their sales forces and lead to greater value for shareholders.

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