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GROWTH INVESTING GROWS UP

THE RISE OF GROWTH LENDING

Reji Vettasseri, Lead Portfolio Manager of Decalia Private Credit

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The New Wave of Growth Investing

The European tech and high-growth investing landscape is developing at an extraordinary pace. The underlying opportunity set is becoming larger, more attractive and more mature. A revolution is also beginning in the way that investors can gain exposure to it.

No longer the sole preserve of gutsy growth equity investors, specialist tech lenders have entered the space. They take advantage of the increased maturity of the segment to offer more downside-protected returns through low LTV, senior secured loans. Yet they still target juicy high-teens IRRs by structuring options to share in the value creation they support.

This profile has attracted interest in the US, where growth lending has delivered strong returns and now accounts for as much as 15-20% of total growth stage capital raised in 2020 (*Pitchbook*). It remains under-penetrated in Europe, but this article will discuss why it could be poised for a similar take-off and potentially even stronger return generation on this side of the Atlantic.

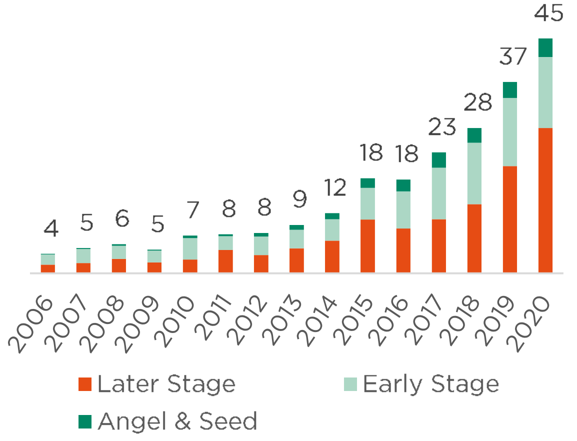
The European Tech Sector Matures

In 2006, the value of European growth stage and VC deals was just €3.8bn *(Pitchbook)*. Many avoided the segment, associating it with small start-ups that had big dreams and little more.

By 2020, volume had increased 12-fold to €45.3bn with an increased focus on later stage companies, including a full-scale herd of 69 European unicorns *(Sifted)*. Tech assets are now prized not only for growth potential but also for defensiveness: durable competitive advantages, low cyclicality, recurring revenues and/or Covid-resilience.

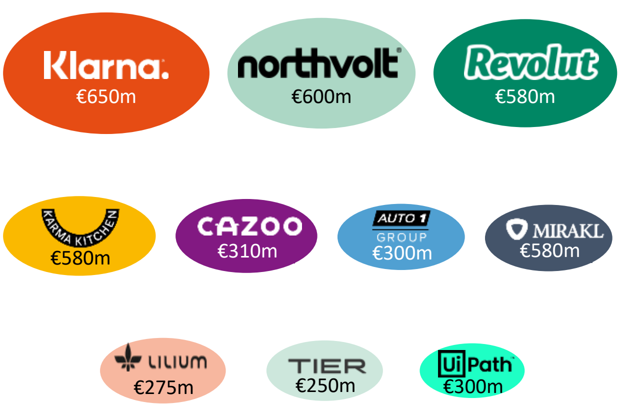
The bulk of private markets' value in the tech sector is now not in "start-ups" but in "scale-ups". These companies have fully developed products with proven, rapidly increasing customer adoption. And if you strip out growth investments into new customer acquisition or R&D, their existing operations are often highly cash flow generative. The question for these companies is not whether they will take off but how high they will fly.

Investments by European Growth and VC Investors (€bn)



Source: Pitchbook, Q1 2021 Venture report

Top 10 European Private Tech Rounds by New Capital Raised 2020 (€bn)



Source: Atomico, The State of European Tech 2020

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The Growth Lending Proposition

These scale-up firms may or may not grow at the rates required to justify the prices paid by their equity investors. But even in severe downside scenarios they should have meaningful value. This makes them credit-worthy, able to pay back loans even if things deviate from plan, as long as the structuring is right. Specialist growth lenders use several techniques on this front:

1. ***Low LTVs (5-20%)***: Growth lenders sit in senior secured positions, typically as the first and only debt in their borrowers' capital structures. They offer loans of no more than 5-20% of borrowers' valuations in their last equity round. Even if you doubt tech valuations and haircut them by half, growth loan LTVs would still compare favourably to the usual 50-80% for standard leveraged loans.

2. ***Rapid de-risking:*** Loans are 36-48 months in duration, with amortising structures and monthly cash interest. Within two years, over half of loan principal should be returned. For lenders to get into trouble, things not only have to go wrong - they have to go wrong quickly.

3. ***Support from equity holders:*** Growth lenders seek borrowers with top-quality, deep-pocketed equity syndicates. If a company wobbles, such investors tend to be supportive of injecting new equity. This gives the company a chance to get back on track. As a side-effect, it also gives time for the loan to de-risk or mature before serious issues arise.

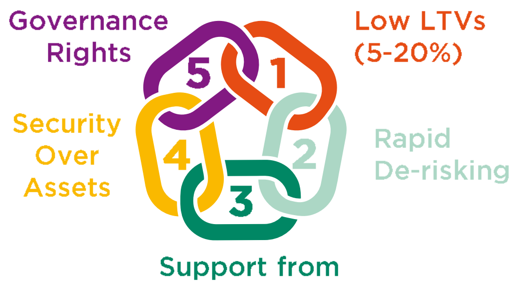
4. ***Security over assets:*** Tech firms are often seen as "asset light" due to their lack of hard PP&E assets, but that ignores soft assets. Marketable IP, accounts receivable, inventory or financial assets (in the case of fintechs) can often be significant, at least relative to a 5-20% LTV loan.

5. ***Governance rights:*** Growth loans also typically incorporate board observer rights and consent rights.

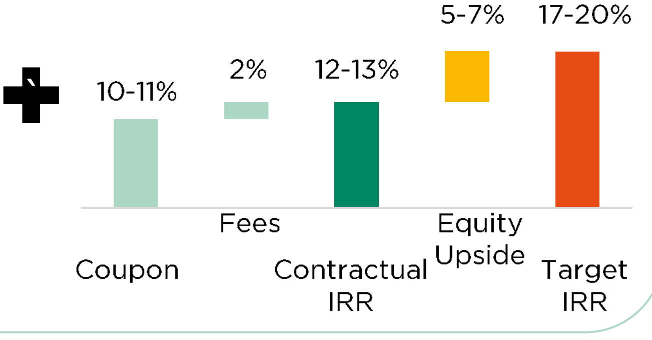
All this creates a very different risk profile from equity - and returns can be compelling. Double-digit coupons and fees lock in 12-13% contractual IRRs. Free equity warrants supplement this with one-sided exposure to valuation upside. Realised warrant value will vary by deal, but growth lenders target all-in portfolio-level gross IRRs close to 20%.

The Tech Lending Value Proposition

Downside Protection



Return Potential



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A History of Impressive Returns

The potential to hit these targets is proven by Decalia analysis of data from 11 European growth lending portfolios containing 750 individual loans from 1999 to 2020, with a value of €2.5bn. The average gross IRR of these portfolios was 20.6% - competitive with traditional PE returns. The net loss rate was 2.9% - comparable with the high yield bond market. And, in practice, those losses were effectively offset by warrant upside elsewhere.

European Tech Lending Historical Industry Level Performance

Gross IRR	20.6%
Loss Rate	2.9%

Source: Decalia analysis of data from 11 European tech lending portfolios. Figures represent capital weighted averages.

A Strategy Poised for Take-off

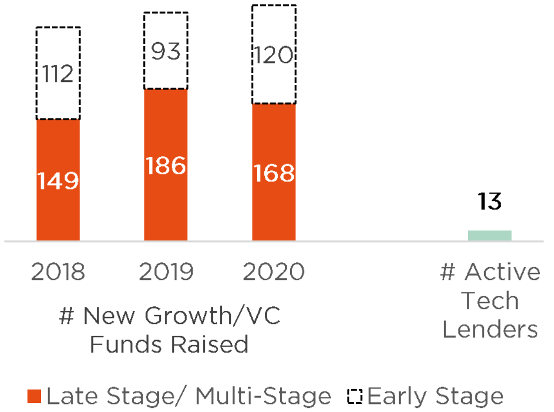
The strategy is not only attractive for investors; it also offers value to high growth borrowers with limited access to banks or traditional private lenders.

Growth lending structures do not fit the standard term sheets of traditional lenders. And even if they did try to offer such a product, they would struggle to, for instance: evaluate innovative tech business models, assess entrepreneurial managers and interpret financials for high growth companies (where run-rate performance may be very different from last year's numbers and where cash flow profiles are complicated by heavy growth investments). Deal flow is a further entry barrier. Portfolios are built of relatively large numbers of assets, as growth loans are often small (€2-15m) and diversification is important for warrants. This requires deep networks in the tech ecosystem and tracking growth companies from an early stage.

Hence, although expensive relative to conventional credit, growth loans have the potential to be an efficient and less dilutive option for the many high growth borrowers whose only alternative is equity. They are often particularly useful as bridge finance between major funding rounds. In such cases, loans give borrowers the extra funding they need to hit key operational milestones, and so drive step changes in valuation, before tapping equity investors again. Here credit is not only cheaper than equity, it also ends up making equity cheaper.

In this context, we see an undersupply of European growth lenders. We have identified just 13 such players, of which many are small (<€100m) funds and/or restricted to specific geographies or sectors. In contrast, a total of 503 new European growth and VC funds were raised from 2018 to 2020, excluding early stage-only vehicles (*EVCA*).

 # New European Growth/VC Funds vs. # Active European Tech Lenders



Source: EVCA, Decalia

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European growth lending amounted to €1.9bn in 2020, more than doubling from €0.8bn in 2016 *(Pitchbook).* The prospect for further expansion is clear.

Part of that is a simple consequence of the underlying tech sector trends. As we saw previously, late-stage growth equity deal volume is rising rapidly, at a CAGR of 34% from 2016-20 *(Pitchbook).*

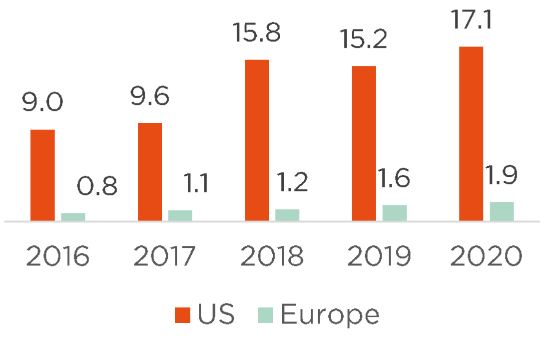
There is also scope for much higher growth lending penetration. In the US, growth lenders are estimated to provide 16% of financing in growth rounds under $100m *(Atomico),* and this excludes mega-deals such as Silver Lake's $1bn pre-IPO loan to Airbnb. In Europe, the equivalent number is 6%, up from 2% in 2015 but a far cry from US levels. Furthermore, penetration is not uniform. Take-up is around 35% lower in the EU than in the UK *(Barclays).*

Conclusion

Tech investors often talk about "adoption curves" - the idea that once a product receives clear buy-in from early adopters, it tends to enjoy rapid growth as it moves into the mainstream. The framework might apply to European growth lending itself. The now proven strategy may be poised for a rapid rise in penetration, to catch up with the US.

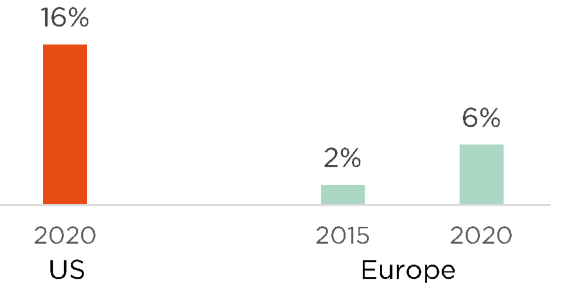
European growth lending has delivered strong risk-adjusted returns due to limited competitive pressure in a market where traditional lenders lack the skillset to play, and which US growth lenders have struggled to enter due to the need for local origination in a fragmented European tech ecosystem. With demand set to rise, and competition still limited, the outlook for return is strong.

Growth Lending Investments (€bn)



Source: Pitchbook

Penetration of Growth Lending in Financing Rounds <$100m



Source: Atomico

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External sources include:

- Pitchbook, “Q1 2021, European Venture Report”
- Pitchbook, “Venture Debt a Maturing Market”
- Sifted, “Europe’s Startup Unicorns”
- Atomico, “The State of European Tech 2020”
- EVCA, “Investing in Europe: PE Activity Statistics 2020”
- Barclays, “Scale Up UK”

All analysis based on latest available data as of May 2021

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