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Trends in Growth Equity Financing in an Uncertain Economy

Deal terms increasingly favor investors, but companies can mitigate downward pressure on valuations by agreeing to certain investor protections.

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The current economic climate has been challenging for privately held companies seeking to raise growth capital. Several factors have contributed to the recent contraction in fundraising, including high interest rates, reduced access to capital, a decline in valuation multiples, and an unfavorable outlook for exits.

Given this market environment, companies seeking to attract new capital have increasingly had to conduct down rounds, equity financings at lower company valuations than in prior rounds. Our Goodwin Deal Database indicates the percentage of down rounds has risen steadily for six quarters (see chart).

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Down rounds seem poised to continue to rise in the near future as companies that could delay an equity financing round in the current market by tapping existing cash runway from prior financings or accessing short-term bridge capital may soon have no choice but to capitulate and seek additional investor capital at a low valuation.

In this environment, it is no surprise that growth financing terms have become more favorable to investors. Below, we examine some terms that growth equity investors have been seeking in the current market, both to bridge valuation gaps between companies and investors and to correct potential misalignment between new and existing investors.

Consent Rights: Enhancing Investor Control

Preferred investors typically obtain protective provisions, also known as veto or block rights, that subject certain company actions to the approval of preferred stockholders voting as a class. In the current environment, investors are seeking more control over governance and operational matters, relative to years past. They often want exclusive rights at the investor level to approve proposals related to certain strategic actions, as well as additional consent rights at the board level over operational matters.

This may be due in part to the challenge investors have historically faced in their efforts to influence management during previous downturns, even when they had substantial stakes. Many growth investors are now eager to shift the power dynamic in connection with new financings. By strengthening their say in operational matters—especially through the power to approve or veto annual budgets, the hiring and firing of senior executives, and changes to executive compensation—investors can increase their ability to keep a company focused on the critical aspects of its business plan during times of economic uncertainty.

Enhanced consent rights can also help bridge potential gaps in expectations between a company's new investors and its existing investors. New investors generally prioritize a company's long-term performance and sustained profitability, while existing investors, who may have invested in a prior round at a higher valuation, may be more concerned with the company's growth outlook, with an eye toward an exit in the near term. These protections can provide new investors additional comfort that companies will not pursue strategic opportunities that may not be optimal over the full life cycle of their investment.

Pay-to-Play Provisions: Incentivizing Investor Commitment

Pay-to-play provisions encourage a company's existing investors to continue investing in the company, especially during economic downturns. They offer investors a stick and carrot by penalizing investors who do not participate in new rounds (typically by converting their preferred holdings to common stock) or rewarding those that do (typically by issuing them a senior class of preferred equity).

Consequently, such pay-to-play provisions help maintain investor unity and company momentum amid uncertainty, addressing potential misalignments between new and existing investors by ensuring that all investors on the cap table have a strong incentive to continue to participate in future financing rounds.

While pay-to-play provisions remain relatively uncommon, we have seen a notable uptick in usage among recent venture capital financings, increasing from less than 1.0% in 2021 to 2.7% in 2022 and up to 4.5% in 2023 (year to date).

Financial Protections: Shielding Exit Returns

The following terms can create more certainty around investor returns, helping investors protect their downside risk upon exit and enhance their potential to harvest upside when exit returns are positive. As a result, investors may be more amenable to providing financing at higher valuations, enabling companies to avoid down rounds or at least mitigate the negative effect on valuations.

Participation Rights

Investors are increasingly requesting "participating preferred" stock in financing rounds. Unlike shares of "convertible preferred" stock, which are more typical, shares of participating preferred stock entitle investors to receive both a liquidation preference as well as their ratable share of returns on an as-converted basis alongside shares of the company's common stock. The structure of this security enables investors to protect their principal investment on exit, as well as to receive additional proceeds based on their company ownership stake.

While participating preferred shares are not the type of security predominantly issued in growth equity financings, they have become more prevalent in today's relatively investor-friendly market.

Liquidation Preferences

Investors are also increasingly able to negotiate for greater value in their liquidation preference. This has taken the form of "senior" liquidation preferences that return invested capital to the investor in preference to existing shareholders of the company, as well as liquidation preference "multiples" potentially greater than 1x the investor's original investment.

Both enhancements to an investor's liquidation preference yield greater downside protection for investors by ensuring the investor will receive the first dollars out in a low-return exit or additional guaranteed returns above and beyond their initial investment, in preference to other shareholders. These protections can allow for additional comfort for investors in exchange for accepting a higher valuation of the company.

Cumulative Dividends

Investors are also more frequently requesting cumulative dividends in connection with their growth investments. Cumulative dividends accrue over time and are paid upon exit in preference to dividends paid to other stockholders of the company. Thus, cumulative dividends provide "sideways" protection, increasing the likelihood of payout in cases when exit returns are relatively flat.

While these terms have become more prevalent, we note it is still relatively rare for investors to have the right to convert the accrued portion of cumulative dividends into common shares when preferred shares convert (or are deemed to convert) into common shares (in other words, only the investment amount converts).

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In today's challenging fundraising environment, companies may succeed in avoiding a significant impairment to their valuation by offering investors additional protections, including in the form of bargained-for consent rights and in structural features of its securities. Investors will continue to press their advantage in this market and should remain informed and flexible to ensure they understand their options and get the best deal available to protect their investments.

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