Morgan Stanley | INVESTMENT MANAGEMENT

The Opportune Time For Climate Growth Investing

1	Private Equity Growth investing offers the potential to benefit to the upside by backing fast-growing, proven businesses while structuring deals to mitigate downside risk
2	Current market environment benefits private equity growth investors with dry powder
3	Climate solutions, such as companies driving emission reductions through operational and supply chain efficiencies, offer attractive growth opportunities, driven by megatrends that have only accelerated in recent years

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Positioned between Venture Capital and Private Equity buyout investing, Private Equity Growth Investing as an asset class may offer attractive risk-adjusted returns by investing in promising high-growth companies with downside risk mitigation typically structured into transactions.

1. Growth equity investors target proven businesses that need capital to scale
Growth companies are established businesses that have demonstrated a clear customer value proposition and a verifiable track record of selling to their target markets.[1] With early stage technology, operational, and market risks assuaged, they now need capital and guidance to scale and institutionalize their business, presenting an opportunity for growth equity investors to underwrite attractive risk-adjusted returns achieved through fundamental value creation, namely earnings growth.

2. Growth equity investors target returns through fundamental value creation
This approach to value creation differs from that typically adopted by other providers of private capital. On the one hand, venture capital investors typically focus on generating growth above all, often expecting future capital injections to support an unprofitable company through its early years as it seeks to demonstrate the viability of its solution; on the other hand, buyout investors typically focus on optimizing the cost base and capital structure of their portfolio companies, with value creation often the consequence of inorganic growth, adopting growth-constraining cost-cutting measures, or re-capitalizing a company with leverage. Creating value at the growth stage requires investors to adopt elements of both approaches to accelerate growth in a capital-efficient manner, scaling solutions with sustainable competitive advantages and pairing them with sustainable business models.

3. Growth equity investors can structure risk-mitigating deal terms
The other element of growth investing that compares favorably to traditional buyouts is the ability to structure in downside risk mitigation into deals. As minority investors, growth equity can benefit from a lot of the structuring more typically available to earlier-stage investors. This includes participating as preferred equity ahead of existing common equity shareholders and, increasingly, benefiting from investor-friendly terms such as liquidation preferences, minimum return hurdles, and anti-dilution rights.

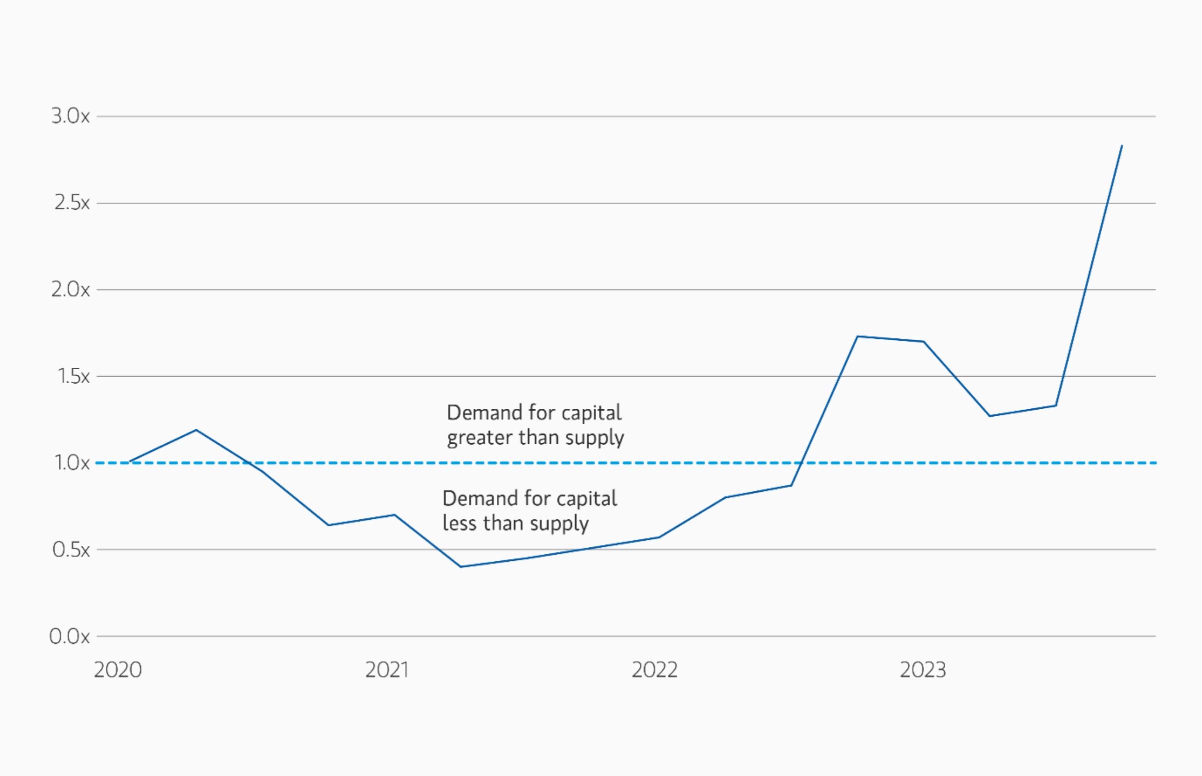
Why Now
While the advantages highlighted above have always characterized growth investing, the current market environment presents a particularly attractive opportunity for investors with dry powder. With the pullback in IPO and SPAC processes, less debt available, and fewer growth equity funds being raised, the demand-supply of capital for growth-stage companies has flipped, resulting in improved pricing and terms for investors.

Attractive demand-supply of capital for growth-stage investors
In 2021, the supply of capital to growth-stage investments outweighed the demand from companies leading to overcompetitive funding rounds at often very high valuations.

Following the recent macroeconomic turmoil including persistently high inflation, higher-for-longer interest rates, reduction in debt financing for earlier-stage companies, and a muted IPO market, the demand-supply of capital has reversed, as shown in *Display 1*. As of September 2023, the demand-to-supply ratio was ~2.8x, meaning that growth-stage companies are seeking nearly 200% more capital than investors are providing.[2]

DISPLAY 1

Demand-supply ratio is well above 1.0x[3]



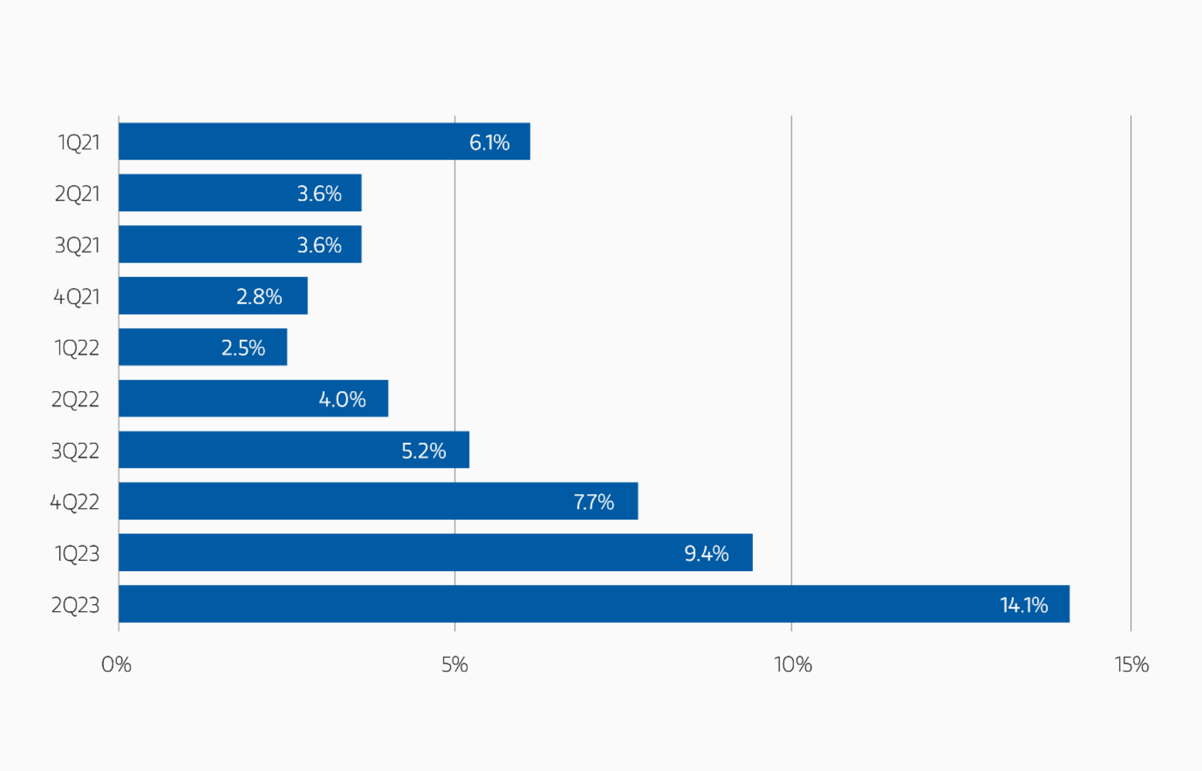
Falling valuations and preferential deal structures
As a result of the more challenging capital raising environment, growth-stage investors have greater negotiation power which has enabled conservative valuations and preferential terms.

Private market valuations tend to lag public market equivalents and for some time, investors/companies were holding valuations high. While emergency cost-saving measures and credit lines raised in 2022 extended cash runways, allowing companies to temporarily pause capital raising activity, that runway is now shrinking, leading many businesses to return to the equity markets to raise smaller amounts of much-needed capital at flat or lower valuations.

This is demonstrated by the numbers, with the deal count remaining fairly resilient, down 10% year-over-year (H1 23 vs H1 22), yet the average size of growth rounds decreased 50% year-over-year and the completed financings in 2Q23 at lower valuations than the previous round reached 14%, as shown in *Display 2*.[5,6] We expect these trends to increase in the coming quarters as fundraising remains challenging and companies, particularly those operating below cash flow breakeven, need to raise fresh capital.

DISPLAY 2

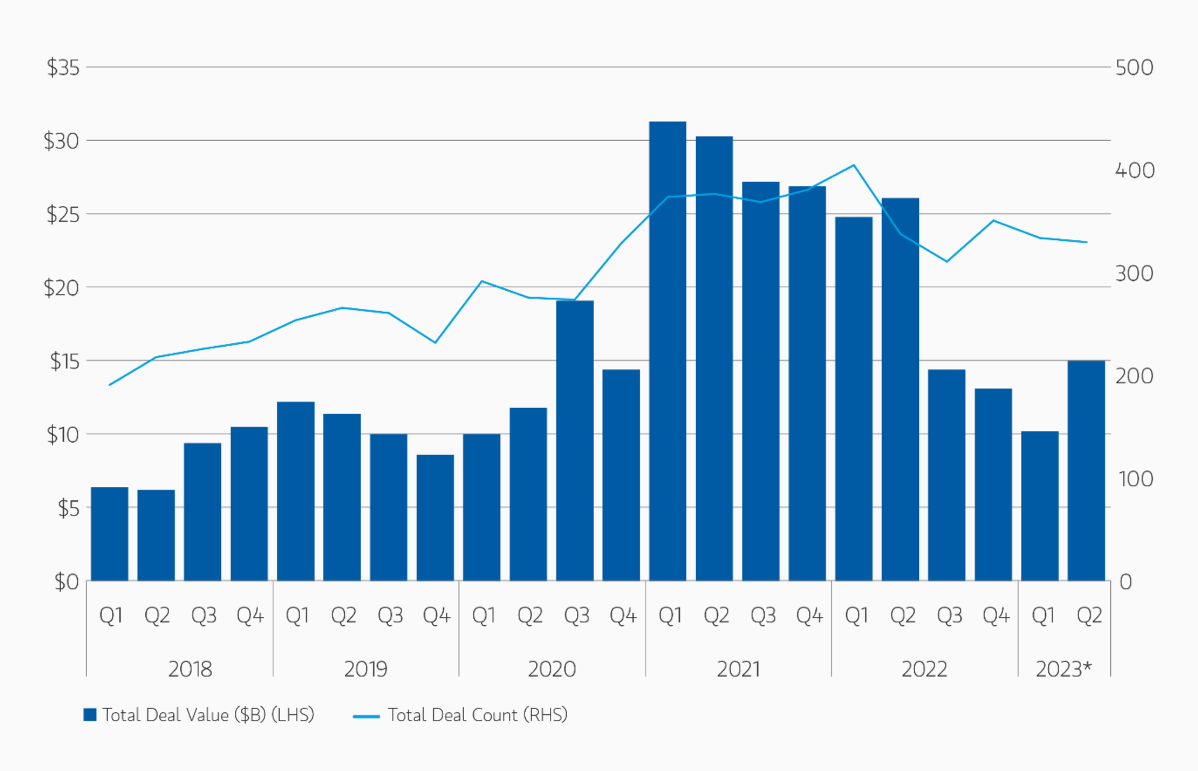
Proportion of Down Rounds as a % of Total Rounds is Increasing[4]



Growth-stage companies are not only increasingly accepting lower valuations but also investor-friendly terms such as the structuring mentioned above. In some cases, and particularly if companies are not willing to accept lower headline valuations, growth equity investors can bridge the gap in valuation expectations through transaction structuring, negotiating preferential terms that can help mitigate downside risk. For example, liquidation preferences are increasing in prevalence, and terms such as drag-along rights and anti-dilution protections are becoming more common.

DISPLAY 3

Deal Count Remains Resilient, but Deal Value Drops Significantly[6]



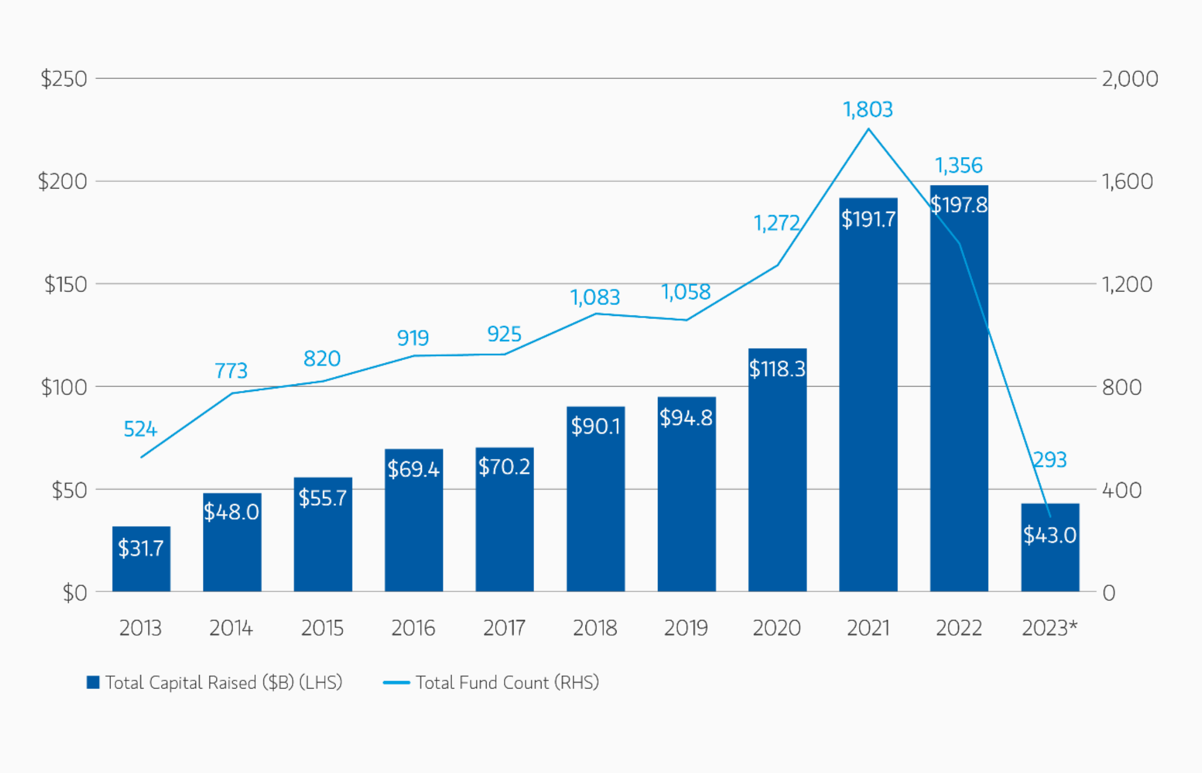
Decreasing competition for deals

Not only has the capital raising environment been challenging for companies, but the same is also true for funds. Growth equity fundraising has stalled in the last 24 months creating a strong platform for established funds with dry powder. Only 41 growth funds have been raised in the US and Europe since the start of 2023 compared to 151 in total through all of 2022.[7] With 2023 YTD fundraising nearly 60% below 2022 levels, the amount of dry capital available in the coming years is likely to decrease.

This means that funds with dry powder are likely to see a decline in overall competition for deals, which should strengthen their negotiating power and ability to get preferential pricing and terms. Furthermore, non-traditional or “tourist” capital (i.e., investors not typically active in the growth stage such as hedge-funds and sovereign wealth funds), not to mention VCs moving later stage or buyout managers moving earlier, have retreated from the growth-stage segment, further increasing the funding gap for companies. Through 1H 2023 the total deal value involving non-traditional investors dropped ~60% compared to 2021 on an annualized basis.[9] With this reduction in the supply of capital for growth-stage companies, the pullback of non-traditional investors is likely to have consequences on both capital-raising timelines and pricing discipline.

DISPLAY 4

North America and Europe Venture & Growth Fundraising[8]



Some of the best growth opportunities are in climate solutions
Within the growth segment, the quality and quantity of climate deal flow has increased in part due to the macroeconomic environment. Having been buffeted by headwinds in recent years, such as persistently high inflation, turbulent energy supply, and supply chain disruption, companies are increasingly turning to climate solutions to help them boost efficiency and maintain supply chain resiliency. These include turning to technologies to help improve resource efficiency, enable energy security through domestic clean energy/transport projects, and better understand climate-related risks. Furthermore, global stakeholder support—such as the landmark legislation passed (e.g.., the Inflation Reduction Act in the US, and the European Climate Law in Europe) as well as corporate net zero commitments—are spurring innovation and demand for climate solutions.

Inflation and energy security is putting pressure on bottom lines, promoting circular solutions and energy efficiency.

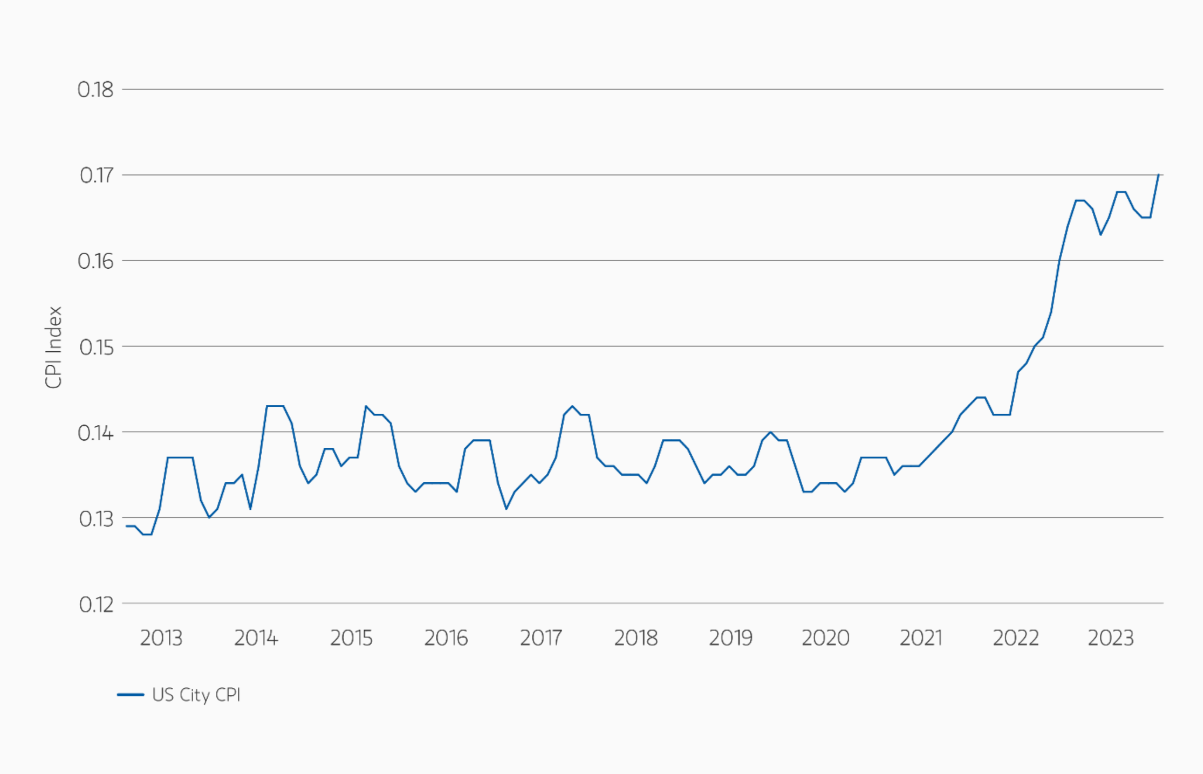
As global inflation remains persistently high, the cost of goods sold has increased, putting business earnings under pressure.

In Europe, it is estimated 57% of the value of steel, plastics, and aluminium is lost through their life cycle.[11] Businesses can combat the impact inflation is having on their input costs by creating more circular business models which re-use raw materials, helping to reduce requirements on resources and drive lower costs.

Additionally, concerns about the security and resilience of energy supply are leading to a resurgence in domestic electricity generation investment (i.e., increasing the amount of energy/electricity produced within a country's own borders rather than relying on transcontinental or international interconnectors). This in turn increases the need for mission-critical software/hardware solutions that unlock a more controllable and sustainable local energy supply. Examples include software that enables greater asset uptime or availability and can be retrofitted onto existing assets. Even incremental improvements and preventative maintenance that can improve asset operational performance over a large installed base can significantly reduce CO_2e emissions. Enabling this transition, through manufacturing and software deployment, will be critical.

DISPLAY 5

Inflationary Pressure Squeeze Margins[10]



Broad stakeholder support for climate solutions is driving innovation
More than 900 of the world's largest companies have committed to net-zero emissions by 2050 which will require new innovations and an average of $9.2 trillion of capital expenditures and investments per year from now through 2050 to achieve these goals.[12] Further, the Net-Zero Asset Owner Alliance represents over $2.4 trillion all directed towards tackling global warming. Driving change in business models, through solutions

which save customers costs and emissions concurrently, presents an enormous opportunity for investors.

Global supply chains generate approximately 60% of all carbon emissions; diagnosing the sources and volumes of emissions across complex supply chains is imperative for firms with net-zero commitments.[13] This focus, combined with recent severe weather events and a continued hangover from pandemic disruption, has made operational and efficiency improvements to supply chains a priority for corporates. Indeed, a recent survey found that 83% of organizations have increased investment in their supply chains.[14] For example, companies can save significant costs, and carbon emissions, through investing in supply chain artificial intelligence solutions. Climate-focused investors can generate significant impact by deploying capital in this sector.

Conclusion

Growth equity investing takes attractive elements from both venture capital and buyout investing. This is apparent not only in the financial profile of companies, but also the approach to value creation and transaction structuring, where investors can back proven, fast-growing businesses while benefiting from downside risk protections typically only seen in early-stage investing.

Naturally, this combination has attracted significant investment, with an increasing share of non-traditional investors participating. That, in part, resulted in unsustainable valuations being paid for companies underserving of the capital. However, a rebalancing of capital supply-demand in recent months, driven by a tightening capital market and fewer private equity funds being raised, presents an unusually attractive opportunity for growth investors to selectively put capital to work in high quality companies that need funding.

While falling valuations and improving terms are seen across sectors, we believe some of the most interesting deal activity is taking place in climate solutions. A confluence of factors from macro headwinds such as inflation and energy security and increasing demand from corporations to understand and reduce their carbon footprints are driving innovation and adoption of climate solutions. Companies that can address these issues and the investors that can identify them, could be major winners.

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[1] Past performance is not indicative of future results.
[2] Source: Pitchbook Dealmaking Indicator
[3] Source: Pitchbook Dealmaking Indicator
[4] Source: Pitchbook. Includes late-stage VC valuations for companies where valuation data was available across rounds
[5] CTVC. https://www.ctvc.co/climate-tech-h1-2023-venture-funding/
[6] Source: Pitchbook NVCA Venture Monitor and European Venture Monitor. Includes

European and North American Venture Growth deals. Includes estimated deal count.

[7] Source: Pitchbook US and EU PE Breakdowns as of June 30, 2023

[8] Source: Pitchbook NVCA Venture Monitor and European Venture Monitor as of June 30, 2023. FX rate for EUR/USD 1.09.

[9] Source: Pitchbook NCVA Venture Monitor. Includes US companies only

[10] Source: US Bureau of Labor Statistics as of August 2023

[11] Source: McKinsey & Co Report: How a ‘materials transition’ can support the net-zero agenda

[12] Sources: UN Net Zero Tracker. McKinsey & Co analysis

[13] Source: Accenture: How Supply Chain Sustainability Helps Unlock Resilience and Growth

[14] Blue Yonder Survey (February 2022)