SVB Capital
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Growth Capital:

Investing in Rapid Growth, High Potential Companies

Venture Capital Update
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When Battery Ventures led a $100 million financing round for ITA Software in the second quarter of 2005, the deal was an unusual one for the company. ITA was operating at a stage when an infusion of fresh capital from a venture fund was not the most obvious source of financing. Already an established leader in the airline software market with nearly a decade of revenues and a prestigious customer list, ITA wanted to accelerate its growth by building an industry-changing reservation system. With the investment, Battery injected the company with capital along with strategic and operational support to push the product strategy forward without exposing its fund to high levels of market risk.[1]

These investments offer the potential for high cash on cash returns (two to three times capital or more) with much less risk.

The ITA Software deal characterizes a typical transaction in the investment space defined as "growth capital." As the financial crisis makes credit scarcer and deals more difficult for traditional small and medium-sized buyout shops and as venture firms lament the lack of an IPO market, growth capital has become one of the most compelling segments of the alternative investing landscape today. These investments offer the potential

[1] We thank Battery Ventures for providing us with this example.

for high cash on cash returns (two to three times capital or more) with much less risk. The companies targeted by growth capital investors typically benefit from higher levels of organic growth and profitability and are less reliant on external sources of capital to sustain themselves. For this reason, these investments are less impacted by the current volatility in the credit markets as compared to leveraged buyout strategies that are more dependent on the availability of debt financing.

Many of today's premier private equity firms have pursued this strategy successfully and have helped drive private equity's historical returns.

Broadly defined, growth capital refers to private equity investments in relatively mature, high-growth companies, which use the funds to expand their operations, either through internal investment, add-on acquisitions or a combination of the two. Growth capital is not a new segment of private equity. In fact, it has been a key investment component for many years. Many of today's premier private equity firms have pursued this strategy successfully and have helped drive private equity's historical returns. By SVB Capital's estimations, there are approximately 250 to 300 institutionally-backed firms that currently operate in the growth capital space in the United States. While the analysis in this article focuses on the United States, our conclusions about growth capital are also applicable to other markets, such as China, India and Brazil, where growth capital is the most active segment of private equity.

Investing in growth capital funds may be new for a number of limited partner investors (LPs). In this issue of the *Venture Capital Update*, SVB Capital sets out to define the growth capital space and explain why we believe it holds compelling return potential for today's investors.

GROWTH CAPITAL COMBINES THE BEST OF BUYOUT AND VENTURE

The term "growth capital" can elicit confusion: Is it simply late-late stage venture or leverage-light buyout? Is it the same as small- or medium-sized buyouts? Growth capital is a hybrid between traditional venture capital and leveraged buyout and provides investors with the attractive characteristics of both investment types. This section highlights how growth capital differs from venture and buyout in terms of target companies, investor skills, and return expectations.

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VCs help companies find out how to develop new ideas into products and services; growth capital managers help companies roll out production and distribution.

Targeting High Growth Companies

Growth capital investors typically look for companies with more stable and faster-than-average (greater than 20%) rates of revenue growth. Target companies have an established product, customers and business model, and in most cases, they are already profitable or close to profitability. This contrasts with venture capitalists who invest in companies well before they earn profit and often times even before they earn revenue.

One growth capital manager we spoke to described it as the difference between a "find out" and a "roll out" opportunity. VCs help companies find out how to develop new ideas into products and services; growth capital managers help companies roll out production and distribution. Likewise, venture capital investors typically recruit the entire management team of the invested company; whereas growth capital investors work with incumbent management and find ways to augment and improve the existing team. The latter is operationally less risky.

Growth capital investors must be very proactive in sourcing deal flow. Many of the most attractive companies for growth capital investors typically do not seek to raise money because they can finance their growth through their own cash flow. As a result, growth capital investors must be hands-on in seeking out investment opportunities in the most suitable targets. Some firms take an industry approach by gaining deep knowledge and relationships in a specific sector. Other firms establish systematic calling efforts that target companies meeting specific criteria. Once these companies are identified, a long process of trust-building begins until the opportunity to invest arises. This is a very long process. It is not unusual for a growth capital firm to spend several years developing an investment opportunity.

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Buyout firms often shy away from growth capital opportunities because of the limited ability to gain a controlling stake in these companies. Buyout firms view the control features of a leveraged buyout as a key risk mitigant, and they are not comfortable investing as a minority stake holder. Yet, in growth capital a minority share might provide the only means of investing in the company. Growth capital investors will often try to lessen these risks by negotiating control-like features into the shareholders agreement. The most successful growth capital investors have built up a high level of trust with the company's management team that allows for a strong working relationship and alignment of interests. The power of this trust should ideally transcend the power afforded by the legal agreement.

Venture Skills with Financial Expertise

Growth capital investors apply venture capital-like skills, and through their understanding of the entrepreneurial nature of the company, identify the right type of expertise and strategy needed for success. They bring critical domain industry expertise, which helps them gain the trust of the owners of the business, and operational expertise, which helps these companies realize their growth potential.

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Growth capital managers also have stronger financial skills than venture capitalists in order to structure the financing of the deal. Growth capital investments are highly structured to provide downside protection for the investor in the event the company underperforms. In addition, financial due diligence is much more important in growth capital transactions because an intimate understanding of the company's accounting, cash-flow and cost-structure is key to recognizing the risks of the investment.

Return Expectations

Neither Thomson Reuters (formerly known as Venture Economics) nor Cambridge Associates, the two leading firms benchmarking the private equity industry, report growth capital returns separately from venture or buyouts. Instead, the performance of these investments is subsumed under the late-stage venture and buyouts categories.

The chart below compares the performance of later stage venture capital funds to returns of small and medium-sized buyout funds. Later stage venture funds outperform small buyout funds for all periods, and they outperform medium buyout funds for all periods except the last five years. Given that growth capital investments resemble venture capital investments in terms of sector focus and limited use of leverage, SVB Capital expects that growth capital returns will bear greater resemblance to venture than to small and medium-sized buyouts. Indeed, we have found that the growth capital space is especially popular with investors who desire the exposure to middle market companies in venture-like industrial sectors, but without the reliance on leverage.

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SVB Capital believes that growth capital returns will differ from venture capital and leveraged buyouts returns. Expectations for total return multiples are typically 2.5 to 3.5x for venture capital funds, 2.0 to 3.0x for growth capital funds, and approximately 1.5 to 2.5x for buyout funds. These figures represent the performance of top-performing managers in all three categories.

SVB has been investing in growth capital funds for almost two decades. By analyzing growth capital and venture capital fund performance, we have identified that time to liquidity is shorter for growth capital investments than for venture investments. The former are profitable at the time of investment and, consequently, take less time to exit. The result is a shorter and shallower J-curve for growth capital funds, i.e. investors begin to receive a positive return on their investment more quickly. All other things being equal, a shorter time to exit would lead to higher IRR performance.

Time to liquidity is shorter for growth capital investments than for venture investments.

IRR PERFORMANCE AS OF MARCH 31, 2008

	Periods				
Fund Type	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
Early/Seed VC	12.0	5.1	5.0	34.1	21.2
Later Stage VC	30.1	13.1	11.1	8.6	14.4
Small Buyouts	14.9	7.0	9.4	4.8	12.5
Medium Buyouts	19.0	10.9	12.2	8.3	12.4
All Buyouts	10.6	12.9	15.6	7.9	12.1

Source: Thomson Reuters. Data for US market. Returns are pooled IRR figures for realized and unrealized returns for all funds during these periods.

GROWTH CAPITAL'S DIFFERENT STRATEGIES CREATE MORE PORTFOLIO DIVERSIFICATION

In order to understand the dynamics of the growth capital segment more thoroughly, SVB Capital had discussions with senior managers at leading growth capital firms, such as Summit Partners, Great Hill, OpenView, TCV, and Oak. These firms focus on different sectors such as software, IT services media, healthcare and financial services and employ separate investment strategies. Not surprisingly, these firms conveyed contrasting ways of defining what they do in private equity.

Peter Chung, Managing Director, Summit Partners, describes his firm as a "growth-oriented private equity firm investing in more mature companies than venture firms." He defines growth capital deals as falling into two camps: traditional late-stage venture deals and buyout deals in high growth companies. Another growth capital partner takes the definition a step further. He defines growth capital as a separate asset class altogether from venture or buyout and believes that limited partners should also view it separately when determining the right mix of private equity in their portfolios.

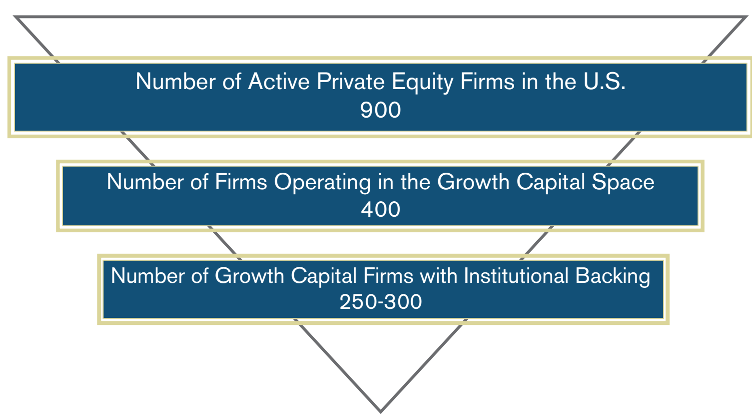
The separate definitions managers have for growth capital may result from their specialized investment strategies. Many growth capital managers leverage their domain expertise and focus on very specific growth sectors and sub-sectors, such as consumer goods or digital media. Still others define themselves by their approach to spurring growth in their companies. For instance, OpenView focuses on developing marketing and distribution channels for its companies in the IT software sector. One general partner uses the term "operational engineering" as opposed to financial engineering to describe his investing approach. He commented, "Any technology risk should be, for the most part, gone, or at least reduced greatly (compared to venture capital investments)… We are not taking the risk that the product or service actually works but that the value proposition…is strong enough and sustainable enough…and that the company can execute on achieving the proposed expansion."

In SVB Capital's analysis of the growth capital segment, we have identified a broad range of sectors where funds focus their investments.

DIVERSITY STAVES OFF COMPETITION

SVB Capital estimates that there are approximately 250 to 300 institutionally-backed firms that currently operate in the growth capital space in the U.S. These funds span across the spectrum of "very late stage" venture capital to "growth-focused" buyouts, across

MARKET SIZING: DETERMINING THE NUMBER OF GROWTH CAPITAL FUNDS



Many investors are drawn to the idea of getting exposure to venture-like industry sectors such as IT, life sciences and communications but with lower-risk (private equity) investments.

sectors and geographies. There is usually a high level of overlap between the industry sectors that venture and growth capital investors focus on. Many investors are drawn to the idea of getting exposure to venture-like industry sectors such as IT, life sciences and communications but with lower-risk (private equity) investments.

During the past decade SVB Capital has seen more and more traditional venture capital firms moving into what we consider as the growth capital space. Venture capitalists' strong network and domain expertise in a specific sector can help fast-growing, more mature companies. Consequently, some venture capital firms possessing unique domain expertise find that they can also compete in the growth capital segment.

Are growth capital firms seeing competition from the venture firms that are investing in much later stage companies? What about from traditional buyout firms looking for deals requiring less leverage? The managers we interviewed agreed that the landscape is becoming more competitive but disagreed that their main competition comes from migrating VCs or buyout firms. We at SVB Capital interpret this response to mean that, although the market place is becoming more competitive as a whole, the growth capital segment contains a wide-range of opportunity, and firms are finding their own investment niches. Just within our own portfolio of growth capital investment funds, we see a wide diversity of investment strategies and focus areas.

GROWTH CAPITAL IN THE CURRENT ENVIRONMENT

The managers we interviewed acknowledge the effects of the souring economy and uncertain financial markets in the U.S. However, they argued that their asset class will not see the same degree of negative effects of the economic slowdown and financial crisis as other asset classes. For instance, growth capital is much less affected than leveraged buyouts by conditions in the credit market because growth capital deals generally do not rely on debt financing. In addition to reduced access to credit, the current economic downturn has made vulnerable many private equity firms that used a significant amount of debt for their deals.[2] In contrast, some of the managers we spoke to did not use leverage in a single deal during the past year.

While the lack of credit has not hurt them directly, growth capital managers do expect that the macroeconomic slowdown could affect the timing of their returns. Exit markets continue to be sluggish with the lack of IPOs slowing the rate of mergers. Reduced confidence in the markets combined with the disruption in the investment banking industry will most likely hurt overall levels of M&A exit activity.

All of the growth capital managers we spoke to generally agree that the current environment is a great time to buy. Many managers expect valuations to drop, although the decrease continues to lag public markets. Taking a positive spin on the current financial conditions, one fund manager stated, "A little downturn needs to happen every once in a while to bring valuations

[2] Emily Thornton. "From Buyout to Busted," Business Week, September 22, 2008.

back into check. It's not all bad."

Some managers argue that the size of the U.S. economy lends itself to opportunities in niche sectors that will continue to grow, despite the softening. "If you can find pockets of growth that are immune and not as heavily impacted by the macro environment, you can still find returns," stated one growth capital partner. These areas are as diverse as the managers' sector specialties. For some managers, they are found in technology. Other managers noted financial services, healthcare services, alternative energy and new media as the growth sectors to watch.

THE GROWTH CAPITAL OPPORTUNITY

Growth capital investments are a form of private equity investment in relatively mature companies. The companies use this capital to expand or restructure operations, enter new markets or finance a significant acquisition without a change of control of the business. Relative to small and medium-sized buyouts, growth capital investments have less downside risk but also provide a higher return on capital with expected cash on cash returns in the 2.0-3.0x range. When looking to gain exposure to this segment of private equity, LP investors should focus on the distinct market dynamics of growth capital investments, differentiated strategies and key skill sets necessary to expand companies rapidly and successfully.

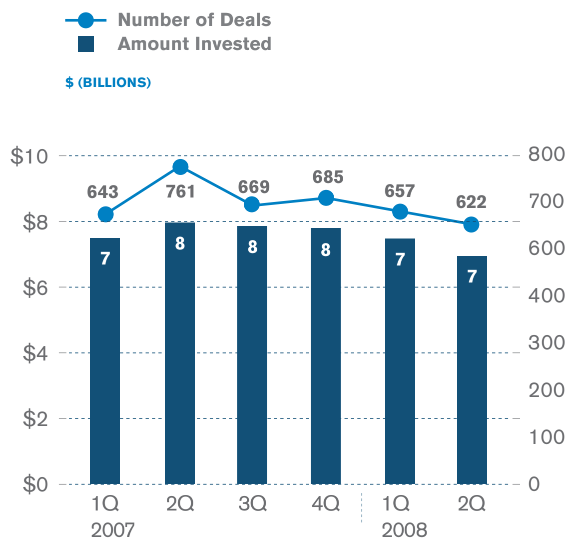
SVB Capital has been investing in and supporting the venture and growth capital communities for more than two decades. We welcome any questions and comments you may have about this topic.

TELL US WHAT YOU THINK

Send your comments and suggestions for topics to Bronwyn Dylla Bailey at bbailey@svb.com.

SECOND QUARTER 2008 U.S. PRIVATE EQUITY SNAPSHOT

U.S. VENTURE INVESTING ACTIVITY



Source: Dow Jones VentureSource

MOST ACTIVE VENTURE INVESTORS

Firm Name	Assets Under Mgmt ($M)	Number of Deals**
Draper Fisher Jurvetson	$4,214	21
U.S. Venture Partners	3,825	17
New Enterprise Associates	8,500	13
Accel Partners	4,000	12
OVP Venture Partners	758	12
Sigma Partners	2,000	12
First Round Capital	N/A*	11
Foundation Capital	2,350	11
Polaris Venture Partners	3,049	11
Sequoia Capital	2,153	11
Battery Ventures	3,150	10
Benchmark Capital	2,900	10
Domain Associates	1,992	10
SV Life Sciences	1,565	10

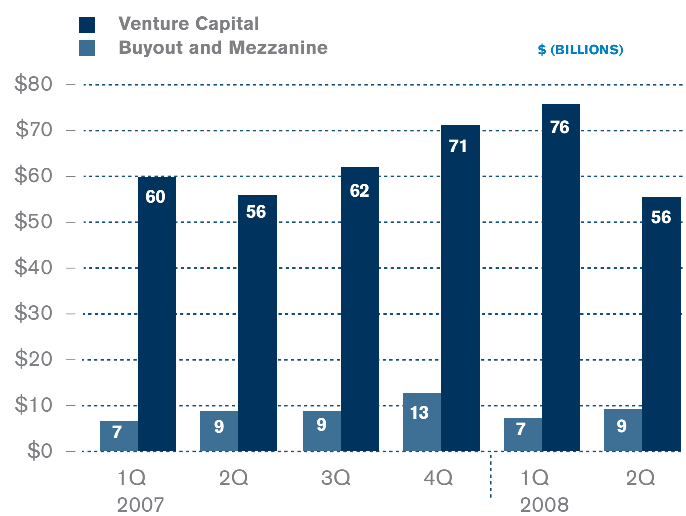
Source: Dow Jones VentureSource
** N/A: Not available*
*** U.S.-based portfolio companies only*

VENTURE INVESTMENT BY REGION, ALL INDUSTRIES

U.S. Region	Num of Deals	Num of Investing firms	Average Per Deal	$ (MILLIONS) Sum Inv.
Bay Area	204	301	$12.8	$2,439.1
New England	78	123	11.6	846.3
Midwest	42	74	11.4	460.2
Los Angeles Metro	35	58	14.2	417.3
New York City Metro	42	68	10.3	389.3
San Diego Metro	23	55	15.0	333.6
Washington State	27	54	13.3	320.4
Potomac	19	39	14.9	279.7
South	31	62	7.4	211.3
Texas	14	35	10.4	126.2
Research Triangle	10	26	11.8	117.8
Oregon	7	12	16.4	114.5
Colorado	10	18	8.9	80.8
Philadelphia Metro	13	11	4.0	66.4

Source: Dow Jones VentureOne

FUNDRAISING BY U.S.-BASED VENTURE AND LBO/ MEZZANINE FIRMS



Source: Thomson Reuters Venture Economics/National Venture Capital Association

IRR PERFORMANCE (%) BY VINTAGE YEAR (U.S.)

Vintage Year	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
1996	35	59.5	83.6	113.9	30.6	1.4
1997	62	46.2	49.6	59.7	20.2	(0.8)
1998	77	24.1	18.8	11.9	1.9	(4.0)
1999	109	(6.8)	(5.5)	0.9	(6.6)	(14.6)
2000	125	0.6	1.7	2.8	(2.8)	(7.6)
2001	56	4.2	5.6	10.7	2.5	(3.8)
2002	20	1.5	3.5	3.8	(1.2)	(2.6)
2003	16	5.9	5.7	12.8	0.9	(2.2)
2004	23	3.5	6.2	8.9	(0.9)	(6.6)
2005	17	1.9	7.3	12.6	2.8	(3.0)
2006	25	(3.0)	(0.7)	0.6	(8.8)	(14.8)
2007	11	(25.1)	(10.8)	(13.0)	(27.2)	(38.8)

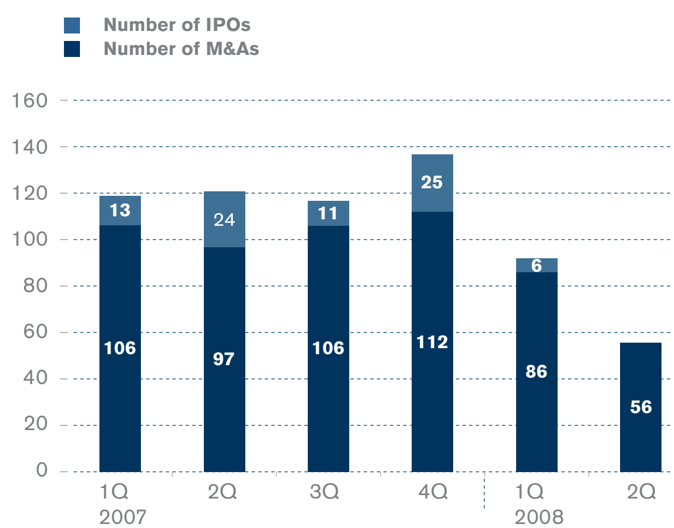
Source: Thomson Reuters Venture Economics/National Venture Capital Association; data as of March 31, 2008

CUMULATIVE IRR PERFORMANCE (%) BY STAGE (U.S.)

Fund Type	Num of Funds	Cap Wtd Avg	Pooled Avg	Upper Quartile	Median	Lower Quartile
Early/Seed VC	591	9.5	19.2	16.0	3.2	(4.9)
Seed Stage VC	66	5.1	9.3	13.3	4.4	(1.2)
Early Stage VC	525	9.7	20.1	16.3	2.9	(5.2)
Balanced VC	452	9.4	14.0	15.0	5.6	(0.3)
Later Stage VC	200	6.9	13.7	15.6	6.9	(0.6)
All Venture	**1,243**	**8.9**	**15.7**	**15.5**	**4.9**	**(2.1)**
Small Buyouts	180	9.3	15.7	17.7	7.7	-
Med Buyouts	114	12.0	17.5	22.5	9.3	(0.1)
Large Buyouts	93	10.5	12.4	17.1	7.3	0.3
Mega Buyouts	128	7.4	11.9	17.8	7.3	0.2
All Buyouts	515	8.3	12.9	18.1	7.9	-
Mezzanine	72	7.4	8.6	12.8	7.6	1.3
Buyouts and Other PE	678	8.4	12.3	17.3	7.9	0.2
All Priv Equity	**1,926**	**8.5**	**13.8**	**16.1**	**6.3**	**(1.4)**

Source: Thomson Reuters Venture Economics/National Venture Capital Association; data as of March 31, 2008. Figures for all funds in database, vintage years 1969-2007.

U.S. IPO VS M&A TRANSACTIONS FOR VENTURE-BACKED COMPANIES



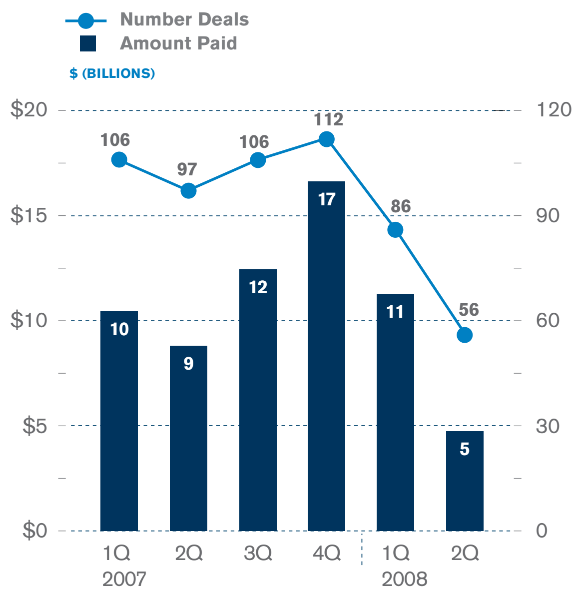
Source: Dow Jones VentureSource

US. VENTURE LIQUIDITY EVENTS BY INDUSTRY

Industry	2006 IPO	2006 M&A	2007 IPO	2007 M&A	2008 1H IPO	2008 1H M&A
Business and Fin. Services	7	58	5	70	0	22
Cons. Goods and Services	2	24	5	22	0	6
Energy and Utilities	1	4	1	4	0	0
Biopharmaceuticals	20	27	17	27	1	8
Healthcare Services	0	6	2	9	1	5
Medical Devices	6	24	8	20	2	4
Medical Software and IT	2	16	3	10	0	3
Ind. Goods and Materials	2	1	1	3	0	0
Comm. and Networking	5	48	10	36	0	8
Elect. & Computer Hdw.	1	16	3	11	0	5
Information Services	1	18	4	29	0	14
Semiconductors	2	18	6	19	0	11
Software	7	159	8	157	2	56
Other	0	2	0	4	0	0
TOTAL	**56**	**421**	**73**	**421**	**6**	**142**

Source: Dow Jones VentureOne

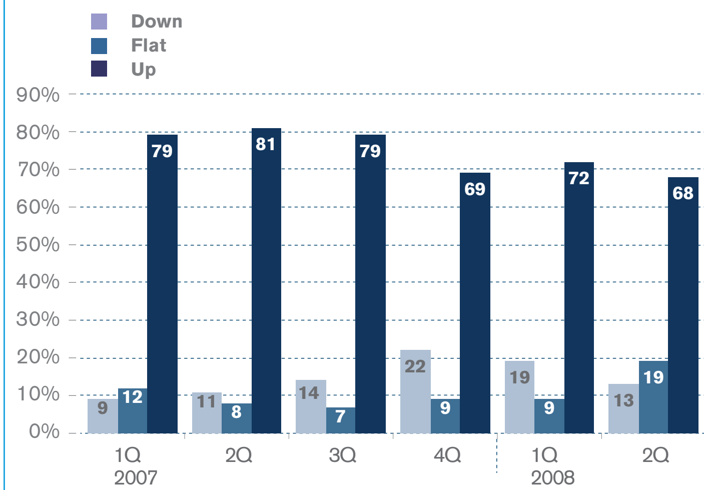
U.S. VENTURE-BACKED M&A ACTIVITY



Source: Dow Jones VentureSource

PRICE CHANGE

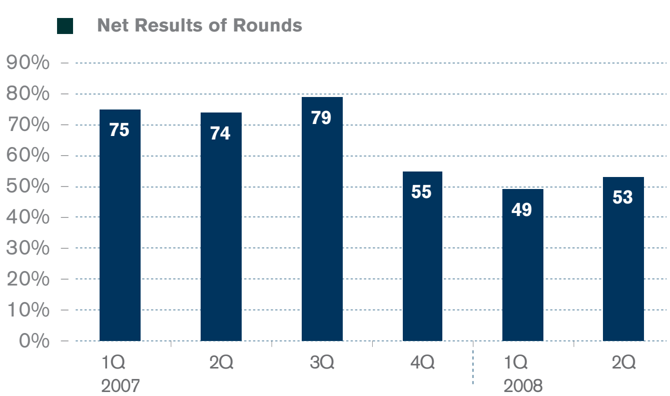
The direction of price changes for 103 San Francisco Bay Area companies receiving financing, compared to their previous rounds.



Source: Fenwick & West L.L.P.

VENTURE CAPITAL BAROMETER™

Average per share % price change from previous round of Silicon Valley companies receiving VC investment in the applicable quarter. Complete report available at http://www.fenwick.com/vctrends.htm



Source: Fenwick & West L.L.P.

*This update is for informational purposes only and is not a solicitation or recommendation that any particular investor should invest in any particular industry, security, or fund.