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WHY GROWTH LENDING NOW?

By Jeff Bede

The downturn in tech stock prices this year, which resumed after a modest summer recovery, demonstrates the sector's current repricing among equity investors. But equity market turbulence is likely obscuring a technology-sector opportunity for fixed-income investors: growth lending, a niche but growing asset class consisting of secured loans to valuable and growing tech companies.

Investing in the credit of privately-owned companies in a sector that equity markets have devalued may seem risky, given fixed-income investors' prevailing concerns about rising interest rates and the possibility of recession. But a closer look at growth and late-stage, venture-backed software and other tech-enabled companies that are raising debt capital reveals a picture that may be surprising.

Thousands of such companies with innovative and successful products and services and proven customer adoption are, indeed, cashflow negative. It is the very market and product success and the resulting investment in hiring the skilled personnel who create, develop, market and sell the innovations that are propelling even greater business expansion. A sizeable number of these companies would be cashflow positive at current revenue levels if they were to curtail spending on these vital growth initiatives. Since raising additional equity capital to fuel growth has become more difficult and more expensive now that valuations have declined, these dynamic companies view debt as an increasingly attractive option.

For one, adding growth capital through debt isn't dilutive to existing equity owners and avoids valuation repricing while extending the growth runway. Second, the cost of servicing debt capital, even at higher interest rates, has grown much less than the cost of equity and the value of the additional capital is high. The resulting debt service is manageable, especially since these companies tend to be very lightly leveraged, with debt typically representing about 10 to 20% of the capital stack.

While demand for debt financing from growth and late-stage tech companies is growing, the question mark for the fixed-income investors who would supply it are the unfavorable cashflows. Simply put, why pile debt onto negative cashflow businesses?

The answer is enterprise value. These businesses are valuable and sustainable already, and the capital coming from debt issuance is being earmarked to further fuel increases in enterprise value, which is likely to occur irrespective of macroeconomic conditions. For investors, this means rethinking return of capital. Instead of coming from cashflow, it largely comes from enterprise value when the business is sold or goes public. Even for companies that underperform, the attractive markets, differentiated products and valuable customers still attract buyers. Further, the predictable recurring revenue and high gross margins result in the operating leverage to drive profitability if needed. Principal protection is not about cash flow at initial investment, it's about the enterprise value of the business and the future cash flow.

For investors, these conditions create an attractive return opportunity. Investors receive an immediate return on their capital in the form of a coupon, with additional return coming from fees and warrants. Given the revenue growth rates driving de-levering, managers can also more readily upsize their investment versus other asset classes to further enhance return.

While similar to cashflow lending, growth lending tends to offer better risk-reward characteristics, in part because cashflow lending has become somewhat commoditized over time. According to PitchBook Data, Inc., growth lending currently offers an internal rate of return in the low teens on average, versus sizably lower returns in cashflow lending. Since loss rates are low and comparable for the two categories, this translates into investors receiving higher nominal as well as risk-adjusted returns from growth lending.

As is usually the case in fixed-income markets, potentially attractive opportunities are likely to come from more complex and relatively underserved and specialized niches. Growth lending is one of these. Managers with experience and track record in the market, who have proven underwriting and portfolio management expertise, who have long-term relationships with management teams and equity sponsors, and who can act with sophistication and dispatch can create opportunities that investors are likely to find rewarding, especially in the current market and macroeconomic environment.

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ABOUT ORIX CORPORATION USA GROWTH CAPITAL

ORIX CORPORATION USA's GROWTH CAPITAL business is a leading growth lending platform that provides flexible debt capital to valuable, high-growth businesses primarily in the technology and healthcare sectors in the U.S. and Canada.

Since 2001, Growth Capital has funded over $2.5 billion to 196 companies. Growth Capital is an enterprise value focused lender and provides customized and flexible debt facilities to growth-stage companies that are under-served by traditional lenders. The team is backed by the stable, long-term, and global sponsorship of ORIX Corporation, a publicly traded company with more than $107 billion in assets as of June 2022.

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