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An Introduction to Growth Equity

July 2023

Growth equity is often described as the private investment strategy occupying the middle ground between venture capital and traditional leveraged buyout strategies. While this may be true, growth equity has evolved into more than just an intermediate private investing approach. With its unique risk-return profile, driven by a focus on accelerated operational improvements and revenue growth, low leverage, and downside protection, growth equity is an appealing addition to a well-diversified portfolio.

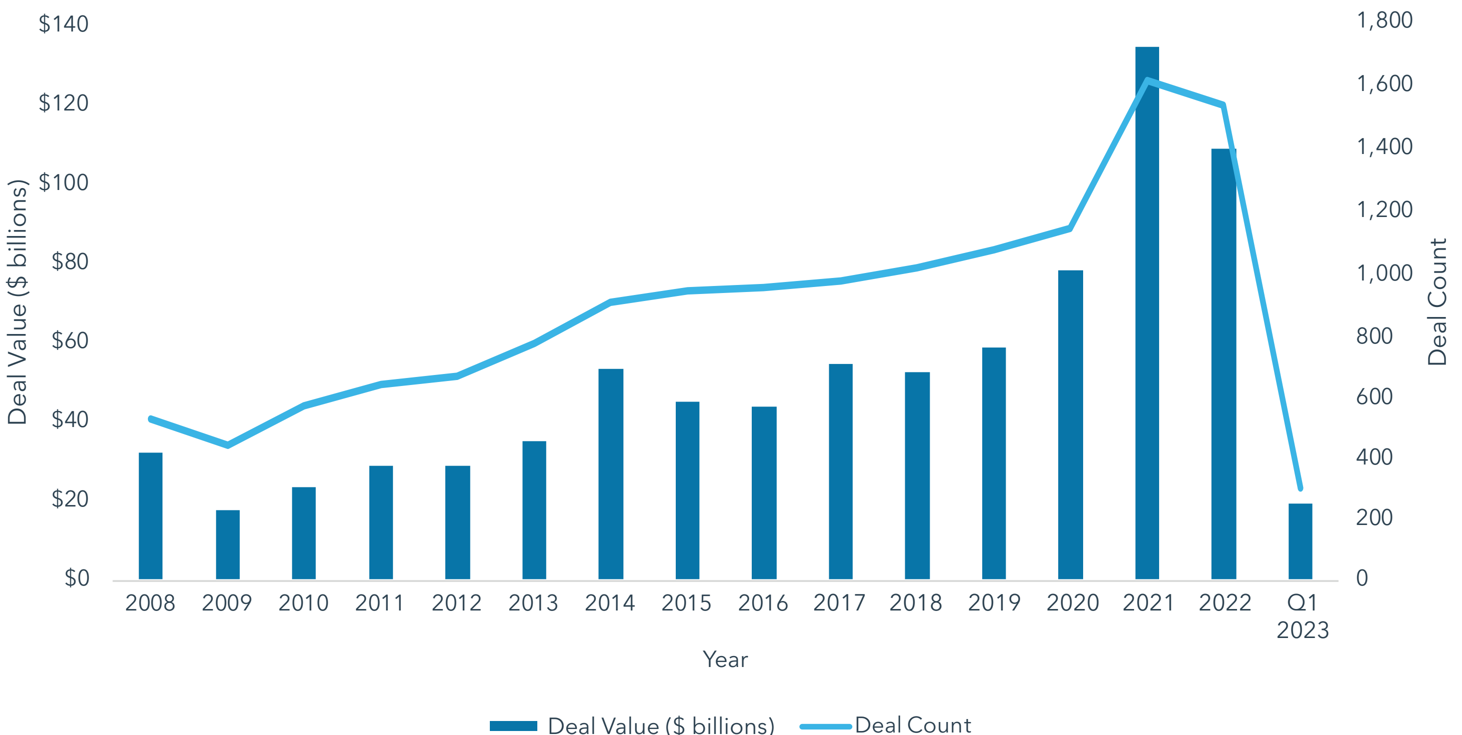
Growth Equity Investment Targets

Growth equity managers pursue companies that are at a development stage between venture capital fund targets (early-stage businesses with limited historical financials) and leveraged buyouts (LBOs), mature companies with established track records of cash generation. Growth equity funds seek to invest in well-run leaders in an industry or subsector, with proven business models bolstered by established products, growing customer bases, and very often, technology. These funds also have a history of identifying portfolio companies with significant and rapid revenue growth, usually in excess of a 10% run-rate, and frequently beyond 20%, which minimizes the earlier stage business risks often associated with venture capital investing. Unlike venture capital deals, which can be based on fairly speculative assumptions about the addressable market for a product and future funding requirements, growth equity investments are typically underwritten based on a clear business plan with some visibility on the next level of growth, defined profitability milestones, and quantifiable funding needs.

There are several key distinctions between growth equity and LBO funds. While typical growth equity stage companies are either already cash flow positive or are expected to reach profitability in the near term, they are often looking to accelerate growth beyond what their current cash flow can finance. In addition, the history of cash flow generation for these companies is often insufficient to support significant debt. This distinguishes these companies from those in later-stage LBOs, which tend to have a longer history of positive cash flows. While they exhibit less growth, these later stage players can support significant leverage, with debt expected to materially contribute to returns.

Exhibit 1: U.S. growth equity activity

By deal value and deal count



Source: PitchBook, as of March 31, 2023. For illustrative purposes only. Past performance not indicative of future results. Future results are not guaranteed.

Growth equity managers focus on private markets, where the universe of attractive targets is substantially larger than those on public stock exchanges. It is estimated that there are approximately 200,000 middle market businesses in the United States, with annual revenues between $10 million and $1 billion.[1] About 91% of these companies are privately owned,[2] and a significant subset fit the definition of growth equity investments.[3] By contrast, there are far fewer publicly listed companies, and the size of this market has contracted meaningfully over the last 25 years. As illustrated in Exhibit 2, the number of publicly listed companies in the United States has fallen by almost 50% since 1996, dropping from approximately 8,090 to 4,266 in 2019.[4] This shrinking universe has also grown older with less growth. In the technology sector, one study found that the average age of a newly listed company rose from five years old in 2000 to 15 years old in 2022. [5]

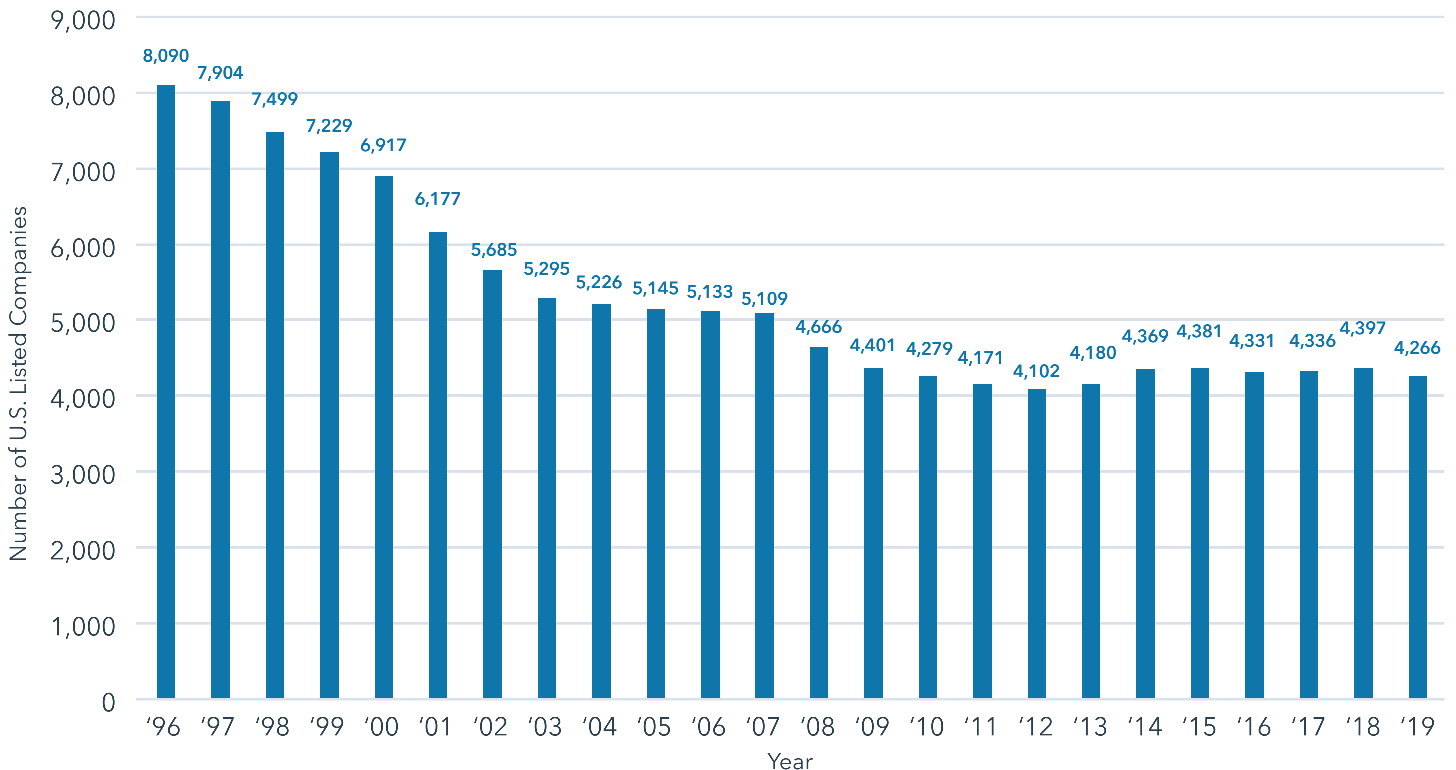
The two major drivers of this decline are mergers and acquisitions and a significant drop off in public listings of small-cap businesses, which have relied far more on private capital over the past two decades to fuel their growth. The abundance of private capital and the increased regulatory burdens of public markets have propelled this trend.[6] While the number of large- and mid-cap initial public offerings (IPOs) has gradually declined, the number of small-cap IPOs (defined as offerings with gross proceeds totaling less than $50 million) has fallen precipitously since the early 2000s (see Exhibit 3).[7] Those companies that do go public tend to be larger and much older than in the 1980s and 1990s.[8]

Naturally, smaller companies tend to exhibit stronger growth profiles than larger, more mature businesses; hence, the decline in small-cap IPOs has made it more difficult to find growth in the public markets, making exposure to private businesses crucial for growth investors.

A timely case in point: In 2021, the IPO market experienced a record year with some 1,035 companies going public amid a robust stock market and increased appetite for growth. The average company was 11 years old at the time of its IPO and was valued at $4.3 billion, versus an average age of six years old and an average valuation of only $700 million in 2000.[9] Most of these companies were already well past their hyper growth phase and were slowing down, and many were

Exhibit 2: Declining number of listed companies in the U.S.

Number of U.S. listed companies by year



Source: The World Bank, as of May 10, 2023. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

still losing money. Yet, in the frothy market of 2021, these companies attracted extremely high valuations by public investors chasing growth at all costs. Today, 43% or 446 of those stocks, many of which are in the technology sector, have fallen since their public debut; moreover, 26% or 265 of those companies are now down by more than 50%.[10]

Not surprisingly, this spike in IPOs occurred during a corresponding surge in the valuations of growth companies, particularly in the tech sector. Exhibit 4 shows the tremendous run-up of software as a service (SaaS) revenue multiples during this period and the steep decline that followed. Many investors who rushed into these high-flying companies in the hopes of capturing growth instead have suffered significant losses, reinforcing the notion that finding sustainable growth at reasonable valuations in the public markets has become increasingly challenging. The logic here is simple yet often understated: Top-line growth does not always translate to a profitable business, and a company without a clear path toward positive cash flow may struggle to sustain long-term growth. The other lesson is that growth is usually more expensive in the public markets than in the private markets.

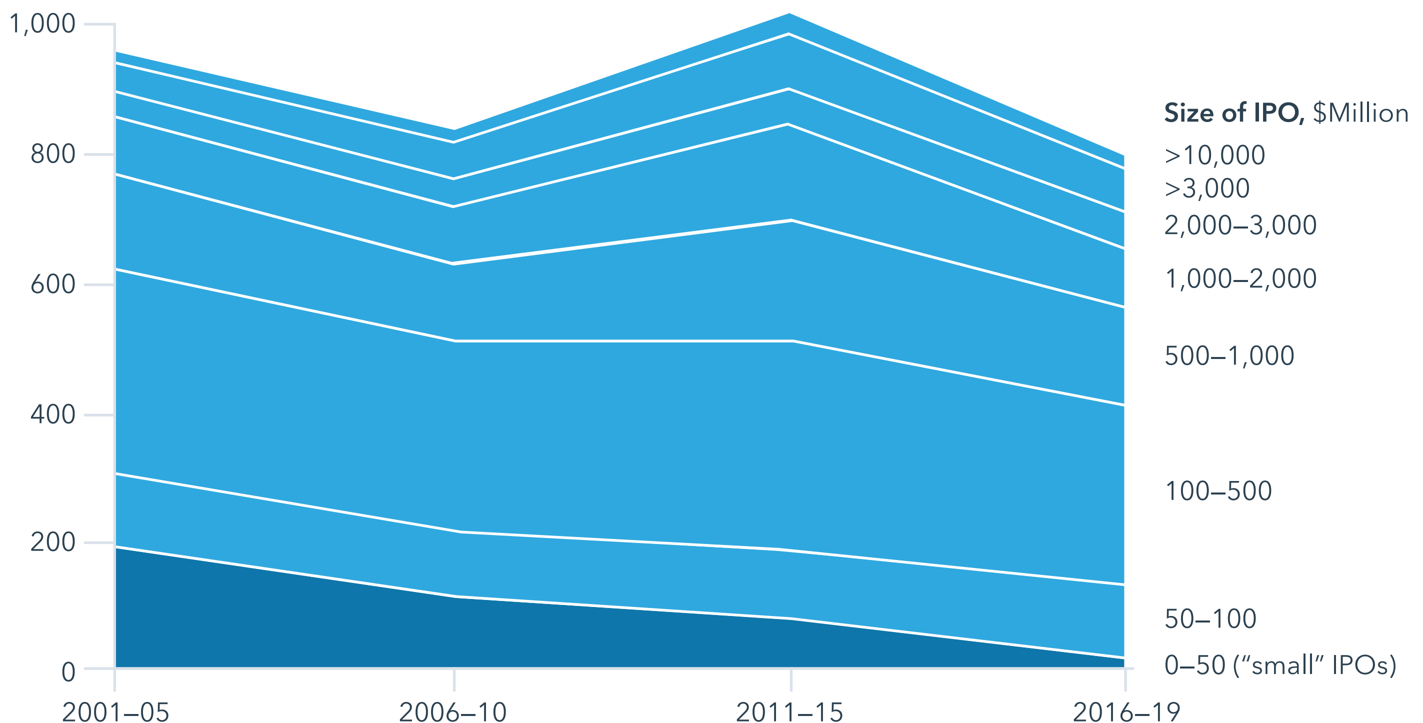
Sourcing

Growth equity managers typically use a combination of thematic investing and/or cold calling to identify prospective targets and generally wait until the competitive landscape is fairly developed in order to identify the market leaders. An attractive target company will often grow faster than both its industry competition and the broader economy. In contrast, with traditional LBOs the emphasis is often on improving operational efficiencies and utilizing debt to generate returns. Thus, growth equity managers tend to focus on industries that exhibit rapid expansion, such as technology, health care, business services, and financials. This focus, combined with growth equity's comparatively lower risk than venture capital, makes this asset class an attractive addition to a well-diversified portfolio.

Companies considering offers from growth equity managers are often still owned by their founders or early management teams and have not yet taken any institutional capital. Because these companies are already stable and able to determine their own future, they typically do not

Exhibit 3: The shrinking market of small-cap IPOs

IPOs, by size



Note: Figures are adjusted for inflation. Source: S&P Global; Corporate Performance Analytics by McKinsey & Company, as of as of Oct. 21, 2021. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

need to raise outside capital and must be convinced of the fund manager's value proposition. This value comes in two (not mutually exclusive) forms:

i. Providing capital and resources to accelerate growth through greater investment in technology and new product development, enhanced sales and marketing, add-on acquisitions, and/or geographic expansion.

ii. Allowing founders to monetize a portion of their stake and create more value in their remaining equity going forward. In many cases, these businesses may be beginning to think about succession planning and prefer to remain private. Growth equity managers are therefore well-positioned to provide the required capital and resources to fuel the next stage of growth.

Given these factors, growth equity managers must be especially proactive in deal sourcing. In many cases, this means that team members will spend months or even years building a relationship with a target company's management team or founders to gain a better understanding of the business and to become the buyer of choice if, and when, that company seeks private capital.

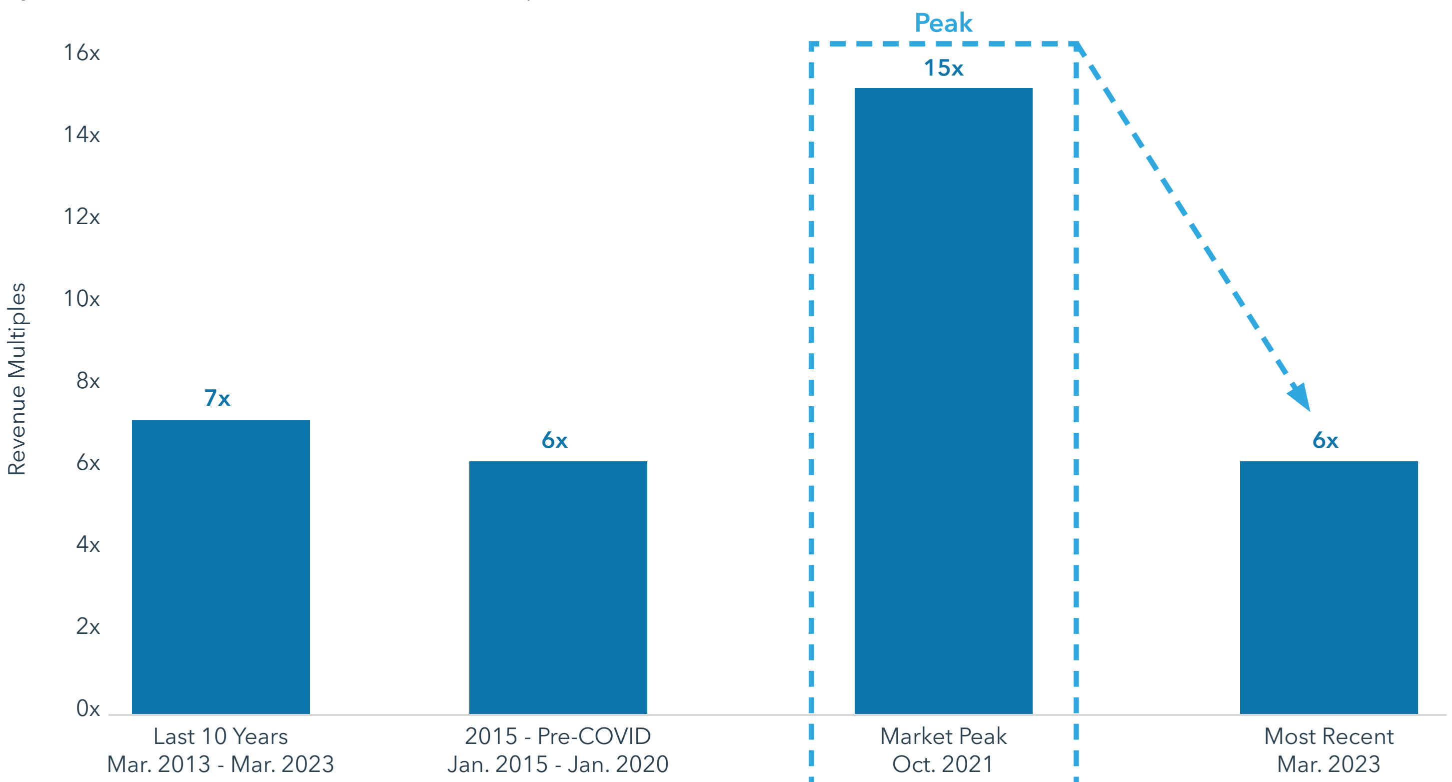
In addition, many growth equity firms have developed in-house value-enhancement resources to position themselves competitively in today's market. This may include internal operating partners or consultants, capital markets teams, talent and recruiting personnel, and/or board-level strategic guidance, all of which serve to help portfolio companies better manage growth and improve operations. Given the level of resources required to canvass a market that may include thousands of businesses, leading growth equity managers who have developed meaningful scale often have a sourcing advantage over smaller firms that are unable to replicate their proactive origination efforts and value-add propositions.

Downside Protection

Growth equity investments in a portfolio company can be minority or majority in nature and typically use little to no debt. The lack of financial leverage allows these businesses to be more flexible in the face of cyclical headwinds and mitigates risk for the fund manager. It

Exhibit 4: Software multiples correcting

By next twelve months (NTM) revenue multiples



Source: Capital IQ, Thomson Consensus. Market data and consensus estimates as of Mar. 31, 2023; Market peak date of Oct. 29, 2021. Software universe includes 228 publicly listed US and European names. Multiples in this chart are based on undiluted equity values. For illustrative purposes only. Past performance not indicative of future results. Future results are not guaranteed.

Exhibit 5: Types of private equity funds

	Venture Capital	Growth Equity	Leveraged Buyout (LBO)
Maturity	Early stage, limited financial history	Inflection point, strong revenue growth, proven business models, and established client bases	Mature, long track record of cash generation
Profitability	Not profitable, ranging from seed stage (pre-revenue) to late stage venture	May or may not be profitable, but clear path to profitability	Profitable with a history of EBITDA and cash flow
Free Cash Flow	No	Typically, limited	Stable
Control Features	Typically, minority	Minority or control	Control
Debt	No	Limited	Yes
Primary Risks	Market and product	Execution and management	Credit default
Sources of Return	Revenue growth and fit between product and strategic buyer needs	Revenue growth, profitability, and strategic value	Earnings growth and debt repayment

Source: iCapital. For illustrative purposes only.

is important to keep this in mind when comparing the internal rates of return (IRR) across funds with various degrees of leverage. Generally speaking, if two funds have the same IRR but different levels of leverage, the fund with less debt has generated more private equity alpha with perhaps less risk.

Growth equity managers will almost always take preferred equity or structure their stake senior to the management team's ownership, and they may also benefit from a set of additional protective provisions and redemption rights. While these rights will vary from deal to deal, they generally include the right to approve material changes in business plans, make new acquisitions or divestitures, initiate capital issuance, hire or fire key employees, and weigh in on other operational matters.

Conclusion

The unique characteristics of growth equity, shown in Exhibit 5, drive a distinct risk-reward profile that offers fund managers potentially attractive return prospects with a modest loss. Strong growth equity managers tend to use minimal leverage and avoid the earlier stage business risks often associated with venture capital, while they enjoy the security of proven revenues, existing cash flow or visibility to positive cash flow, comprehensive shareholder rights, reduced cyclicality, and higher average secular growth rates. This combination of factors can be compelling in any environment, and even more so in the latter stages of the market cycle.

COMPOSED BY

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ENDNOTES

1. National Center for the Middle Market, Middle Market Indicator, as of February 2, 2023.
2. Privately owned excludes publicly listed companies and companies that have public filing obligations.
3. National Center for the Middle Market, Middle Market Indicator, as of February 2, 2023.
4. The World Bank, as of May 10, 2023.
5. University of Florida, Warrington College of Business, Initial Public Offerings: Updated Statistics, as of May 23, 2023.
6. E&Y, The declining number of public companies and mandatory reporting requirements, June 2022.
7. McKinsey & Company, Reports of corporates' demise have been greatly exaggerated, Oct. 21, 2021.
8. Ewens, Michael and Joan Farre-Mensa, "The Deregulation of the Private Equity Markets and the Decline in IPO," The Review of Financial Studies, Volume 33, Issue 12, December 2020.
9. University of Florida, Warrington College of Business, Initial Public Offerings: Median Age of IPOs Through 2022, as of June 29, 2023; Bloomberg, as of Oct. 2021.
10. Stock Analysis, All 2021 IPOs; prices reflect intraday trading, May 23, 2023.

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