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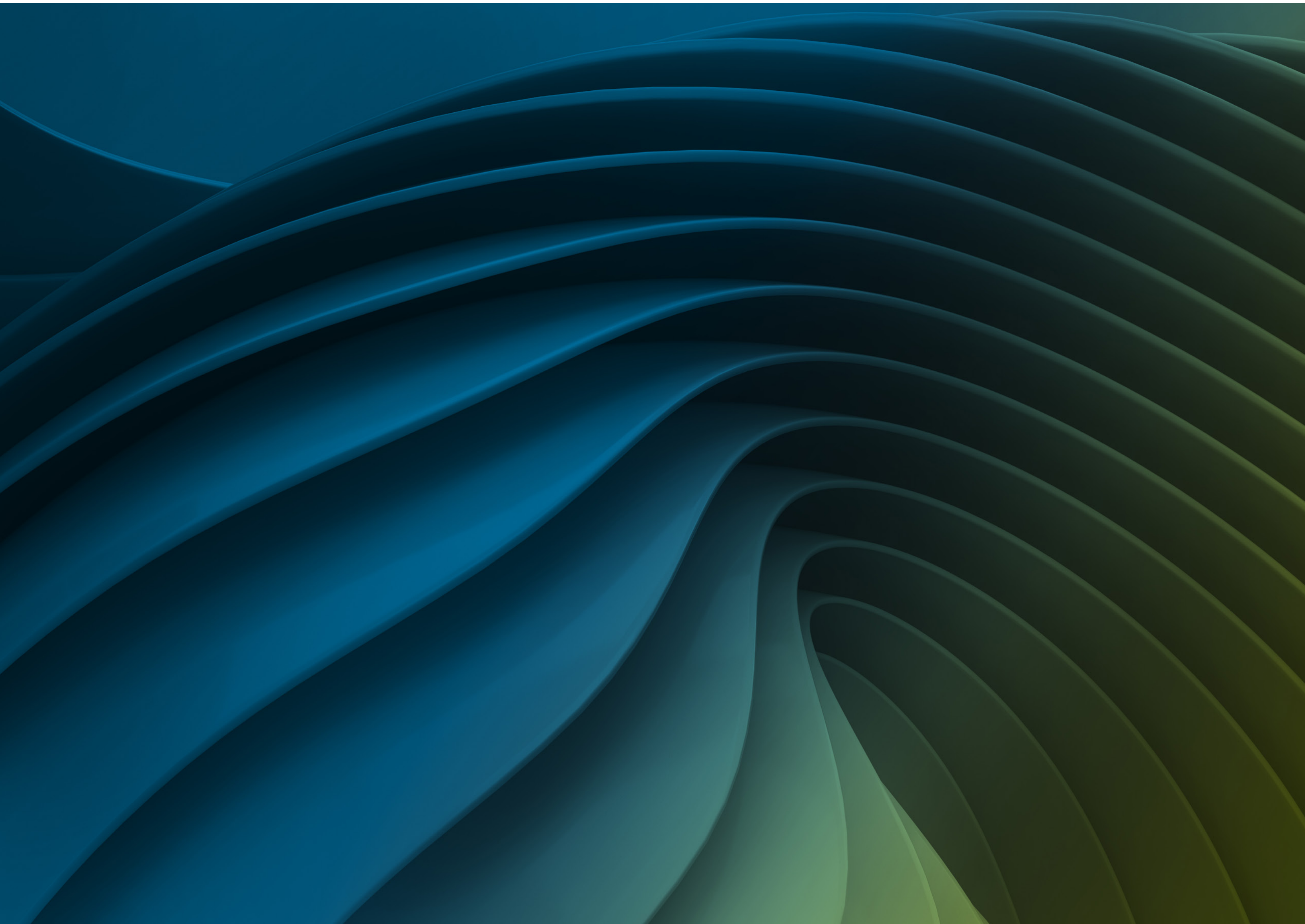
Don’t Forget About the Growth in Equity

July 2024



While venture capital and buyout strategies get the bulk of the headlines, it's growth equity that remains the top performer.

Of all the strategies in private equity, growth equity seems to be the middle child; it's often overshadowed by venture capital and traditional leveraged buyout and can be hard to define. Yet, there's a lot to like. Growth equity strategies aim to generate returns by unlocking untapped potential in operating performance and scale. While the last two years didn't do any favors for growth equity, as companies emphasized cash flow over growth, there are bright spots which could reemphasize the opportunities and strong performance of the strategy.

GROWTH EQUITY: DEFINING A VAGUE DEFINITION

Growth equity often is described as occupying the middle ground between venture capital and buyout, where the boundary lines are hard to see. A late-stage venture strategy, which provides capital to high-growth companies with a product-market fit, and the middle part of the buyout market, which may also pursue growth companies, seemingly infringe on growth equity territory.

However, growth equity has evolved into much more than an intermediate private investing approach. A typical growth equity fund will invest in profitable companies that have proven business models and a growing customer base. Most investment targets are cash flow positive or are expected to generate cash in the near term and are looking to accelerate growth beyond what their current capital can support. This distinguishes these companies from venture, which can be more speculative, and buyout opportunities, which use leverage and tend to target companies with a longer history of cash flows.

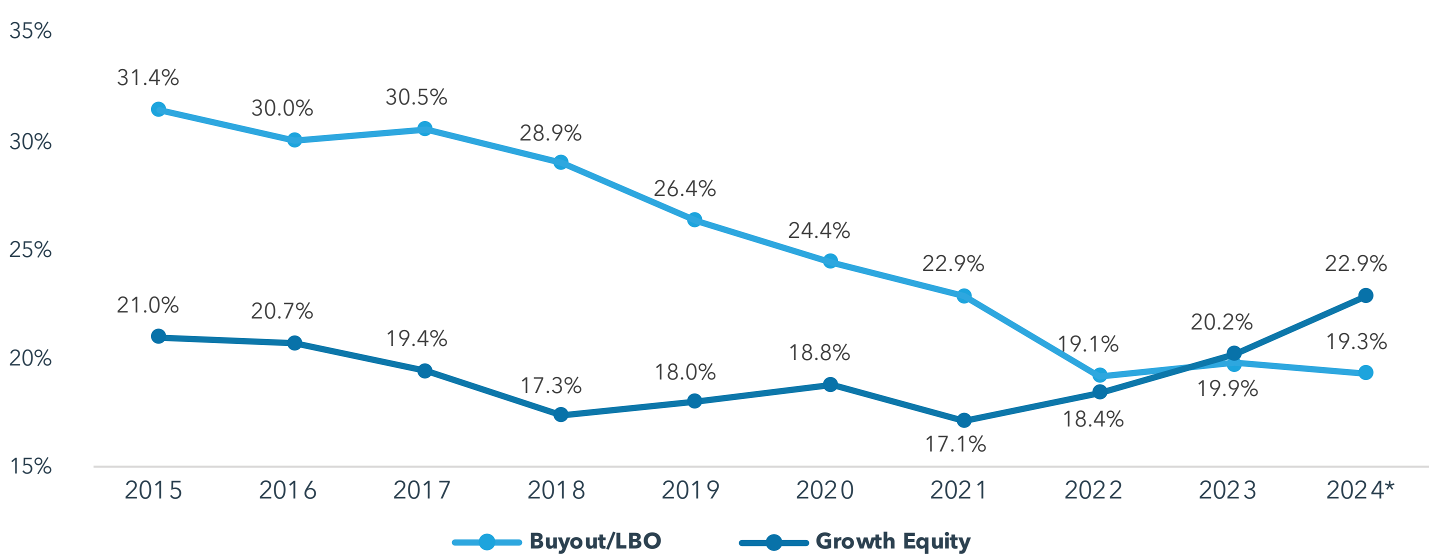
Because growth equity aims to accelerate growth, they look for opportunities where an investment can unlock product distribution to new markets or customers, or scale technological innovation. With this strategy, some managers have a vertical focus and are industry experts in areas such as software or health care.

RECALIBRATING THE CYCLE

Recent fundraising has been particularly difficult with $22 billion raised by U.S. growth equity funds in the first half of 2024, compared to $78 billion for all of 2023.[1] This has been attributed to companies that are shying away from a grow-at-all-cost approach. Despite this headwind, capital has been consistently deployed and investor sentiment appears to be improving.

Through the first half of 2024, growth equity has increased its share of private equity deals to 23%, surpassing buyout (see Exhibit 1). Moreover, growth equity is on track for its largest share of private equity deals for at least the last

Exhibit 1: Buyout and Growth Equity as a Share of All Private Equity Deals



*Source: PitchBook, "Q2 2024 US PE Breakdown". *2024 data through June 20, 2024.*

17 years. But for investors to compare different strategies, it often comes down to performance. And growth equity has generated sustainable returns outperforming all private capital, including private equity,buyout, and venture on a 5-, 10-, and 15-year basis (see Exhibit 2).

Exhibit 2: Growth Equity Has Been a Top Performer Over the Shorter and Longer Term

Private equity indexes annualized returns

Strategy	5-year	10-year	15-year
Growth Equity	**18.5%**	**16.2%**	**15.5%**
Private Equity	17.1%	15.4%	14.8%
Buyout	16.9%	15.3%	14.7%
Venture Capital	14.1%	13.3%	12.4%
Private Capital	13.8%	12.7%	12.4%

Source: PitchBook, "Private Capital Indexes", as of December 31, 2023.

Why the strong performance? For starters, the opportunity set is large. It's estimated that there are 200,000 middle market businesses in the United States with annual revenues between $10 million and $1 billion.[2] Approximately 90% of these companies are privately owned and, based on the latest Middle Market Indicator Survey fielded in December 2023, the projected revenue growth accelerated to 12.4%, the highest rate in four years.[3]

Growth equity also offers several investor-friendly features. These characteristics include little or no leverage as well as downside protection through board seats and other value-enhancement initiatives. For example, several larger growth equity managers have in-house resources such as operating partners, capital markets teams, and talent and recruiting personnel to help portfolio companies better position for growth acceleration and improve operations.

Growth equity firms may also negotiate senior security positions and protective rights with change in control provisions, exit preferences, or pro rata follow-on rights. And some managers may look to hold positions through an IPO exit and beyond. As a result, growth equity managers are not only able to capture significant company growth, typically in excess of a 10% run rate, and often beyond 20%, but also to offer protection on the downside.

Despite typically being overshadowed by venture and buyout strategies, growth equity strategies have several long-term beneficial qualities. Managers with a long track record and large networks should be well positioned to create value in any environment, and even more so in the latter stages of a market cycle.

ENDNOTES

1. PitchBook, "Q2 2024 US PE Breakdown."
2. National Center for the Middle Market, Middle Market Indicator, as of December 2023
3. Ibid.

iCapital®

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

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