Growth Equity–Feeling the L-O-V-E

In 2014, we invoked Aretha Franklin's famous line in writing that US growth equity deserved more R-E-S-P-E-C-T. Although it is often viewed as a sub-strategy with no dedicated LP allocation, we argued that growth equity's attractive risk-adjusted returns and less competitive GP access dynamics warranted more attention from institutional investors. Since then, LPs have come to embrace it. As a result, the strategy has matured and attracted significant amounts of capital. To borrow from Nat King Cole, "growth" is feeling the L-O-V-E from GPs and LPs alike.

Defining Growth Equity

Growth equity can evoke different meanings for different investors. While venture capitalists tend to use the term to refer to late-stage cash-burning companies, the traditional definition we use places growth between VC and buyout where it shares some of the best characteristics of both **(Figure 1)**.

Growth equity investors typically represent the first institutional capital in a founder-owned business. They target growing businesses led by teams that have successfully grown their companies by bootstrapping them rather than relying on VC financing. As a result, these businesses are nearly always profitable or breaking even at entry since they were built in a

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FIGURE 1 | PE STRATEGY SPECTRUM

STAGE	EARLY-STAGE VC	LATE-STAGE VC	VENTURE GROWTH	GROWTH EQUITY	GROWTH BUYOUT	BUYOUT
Profitability	Very High Cash Burn	High Cash Burn	Modest Cash Burn	EBITDA+	Modest EBITDA	High EBITDA
Growth Rate	>100%	>75%	>50%	>30%	>20%	<20%
Return Target	>10x+	>5x	>5x	>3x	>2.5x	>2x
Expected Loss Ratio	>50%	25%	25%	<20%	<20%	<20%
Leverage	None	None or Modest	None or Modest	0–3x EBITDA	2–5x EBITDA	>5x EBITDA
Revenue Multiple	>20x	>10x	>8x	>5x	>4x	>3x
Strategy	Find Product-Market Fit	Scale Business	Market Leadership	Profitable Growth	M&A	Cut Costs

Source: StepStone Group, August 2022.
StepStone Group Analysis based on external market data. For illustrative purposes only.
Target returns are hypothetical and are neither guarantees nor predictions or projections of future performance. Future performance indications and financial market scenarios are no guarantee of current or future performance. There can be no assurance that such target IRRs will be achieved or that the investment will be able to implement its investment strategy, achieve its investment objectives or avoid substantial losses. Further information regarding target IRR calculations is available upon request.

capital-efficient manner. Furthermore, growth equity investors tend to back companies in higher-growth sectors such as technology, consumer and healthcare rather than asset-heavy industrials or lower-growth sectors.

Growth equity investors have also tended to target companies and transactions with the following characteristics:

» Founder- or management-owned, with limited or no prior institutional capital raised;

» Maturing business that is at least five years old;

» Proven business model with demonstrated revenue and product traction;

» Revenue growth rates above 20%;

» Strong capital efficiency, with positive or near-positive EBITDA margins;

» Meaningful minority stake (e.g., >20% ownership) or control stake;

» Investment made through preferred shares with structural downside protection;

» Limited or no leverage; and

» Expected hold period of 3–5 years and an exit path to buyout firms or strategic acquirers.

Fundraising & Market Size

Private equity fundraising increased substantially between 2019 and 2022 as many LPs committed more to private markets at the expense of public markets. In our 2014 white paper, we noted that growth equity fundraising represented less than 10% of total US private equity fundraising historically. Since then, however, it has grown at a disproportionate rate relative to other strategies. According to Preqin, between 2010 and 2017, growth equity represented 10% of dollars raised. By the

Shades of Growth Equity

As growth equity has evolved and attracted venture capitalists and buyout firms alike, two new sub-strategies have emerged that provide yet another gradient on the private equity spectrum.

Growth buyouts tend to look similar to growth equity but with an emphasis on control instead of minority ownership. Because growth-buyout GPs have control, they may take a larger role in management team selection, pushing through specific operational initiatives and M&A.

Venture growth on the other hand is more like VC, sitting in the rounds between early-and late-stage financing. Venture-growth companies tend to be unprofitable for at least a few years post-investment, but are significantly derisked relative to early-stage investments.

end of 2022, its share of the fundraising market is on pace to be double that amount (**Figure 2**).

But increased fundraising for dedicated growth equity funds only partly explains the greater capital inflows. Increasingly, buyout firms have taken to investing in growth equity–style transactions. Adjacent to their flagship products, these GPs have established dedicated growth-specific funds with flexible mandates. Many of these firms are also increasingly willing to acquire or recapitalize investments held by growth equity managers even though they may have lower EBITDA margins.

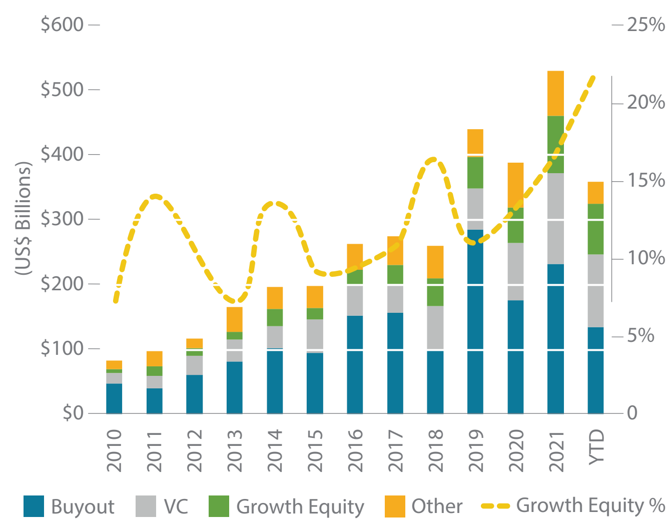
VC-backed companies may receive the lion's share of publicity, but there is a significant universe of companies that do not utilize traditional VC funding. According to Zippia and PitchBook, there are at least 585,000 technology companies in the US, but fewer than 53,000 angel and seed rounds have been completed over the past 10 years. With over 90% of US technology companies seemingly operating outside the VC ecosystem, we believe that growth equity investors still have ample opportunity to invest in emerging technology businesses.

Downstream Dry Powder

After several years of partnering with a growth equity investor, a business will have been professionalized and grown to the point that it becomes an acquisition target. These companies have typically upgraded and expanded their management teams, buttoned up their back offices, and built sufficiently large revenue bases to support increasing EBITDA margins over the coming years. As a result, buyout managers are emerging as the likeliest acquirers of growth equity–backed businesses.

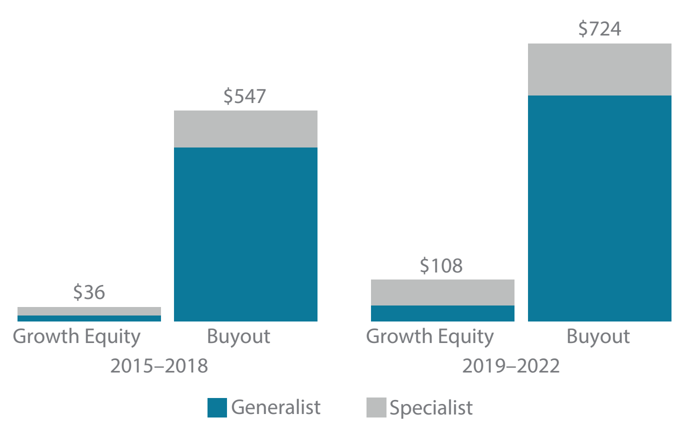
Further driving these exit dynamics is the growing pool of dry powder managed by buyout firms. As the buyout market has grown and become more competitive, GPs must look to new sources of deal flow. Growth equity–backed businesses can provide an attractive financial profile at entry, either as a platform investment or as a growth-oriented add-on for an existing portfolio company. In the US/European software and technology space, which is home to the majority of growth equity companies, we have tracked more than US$825 billion of capital commitments raised by midsize and large buyout/growth equity managers since 2019 (**Figure 3**). Accounting for additional managers in this category that are currently fundraising, the total commitments would exceed $1 trillion. This increasingly competitive end of the market should continue to benefit the small and midsize growth equity managers that are willing to take the risk of backing and institutionalizing founder-owned businesses.

FIGURE 2 | CHANGE TO US PE FUNDRAISING BY STRATEGY



Source: Preqin, August 2022.

FIGURE 3 | CAPITAL INFLOWS TO TECHNOLOGY BUYOUT AND GROWTH EQUITY FIRMS (US$ BILLIONS)



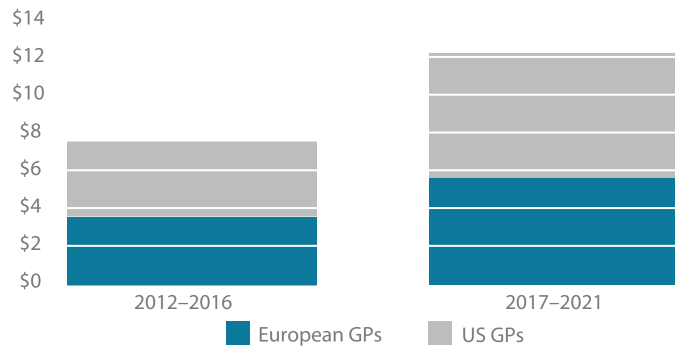
Source: SPI, September 2022. SPI data are continually updated; historical value subject to change.
Note: Includes only closed funds.

Hopping Across The Pond

As the American growth equity market has grown more competitive, many firms are looking to Europe as an opportunity to source platforms or add-ons in a less competitive setting. Growth equity investors from both sides of the Atlantic are finding more opportunities in Europe, where a robust VC ecosystem is creating a flourishing community of successful entrepreneurs who have the flexibility to bootstrap their next business (**Figure 4**). Notwithstanding the maturity of Europe's VC market, local investors tend to focus on early-stage opportunities—creating a funding gap for venture-growth companies and more mature founder-owned businesses.

Despite the increasing volume of growth equity opportunities, only a few local European GPs are taking advantage of the funding gap. This results in a valuation gap whereby European growth equity deals are priced at a significant discount to their US peers on a revenue-multiple basis (4.7x vs. 8.8x) and an EBITDA-multiple basis (16.5x vs. 24.1x).[1] American investors have largely filled this gap in recent years, enabling them to invest in attractive companies at relatively lower valuations. Although investors based in the US may face challenges sourcing transactions in Europe without "boots on the ground," they have found that some entrepreneurs value having a US-based partner as an avenue for expanding their business into the US. As a result, some US-based firms have established satellite offices in Europe's tech hubs to build brand recognition with local founders. While American firms' share of Europe's growth equity market has grown rapidly, there is still a stable of notable European growth equity managers that have historically been the first to provide institutional capital to founder-owned companies. Local managers in particular may be more inclined to capitalize on buy-and-build or consolidation plays in Europe's highly fragmented market, which we believe becomes even more attractive when private and public market valuations are falling.

FIGURE 4 | INCREASING INVESTMENT IN EUROPEAN GROWTH EQUITY (US$ BILLIONS)



Source: SPI, August 2022. StepStone data are updated continually; historical values subject to change.

Although deal activity across Europe is slowing down in 2022 because of slowing economic growth, rising inflation, and geopolitical uncertainty caused by the war in Ukraine, we expect growth equity activity to persist over the long term. Strategic- and sponsor-driven M&A remains the most important exit avenue for profitable or breakeven businesses in an environment where technology adoption remains a key driver of both growth and cost rationalization.

Risk-Adjusted Performance

We believe the most compelling evidence to support an allocation to growth equity is that historical data on returns suggest the strategy has the potential to provide VC upside with buyout-level loss ratios.

Using SPI,[2] we measured the return distributions from more than 25,000 realized North American private equity transactions completed between 2005 and 2019. The data suggest that growth equity has offered both a lower likelihood of losing capital (i.e., generating a money multiple less than

[1] StepStone Private Markets Intelligence. Compares the average LTM-revenue multiple and average LTM-EBITDA multiple at entry.

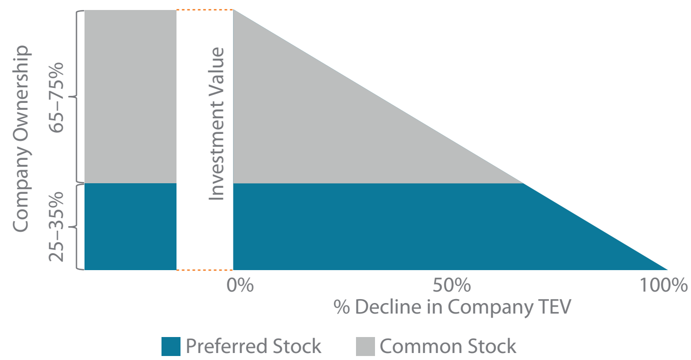
[2] StepStone Private Markets Intelligence, or SPI, is our proprietary private markets research library. Visit www.stepstonegroup.com/technology-solutions/ to learn more.

1.0x) and the highest likelihood of generating outsize returns. In contemplating downside potential, one would expect VC investments to generate the highest number of capital losses but it may be more surprising that the proportion of growth deals that lost money is even lower than that of buyouts, albeit slightly. A combination of factors may explain this phenomenon: Growth equity GPs typically invest through preferred shares, and they have tended to invest more heavily in software and technology, both of which have low historical loss rates. According to SPI, between 2005 and 2019, North American growth equity investments in the IT sector generated a realized loss ratio of 10%; North American growth equity as a whole generated a loss ratio of 14% during the same period.

By placing investing through preferred shares, growth investors ensure their capital is at the top of the cap table, where it has a cushion against a loss of capital without restricting the upside. Investors may seek to improve their position through accruing dividends or participating preferred shares, though these additional requests will affect the firm's negotiating position. **Figure 5** represents a hypothetical waterfall structure for a minority investment structured as convertible preferred stock without participation rights or accruing dividends. With a 25–35% ownership stake, the TEV must decline by 65% to 75% for the preferred stock to generate a loss due to its senior position in the capital structure.

The magic of growth equity is that its strong downside protection does not preclude investors from upside potential. In fact, based on SPI's data, growth equity investors have achieved higher proportions of >3.0x and >5.0x returns relative to other strategies (**Figure 6**). Although VC investors still have the potential to demonstrate outsize returns (>10.0x), we believe that growth equity's combination of downside protection and upside potential is very attractive.

FIGURE 5 | DOWNSIDE IMPACT FOR PREFERRED SHAREHOLDERS



For illustrative purposes only.

Strategy Resiliency

While it is impossible to time the market, LPs have asked whether it is better to invest in growth equity at the peak of the market or in a trough. To investigate this point, we compared growth and buyout's performance in the years before and after the Global Financial Crisis (GFC).

FIGURE 6 | GROSS REALIZED RETURN DISTRIBUTION BY STRATEGY 2005–2019

STRATEGY	<1.0X	1.0–2.0x	2.0–3.0x	3.0–5.0x	5.0–10.0x	>10.0x	>3.0x	>5.0x
Buyout	25%	27%	19%	19%	8%	2%	29%	10%
Growth Equity	24%	24%	20%	18%	11%	4%	32%	14%
Venture Capital	58%	14%	9%	9%	6%	4%	19%	10%

Source: SPI, March 2022.
Note: Includes data on 25,393 fully-realized North American buyout, growth equity and venture capital deals.
Past performance is not necessarily indicative of future results and there can be no assurance that the investment will achieve comparable results or avoid substantial losses.

FIGURE 7 | BUYOUT VS. GROWTH EQUITY VINTAGE PERFORMANCE 2005–2012

GROSS TVM		
YEAR	BUYOUT	GROWTH EQUITY
2005	2.5x	3.1x
2006	1.8x	2.4x
2007	1.8x	2.3x
2008	1.9x	2.7x
2005–2008	**1.9x**	**2.6x**
2009	2.4x	3.5x
2010	2.6x	3.0x
2011	2.9x	2.7x
2012	2.7x	3.3x
2009–2012	**2.7x**	**3.1x**

LOSS RATIO		
YEAR	BUYOUT	GROWTH EQUITY
2005	18%	3%
2006	25%	23%
2007	23%	27%
2008	20%	12%
2005–2008	**22%**	**16%**
2009	9%	11%
2010	11%	12%
2011	12%	20%
2012	14%	12%
2009–2012	**12%**	**14%**

Source: SPI, March 2022.
Note: Includes data on 4,883 fully-realized North American buyout and growth equity deals.
Past performance is not necessarily indicative of future results and there can be no assurance that the investment will achieve comparable results or avoid substantial losses. IRR and TVM for certain vehicles may have been impacted by StepStone's or the underlying GPs' use of subscription-backed credit facilities by such vehicles. Reinvested/recycled amounts increase contributed capital.

In terms of gross TVM, buyout deals completed between 2005 and 2008 generated a 1.9x compared with a 2.6x for growth equity (**Figure 7**). Growth equity transactions outperformed buyout transactions in each of these years by a meaningful margin. But was growth's outperformance the result of higher risk-taking? Not necessarily. During this same period buyout transactions generated a 22% loss ratio compared with 16% for growth equity.

When examining 2009–2012, which were generally stronger vintages for buyout transactions, growth equity's performance improved further, delivering a gross TVM of 3.1x versus buyout's 2.7x. While buyout deals had a modestly lower loss ratio during this period, we believe it is valuable to compare the returns of the two strategies on a risk-adjusted basis.

We utilize the risk-adjusted performance (RAP) metric to evaluate the trade-off between deal-level returns and loss ratios, calculated as gross TVM/(1 + loss ratio). This is meant to simulate the Sharpe ratio used for other asset classes. In the pre-GFC vintages, growth equity generated a RAP of 2.3x compared with 1.6x for buyout. This degree of outperformance makes sense given that growth equity generated higher returns with a lower loss ratio. However, even in the post-GFC vintages when growth equity generated a higher loss ratio, it still had a higher RAP (2.7x vs. 2.4x), implying that growth equity's modestly higher loss ratio was justified by higher returns.

These data support the notion that growth equity can be a resilient, all-weather strategy that is not dependent on market cycles to generate outperformance.

FIGURE 8 | RISK-ADJUSTED PERFORMANCE BY STRATEGY & FUND SIZE BUYOUT VS. GROWTH EQUITY BY FUND SIZE

BUYOUT				GROWTH EQUITY			
<$500M	$500M–1B	$1B–2B	>$2B	<$500M	$500M–1B	$1B–2B	>$2B
2.3x	2.2x	2.1x	1.8x	2.6x	2.6x	2.5x	2.5x

Source: SPI, March 2022.
Note: Includes data on 6,053 fully-realized North American buyout and growth equity deals.

Scalability

With growth equity's traits increasingly appreciated by GPs and LPs alike, one would expect more capital inflows. It has been well observed that there is generally a negative correlation between return potential and fund size. LPs will often invest energy into sourcing the next emerging buyout or VC manager before a series of successful funds leads that manager to meaningfully increase their fund size. But do these same standards apply to growth equity managers?

Returning to our RAP analysis, we compared the deal-level performance of buyout and growth equity transactions completed within four different fund-size tranches: below $500 million, $500 million–1 billion, $1 billion–2 billion, and over $2 billion. In line with conventional wisdom, both buyout and growth equity transactions saw a decline in realized returns across the increasingly large fund-size tranches (**Figure 8**). However, on a risk-adjusted basis this negative correlation is less severe. The loss ratios of buyout transactions were less affected by fund size, showing a fairly small delta between the loss ratio of the smallest fund (20%) and the largest funds (18%). However, growth equity transactions showed a strong negative correlation between fund size and loss ratio: The smallest funds generated a loss ratio of 17%, and the largest funds generated a loss ratio of 10%. The larger growth equity funds' lower loss ratios may be driven by a combination of factors—backing larger high-growth businesses, focusing on preferred equity investments, and utilizing less leverage than buyout funds.

Factoring in both the returns and loss ratios, buyout funds saw a consistent RAP decline from 2.3x for the smallest funds to 1.8x for the largest funds, representing a decrease of 21%. While growth equity managers also saw a decline in RAP as fund size increased, it was less severe (only 7%). This may imply that growth equity funds can scale more successfully than buyout fund strategies without experiencing as significant an impact to risk-adjusted returns. That said, the strategies employed by these larger funds must also evolve to accommodate larger equity checks. Most commonly these GPs bridge the increased investment sizes through more expansive M&A or focus more on growth buyout opportunities where they can acquire larger stakes in similar-size companies.

Conclusion

Growth equity is no longer underappreciated. Fundraising for the strategy has increased meaningfully in recent years, and more LPs are carving out dedicated allocations to it. While the space has become more competitive, we believe that the outlook for growth equity remains bright. Company formation and funding data suggest that 90% of US technology businesses are operating without traditional VC funding, and the expansion of cloud technology has increased founders' abilities to develop their new businesses in a capital efficient manner. Managers at the low end of the market are developing better sourcing tools for emerging investment candidates and have a growing pool of downstream capital to leverage for exit opportunities. Furthermore, our data suggest that successful managers can increase their fund sizes meaningfully without experiencing a drastic decline in risk-adjusted returns.

Not all growth equity investors are created equal, though. Sourcing and winning investments in founder-backed business has become more competitive as GPs continue to invest in technology that can uncover lesser-known prospects. While some growth equity GPs can differentiate themselves with their experience, operational value-add resources or networks, others may have to resort to higher valuations or compromises on deal structures to win. Heavily utilizing technology to assist with sourcing is now table stakes—growth equity sponsors must find other ways to differentiate themselves in an increasingly active market.

Other investors may find the difficult work of sourcing the classic diamonds-in-the-rough growth equity deals too challenging, widening their deal sourcing aperture into the venture-growth space. While there are successful venture-growth investors, the underwriting, risk profile and value creation playbook tend to be different from classic growth equity strategies. And some companies that had historically relied on VC financing to fuel their growth may have difficulty rapidly adjusting to focus on margin improvement.

While we believe growth equity should remain a meaningful part of an LP's private equity portfolio, it is important to spend the time to understand the nuances of the market and ensure access to the strongest, most resilient fund managers. We continue to view growth equity as an attractive, all-weather strategy, and for those who still have not prioritized an allocation to the strategy, it's not too late to show it some love.

StepStone Group (Nasdaq: STEP) is a global private markets investment firm focused on providing customized investment solutions and advisory and data services to our clients. StepStone's clients include some of the world's largest public and private defined benefit and defined contribution pension funds, sovereign wealth funds and insurance companies, as well as prominent endowments, foundations, family offices and private wealth clients, which include high-net-worth and mass affluent individuals. StepStone partners with its clients to develop and build private markets portfolios designed to meet their specific objectives across the private equity, infrastructure, private debt and real estate asset classes.

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