



# AN INTRODUCTION TO GROWTH EQUITY

**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, the strategy has evolved into more than just an intermediate private investing approach. Growth equity's unique risk-return profile, driven by a focus on accelerated operational improvements and revenue growth, low leverage, and downside protection, has resulted in the creation of dedicated allocations across many portfolios and has made it a bright spot in today's investment landscape.**

## GROWTH EQUITY INVESTMENT TARGETS

Growth equity investors pursue companies at a development stage between venture capital (early stage businesses with limited historical financials) and leveraged buyouts ("LBOs") (mature companies with a long track record of cash generation). Growth equity funds seek to invest in well-run companies with proven business models (i.e., established products and/or technology and existing customers) and a history of significant and rapid revenue growth (usually in excess of a 10% run-rate and often more than 20%), which minimizes the technology adoption risks often associated with venture capital investing. Also, unlike venture capital deals, which are often made on fairly speculative assumptions about the total addressable market for a product and future funding requirements, growth equity investments are typically underwritten on relatively defined profitability milestones and tend to have limited, quantifiable future funding needs to achieve their goals.

There are several key distinctions between growth capital and leveraged buyouts. 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 grow even faster than what their internally generated cash flow can support. In addition, the level of cash flow for

these companies is generally not yet large or stable enough to support significant debt. This distinguishes these companies from late-stage leveraged buyout companies, which also tend to be characterized by incremental growth and steady cash flows, but which are typically highly leveraged with debt expected to materially contribute to returns.

Growth equity managers focus primarily on private markets, where the universe of attractive targets is substantially larger than can be found on public stock exchanges. It is estimated that there are approximately 200,000 middle market businesses in the U.S.<sup>1</sup> About 98% of these companies are privately-owned, and a significant subset fit the definition of growth equity investments. By contrast, there are far fewer publicly-listed companies, and the size of this market has contracted meaningfully over the last two decades. Since 1996, the number of public companies in the U.S. has fallen by nearly 50%, dropping from approximately 7,300 to under 3,700 in 2016.<sup>2</sup>

A disproportionate amount of this attrition can be attributed to small-cap businesses, which have displayed a preference for accepting private capital

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in order to avoid the regulatory burdens of public markets. While the number of large cap IPOs has remained relatively steady, the number of smaller IPOs (defined as offerings with gross proceeds totaling less than \$100 million) has fallen precipitously since the late 1990s and early 2000s.<sup>3</sup> Smaller companies tend to exhibit stronger growth profiles than larger, more mature businesses; this trend has made it increasingly difficult to find growth in public markets, making exposure to private businesses crucial for growth investors.

## SOURCING

Growth equity investors typically use a combination of thematic thesis development and / or “cold calling” to identify prospective targets. An attractive growth equity investment target will often be growing faster than both its industry competition and the broader economy. Growth equity investors generally wait until the competitive landscape is more mature in order to identify a market leader. Similar to venture capital, however, growth equity firms focus their sourcing on sectors positioned for meaningful secular growth (in contrast to traditional LBOs, where the emphasis is often more on improving operational efficiencies and the use of debt to generate returns). As a result, growth equity managers tend to focus on sectors that are expected to exhibit more rapid expansion than the broader economy, such as technology, healthcare, business services, and financials. This focus, combined with growth equity’s comparatively lower risk than venture, has made the asset class attractive in today’s macroeconomic environment.

In addition, companies considering overtures from growth equity investors 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 performing well, they typically don’t need to raise outside capital and thus must be convinced of the investor’s value proposition. This value typically comes in two (not mutually exclusive) forms:

(i) allowing founders to monetize a portion of their stake. In many cases, these businesses are 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.

(ii) providing capital and resources to accelerate growth through greater investment in technology and new product development, enhanced sales and marketing, add-on acquisitions, and geographic expansion.

As a result, growth equity investors 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 / founders to gain a better understanding of the business and to become the “buyer of choice” if, and when, that company seeks an institutional investor. In addition, many growth equity firms have developed in-house value-enhancement resources to position themselves competitively in today’s market. This may include in-house operating partners or consultants, capital markets teams, and / or talent and recruiting teams, and may also include providing board-level strategic guidance, all of which serve to help portfolio companies manage growth and improve operations. Given the level of resources required to canvass a market that includes tens of thousands of businesses, leading growth equity managers that have developed meaningful scale often have a sourcing advantage over smaller firms that are

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## DOWNSIDE PROTECTION

Growth equity investments can be minority or majority in nature, but 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 investors.

In addition, while both venture capital and growth investors will almost always take preferred equity or otherwise structure the investment to be senior to management's ownership, growth equity investors typically also benefit from a set of protective provisions and redemption rights. While these rights will vary from investment to investment, they generally include the right to approve material changes in business plans, new acquisitions or divestitures, capital issuance, the

hiring or firing of key employees, and other operational matters. Redemption rights are also heavily negotiated and generally based on either time elapsed since investment or testing business results against pre-set performance milestones or financial covenants.

## CONCLUSION

The unique characteristics of growth equity, shown in Figure 1, drive a distinct risk-reward profile that offers investors potentially attractive return prospects with a modest loss ratio. Growth equity investors often use minimal leverage and do not have to deal with technology / market adoption risk, while they enjoy the security of existing cashflow, comprehensive shareholder rights, reduced cyclicity 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.

FIGURE 1

	Venture Capital	Growth Equity	Leveraged Buyout
<b>Maturity</b>	Early stage, limited financial history	Inflection point, unit economics proven	Mature, long track record of cash generation
<b>Profitability</b>	Not profitable	May or may not be profitable, but clear path to profitability	Profitable with a history of EBITDA and cash flow
<b>Free Cash Flow</b>	No	Limited	Stable
<b>Control Features</b>	Typically minority	Minority or control	Control
<b>Debt</b>	No	Limited	Yes
<b>Protective Provisions</b>	Generally No	Generally yes	Yes
<b>Primary Risks</b>	Market and product	Execution and management	Credit default
<b>Sources of Return</b>	Revenue growth and fit between product and strategic buyer needs	Revenue growth, profitability and strategic value	Earning growth and debt repayment

Source: iCapital. For illustrative purposes only.



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## END NOTES

<sup>1</sup> Source: National Center for the Middle Market. Q3 2018.

<sup>2</sup> Source: Credit Suisse, "The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities" by Michael Mauboussin, Dan Callahan, CFA, and Darius Majd (March 22, 2017)

<sup>3</sup> Source: Vanguard. "What's behind the falling number of private companies?" November 2017. Based on data from Bloomberg.



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