MEKETA

Growth Equity Primer

WHITEPAPER
MAY 2024

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Key takeaways

→ **Growth equity overview |** Growth equity is a private equity strategy focusing on minority (ie., non-control) investments in companies with high growth potential. Growth equity investors offer companies strategic guidance and capital for expansion.

→ **Risk and return profile |** Growth equity generally falls between venture capital and buyouts in terms of risk and returns. Growth equity typically carries less risk than venture capital by targeting more established companies, yet still offers potential for high returns through companies' growth trajectories.

→ **Market evolution |** The growth equity market has evolved significantly since the late 1990s, with a substantial increase in aggregate capital raised, indicating its growing importance within private equity.

→ **Investment characteristics |** Growth equity investments typically involve little to no leverage (unlike buyouts) and focus on organic growth and strategic acquisitions rather than cost-cutting measures.

→ **Strong performance |** Growth equity performance has been in line with that of venture capital and buyouts historically, though there is cyclicality in its performance. Similar to the other categories of private equity, selecting top-performing managers is crucial, as the performance spread between the best and worst managers can significantly impact overall returns.

This primer introduces a subset of the private equity asset class commonly known as growth equity. It attempts to answer the types of questions institutional investors would be likely to ask when considering an investment in this area.

Growth equity is often overshadowed by its cousins in buyouts and venture capital, but it should not be overlooked. This paper discusses the characteristics of the asset class and reasons for investing in growth equity. It presents an analysis of major return, risk, and implementation considerations for institutional investors. It does not suggest a target allocation, nor does it specify how to implement an investment program. These issues are investor specific and should be addressed by the decision-makers overseeing the allocation.

What is growth equity?

Growth equity refers to one of the primary private equity investment strategies where investors look for companies with strong growth potential in which to invest. Unlike buyout strategies, which typically involve buying out a company with majority ownership, growth equity focuses on expanding and scaling a business via a minority ownership position. Growth equity investors provide not only funding to the underlying companies, but also strategic guidance to help the company grow its market share, develop new products, or expand geographically. This investment approach typically involves less risk than venture capital since it targets more established companies rather than newer startups. However, the growth equity strategy still offers the potential for increased returns if the invested companies' growth trajectory continues upward.

The growth equity proposition

Growth equity investors typically target companies that they perceive to offer high growth potential, scalability, and innovative business models. These companies are often in a stage of development where they have established product-market fit and are seeking to expand their market share or enter new markets. They tend to have leadership teams with a clear strategic direction and the ability to execute growth initiatives. Financially, these companies may have consistent revenue growth and a path to profitability, although they may not yet be profitable due to reinvestment in the business.

Growth equity managers provide capital to companies that they believe exhibit the potential for significant expansion and profitability. Growth equity investors' focus is on accelerating company growth organically or through strategic acquisitions, rather than on immediate returns through cost-cutting or operational efficiencies.

While the capital provided by growth equity investors is often intended to fund identified growth initiatives, growth equity investors may also add value through a hands-on approach by assisting with strategic planning, operational improvements, and scaling efforts. As a minority investor, these efforts are implemented collaboratively with the founders and management team. By leveraging their industry expertise and networks, growth equity managers aim to help portfolio companies navigate complex market dynamics, optimize performance, and ultimately drive increased returns for investors.

Growth equity's evolution and current universe

The history of growth equity can be traced back to the late 1990s when private equity firms began diversifying their investment strategies beyond leveraged buyouts and venture capital. Growth equity has since evolved into a distinct asset class within private equity and has grown substantially (see Figure 1). The increasing opportunity set of growing companies combined with the differentiated return profile and broader adoption of the market segment have contributed to this growth. Aggregate capital raised hit an all-time high in 2022 at roughly $176 billion, an increase of 4.5x from 10 years prior.

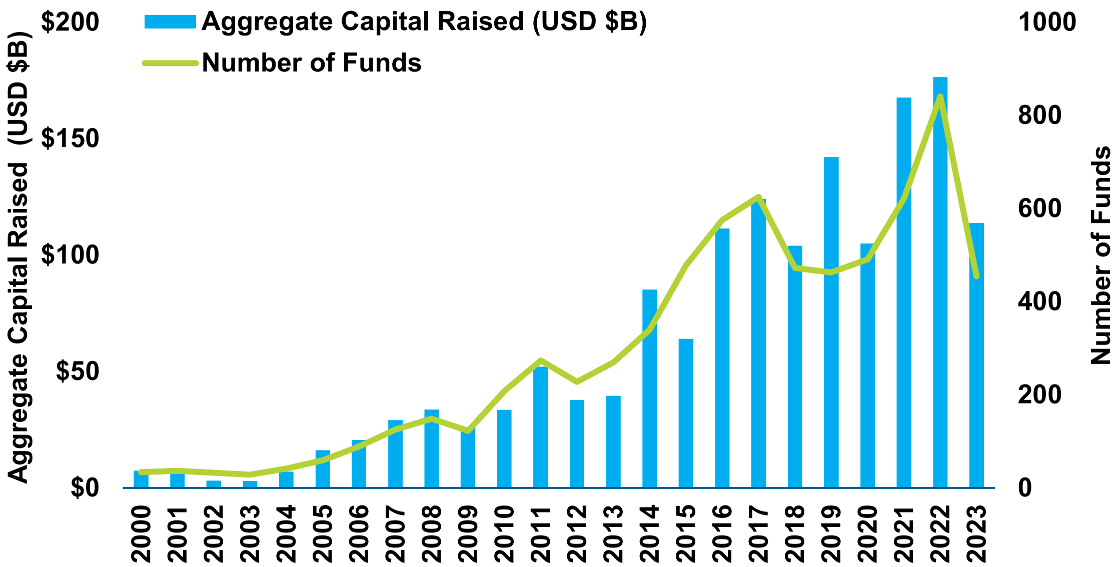

FIGURE 1
Growth Equity Historical Fundraising

Source: Preqin, as of December 31, 2023. Data pulled on April 13, 2024.

Figure 2 provides a visual representation of where the size of the growth equity universe falls in comparison to the other private equity strategies. Unlike venture capital's high number of funds at a smaller average fund size, or buyout's slightly lower number of funds at a much higher average fund size, growth equity's universe tends to target a more middle-of-the-road tier. While growth equity's average fund size over the past 10 years has been $301 million, it has seen a wide span of average fund sizes depending on the year. Over the past decade, average fund size has ranged from a minimum of $159 million in 2015 to a maximum of $513 million most recently in 2023[1]

[1] Source: Preqin, as of December 31, 2023. Data pulled on April 13, 2024.

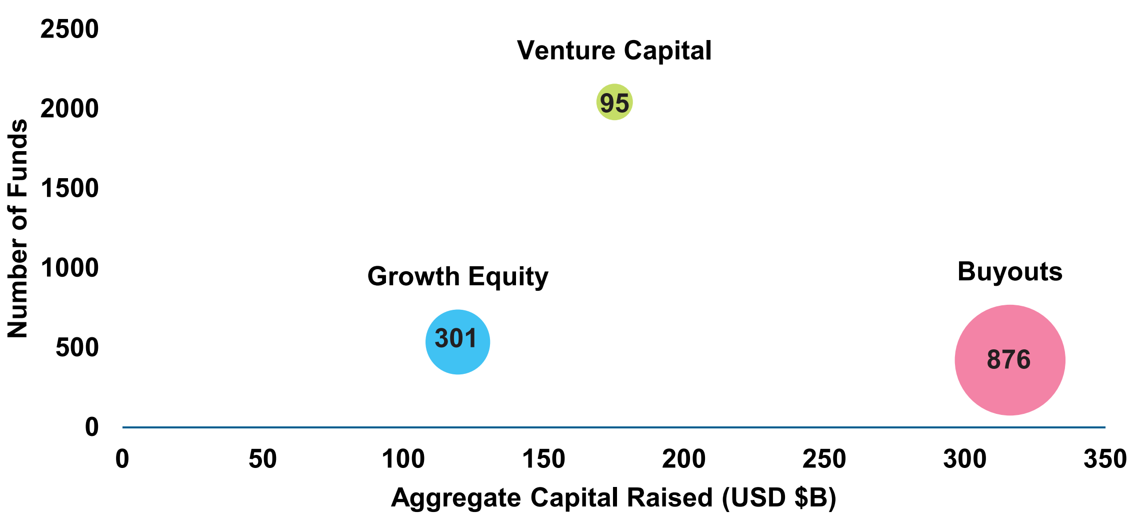

FIGURE 2
Primary Private Equity Strategies by Average Aggregate Capital Raised, Average Number of Funds, and Average Fund Size over the Past 10 Years

Source: Preqin, as of December 31, 2023. Data pulled on April 13, 2024. Bubble size represents average fund size (in millions of USD).

Growth equity versus venture capital and buyouts

Growth equity, buyout, and venture capital represent distinct strategies within the private equity domain, each with unique risk profiles, investment horizons, and value creation mechanisms. Growth equity focuses on providing capital to established companies aiming for expansion without a change in control. Buyouts involve acquiring a controlling interest in a company, often with significant leverage, to improve operational efficiencies and drive financial performance. Venture capital targets early-stage companies with high growth potential, offering not just funding but also strategic guidance to navigate the nascent phases of business development. Another notable distinction between the strategies is that while growth equity seeks to fuel organic growth through operational improvements and market expansion, buyouts typically take a buy-and-build approach to growth while some strategies may focus on cost-cutting or restructuring. Venture capital differs in its tolerance for risk and emphasis on innovation as a driver for outsized returns.

	Venture Capital	Growth Equity	Buyouts
Company stage	Early-stage startups	Growing and proven startups	Mature companies
Fundraising stage	Angel to Series B	Series C and later*	Post venture rounds
Characteristics	Limited financial history	Strong revenue growth, proven business model, established client base; often at an inflection point.	Long track record of solid financial performance and a stable customer base
Profitability	Not profitable (negative EBITDA); possibly even pre-revenue	May or may not be profitable (often EBITDA positive), but clear path to profitability	Profitable (EBITDA positive)
Sourcing	Proprietary	Proprietary	Proprietary, limited auction, full auction
Capital structuring	Equity	Primarily equity/possibly limited debt	Equity and debt
Due Diligence	Limited due to lack of financial history, etc.	More complex with established performance metrics.	The most complex and expensive. Commonly involving multiple 3rd party specialists, such as lawyers, management consultants, or auditors
Target Gross Internal Rate of Return (IRR)	35 – 50%	30 – 40%	25 – 35%
Target Gross Total Value Multiple (TVM)	5 – 10x	3 – 7x	2 – 5x
Average Loss Ratio**	27%	20%	13%
Return profile	Portfolio returns driven by a select few transactions, with a large portion of the portfolio only returning capital or exhibiting losses	Majority of transactions are expected to generate positive outcomes, with less upside than venture capital and a corresponding decreased downside.	All investments within a portfolio are underwritten to expect positive outcomes.
Ownership Position/ Control	Minority ownership and likely involved in strategic direction	Mostly minority transactions, with possibility for involvement in strategic direction or majority control	Control/majority ownership transactions
Common value-add from the GP	Strategic direction, human capital retention and development, networking go to market strategies, etc.	Executing growth initiatives, improving operations, etc.	Strategic direction, hands-on operational improvement, growth, buy and builds, cost cutting, etc.

FIGURE 3
Comparison of Venture Capital, Growth Equity, and Buyouts

Source: Based on observations by Meketa Investment Group unless otherwise noted.

Note:
* While growth equity may include follow-ons to early-stage venture financing, it may also include companies that have not had previous institutional backing.

**Source: Preqin. Loss ratio is calculated as amount lost on losing deals divided by the amount invested overall. Represents the average loss ratio for funds raised in the ten vintage years from 2007 through 2016, as these datasets are fairly sizeable and the vintage years are reasonably mature. Loss ratios for vintage years tend to vary with market conditions.

Historical performance

Over the past thirty years, the growth equity category has performed similar to both the buyout and venture capital categories.[2] However, as evident in Figure 4, this relationship has changed over time and has varied with different market environments.

Depending on the cycle, growth equity typically performs between venture capital and buyouts, but not always. For example, growth equity returns were above buyouts but below venture capital during the "Dot-Com" bubble, and growth equity then remained in the middle – though above venture capital and below buyouts - during the subsequent bubble "pop." As the private equity industry has matured, the large differences in the strategies' returns that was evident in the 1990s and early 2000s has become more subdued.

[2] Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts. Returns are net of fees. Period is 1/1/1993 to 9/30/2023. The Cambridge Associates US Growth Equity composite only includes funds targeting high-growth, established, companies where the manager "is the sole or largest institutional shareholder" and is the "first and likely last institutional investor." However, other funds that may be classified as "growth equity" by the definitions given in this paper may instead be captured within the Cambridge US Late & Expansion Stage Venture Capital composite (comprising a portion of the US Venture Capital composite shown in the chart) which includes funds similarly targeting high-growth, established, companies but where the manager is generally not the only, first, or largest institutional investor.

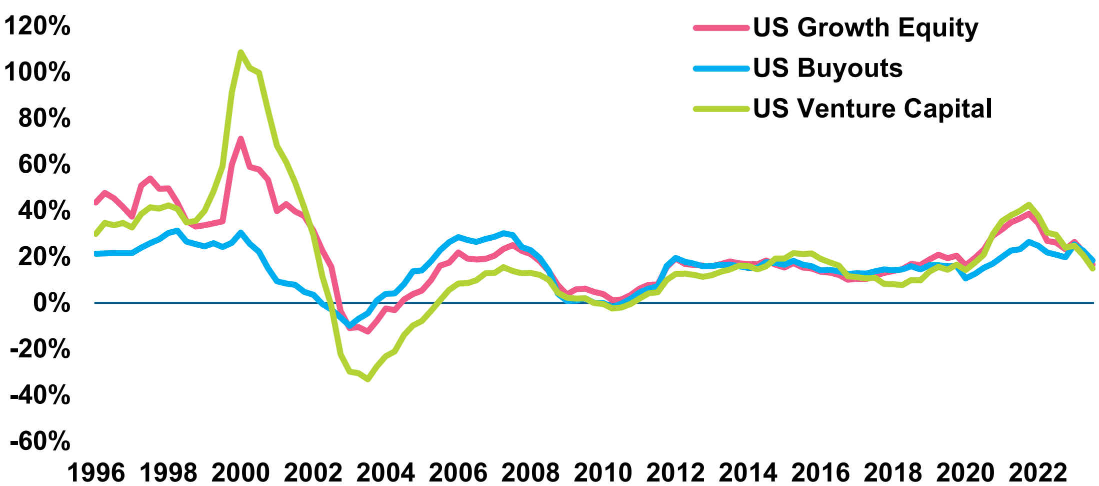

FIGURE 4
Rolling 3-Year Annualized Returns

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts. Returns are net of fees.

Over the past 10- and 20- years, growth equity has, perhaps surprisingly, generated slightly higher returns compared to the other private equity categories (see Figure 5).

Time Period	US Venture Capital	US Growth Equity	US Buyouts
Trailing 10 years	16.4%	17.2%	16.0%
Trailing 20 years	12.5%	15.7%	15.6%

FIGURE 5
Trailing Annualized IRRs

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts. Returns are net of fees. 20-year period is 10/1/2003 to 9/30/2023, 10-year period is 10/1/2013 to 9/30/2023.

Historical volatility

Consistent with its distinct risk-reward profile, growth equity has historically exhibited a level of volatility similar to other private equity categories. Since 1993, growth equity's volatility has been below that of venture capital and above that of buyouts (Figure 6), but the relationships have changed during different market environments.

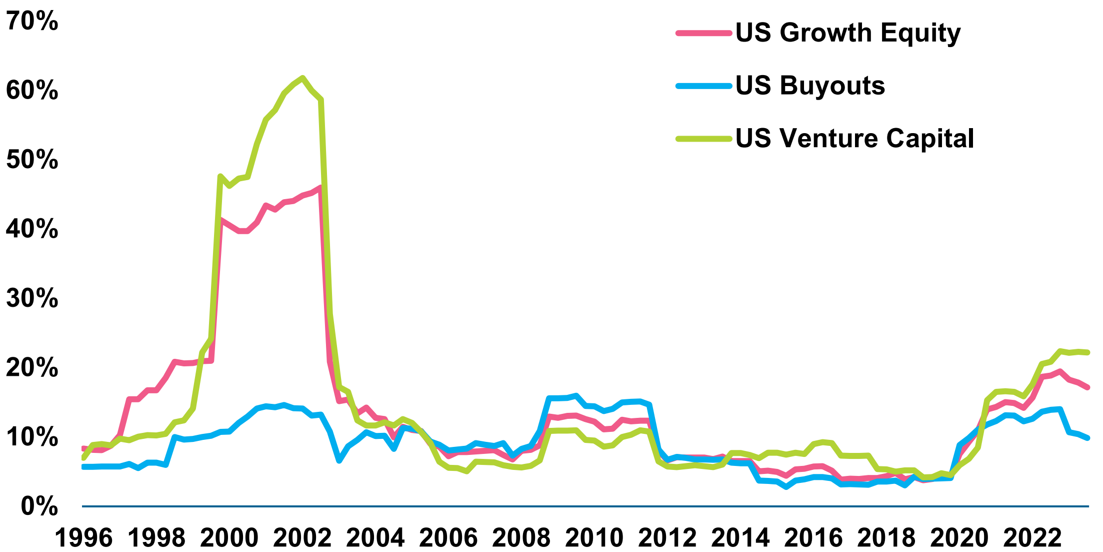

FIGURE 6
Rolling 3-Year Annualized Volatility

Source: Cambridge Associates via IHS Markit, annualized quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts.

The importance of manager selection

Interquartile spreads can be interpreted as how much potential value lies in selecting superior funds or managers within each asset class. Figure 7 shows that the three primary private equity strategies had very similar interquartile spreads over the trailing 10 years, all within 1% of each other, with US venture capital being the highest and US growth equity being the lowest. These high interquartile spreads imply that private equity strategies - including growth equity - offer increased potential for out- (or under-) performing managers/funds to add (or detract) value from a portfolio compared to most other asset classes.

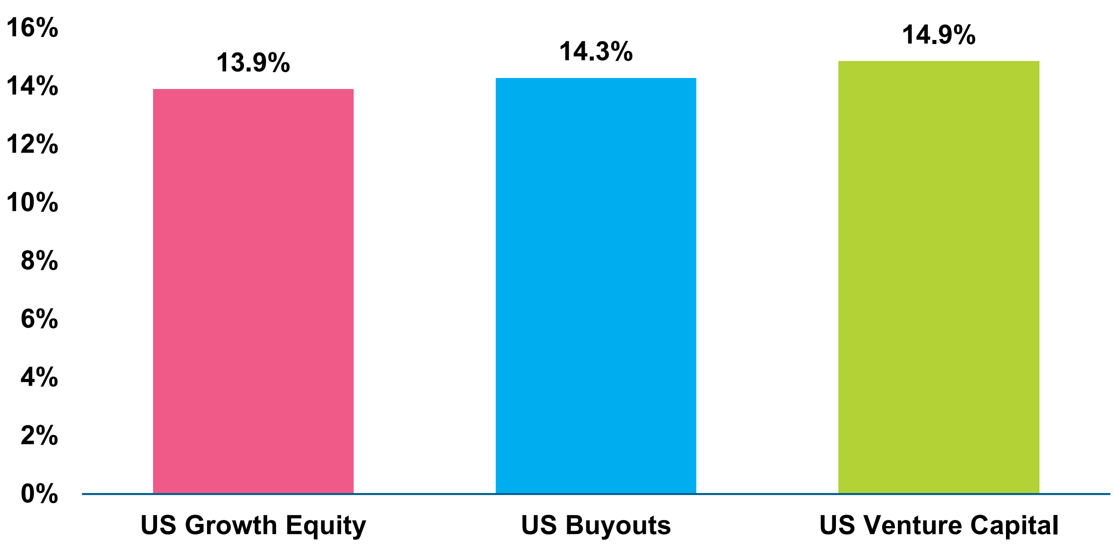

FIGURE 7
Trailing 10-Year Interquartile Spread

Source: Cambridge Associates via IHS Markit, annual IRR quartiles by vintage year as of September 30, 2023 (pulled in January 2024). Funds raised Vintage Year 2012 to 2021. Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts. Vintages years 2022 and 2023 are excluded as they are too recent. The interquartile spreads shown are subject to endpoint bias where the averages may change materially based on the set of vintage years being included.

Why invest in growth equity?

An investment in growth equity, typically, as part of a broader private equity strategy, may offer potential benefits to investors' portfolios. One such benefit is increased diversification, particularly relative to certain major public and private asset classes. In addition to the potential benefits inherent to private equity,[3] growth equity may also offer unique benefits within the asset class. As mentioned previously, growth equity offers a distinct risk/return profile between that of venture capital and buyouts, which means that investors may include it at varying proportions given the objectives of the program and perceived role in the portfolio. For example, some large investors acknowledge that it is challenging for them to access the smallest, most sought after opportunities in the venture capital space in a size that would help them achieve their target allocation. Hence, they may seek additional growth equity exposure as a relative proxy to venture capital exposure.

[3] See Meketa's Private Equity Primer for more information on the potential benefits of the private equity asset class.

Diversification benefits

Since 2000, growth equity has exhibited an average correlation of 0.73 to US equity, 0.0 to US bonds, 0.23 to core private real estate, 0.43 to non-core private real estate, and 0.44 to private infrastructure.[4] This implies that growth equity may provide a portfolio with diversification benefits relative to public markets such as traditional bonds as well as private markets such as real estate and infrastructure. However, it may not provide substantial diversification relative to public equities.

[4] Source: Cambridge Associates via IHS Markit, quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Bloomberg, as of September 30, 2023. Monthly returns converted to quarterly. Indices: Cambridge US Growth Equity, Russell 3000, Bloomberg Aggregate Bond Index, NCREIF ODCE EW Net, Cambridge Real Estate Composite, Cambridge Infrastructure Composite. For the period 1/1/2000 to 9/30/2023.

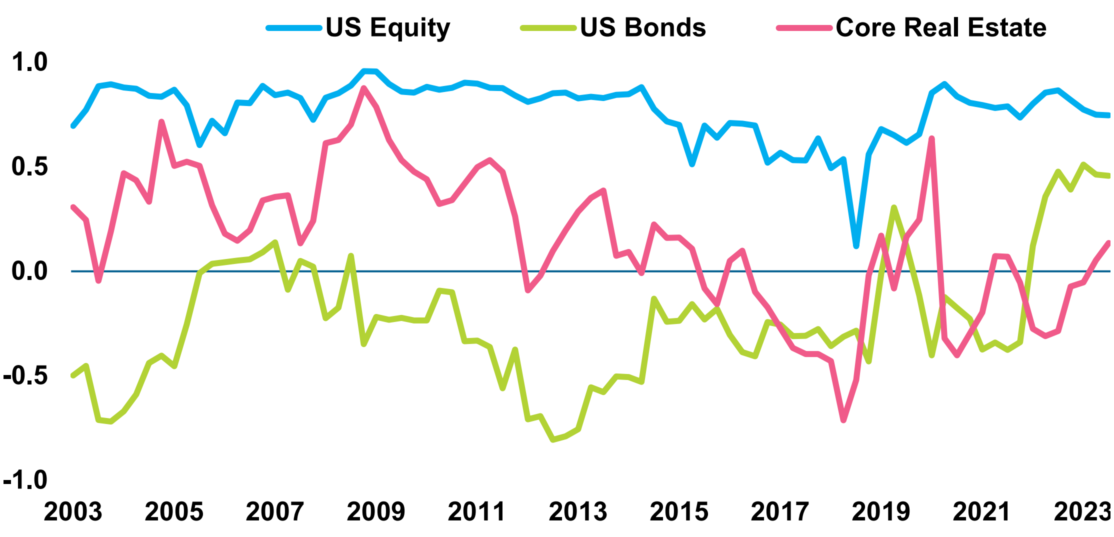

FIGURE 8
Major Assets' Rolling 3-Year Correlation to Growth Equity

Source: Cambridge Associates via IHS Markit, quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Bloomberg, as of September 30, 2023. Monthly returns converted to quarterly. Indices: Cambridge US Growth Equity, Russell 3000, Bloomberg Aggregate Bond Index, NCREIF ODCE EW Net.

When compared to other private equity strategies, growth equity has had an average correlation of 0.89 with venture capital and 0.66 with buyouts since 1993.[5] These high correlations are unsurprising given the similarities in the strategies as well as their common valuation approaches.

[5] Source: Cambridge Associates via IHS Markit, quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts. Period is 1/1/1993 to 9/30/2023.

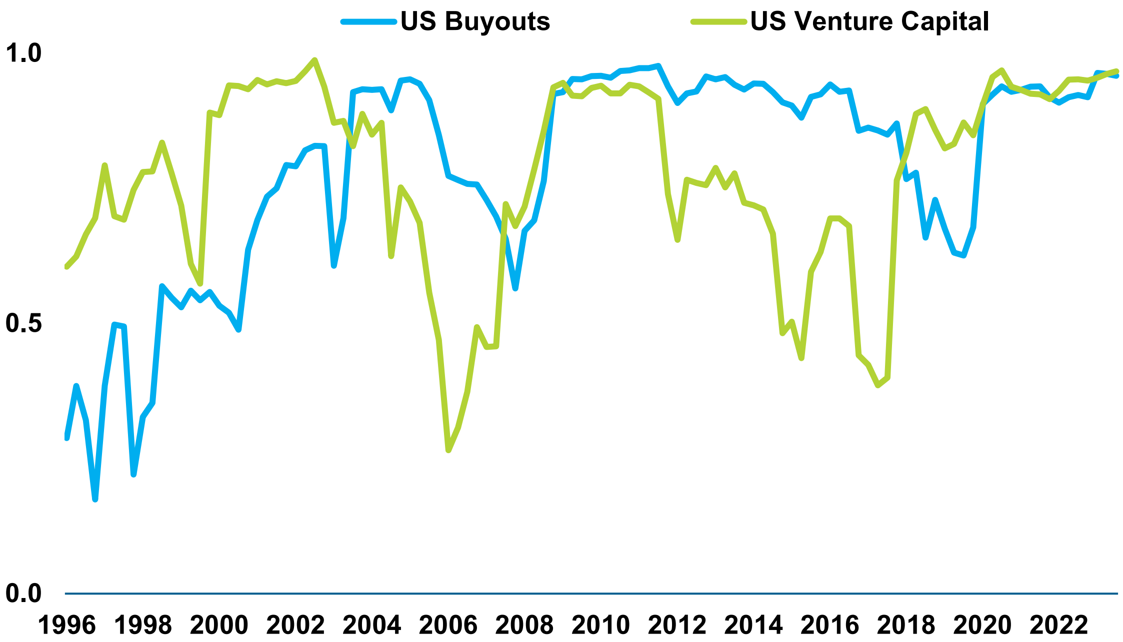

FIGURE 9
Private Equity Strategies' Rolling 3-Year Correlation to Growth Equity

Source: Cambridge Associates via IHS Markit, quarterly Pooled IRR as of September 30, 2023 (pulled in January 2024). Indices: Cambridge US Venture Capital, Cambridge US Growth Equity, Cambridge US Buyouts.

What are the risks?

Growth equity investments carry inherent risks, some of which are common amongst private markets and some of which may be unique to growth equity.

Some of the risks typically inherent to private markets include illiquidity and the "J-curve." As with other private assets, growth equity investments are often not publicly traded and thus cannot be easily sold or exchanged, thus creating a potential liquidity issue for investors.

Additionally, in the beginning, investments are generally carried at cost, and the investors might experience a small negative return, calculated as their initial investment minus the associated organizational expenses and management fees. Because of these initial negative returns, which typically turn positive, a graph of returns is usually J-shaped. This so-called "J-curve" is normal, and limited partners should expect this early in the partnership's lifetime. Other factors that investors should consider include their overall risk tolerance, or the level of risk that they are comfortable with in their portfolio, as well as their investment horizon.

There are also potential risks more niche and specific to the growth equity strategy. Unlike buyouts, which target a majority ownership position, growth equity investments are usually minority positions, which means investors have limited control over business decisions, potentially leading to conflicts with existing owners or management.

Another factor that investors should be aware of is market risk, as the success of growth equity investments is closely tied to the overall performance of the economy and specific market sectors. Growth equity tends to be focused on, though is not limited to, sectors such as technology, financial services, healthcare, and certain consumer sectors. Growth equity investments are generally expected to have longer holding periods, relative to buyout transaction, and the ultimate exit may be reliant on a strong stock market and IPO environment. In the absence of these factors, holding periods could be prolonged and additional investment capital could be deemed necessary.

There is also execution risk, where companies may fail to achieve their growth targets due to operational challenges or competitive pressures, leading to underperformance, and/or the investment of additional capital.

Furthermore, valuation risk arises when investors pay too much for an equity stake in anticipation of future growth that may not materialize at the expected level.

While there is no way to completely reduce these risks, there are several ways that investors can help to mitigate them. One such way is through diversification, both in terms of geography and sector focus, as well as by vintage year. Diversifying across vintage years can help investors reduce the impact of poor performance in a particular year or economic environment. This helps to mitigate risk and minimize the potential negative effects of a single vintage year's underperformance.

Moreover, developing pacing plans, following them, and regularly updating them, is considered a "best practice" for maintaining vintage year diversification. Lastly, comprehensive due diligence is crucial to mitigating these risks.

Summary

Growth equity falls between venture capital and buyouts on the risk-return spectrum for private equity strategies. Growth equity investments tend to be made in companies that are more stable than typically is the case for venture capital, while offering higher growth prospects than is typically true for buyouts. Growth equity also offers relatively high alpha potential. However, the large return spread between top and bottom tier managers acts as a double-edged sword, as below-average performance can significantly dampen returns.

For investors who can tolerate the risk profile and long-term illiquidity inherent in private equity, the case for including an allocation to growth equity in their private equity portfolio is compelling. Still, investors should be aware of the asset class's unique risks. As always, investors should conduct careful due diligence to make sure that investments match their objectives and constraints.

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