New Favorite of Global PE Investors, Balanced with Growth and Risk-Return Profile

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Abstract

Growth equity compared with the traditional leveraged buyout strategy has more flexible investment structure and superior return. The growth company is more mature in its product and business stage than VC and is less dependent on leverage than mergers and acquisitions, high-quality growth companies in the current interest rate hiking environment can generate stable cash flow and beat the pressure of interest rate increasing by growing well, and avoid the potential risks brought by high leverage. Growth funds show good resilience in the crisis and will be a good supplement to the PE allocation. The risk of growth strategy is between VC and traditional buyout with overall performance increased and the characteristics significantly improved. In PE asset allocation, a portfolio structure based on mergers and acquisitions and growth exposure should gradually be formed. Suggest to optimize PE investors’ portfolio and diversify their asset allocation, evaluate excellent growth managers in addition to buyout or secondary strategies. We can still have a good expectation on Growth funds which could be a very important part to overall PE portfolio. So the independent growth funds with excellent track record, growth strategy in large alternative platforms with strong networking and brand, high-growth sector-focus funds, Asia growth opportunities are pretty good categories which investors should pay more attention to. (The article represents only the author's opinion).

Keywords

Growth Equity, Venture Capital, Leverage Buyout, Asset Under Management (AUM), Dry Powder, Internal Rate of Return (IRR), Cash flow

Over the past decade, global private equity performed well and the returns on PE assets have rebounded after the 2008 financial crisis. PE funds outperforming the public market indexes. In early 2020, global central banks injected liquidity to the market stimulating all kinds of assets and investments, especially private equity has been benefited in the period of liquidity releasing, low interest rates environment (Preqin Global Private Equity, 2019). PE investments are highly active with rich dry powder and delivered splendid return. Investors are seeking more growth-based equity investments to meet their diversification needs compared with VC and traditional leverage buyouts.

In private equity, especially large and experienced buyout funds are more active, large GP funds are looking for big deals after raising enough capital. In particular, PE investment in 2021 undoubtedly set a new benchmark for the market in terms of the deal number, deal value, investment/exit pace and fundraising scale.

Not only in PE transaction volume, quantity and fundraising pace, but a large number of big M&A deals emerged.
such as the medical transaction Medline sponsored by Blackstone, Carlyle and Hellman & Friedman with transaction value of $30 billion, the number of deals over $1 billion doubled from 2020 to 2021, average size of a single deal increased by 57% on average (Cambridge Associate, June 2013).

Sources: Dealogic; Preqin; Bain analysis

**Figure 1.**

Although buyout firms performed well in the past decade, the risk gradually accumulated with low financing cost and friendly credit environment pushing up the asset prices, which make the future exit uncertain. For those large scale companies lack of growth and with cash flow shortage, future realization is in question, which forced GP and institutional investors to think about how to seek other diversified layout, they are searching for technology, healthcare or ESG theme funds and to diversity PE portfolio to mitigate the potential risk.

Growth equity funds have achieved the same good returns over the past decade compared with buyout funds and have gradually become a new favorite of global GPs and LPs. Given its low use of leverage, Global investors have focused on finding growth deals because growth strategy is in the middle of Mergers and Acquisitions and Start-up investment, its AUM in the past 20 years has doubled. In 2021, growth equity and VC strategy assets accounted for 82% of total buyout funds, especially growth equity and late VC strategy invested as unprecedented speed. The investment pace is faster than buyout strategy and the AUM in the past decade maintained about 20% of the compound growth.

**Figure 2.**

1. In the future, global PE investors will continue to increase their allocation in growth funds and late stage VC for diversification requirement and risk reduction purpose.

First, the release of global liquidity has helped M&A funds raised a lot of dry powders over the past three years, GP
fundraising scale increased, the pace of fundraising accelerated, abundant dry powder has forced fund managers to face huge investment pressure to spend money. Second, the number of high quality acquisitions in PE market is limited, competition between GP intensifies; Third, Loose monetary policy keeps M&A financing costs lower, low cost of capital has boosted leverage, it also accumulated risks; Fourth, LPs' commitments increasing and low financing costs can continue to push up the transaction prices, projects with high valuation in 2020-2021 will lead to serious exit problem and uncertainty in future market.

2. Characteristics and types of growth equity

Growth equity is a PE investment strategy between venture capital and leveraged buyout. It has both the high growth and the relative maturity of business with low developing or leverage risk. These features can obtain high growth exposure and be a great supplement to the traditional PE portfolio. Different from venture capital and leveraged buyout funds, the typical characteristics of Growth strategy include:

(1) The investment target is relatively mature with no early product development risk, and the business model has begun to take shape
(2) Revenue growth at least 10% or above 20%, which is already profitable or will be profitable in the next 12-18 months
(3) Such growth companies usually have not been invested in other PE firm and have been held by the founders from day one
(4) Using less leverage, GP usually invests in minority equity
(5) Some late-stage growth enterprises have begun to increase leverage or seek experienced investors for operational improvement.

At present, the growth private equity funds participating in the market mainly include three categories: Late VC / mixed strategy funds, Independent growth funds, Growth strategy in large alternative asset management platforms, Among them:

(1) Late VC / early growth mainly selects excellent management and a business model with potential development, Operational role is limited, Focusing on high-growth, VC-invested technology startups but with small investments size, Such as Sequia, Lightspeed, Softbank, etc;
(2) Independent growth fund was firstly appeared and became mature in the PE market, mainly focus on the relatively mature stage of technology, healthcare or other growth product leading enterprises, they have strong data mining capabilities such as “Cold Call” deal sourcing and CRM systems, and to improve the necessary operation with minority equity investments and have acquired outstanding past performance, such as Summit, TA, TCV;
(3) The growth funds under large platforms often have high scale, good platform brand effect and operation improvement ability, and the investment strategy is mainly minority equity, such as Blackstone BXG, TPG Growth, Apax Digital, KKR NGT, etc.

3. Growth fund fundraising situation and investment performance

In recent years, the proportion of growth equity investment in PE market has increased year over year, which is not only due to the needs of GPs and LPs, but also the allocation optimization requirement in the market environment. Among them, the number of growth funds raised by more than US $1 billion has increased in recent year, including Blackstone, Carlyle and other large GPs, they have begun to raise growth strategies and the fund scale continues to reach new highs.

In terms of return, in the past 20 years, the return of growth funds was flat but now have surpassed the buyout funds. Especially after the previous economic fluctuations, growth funds have achieved a rapid rebound in performance with financial support, and the performance dispersion of M & A funds is higher. Before the 2008 financial crisis, as there was a gap between the growth performance and buyout funds. With the continuous development and maturity of the growth strategy, its income gradually increased and surpassed the buyout strategy.

According to Bain capital and Cambridge Associates research report, as of June 2021 US growth PE in the past 3,5,10 years and 15 years returns beyond the buyout fund, long-term 10-15 years of internal return also consistently higher than buyout, which to some extent reflects the strategy of enterprise growth premium and long-term performance. Especially in the past 3 years, the return of growth strategy was particularly prominent. From 2019 to 2021, the whole PE market had active investment, the pace of fund raising and investment accelerated, the transaction volume soared and some projects benefited from listing and exit, and the overall internal rate of return in Growth equity was significantly higher than traditional leverage buyout funds.
The underlying reasons for high returns in growth are: it relies less on leverage, growth deals have no clear requirement for control and use of leverage.

Founders, management team and investors share the same goal and relying on capital investment to continue to drive growth, this puts a large number of companies out of their early stages and establishing a business model that fits industry trends and strong market needs. They will be quickly supported by private capital to achieve a rapid expansion and as the scale expands, the line between growth and acquisition becomes blurred, there are more opportunities for mass growth and can reshape their competitive advantage by using patented technology, huge capital support and operational improvements. This explains why new unicorns or high quality growth companies over $1 billion emerge almost every day in the market, rather than a few times a year.

At the same time, these growth companies prefer to keep privatization for longer time, compared with expensive and time-consuming IPO program, private capital can provide support for these enterprises at any time, these companies can gradually come into late growth stage, pushing up the market average transaction size and price. In terms of the industry, the technology-driven sectors have occurred rapidly growth and changed the ecosytem especially since the 2020 Covid outbreak. The tech-enable companies have received more than one-third of capital support from the market. In addition to tech, there are also healthcare, consumer, business services and financial sectors also influenced by technology such as HCIT, consumer tech, FinTech and energy technology transformation. Over the past five years, the tech sector has grown by 32% in CAGR.
Growth equity funds in terms of their performance are not only reflected in the improvement of IRR, such as late VC raised and growth equity raised since 2010 have realized large size, the average internal rate of return has exceeded all kinds of large and medium-sized buyout funds (as the figure below), at the same time growth fund in the capital return (DPI) scale also beyond buyout strategy funds.

The above analysis shows that the growth strategy has a more flexible investment structure than the traditional buyout strategy and has the similar return as buyout strategy looking from a long run. From the risk aspect, due to the business model of the companies are relatively mature compared with VC and early growth, and they are using less leverage, then in the current market environment with high pressure of interest rate increasing, growth companies can generate stable cash flow and beat the cycle impact by growth and avoid the losses of high leverage amplification risk. The current loss rate of growth funds is close to buyout funds and their performance showed good resilience in times of crisis (GLOBAL PRIVATE EQUITY REPORT, 2022). So we still have a good expectation on Growth strategy and they should be an important part to PE allocation.

4. Future allocation recommendations for growth funds:

First, the independent growth funds with excellent track record are recommended. The return of growth funds tends to be stabilized, but the number of growth funds in the market is large with uneven quality, the performance dispersion is high. Therefore, we should continue to choose those funds with excellent track records, mature investment strategy and experienced team.

Second, pay attention to the growth strategy in large alternative platforms. These GPs have strong networking and famous brand with rich resource advantages over years, those natural advantages are important which other small and medium-sized growth funds do not have, including talents recruitment, resource reserve, regional layout and operation improvement capabilities. Such as KKR, Blackstone, Carlyle, TPG, Apax, etc., these GP tend to raise larger scale funds recently (Hamilton Lane 2022-Market-Overview).

Third, continue to evaluate high-growth sector-focus funds. As mentioned above, software services and high-tech sub-sectors can not only outperform in the uncertain market, but more importantly, they have realized strong and stable cash flow, good customer base, especially in the current market, public market volatility can lead to an uncertainty of IPO exit channel, to invest in growth and avoid high leverage risk and earn another way to cash out or distribute dividend. Unlike the traditional industry, they oppositely has great pressure with low growth potential (Bloomberg Data, 2022).

Fourth, we should evaluate opportunities in Asia. Asian market is growing rapidly with large number of fund managers in differentiated strategies, including local Asian firms and large fund platforms such as KKR, Blackstone, Carlyle and Bain. Regions including India, China, Japan and Southeast Asia have different industry development characteristics, GPs with regional resource advantages and investment strategy are also competitive. Overall, TMT, business services, consumer and financial sector in Asia maintained high growth rate, for example, India and China have seen strong for-
eign inflows in recent years, including US $25 billion in 2020, the highest level in a decade. Overall, the risk of growth strategy is between VC and traditional buyout, the risk is lower than VC and does not rely on leverage, the overall performance increases and the characteristics is significantly improved. In the event of crisis, growth equity assets reflect good resilience. In PE asset allocation, a portfolio structure based on mergers and acquisitions and growth exposure should gradually be formed.

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