StepStone RPM Ep 21 Transcript

Michael Venne: [00:00:00.12] Welcome to RPM, the podcast that explores the world of private markets. I'm your host, Michael Venne. When investors think of safe havens, they may consider gold or infrastructure or real estate and other tangible assets that many consider to be uncorrelated with traditional equities or hedge against unexpected inflation. But what if I told you growth equity is an equally compelling strategy to consider during times of economic uncertainty. Joining me today to discuss why is John Coelho a partner on our venture capital and growth equity team. John, It's good to have you. Welcome to RPM.

JC: [00:00:34.35] Thanks, Michael. It's good to be here.

MV: [00:00:36.21] John, before we begin to try to convince listeners of growth equities resilience, let's start by defining it. We wrote our first paper on growth equity in 2014, which was really a call for investors to regard it in the same light as buyouts or venture. As I understand it, the definition of growth has changed somewhat over the years. Could you briefly describe this evolution and how investors think about this strategy today?

JC: [00:01:01.11] Sure. I mean, the definition of growth equity has always been one of our favorite terms to debate, because it's a term that means different things to different people.

The classic definition of growth equity has historically been minority equity investments and founder owned or so called bootstrapped or self-funded businesses. These were typically lower middle market companies, especially in the tech or health care sectors, but also in other sectors such as consumer or financial services. The US has historically been the largest and most developed market for growth equity, but the strategy has also been very prevalent in emerging markets, such as China. We see a dynamic where founders of these high growth companies are hesitant to sell control in these businesses because of the upside they see.

We often hear the term growth equity applied in the VC ecosystem to refer to late-stage rounds and companies after they've built a product, achieve product market fit and are seeking expansion capital. That said, at StepStone, we prefer to draw a bright line between venture capital and growth equity based on a company's profitability level, because companies that require further equity funding simply have a different risk profile than companies which are self-sustaining and don't require ongoing equity financing. So, it's helpful to have that bright line in our view.

So, growth equity for StepStone represents this Goldilocks sort of strategy that borrows from venture in the sense that the investments are often minority non control and they target high growth assets. But growth equity also has some characteristics typical of private equity and buyouts in the sense that these growth companies have meaningful free cash flow and EBITDA. We believe this risk reward is quite compelling as the expected loss rates are much lower with cash flow and growth equity businesses than a typical venture backed company and unlike buyout deals, the growth companies typically don't rely on leverage to generate their return. And what we've seen since we first published that growth equity piece several years ago was and really over the last decade plus since the global financial crisis has been the rise of software as a target sector within private markets.

Software is now the fastest growing and best performing industry sector in the buyout market and most major buyout investors are active in software and are increasing their activity. On the venture side of software, we've also seen the rise of the mega platform companies. In enterprise SaaS and consumer Internet, these platforms that are reaching a scale that we've never seen before and while continuing to grow profitably north of 20% year over year. So as software has eaten the world, to borrow a phrase from Marc Andreessen back in 2011, we've seen software evolve from a niche within venture capital to the most important and best performing category within private equity, be it buyouts or growth equity. Software has these critical attributes of very high gross margins, oftentimes recurring revenues if it's a SaaS model and over time, lenders have come to understand these business models and now willingly extend credit to PE buyers to execute on software acquisitions.

So, what we've seen now with the rise of software is a major bifurcation of the growth equity market. On the one hand, we've seen larger and larger transactions in software. The cohort of classic growth equity managers we follow, these GP's have increasingly sought to take control of their companies and not just be a passive minority investor. By having control, it enables the GP to impact management more directly, but also to do things like seek add on acquisitions, and to consolidate fragmented market segments and therefore they're more rapidly building up these lower middle market companies to a scale where they're attractive acquisition companies for the larger buyout funds. So that's sort of one side of the growth equity coin has really become critical deal flow to sell into the to larger private equity funds. On the other side, it has the rise of these venture growth platform companies. These are the most elite venture backed software companies that are continuing to scale and raise equity capital in the private and public markets. A subset of these platforms is actually cash flowing businesses, who until very recently have typically sought to optimize their top line revenue growth as opposed to cash flow, and they're clearly focused on the IPO market as their exit path. And so, what's happened with the rise of software is kind of a hollowing out of classic minority growth equity investing. This style of just add water to good companies and not do much post investment. That style is no longer as prominent. Classic growth equity has shifted more to growth buyouts. And then there's also this subset of household names, market leading kind of venture growth platforms that have achieved this massive scale. So that former bucket is really, really connected to the private equity market, and that latter bucket is really connected to venture capital.

MV: [00:06:47.91] I want to stick with the topic of software for a bit longer. Over the years, I've often heard you talk about tech trends and the effect on capital efficiency. Owing to things like the cloud and mobile platforms, there's been major changes in the venture space. How have these technological changes affected growth equity?

JC: [00:07:11.64] Yeah, great question because I think a lot of people focus on the changes in the tech stack and how that has driven dramatic evolution in the venture market. So, with the rise of the cloud, open-source software, and mobile platforms like Android and iOS, you know, this is infrastructure that startups can use to iterate, to experiment. And so, the cost of starting up has come down dramatically since the late nineties, for example. So that has kind of fed this renaissance in seed stage venture. Those trends also apply to the growth equity market. I mean, we don't typically think about it as impacting growth equity, but founders operating in the growth equity category, they're leveraging the same trends, these same advancements in the IT tech stack to become more efficient, productive, and it's enabled them to start and grow their businesses oftentimes without raising any capital. And so, we see capital efficiency impacting both early-stage venture, but it's also impacted this founder led technology growth equity sector as well.

MV: [00:08:36.54] That's really, really interesting. I'd like to dig into, I guess, growth equity's role in capital markets. There seems to be a bit of chicken or the egg going on here, right? I mean, has growth equity grown in stature because companies have a viable alternative to going public or companies opting to stay private longer because growth equity exists? What do you reckon?

JC: [00:08:57.33] I think this idea of growth equity as an alternative to an IPO is more applicable to that venture growth cohort that I described. Now that the public markets have corrected materially in 2022, I do expect that private growth companies will be more hesitant to pursue an IPO and they will turn to late-stage VC funds and larger growth equity and tech buyout funds for this funding. However, the bulk of the companies we're talking about when we consider growth equity, I mean, they really are lower middle market software and tech enabled services companies. Most of these companies will not seek a liquidity event through an IPO. M&A has always been the most common exit path for classic growth equity companies. And what's changed with the rise of software and the increasing interest from PE buyers is that these M&A exits are now increasingly being executed by buyout funds and not just large technology companies. I mean, that we think that is a critical point when we think about the risk profile of growth equity compared to venture capital and buyouts. Growth equity companies are not reliant on the venture market for funding. They're not reliant on the IPO market for exit liquidity. And we know there's a tremendous amount of dry powder sitting in large buyout funds coffers currently and that these players have become the most logical acquirers of growth equity backed software companies. And we think this is a very attractive dynamic for growth equity investors, that they have a clearer path to an exit. There's a wide range of potential buyers and this is despite the challenged state of the public markets today.

MV: [00:10:41.44] Let's talk about performance. In a new research report that we hope to have published by the time this airs, we describe growth equity as offering the best of both worlds, something you've touched on earlier, venture upside with buyout risk. Could you talk a little bit about the growth equity's performance in both absolute terms and relative to other private equity strategies?

JC: [00:11:05.62] Sure. I mean, if you look at the 25,000 plus realized deals in StepStone SPI database across venture capital, growth equity, and buyout, you will see that the growth equity cohort outperformed both venture capital and buyout and software as a category outperformed other industry sectors. The overall growth equity realized multiple in this cohort of realized deals was 2.6 X with a 19% loss rate and this compares to 2.3 X realized multiple for both buyouts and venture capital. So, a higher multiple in growth than both buyouts and venture capital. It's worth noting that the buyout loss rate in that cohort was 20% or slightly higher than growth equity. And of course, the venture capital loss rate was significantly higher at 41%. And we think this data really underscores why growth equity is a compelling risk reward proposition for investors and that it offers, as you said, that the upside potential of venture capital with the risk profile of traditional private equity or buyouts. And when you consider that most growth equity businesses are unlevered, this also reduces the risk profile relative to buyouts, which typically are much more reliant on leverage.

MV: [00:12:36.61] Granted, a lot of this outperformance occurred during the bull market that ran from the end of the financial crisis up to the start of the pandemic. That is to say, when investor sentiment was positive and the outlook was more certain. Things are a bit different today. Supply side inflation is still high, interest rates are rising, stock values have fallen, and investors are turning to things like real estate and other uncorrelated assets. Here's our topic du jour: John, why do you believe growth equity is a compelling option for investors in times like these?

JC: [00:13:12.91] My view is that growth equity is particularly attractive during periods of market dislocation and uncertainty. Again, growth equity companies are less reliant on the capital markets for funding as remember they're profitable and self-sustaining businesses. They don't require ongoing equity funding like venture backed companies do, and also, they're unlevered or under levered businesses, which means they're also less reliant on the credit markets. Of course, it's true that technology is out of favor in the public markets currently, and multiples have compressed dramatically in recent months. The carnage we've seen in the public markets has been most acute with the cash-burning unicorns and SPACs, however, I mean, profitable companies have seen much more muted adjustments to their valuations. The secular trend of software aiding the world is not likely to shift in any meaningful way. In our view, in the coming years. I mean, the cloud, internet of things, artificial intelligence, machine learning, the trend towards e-commerce, these are trends that we believe will continue. And software and tech enabled services companies providing a mission, critical application or services to business continues to represent an attractive investment opportunity for private markets investors in our view. I mean, founders of growth equity businesses have many options for how and when they raise capital. I do expect that many founders will choose not to raise capital during this initial period of dislocation. You know, of course, many venture backed companies do not have this luxury. They need to raise capital to keep the lights on. But when you have profits, you have a degree of flexibility. So, I mean, even if that's growth equity founders are not wanting to pursue transactions in the current environment. Over time, I do believe the market will adjust. Sellers will come to accept the new normal and we should see meaningful investment activity in the growth equity sector in the coming months. So, in summary, I would say we believe growth equity is very compelling in the current environment because it's focused on cash flowing businesses delivering this mission-critical application, or service and we expect entry valuations to be more attractive in this category than we've seen in recent years.

MV: [00:15:38.04] John, before we go, I have one final question. The last thing I want is for people to come away from this thinking there's an either-or approach to growth and venture or growth and buyouts. Could you quickly explain why it is important for investors to diversify their portfolios across private equity strategies?

JC: [00:15:57.99] Sure. I think for us, diversification is all about risk reduction and creating a basket of exposures that can perform differently in different market environments. So having exposure to the US, Europe, Asia, and other markets is important if you want to build global private equity exposure. Similarly, with respect to private equity strategies, our clients are typically building private equity portfolios that contain meaningful exposure to buyouts at various sizes- small, middle market, large market, and venture capital at various stages- seed, early, late stage. We also encourage our clients to develop meaningful exposure to growth equity because it offers these compelling risk reward characteristics and we believe the category can continue to perform well in a variety of economic environments.

MV: [00:16:50.01] John, it looks like we're out of time. Thank you as always for joining us today. Be well and looking forward to the next one.

JC: [00:16:56.73] Thanks for having me, Michael.

MV: [00:16:58.32] That does it for this episode of RPM. If you want to learn more about growth equity, head to StepStoneGroup.com where you can find all our research on it and other investment strategies. RPM is available on Apple Podcasts, Spotify, Stitcher, and other podcast platforms.