Growth Equity Market Appears Primed to Shine, But Beware of Slippery Rocks

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KEY TAKEAWAYS

- Growth equity may be entering a golden age as innovative companies that delayed fundraising over the past year or so return to market, creating excess demand for capital
- To generate consistent above-market performance, we believe growth equity managers must exhibit three specific traits
- Growth equity investors should undertake due diligence to ensure the growth equity managers they work with have the right characteristics to outperform

Rapid evolution over the past few decades has contributed to confusion about what exactly growth equity is as an investment strategy.

A majority would likely agree that growth equity sits between early-stage venture capital (VC), which generally focuses on businesses at the creation stage, and buyout, which typically targets more mature, profitable companies.

One common definition is that growth equity managers take significant minority positions in growing technology companies that haven't scaled through the traditional VC formation process. At Adams Street, we define growth equity as investing in minority positions in venture-backed companies with rapid growth, an efficient and scaling sales model, meaningful revenue scale, and market-leading potential.

Why Growth Equity Could Be Primed to Shine

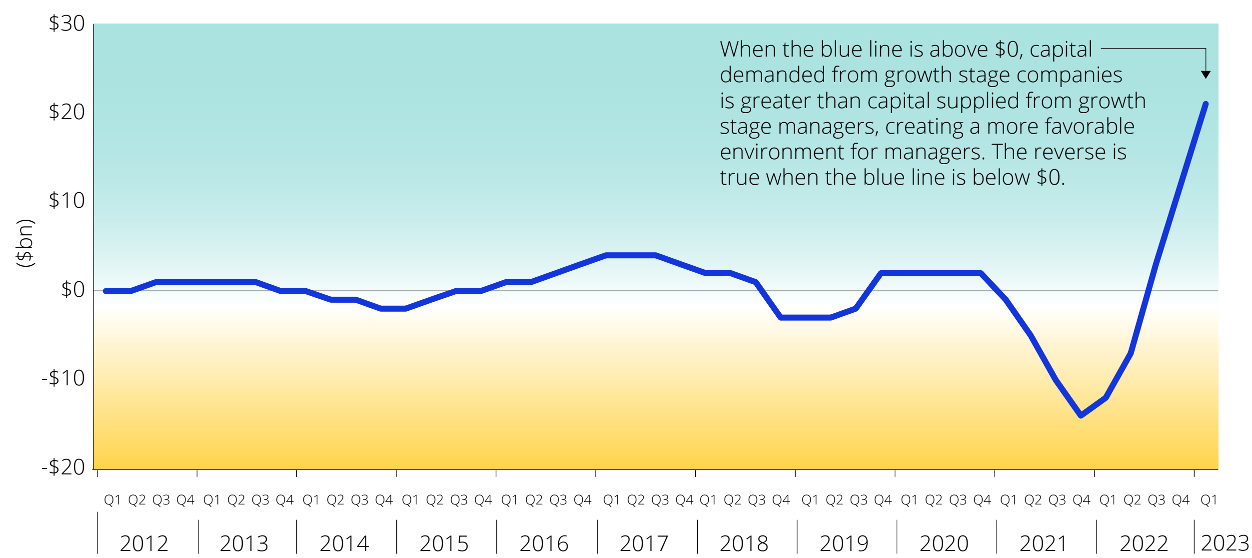
At Adams Street, we've been in the fortunate position to observe the intricacies of the growth stage ecosystem over several market cycles, when there have been great as well as less attractive times to invest. In our view, which period we are in tends to be largely determined by two (mostly) independent factors.

The first is the state of technological innovation, which provides the basis for managers to make compelling investments. While it is difficult to predict the "what" or "when" of each innovation cycle – be it smartphones, the Internet, cloud computing or generative AI – technological innovation is an immutable force that compounds over time, which can provide larger and ever more significant value creation – and capture – for companies and their managers over subsequent decades.

The second factor is the balance, or ratio, between the supply of capital provided by growth managers, and the demand for capital by growth companies. In late 2020, supply of growth capital outweighed demand, which is why we saw the size of capital rounds balloon and valuations skyrocket. That imbalance has now reversed so that today – and, in our opinion, likely for the foreseeable future – demand for growth capital far outweighs supply.

Figure 1: Excess Demand & Constrained Supply Creates Massive Market Opportunity[1]

US Late-Stage VC funding gap (12-month rolling average)



Three Key Reasons

We think there are three key reasons for this recent reversal:

- In late 2022 and early 2023, the valuation reset encouraged many growth companies to delay fundraising. Many of those companies now need to raise capital because their cash balances have dwindled
- Over the past handful of years, an active and vibrant early-stage VC ecosystem funded a significant pipeline of promising and highly innovative companies. As these companies mature and grow, many will graduate into the growth stage and require capital to continue their trajectory
- For numerous reasons, many non-traditional growth equity participants have left the market. In 2022, their share of deal volume fell, in our opinion a trend that is likely to continue in 2023 and beyond, reducing the pool of available capital to growth stage companies.[2]

This supply/demand dynamic is so important because it significantly influences investment returns. Owing to the current state of technological innovation and the current supply/demand dynamic, we believe we could be at the onset of one of the best investing environments in almost a decade.

Beware of Slippery Rocks

Past returns of growth equity managers can give investors a false sense of security. Robust economic conditions over the past decade allowed many managers to experience unrealized mark-ups (as well as lower loss rates) in their portfolios. But the economic climate has changed, which is likely to put pressure on many managers' portfolios.

As in other corners of the private market, it can be challenging to identify growth equity managers that can replicate performance in a more testing environment. In our experience, three factors help to distinguish growth equity managers:

- A differentiated platform for sourcing and – importantly – winning deals;
- A disciplined approach to underwriting across market cycles; and
- An experienced team to help navigate and capitalize on changing market conditions

We have found that a deficiency in any of these critical characteristics is more likely to lead to below-average returns. Problem is, pinpointing the specific cause can be challenging. One way is to conduct thorough diligence on a manager's existing portfolio by evaluating four factors that we believe provide significant insight into a manager's strength and expertise.

Revenue Growth

When assessing the health of a business, focus has recently shifted in the direction of profitability, but revenue growth remains an essential metric. Revenue growth shows that a company has built a product customers love, or demonstrates an ability to rapidly grow into – or past – its last round valuation. Perhaps most crucially, strong revenue growth meaningfully increases a company's access to future capital in both private and public markets. Managers still place a substantial premium on revenue growth because it is a primary source of returns for growth stage companies, allowing managers to potentially capture additional upside above modeled returns.

Revenue Scale

The next diligence component to focus on is assessing revenue scale of businesses in a portfolio. Scale provides optionality for a company. When a business deviates from a manager's underwriting case – whether that is due to market, competitive, or execution challenges – scale allows it to drive towards profitability more easily and efficiently. A larger company can more readily right size its cost structure relative to its topline revenue than a smaller company, which should allow the bigger business to control its destiny more effectively by using profits to fuel growth.

Cash Runway and Burn

Cash is king. Always has been, always will be. And this metric becomes still more important when the fundraising environment is challenging – no company wants to fundraise when they are desperate for capital because it shifts the negotiating power away from them. Cash also allows a company to invest in growth opportunities to scale faster, develop a more robust and innovative product roadmap, or be more acquisitive, all of which can increase the likelihood that it delivers positive returns for the manager.

Deal Terms

While the first three diligence ingredients revolve around assessment of the business, equally important is deal analysis. During the "go-go-up-and-to-the-right" days, deal terms received little attention, given the limited impact they seemed to have on a manager's performance. But in today's environment, deal terms have the potential to boost downside protection. At a high level, we think three items are worthy of diligence on this topic:

1. **WHAT SECURITY – PREFERRED VERSUS COMMON – IS OWNED BY THE MANAGER FOR EACH UNDERLYING PORTFOLIO COMPANY?**
   This matters because common stock doesn't come with the rights and privileges afforded to preferred shareholders. For example, preferred shareholders can have the right to receive proceeds before common stockholders in a liquidation.

2. **DOES THE MANAGER HAVE PROTECTION AGAINST AUTOMATIC CONVERSION FROM PREFERRED TO COMMON?**
   In frothy markets, managers can overlook conversion terms. Preferred shares sometimes can be converted by the various classes of preferred voting as a class, which materially benefits earlier shareholders. In other cases, the conversion requires voting as the particular series of preferred – which provides significantly more protection to growth stage managers but also sets up potential stand-offs between shareholders with differing classes of preferred. Given most institutional shareholders will own more than one class of preferred, understanding the economic motivation and voting thresholds is paramount. This is complicated.

3. **DOES A COMPANY'S TOTAL PREFERENCE ISSUANCE EXCEED ITS VALUATION?**
   When a company's total preference is greater than the valuation of the company, the equity value becomes impaired. There are many implications to this, perhaps the most important being that it can become difficult to retain key executives. When employees realize their stock options are far out-of-the-money, they might be financially motivated to leave the company.

Conclusion

In our view, robust innovation trends coupled with a favorable ratio of capital demanded to capital supplied are likely set to create one of the best growth stage investing environments in recent memory.

Such investment periods don't come around often, making it critical for managers to take advantage of the opportunity. To do so, we believe growth equity managers must possess three key characteristics: a differentiated approach to originating and winning deals; a proven approach to underwriting; and an experienced team that can execute against the opportunity set. Conducting diligence on a growth manager's existing portfolio is also essential to expose the absence of one or more of these critical traits. ■

1. Source: Q1 2023 PitchBook-NVCA Venture Monitor.
2. Source: PitchBook "Q1 2023 Analyst Note: When Dry Powder Stays Dry."