

Revisiting the growth equity market opportunity

February 2025

When we wrote our last [whitepaper](#) on growth equity in 2022, we highlighted its compelling historical returns and low loss ratios, as well as the macro dynamics that we believed would support strong performance into the future.

Since then, the economic landscape has changed dramatically. Rates are higher. Distributions are lower. Fundraising for all asset classes is more challenging.

Yet despite these forces, growth equity has continued to deliver on investors' expectations for venture-like upside with buyout-level risk. In this paper, we revisit our prior conclusions and the extent to which they still hold true in today's environment, and seek to provide LPs with some guidance on how to navigate this niche of the market.

What transpired?

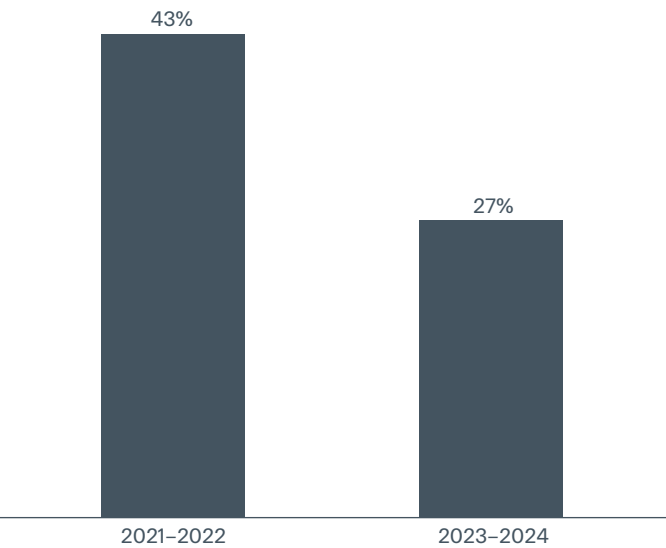
Inflationary environment slows fundraising

As inflationary forces accelerated throughout 2022 and into 2023, central banks around the world initiated rapid interest rate hikes, highlighted by the US Fed raising rates by over 500 basis points during the period. Liquid markets adjusted accordingly.

- The NASDAQ fell about 30% from its peak in late 2021 to its trough in mid-2022, as investors saw better relative value and safety in yielding assets.
- The decline in public equity markets, coupled with delayed downward valuation pressure in the venture and growth market, led to the denominator effect whereby institutions found themselves overallocated to the private markets.

The confluence of these events brought venture capital and growth equity fundraising to a halt. Allocations to the two sub-asset classes declined 37% in the past two years versus the prior two years (**Figure 1**).

FIGURE 1: VENTURE-GROWTH FUNDRAISING AS A % OF PRIVATE MARKETS TOTAL



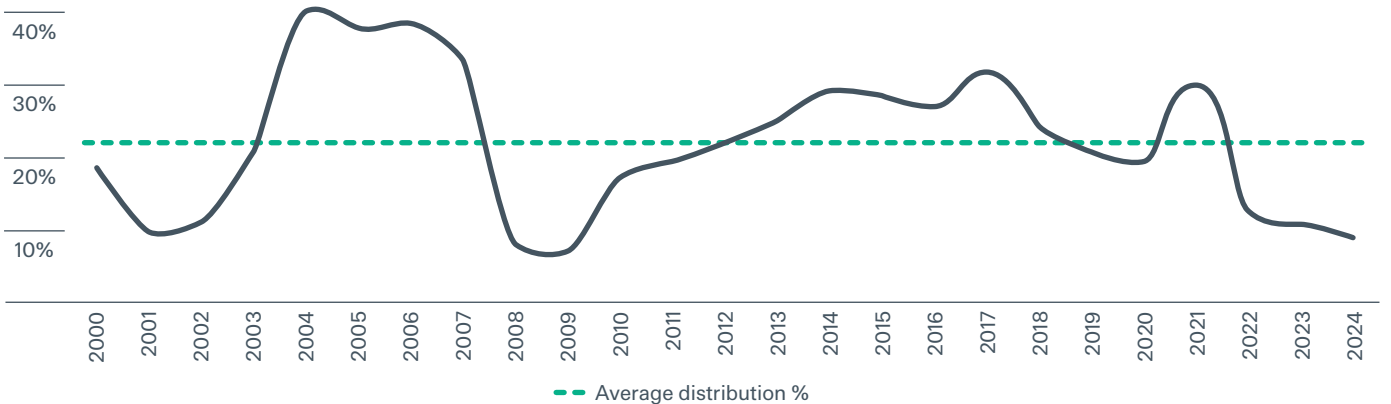
Source: Preqin as of November 2024.

Historically low liquidity environment

Similarly, M&A and IPO activity slowed significantly as rates increased. This led to a substantial decline in liquidity across

the private markets that continued into 2024. SPI by StepStone suggests the annual rate of distributions relative to the unrealized value of an investor's private equity portfolio was just 9% in 2024. This represents the lowest distribution rate since the Global Financial Crisis, nearly 60% below the 10-year average of 22% (**Figure 2**).

FIGURE 2: PRIVATE EQUITY DISTRIBUTIONS AS A % OF PRIOR YEAR NAV

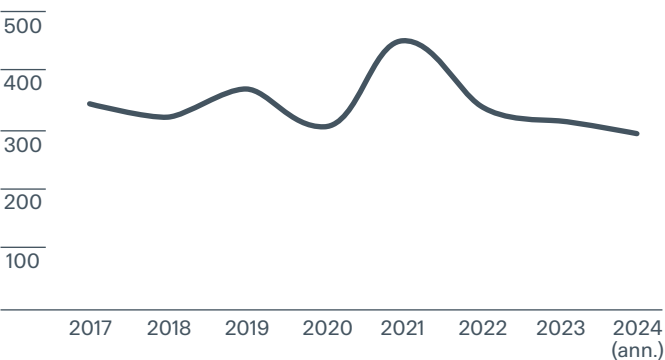


Source: SPI by StepStone as of November 2024.

Financial sponsors: a bright spot in the lower middle market

Despite this overall slowdown in liquidity, a different story emerges when examining the activity levels of financial sponsors acquiring lower middle market companies.¹ According to PitchBook, private equity firms’ appetite for these businesses has remained resilient, declining only 8% in the past three years compared with the three years leading up to the pandemic (Figure 3).

FIGURE 3: NUMBER OF PE-BACKED ACQUISITIONS (\$100M–\$1B IN SIZE)



Source: PitchBook data & StepStone analysis as of October 2024.

Our experience in our growth equity practice parallels market trends. In the past three years, 46 of our direct growth equity investments have been fully or partially acquired, resulting in \$2.7 billion in proceeds, which represents a 22% annual rate of distributions relative to the value of our growth equity portfolio during that time. We believe the resilience of the growth equity space is in part related to the profile of the companies targeted for investment.

- Most are founder-owned businesses with robust top-line growth, strong gross margins and minimal leverage.

¹ Defined as companies with a TEV between \$100 million and \$1 billion.

- These characteristics engender defensibility throughout business cycles; minimal debt ensures that returns will not suffer in a rising rate environment; less reliance on the IPO market for exits compared with other private equity strategies means liquidity droughts are fewer and farther between.
- These dynamics are best explained by growth equity’s consistently low loss ratios, which have averaged 9% since 2014, relative to 19% for late-stage VC transactions, and in line with buyouts at 8% (Figure 4).

FIGURE 4: LOSS RATES BY ASSET CLASS



Source: SPI by StepStone as of November 2024. Includes all realized transactions categorized by investment year.

To be sure, further maturation of more recent vintages is necessary to definitively conclude whether this loss ratio trend has persisted through the business cycle. However, we believe that the increasing cost of debt beginning in 2022 has affected growth equity transactions less than buyouts, which tend to use more leverage. Therefore, when we look back on this era, we suppose loss rates for growth equity transactions will remain in line with, if not lower than, buyouts’.

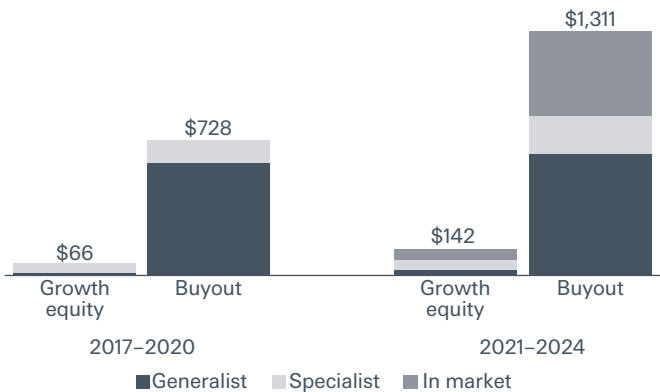
The same, but different

Downstream dynamics

In 2022 we highlighted the abundance of available dry powder held by larger, downstream private equity firms that invest in tech assets. Our thesis was that these firms would be natural acquirers of businesses backed by small and midsize growth equity managers willing to take the risk of institutionalizing small, founder-owned businesses.

Over the past two years that trend has played out, further underscoring the resilience of the exit opportunities for the growth equity space. Since the start of 2021, over \$900 billion has been raised by private equity funds capitalized at over \$1 billion. Combined with managers in the same category who are currently in market, we estimate outstanding dry powder in excess of \$1.3 trillion (Figure 5). For growth equity GPs, this large pool of capital should continue to support demand for lower middle market businesses with strong operating metrics, thus creating an exit environment that is active compared with other areas of private markets.

FIGURE 5: CAPITAL INFLOWS TO >\$1B TECHNOLOGY BUYOUT AND GROWTH EQUITY FUNDS (IN \$BILLIONS)

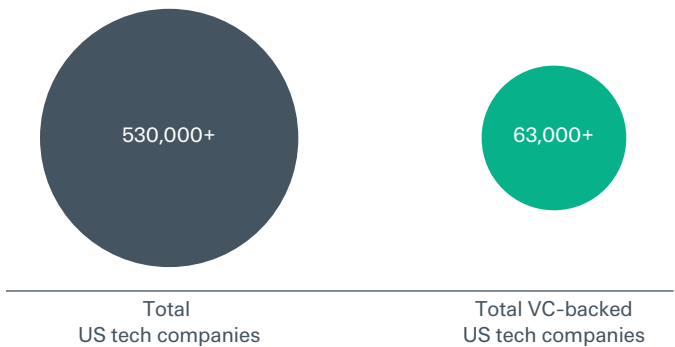


Source: SPI by StepStone as of November 2024.

Stable and healthy supply of potential investments

In 2022 we also noted that despite the increasing prevalence of growth equity as a stand-alone asset class, roughly 90% of US technology companies operate outside the traditional VC ecosystem, meaning that growth equity investors have ample opportunity to invest in emerging technology businesses (Figure 6). This dynamic remains the same today. We believe the universe of bootstrapped tech companies may even expand in the near term given the dramatic pullback in the capital raised by VC funds over the past two years.²

FIGURE 6: TOTAL US TECH COMPANIES



Source: PitchBook data as of November 2024.

Large-cap private equity firms continue to acquire businesses backed by small and midsize growth equity managers, underscoring the resilience of exit opportunities in the growth equity space and sustained demand in the lower middle market.

² StepStone analysis of data from Zippia and PitchBook, November 2024.

A growing opportunity doesn't necessitate fund size growth

Revisiting scalability

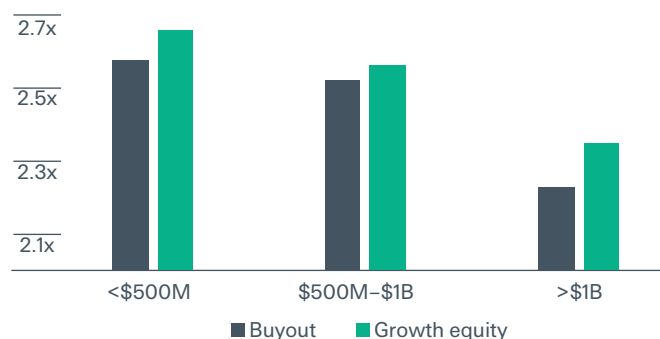
As is typical across private markets, successful growth equity firms of the past decade have grown fund sizes in subsequent vintages. SPI by StepStone data shows that median growth equity fund sizes have roughly doubled over the past 10 years.³ To successfully execute strategies with increasingly large pools of capital, managers are forced to refine their approach.

- GPs have a few different options, but most must invest in larger businesses or pursue greater ownership positions.
- Larger businesses tend to be more institutionalized with limited top-line growth.
- Their size, the health of their balance sheets, and the knowledge of their management team in many cases allow them to invest in technology and optimize processes.

These dynamics can limit the number of available levers that growth equity GPs use to drive alpha relative to investments in smaller, less institutionalized businesses. GPs pursuing controlling stakes in portfolio companies also may find themselves competing with, rather than selling into, the wall of dry powder raised by downstream buyout funds. When we layer these trends over the backdrop of simple “fund size math,” which dictates that smaller funds require fewer heroic outcomes to generate alpha, it’s unsurprising that SPI by StepStone data shows most top-quartile growth equity funds since 2011 have been “micro growth equity” funds under \$500 million in size. Since 2017, over 60% of top-quartile funds have come from the smaller end of the growth equity market.⁴

When we updated the analysis from our 2022 paper, which examined the scalability of growth equity compared with buyouts, we found that growth equity continues to outperform buyout funds at all fund sizes (**Figure 7**). However, growth equity performance today is showing greater levels of degradation as fund sizes grow—further underscoring the correlation between fund size growth and underperformance.

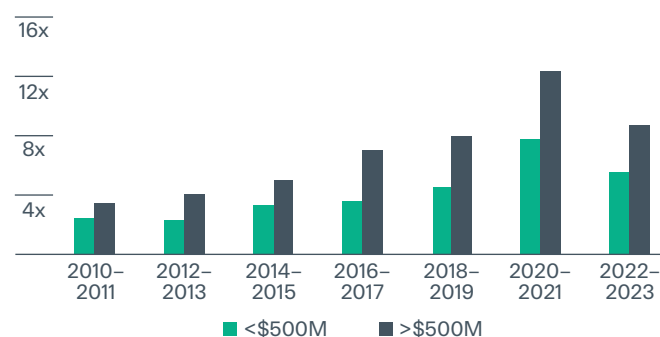
FIGURE 7: REALIZED DEAL LEVEL TVPI BY ASSET CLASS



Source: SPI by StepStone as of November 2024.

When considering the drivers of potential future returns, we can reference SPI by StepStone deal-level data to examine entry prices as a multiple of revenue paid by small funds versus large funds. While pricing has increased over time in both categories (a trend seen across the entire private equity market), entry valuations paid by funds under \$500 million have consistently remained several turns lower than their larger peers (**Figure 8**). Entry multiples are crucial to investment returns, as they influence the performance metrics a business must meet to ensure a robust return on investment. Lower valuation multiples at entry mean that investors can underwrite an investment using more conservative growth assumptions to achieve a target return compared with higher valuation multiples at entry.

FIGURE 8: MEDIAN TEV/LTM REVENUE ENTRY MULTIPLES BY GROWTH EQUITY FUND SIZE



Source: SPI by StepStone as of November 2024.

³ SPI by StepStone SPI.

⁴ Ibid.

The compelling micro growth equity opportunity

We are currently tracking roughly 60 micro growth equity GPs that are actively pursuing the large addressable market of technology companies that exist outside the traditional VC ecosystem.⁵ Similar to developments we saw in the VC and buyout markets in prior decades, we believe this number is small relative to the large and compelling opportunity set.

The challenge is a familiar one: Many of these firms are newly formed partnerships spun out of larger, branded firms. As we have discussed in the past, when evaluating emerging GPs, selection is critical. Nascent firms with largely unrealized track records are inherently difficult to underwrite. That said, we have found success backing modest-size first-time spinout funds in this category. Historically, we have allocated over \$250 million on a discretionary basis to 11 first-time micro growth equity funds. In turn, those managers have generated a 2.8x net multiple and 24% net IRR.⁶ Generally, we have found GPs to be highly motivated during the deployment of their early funds. Rather than being one of several partners at a larger firm with some but not unlimited discretion, managers with “their names on the door” will live or die based on their investment, brand building and personnel decisions. The weight of this responsibility often brings out the best in talented managers. Modest early fund sizes also help ensure that GPs can target smaller companies and deploy capital at a reasonable pace.

- With our large and experienced team, combined with the data and deep relationships built over 25 years in the venture and growth equity space, we believe we are well positioned to execute in this specialized area of the market.

- Our 85-person investment team is constantly canvassing the market, cultivating relationships with and building informed opinions on firms and, crucially, on the individual investing partners within those firms.
- Further, our direct investment experience and proprietary data on over 125,000 private companies allow us to create asset-level projections of unrealized portfolios, which helps us to develop conviction in emerging managers’ largely unrealized track records.
- Lastly, our emphasis on building deep, trustful relationships with our GPs provides our team with unparalleled access and positions us as a first call for GPs who eventually spin out.

Conclusion

After seeing a full business cycle play out over the past few years, we remain bullish on growth equity. Persistent performance and uncorrelated liquidity offer complementary exposure to classic buyouts and venture capital. However, looking more closely, we see evolving nuances. Although growth equity’s maturation over the past 15 years has provided LPs in a distinct segment of the market with compelling risk-adjusted returns, the fund size growth seen at established firms has created a void in the smaller, more rationally priced end of the market, which new entrants are seeking to capitalize on. Several of these nascent firms may one day join the ranks of the dominant growth equity brands, and we believe the investors willing and able to appropriately diligence this segment of the market may be rewarded.

⁵ Ibid.

⁶ As of September 30, 2024.

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All data is as of February 2025 unless otherwise noted.

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