The next test for growth equity

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Introduction

When we last wrote about growth equity in February 2025, the case we made was fundamentally one about the strategy's consistently strong absolute and risk-adjusted returns over the prior decade. Those results were driven by three structural advantages:

1. A broad opportunity set at the smaller end of a fragmented market, where companies could often be acquired at lower entry multiples than larger, more mature businesses;
2. A deep pool of downstream buyout capital that provided attractive exit opportunities without reliance on the IPO market; and
3. Secular growth as SaaS business models permeated nearly every major enterprise end market.

Together, these conditions supported a return profile characterized by loss ratios that had averaged 9% since 2014, nearer to buyout at 8% than to late-stage venture at 19%, with upside approaching that of venture capital.

In hindsight, it proved to be an interesting moment in time to make that argument. ChatGPT had already captured the industry's attention, and enterprise adoption of generative AI was accelerating rapidly, yet the full implications of large language models and AI-native applications for software economics remained largely theoretical.

Nineteen months later, investors are increasingly questioning whether this segment can operate as it has in the past. Sponsor-led software platform buyouts have slowed. AI is changing how quickly products can be built and differentiated, and the strongest smaller companies may command more competitive valuations as their growth rates and strategic relevance both increase. The strategy retains meaningful structural advantages, but the conditions supporting its historical performance are changing, placing greater weight on the quality of the underlying asset and a manager's ability to assess its durability.

With the benefit of additional data, broader enterprise adoption, and a deeper understanding of how AI is reshaping the competitive landscape, this paper revisits the original case point by point. Downside protection remains meaningful, but product-market fit may be less durable. Attractive entry prices remain available across much of the smaller end of the market, where well-positioned companies may also use AI to grow faster and address larger opportunities. Downstream capital remains substantial, but buyers have become more selective about which businesses can maintain their position through a five- to seven-year ownership period. Against this new paradigm, we're considering how growth equity can adapt to these changes while preserving its distinct and complementary role in investors' portfolios.

Downside protection remains, while AI expands the upside

A meaningful share of growth equity's historical reliability has been structural. Low leverage protected returns as rates rose, while preferred equity provided a structural buffer against loss compared with common shares. Disciplined entry pricing reduced the growth required to clear a target return, and founder-owned businesses with real revenue growth, established customers, and positive unit economics began from a defensible position. Those characteristics continue to support a risk-return profile distinct from venture capital and buyouts.

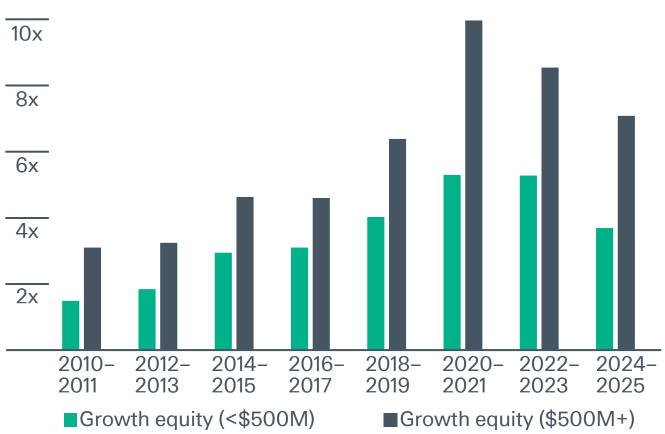
At the same time, these same traits may be less predictive on their own. Growth equity underwriting typically begins with evidence that a company has achieved product-market fit and can scale from an established position. AI does not invalidate that evidence, but it may shorten the period over which the position remains differentiated. Historical loss rates remain informative, but the protection associated with product-market fit will depend more heavily on the strength of the underlying customer relationship, workflow position, and economic model.

The implications extend in both directions. A company with sound current metrics may face a less predictable competitive path than a similar business did several years ago. Businesses positioned to benefit from AI, however, may grow faster, improve operating leverage, and address larger markets than previously anticipated, supporting greater scale and higher terminal values. For the right business, the potential upside may be greater, but capturing it requires confidence that current growth can translate into durable economic value.

Attractive entry prices can still be found

The valuation case also requires a more nuanced update. Companies backed by smaller growth funds have historically been available at meaningful discounts to those backed by larger vehicles, reducing the growth required to achieve a target return. That advantage remains evident in recent data, preserving an important element of the growth equity proposition (**Figure 1**).

FIGURE 1: MEDIAN TEV/LTM REVENUE ENTRY MULTIPLES BY FUND SIZE



Source: StepStone SPI Database, as of April 2026. Includes data on over 7,500 growth equity transactions from 2010–2025.

The strongest smaller companies may nevertheless command more competitive valuations as their growth rates, capabilities, and strategic relevance increase. But a premium valuation, where it arises, does not necessarily weaken the investment case; rather, entry price must be considered in relation to the growth, capital requirements, and potential terminal value of the business. A company capable of growing faster or addressing a larger market may support an attractive return even at a higher multiple.

The historical discount remains an important source of protection, but it should not be considered in isolation. Investors must also determine whether the growth and competitive position reflected in the price can endure. The relevant distinction is between paying a reasonable price for sustained economic progress and paying for product momentum that may prove temporary.

Downstream demand has refocused on growth

Growth capital continues to flow into software, while control-oriented investors have become more cautious. According to PitchBook, 136 large-scale software growth equity deals closed in the first five months of 2026, putting the strategy on pace for its highest annual count since 2021. Over the same period, 63 software platform acquisitions were completed, an annualized pace roughly 20% below the 2018–2025 average. Further, these platform deals represented 41% of overall private equity deal value in software, the lowest share in at least a decade and down roughly 30 percentage points from the prior year.[1]

That divergence simply refines, rather than invalidates, the exit thesis we outlined in 2025. We previously argued that more than $1.3 trillion of dry powder held by large technology

[1] PitchBook, as of June 2026.

buyout funds would continue to support demand for lower middle market software assets. That capital remains available, but tighter credit conditions, valuation resets, and uncertainty around software durability have made buyers more selective.

The exit path is still open, particularly for smaller, high-growth companies operating in markets viewed as more resilient to AI disruption or, more importantly, those likely to benefit from it. The higher bar is whether a company can maintain its competitive standing through a buyer's ownership period. Buyout capital continues to support exits, but buyers are increasingly directing it toward companies which combine strong growth with a durable competitive position.

AI is changing the underwrite

The continued availability of downstream capital addresses only one part of the original thesis. The more consequential question is whether the businesses attracting that capital can sustain their growth and competitive position over time. AI has increased both the opportunity available to leading companies and the importance of determining whether their advantages can persist.

Lower development costs and faster iteration make it easier to bring competitive products to market and to reach functional parity in features that once remained differentiated for longer. They also allow established businesses to expand their products and respond more quickly to changing customer needs. As a result, the ability to execute and the underlying sources of differentiation become more important.

Traditional measures such as growth, retention, capital efficiency, margin structure, customer concentration, and exit optionality remain the starting point. It's also important to consider what those metrics reveal about the company's ability to sustain its performance. Strong retention may reflect workflow ownership, while margin trends may show whether AI is improving operating leverage or introducing new costs. Historical performance needs to be analyzed alongside a more qualitative assessment of how the company's position may evolve as the basis of competition changes.

Growth equity's advantage

Entry prices are only part of the opportunity. Smaller growth-stage companies may be well-positioned as product cycles shorten because the traits which have historically made growth equity attractive—including focus, capital efficiency, and founder-led execution—can become more valuable in a faster-moving market.

Growth-stage companies often operate with narrower mandates and flatter organizational structures than larger incumbents. This can make it easier to adjust product roadmaps, reallocate engineering resources, and modify go-to-market strategies as customer needs evolve. Larger software vendors may have greater resources, distribution, and customer reach, but they may also contend with longer planning cycles, legacy architectures, technical debt, or product complexity accumulated through acquisitions. As product cycles compress, the ability to make and implement decisions quickly may become a more important source of competitive advantage.

Capital efficiency reinforces this advantage. Businesses which have grown with limited reliance on external financing may be better positioned to continue investing through periods of uncertainty without materially changing their operating model. Focused growth-stage companies can also access technologies that once required substantial internal research budgets and apply them to narrow, high-value customer problems.

These advantages are not universal. Growth-stage companies face competition from AI-native entrants that can build quickly without supporting legacy products or an installed customer base. Larger incumbents may also retain meaningful benefits from distribution, proprietary data, procurement relationships, customer trust, and deeply embedded workflows. Agility matters most when it is paired with an existing position that is difficult to replicate.

In our view, that position is supported by some combination of procurement access, permissioned data, and workflow depth. Existing vendor relationships and completed security reviews can reduce friction when customers adopt new capabilities. Proprietary or permissioned data may improve the product in ways that competitors using the same underlying model cannot easily reproduce. Products embedded within core workflows may also benefit more directly from incremental improvements and may be more difficult to replace than standalone tools.

Underwriting durability

AI should sharpen, rather than replace, traditional growth equity underwriting. Five questions deserve particular attention:

1. **Customer impact.** Is AI changing how customers use the product, improving retention or expansion, reducing implementation time, or lowering the cost to serve? Features that improve positioning without changing customer behavior may prove less durable.
2. **Data rights and improvement.** Does the company hold the rights needed to use customer data, and is there evidence that the product improves as usage grows? Where rights are ambiguous or the underlying information is broadly available, we assign less value to the claimed advantage.
3. **Value capture.** Can the company translate improved customer outcomes into pricing or expansion, or does the economic benefit accrue entirely to the customer?
4. **Margin impacts.** How do inference, infrastructure, and third-party costs affect gross margins? Revenue growth alone may not show whether AI is improving the model or adding a new cost layer.
5. **Execution.** How quickly can the team adjust its roadmap, and what evidence shows that it can reallocate resources as priorities change?

These questions are intended to distinguish between a current product lead and an advantage that can compound. They also place greater weight on management discipline, as rapid product development is useful only when tied to customer needs and sound economics.

We see that distinction in our own portfolio, where AI has been applied within an established workflow rather than introduced as a standalone feature. Two holdings illustrate the point (**Figure 2**).

FIGURE 2: AI APPLIED WITHIN ESTABLISHED WORKFLOWS FOR TWO PORTFOLIO HOLDINGS

	Nerdio	VALD
Established workflow	Automates the deployment and management of Microsoft Azure	Owns the system of record for musculoskeletal measurement, backed by a proprietary dataset
How AI is applied	AI-driven optimization now handles cost and capacity decisions administrators previously made by hand	VALD AI lets practitioners interrogate the data directly rather than exporting it
Result	**ARR growth: 39% YoY as of 2Q26** ARR $ volume: +74% vs. underwriting **Gross margin 90%→97%** widens with scale	**ARR growth: 47% YoY as of 2Q26** ARR $ volume: +11% vs. underwriting **Gross margin 85%→89%** widens with scale

In each case, AI is reinforcing an existing customer relationship and workflow position while producing measurable operating benefits. These examples illustrate the types of evidence which can support an underwriting view on durability and execution.

The rising importance of manager selection

Manager selection has always mattered in growth equity, but the asset class has historically benefited from lower loss rates, valuation discipline, and structural protections that supported a broad range of outcomes. If those protections become less sufficient on their own, the value of selecting managers that can distinguish between temporary product momentum and lasting advantage should increase.

Managers must recognize when AI can expand a company's product set, market opportunity, or operating leverage in ways that are not yet fully reflected in current performance. They also need the discipline to pass on companies which screen well on traditional metrics when the underlying position appears vulnerable. Technical judgment and sector depth matter because neither opportunity nor vulnerability is always visible in financial statements. This does not remove the downside protections that distinguish growth equity from venture capital, and we would continue to expect materially different risk profiles across the two strategies. It does, however, move parts of the underwriting closer to venture, where networks, sector knowledge, and informed views on companies and management teams can materially influence access and selection. Historical performance should therefore be considered alongside current sourcing, portfolio construction, and the quality of the unrealized portfolio.

The historical 9% loss ratio may become less representative as outcomes vary more across managers. Portfolios concentrated in durable workflow companies may produce higher right-tail outcomes as AI strengthens their role in customer operations. Exposure to products that customers can replace easily may raise impairment rates.

Conclusion

Growth equity remains an attractive strategy, but the opportunity set is becoming more selective. Companies with capital efficiency, proven customer traction, sound unit economics, and visible paths to scale are still attractive. While many of the structural conditions that supported the strategy's historical performance are still relevant, shorter product cycles and evolving competitive dynamics are placing greater emphasis on company selection and execution.

The change presents opportunity as well as risk. Lower development costs and faster iteration may allow well-positioned businesses to expand their product offerings, improve operating leverage, and address larger markets. They also place greater pressure on companies to sustain differentiation after achieving product-market fit. The task for investors is to distinguish companies using AI to reinforce an existing advantage from those benefiting from product momentum that may prove temporary.

This represents a meaningful test for a strategy whose modern identity was shaped during the expansion of enterprise software. We believe growth equity can adapt while preserving its distinct and complementary role in investors' portfolios, but future performance is likely to depend more heavily on asset and manager selection than it did over the prior decade. Technical judgment, sector expertise, and informed networks will matter alongside the financial discipline that has long defined the strategy. Our experience across venture and growth equity, together with the breadth of our relationships across both markets, provides a strong foundation as those capabilities become more important.

All data is as of September 2026 unless otherwise noted.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. ACTUAL PERFORMANCE MAY VARY.

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