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Chief Investment Office GWM
Investment Research

Growth equity

Private market education

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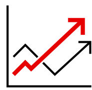
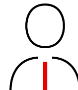
This primer provides an overview of growth equity and covers the strategy basics, manager value-add, performance, and benefits in an investor's portfolio.



Growth equity (GE) funds target companies that have potential for scalable, repeatable growth.



GE managers look to add value by providing expansion capital and strategic advice to fast-growing, established businesses.

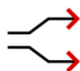
Success in driving revenue growth, scaling organizations, and developing management teams is key to driving returns above public markets over a long time horizon.

Summary

- Growth equity (GE) funds target companies that have high organic growth rates where unit economics have been established. Attractive targets exhibit potential for scalable, repeatable growth.
- Because targeted firms typically have limited free cash flow generation restricting their ability to raise debt, funds rarely use leverage.
- GE funds typically take minority positions but negotiate specific rights to protect their investors. These may include board representation, control provisions, and redemption rights.
- Managers supply expansion capital to grow and scale operations and develop management teams.
- GE managers also manage the exit process via a sale to another private equity fund, buyback to owner, or via public listing.
- GE strategies delivered a median 14.0% pooled vintage year internal rate of return (IRR) and 1.9x total value to paid-in (TVPI) over the 1993–2019 period. The standard deviation of vintage year IRR was 9.4% and 0.6x on a TVPI basis.
- They outperformed public markets by about 654bps when observing public market equivalent (PME) returns over the 1993–2019 period.
- GE strategies are also modestly linked to economic cycles. GE funds target companies that are growing faster than the market, which may reduce cyclicality but introduce more idiosyncratic risk in returns.
- While companies with this profile can trade on public markets, investing in common equity does not provide the same provisions to influence control across business and governance dynamics as private investments.
- With significant differences in manager performance, key risks include sector concentration, operational execution, and exit timing. Other, more general private markets risks also apply, including significant illiquidity, limited control, and additional fees.

This report is part of a series of short primers on specific private market strategies. For a deeper understanding of private markets, please read our Introduction to Private Markets. Find more information on the client portal or contact your advisor for assistance.

14.0%
Median pooled IRR



~654 bps
Median annualized IRR outperformance vs. public markets

1.9 x
Median pooled TVPI (total value to paid in) multiple

-4.3%
Lower quartile IRR*

30.6%
Upper quartile IRR*

0.09
Correlation to public markets

Source: Based on historical data for funds launched between vintage years 1993-2019 using Cambridge Associates data, UBS estimates. *Quartile IRR's reflect minimum and maximum value across vintage years. Note: Given most funds take a few years for performance to settle, performance of recent vintage years may be less meaningful. Internal rates of returns are net of fees, expenses, and carried interest. Data as of November 2023.

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What does the growth equity strategy do?

Growth equity (GE) has established itself as a significant presence in the industry, growing from 4% of private markets assets under management (AUM) in 2007 to over 7% in 2022 (figure 1). Growth equity funds focus on purchasing minority stakes in fast-growing businesses that have moved past the startup stage.

Target GE investments

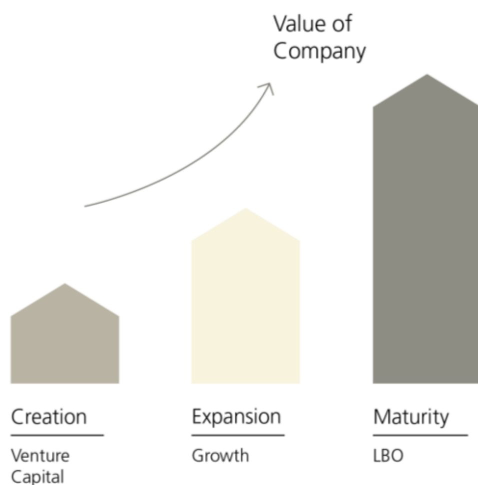
- Target companies are usually mid-life cycle that have high organic growth rates where unit economics (which describes direct revenues, costs on a per-unit basis) have been established. Attractive targets exhibit potential for scalable, repeatable growth (figure 1).
- These companies may be late stage venture capital firms, mature companies in the middle market space, or spin-offs from larger firms.
- GE managers value companies based on historical and future revenue or cash flows, along with revenue or profit multiples (such as EV/EBITDA) to assess attractive entry points.

Leverage, holding period, and exit

- Because targeted firms typically have limited free cash flow generation restricting their ability to raise debt, GE funds rarely use leverage in deals.
- GE funds provide expansion capital used for production capacity, sales efforts, or new product lines while also providing support for strategic development. GE transactions can also provide liquidity for owners.
- A holding period for a particular GE investment can range between three and seven years.
- Unlike buyout strategies that aim to take a controlling position in a company, GE funds acquire minority stakes, leaving control to the existing owners.
- However, GE managers negotiate specific rights to protect their investors. These may include board representation, control provisions designed to provide influence in business decisions, and redemption rights which allow managers to sell their stakes back to the controlling shareholders at a predetermined event/price.
- The two main exit routes are via a secondary sale to another private equity fund, or via a buyback from the business owner. Larger portfolio companies may choose to go public.

Fig. 1: Investing in a company's life cycle

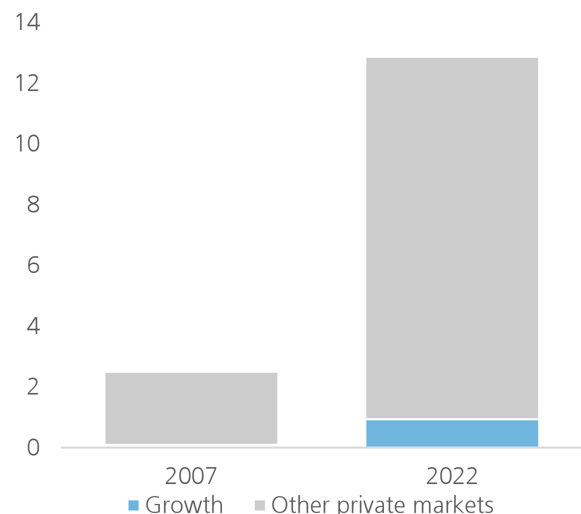
GE investors typically seek to invest in established but growing businesses



Source: UBS

Fig. 2: The private market industry has grown rapidly in the last decade

With about 1trn, growth equity makes up about 7.3% of total private markets AUM



Source: Pitchbook, UBS, November 2023

Sources of value add

GE managers seek to add value by providing expansion capital and strategic advice to further develop established business models.

- Accelerate revenue growth: GE managers formulate strategies to grow revenues by improving sales force effectiveness, optimizing pricing strategies, and identifying expansion into new geographic markets and product lines. Managers can utilize their network to introduce the company to new customers not otherwise attainable without GE manager involvement.
- Scaling organizations: GE managers help analyze unit economics such as customer acquisition costs. GE managers also advise on deploying fixed assets (i.e. new plants), and upgrading financial and governance systems to better track operations as the company matures.
- Management team development: With portfolio companies often lacking a deep bench of experienced executives in C-suite positions, GE funds can leverage their network to supplement current leadership and establish independent boards.
- Capital markets and exit planning: GE funds advise on sourcing and integrating acquisitions, raising additional capital, and preparing companies for eventual exits through strategic sale or IPO.
- Deal sourcing: With attractive portfolio companies often not explicitly requiring external capital, GE funds with proprietary industry networks and expertise in formulating and pitching strategic growth plans have an advantage over peer funds in sourcing investments.

Performance analysis

Introduction to vintage year returns

- Private market returns are assessed using the vintage year, the year in which the first influx of capital is delivered to a project or a company. For example, if hypothetical fund ABC reported vintage year 2005 IRR of 15%, ABC was incepted in 2005 and the IRR reflects all investment activity performed over the course of its lifecycle: contributions and distributions made in 2005, 2006, 2007, etc., until the end of the fund, which typically lasts 10 years (2015 in this example).
- If hypothetical fund XYZ reported vintage year 2008 TVPI of 1.3x, the fund returned USD 1.30 for every USD 1 invested through the duration of the fund's life (2008–2018).

Table 1: Median pooled performance for vintage years 1993–2019

	Global Buyout	Global Growth Equity	US Venture Capital
Median Pooled IRR (%)	16.2	14.0	18.7
Std Deviation IRR (%)	5.2	9.4	28.2
Median Pooled TVPI	1.9x	1.9x	2.1x
Std Deviation TVPI	0.3x	0.6x	1.4x

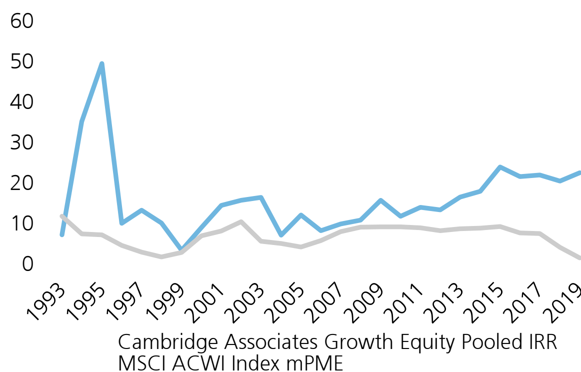
Source: Cambridge Associates, UBS. Data as of November 2023

Historical performance and comparisons versus public market returns

- Using Cambridge Associates data, growth equity delivered a median 14.0% pooled vintage year IRR and 1.9x TVPI for funds launched between 1993–2019 period (table 1).
- The standard deviation of vintage year IRR was 9.4% and 0.6x on a TVPI basis over the 1993–2019 period.
- GE strategies outperformed public markets when observing PME returns. With the median MSCI ACWI PME of 7.6%, GE outperformed listed equities by about 654bps over the 1993–2019 period (figure 3).
- GE returns have consistently outperformed the MSCI ACWI PME in 26 of the 27 vintage years observed, indicating a durable return premium historically.
- We observe significant differences in lower quartile versus upper quartile returns, indicating elevated dispersion between fund managers and highlighting the importance of manager due diligence (figure 4).

Fig 3: Growth equity pooled IRR vs. MSCI ACWI PME

GE has outperformed public markets across vintage years 1993–2019 (IRR in %)



Source: Cambridge Associates, UBS, November 2023.

How do GE returns compare with other private equity strategies?

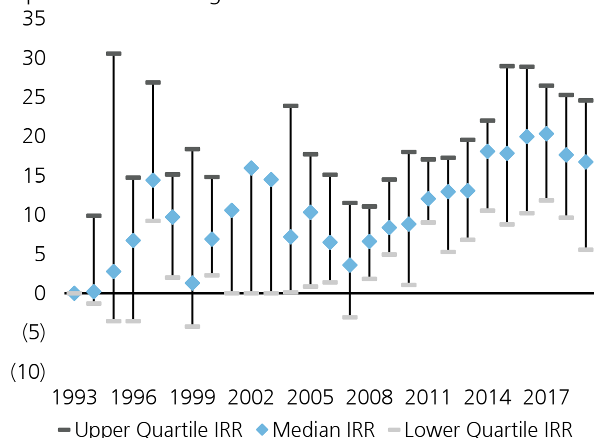
- GE strategies generated the lowest median IRR compared with buyout and VC over the 1993–2019 vintage year period (table 1). However, when observing performance from 2000 to 2019, they have displayed attractive relative returns versus buyout and venture capital strategies.
- Funds target companies developing from startup stage but before maturity stage. As a consequence, returns exhibit variability in between that of buyout and venture capital when observing the standard deviation in IRR and TVPI multiples.
- Per vintage year, GE returns show fewer outlier years when compared to VC but more dispersed when compared to buyout.

Growth equity and the business cycle

- GE strategies are modestly linked to economic cycles. Funds target companies that are growing faster than the market, which may reduce cyclicality but introduce more idiosyncratic risk in returns.
- GE strategies are less cyclical than buyout strategies as they do not typically utilize leverage in deals, and target companies less mature. But they may be more cyclical than venture capital given the highly idiosyncratic nature of early stage venture capital targets.
- Valuations, earnings growth, and dry powder can influence GE returns. The IPO and M&A environment can drive exit opportunities.
- Historically, GE returns were highest during the 1995 vintage year and lowest before the dot-com bubble (1999 vintage) and global financial crisis (2006 vintage).
- Managers have fared better than public markets before and during prior market peaks.
- When observing performance before the financial crisis, GE returns in 2006–2007 vintage years outperformed the MSCI ACWI PME by around 215bps. Additionally, before the dot-com bubble in 1999–2000, these vintage years outperformed the MSCI ACWI PME by around 129bps.
- When observing performance during the financial crisis, GE returns in the 2008-2009 vintage years outperformed the MSCI ACWI PME by about 414bps. Additionally, during the dot-com bubble in 2001–2002, these vintage years outperformed the MSCI ACWI PME by about 581bps.

Fig. 4: GE return dispersion per vintage year between 1994–2019

High level of dispersions within each vintage year show importance of manager selection



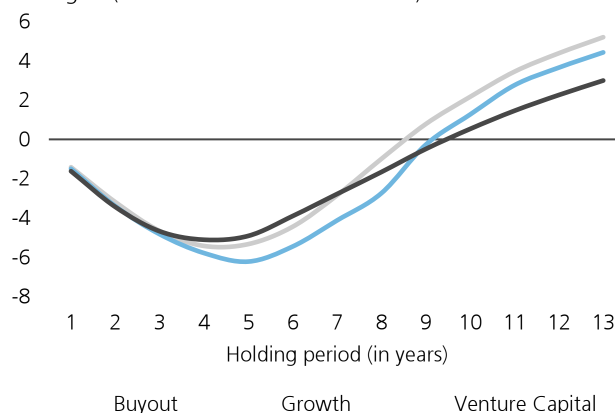
Source: Cambridge Associates, UBS, November 2023

Growth equity in your portfolio

- GE can add differentiated, active exposure to companies that exhibit a balance of proven business models and accelerating growth potential.
- While companies with this profile may trade on public markets, investing in their common equity does not provide the same provisions for influencing control across business and governance dynamics as GE investments do.
- GE funds can take 9–10 years to break even when measuring historical cash flows. This duration is about a year longer than that of buyout strategies as GE invests in earlier-stage companies that could take longer to develop and realize value (figure 5).
- GE fund managers can continue earning a premium above public markets through an active approach to sourcing and partnering with portfolio companies to drive strategic growth.

Fig. 5: Cumulative net cash flows of various private equity strategies ("J" curve)

GE strategies typically second to break even among other PE strategies (net cash flow in USD millions)



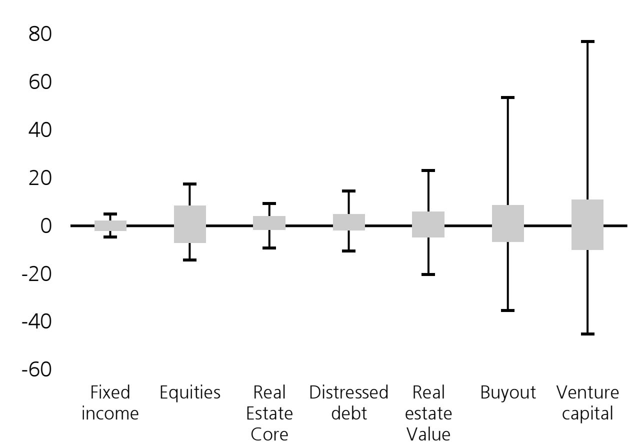
Figures normalized to USD 10m commitment. Source: Pitchbook, UBS, November 2023

Risks

- Risks of investing in GE funds include blind pool structure, potential for unwanted or unintended sector concentration, and competition for investment opportunities from strategic buyers and other GE firms
- GE investments can be concentrated in technology, healthcare, and consumer sectors, among others.
- Given the complex nature of pooling together financial, business, and managerial resources, there are execution risks in enacting transformational change, particularly as a minority investor.
- The ability of private equity funds to exit portfolio company investments and return capital to investors is dependent on prevailing equity market conditions.
- Performance can differ greatly among managers (figure 6), which can be mitigated through strict manager selection.
- Other, more general private markets risks also apply, including significant illiquidity of fund vehicles, limited control, disclosure and transparency on underlying holdings, and additional fees. These risks cannot be fully eliminated but can be reduced through extensive institutional due diligence and rigorous investment and monitoring processes.

Fig. 6: Public vs. private manager fund returns

PE exhibits high dispersion compared to traditional markets



Source: Pitchbook, Bloomberg, UBS. Dispersion of fund returns relative to median performance. Data references 1995-2019 for private market funds, 1995-2022 for traditional equity and fixed income funds.

Appendix

Selected definitions

- **Correlation**: the degree to which the fluctuations of one variable are similar to those of another.
- **Leverage**: the use of borrowed capital or instruments to increase the potential return (but also potential losses) of an investment, a simple example is a mortgage used in real estate transactions.
- **Leveraged buyout funds**: a private equity strategy using borrowed capital to gain control of a company.
- **Illiquidity premia**: the premium that an investor can demand depending on how difficult it is to convert the underlying security can be converted to cash.
- **Multiples**: a term that measures some aspect of a company's financial well-being, determined by dividing one metric by another metric. The metric in the numerator is typically larger than the one in the denominator, because the top metric is usually supposed to be many times larger than the bottom metric.
- **Multiple expansion**: describes the way a particular valuation metric increases to reflect a higher value assigned to an underlying investment.
- **Value add**: describes the operational, business, or structural improvements private market managers seek through underlying portfolio investments.
- **Cash flows**: cash flow is the net amount of cash and cash-equivalents being transferred into and out of a fund.
- **Public Market Equivalent (PME):** a method that converts public market returns to a benchmark that can be compared to private market returns.
- **IRR**: a return method used to evaluate private market investments and reflects the discount rate at which the present value of an investment's future cash flow equals the cost of the investment.
- **TVPI (Total Value to Paid In**): a return metric that describes the total capital distributed back to the investor + residual value left in the fund divided by invested capital.
- **Exit**: the time period in which an investor can convert holdings into cash to be liquidated over a designated period of time.
- **IPO**: the first sale of stock by a private company to the public. Also referred to as an "initial public offering."
- **Standard deviation**: a measure of the degree to which individual values vary from the distribution mean. The higher the number, the greater the risk.
- **Dry powder**: refers to cash reserves kept on hand by a private markets firm to cover future obligations, purchase assets or make acquisitions.
- **J-curve**: illustrates a period of initial negative cash flows (contributions) towards positive cash flows (distributions back to the investor) over a period of time.
- **Sponsor**: the general partner in a limited partnership who organizes and signs up investors.
- **Secondary buyout**: describes a sale between private market firms
- **Trade sale/strategic sale**: describes a sale of a business to another business operating in a similar industry.
- **Senior debt**: loans or debt securities that have claim prior to junior obligations and equity on a corporation's assets in the event of liquidation.
- **Junior debt**: loan or security that ranks below other loans or securities with regard to claims on assets or earnings. In the case of borrower default, creditors who own subordinated debt won't be paid out until after senior debt holders are paid in full.
- **Vintage year**: is the year in which the first influx of investment capital is delivered to a project or company. This marks when capital is contributed by venture capital, a private equity fund or a partnership drawing down from its investors.
- **M&A**: mergers and acquisitions is a general term that refers to the consolidation of companies or assets through various types of financial transactions. M&A can include a number of different

transactions, such as mergers, acquisitions, consolidations, tender offers, purchase of assets and management acquisitions.

- **Blind pool**: money collected from several people which is put into a fund and invested for their profit. It is left unspecified which properties are to be acquired.
- **Unit economics**: a measure of direct revenues and costs on a unit basis for a particular business model.
- **Minority stake**: reflects a non-controlling interest that is less than 50% of a particular entity.
- **Spin off**: describes the separation of an independent company from a larger parent.
- **Control provisions**: designed to provide a level of influence over significant operational and business matters.
- **Redemption rights**: gives investors the right to force a company to repurchase their shares after a period of time.
- **Idiosyncratic risk**: risk associated with a narrow set of factors pertaining to a particular company. Risk that has little association with overall market risk.
- **Tag-along provisions**: provides a minority shareholder the right to join in on a sale of a company that is initiated by a majority shareholder.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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