Whitepaper 2022

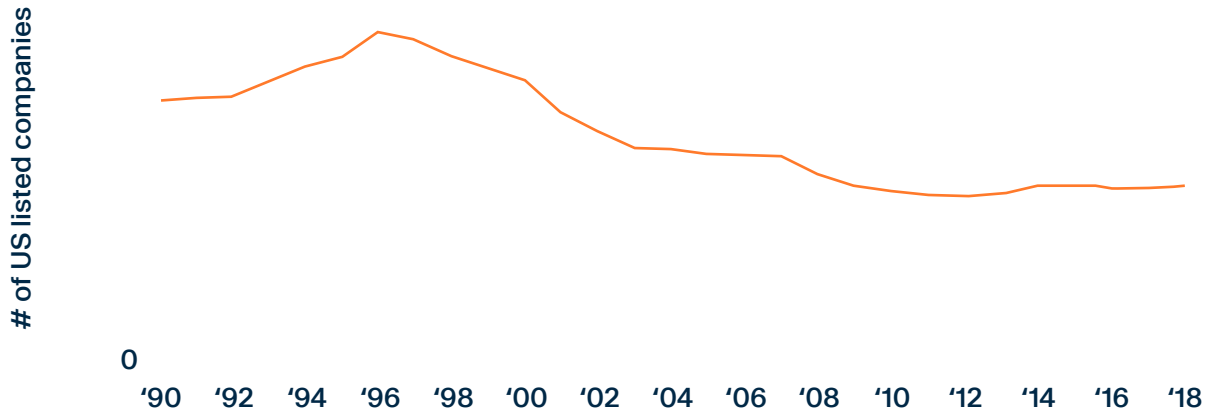
Growth Equity: *Staying Private for longer*

Moonfare®

LISTED COMPANIES ON DECLINE

It is a fact that the number of US listed companies has been declining since 1996 (Figure 1). The common culprits mentioned in this context are often public and IPO markets that are supposedly "broken", plagued by agency costs, heavy reporting requirements, and short-termism. Indeed, the number of listed companies has been declining as fewer companies have been going public, more companies have been taken private, and many listed companies have been acquired. However, another possible narrative could be that the underlying driver of this trend is actually the declining profitability of smaller firms, as is evidenced by the fact that the proportion of unprofitable small public companies has been increasing consistently over the longer term[1].

Figure 1: Number of Listed US Domestic Companies[2]

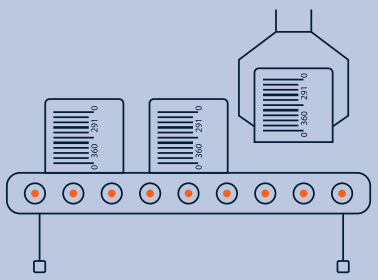


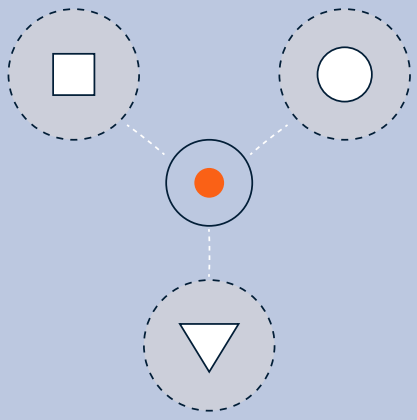
Source: World Bank.

WHY IS SMALL COMPANIES' PROFITABILITY DECLINING?

1. Economies of scale

Economies of scale are achieved by deploying a technology or product with lower marginal costs, thereby increasing a firm's marginal cost efficiency.
Example: Walmart utilizes economies of scale due to its ability to buy in bulk and drive marginal costs down.





2. Economies of scope

Economies of scope arise when the costs of production and distribution of complementary products by a single firm are lower than if they were produced by independent firms. Economies of scope thus increase the average total cost efficiency of a company and relates to its cross-sectional efficiencies.
Example: Proctor & Gamble benefits from economies of scope since it can utilize similar distribution lines for its hygiene related products.

3. Big data

Big data relates to the potential of large data sets to be analysed computationally in order to reveal valuable patterns and trends relating to human behavior. The use of big data has been especially important for high growth of technology companies and is able to increase the effectiveness of firms' commercial operations.
Example: Google has been able to benefit from its use of big data in order to generate some of the most sought out advertisement channels.

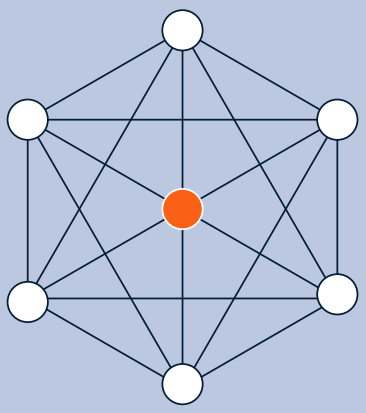
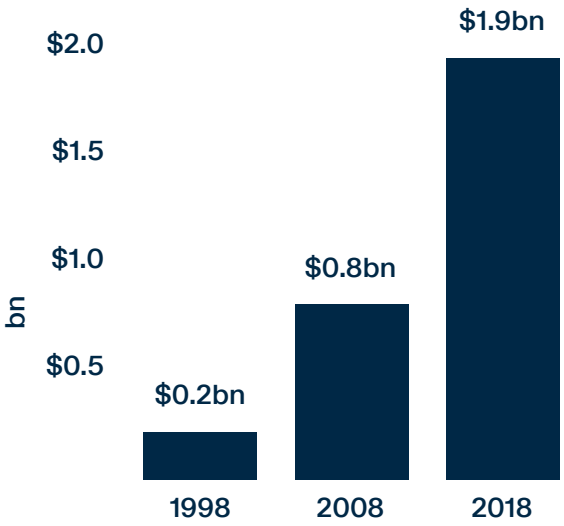
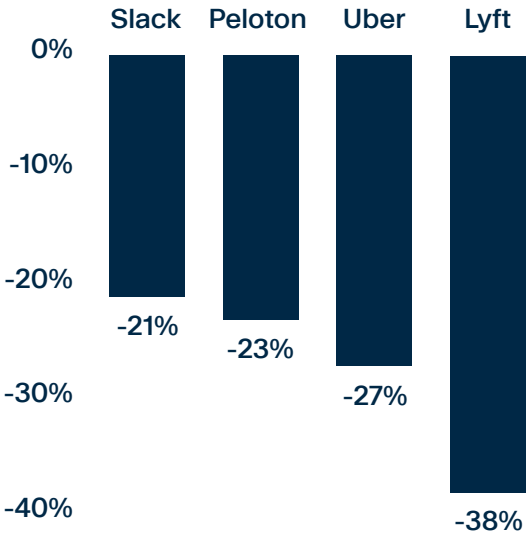


Figure 2: Median Market Cap at IPO[3]



Source: Ritter, 2018.

Figure 3: Examples of 2019 IPOs[4]



Source: Yahoo Finance.
Note: Performance data from time of listing to October 25th 2019.

The more than 8x increase in the median size of US IPOs in the last 20 years is evidence of this trend. All things being equal, this dynamic has led public markets to prefer larger companies. Yet, the trend has faced resistance year to date, as we have also witnessed that the share price of a number of the very large growth companies, specifically in the tech sector, that went public have been heavily hit. This under-performance could be seen as a signal of the market's skepticism to the very high valuations of these companies, but the trend towards larger companies going public is undeniable.

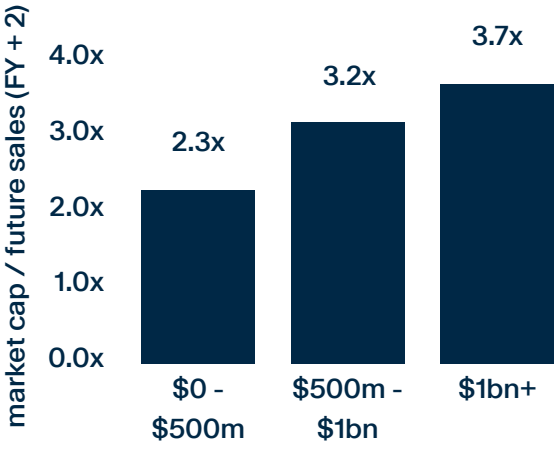
"I WISH I COULD BE VALUED LIKE THESE LARGER COMPANIES"

Organic growth has traditionally been heralded as the most dependable way of growing one's business. However, the recent shifts in technology and markets have brought more attention to the potential of rapid growth funded by external financing or fueled by acquisitions. The economics of most of these tech-enabled services is such that large market shares and strong customer retention appear to be the most highly valued and provide the maximum potential for further growth and margin expansion.

Between 2012 and 2015, companies that entered public markets at a market cap above $1bn achieved a 60% higher valuation, in terms of sales multiple, compared to companies with a market cap under $500m.

For fast growing start-ups, going public may not be the optimal route. As shown in Figure 4, between 2012 and 2015, US tech companies that entered public markets at a market cap above $1bn achieved a 60% higher valuation, in terms of sales multiple, compared to companies with a market cap under $500m. Thus, for smaller scale tech companies, it is in fact often in their interest to delay going public by either growing privately before entering stock markets or being acquired by a larger tech company willing to pay the significant premium often applied to rapidly growing targets. As stated by IPO expert Professor Jay Ritter, "For a lot of tech companies, getting big fast is the value maximising strategy, and organic growth takes too long".

Figure 4: US Tech Companies IPO Valuation 2012-2015[5]



Source: Abelson, Narasin, 2015.

GROWTH EQUITY ENTERS

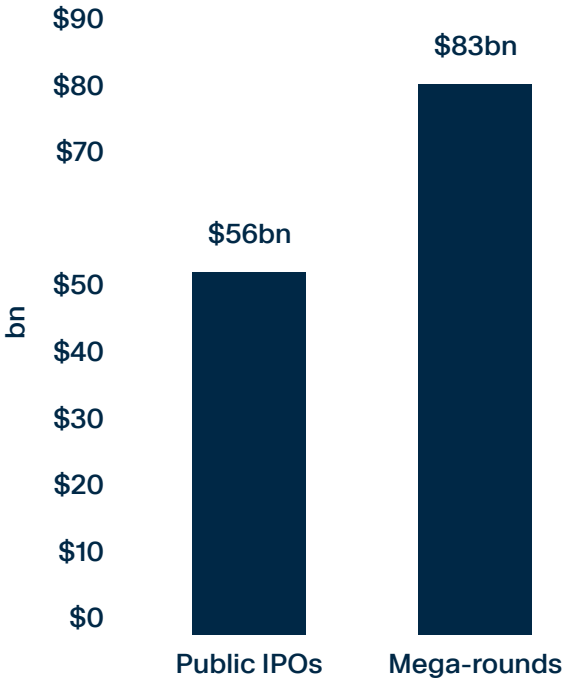
This is where growth equity enters the picture. The rise of the mega-round, i.e. private placement rounds exceeding $100m, has been broadly publicized; in fact, during 2017 and 2018, it made up 45% of all US venture capital funding[6]. As shown in Figure 5, mega-rounds have actually exceeded the amount of funding that has been secured by public IPOs, representing the largest funding avenue in US markets. These large rounds are the bread and butter of growth equity funds.

Growth equity funds target companies that are between the venture capital and the fully mature stage, the latter of which is normally the focus of buyout funds. These are companies that are also looking for substantial amounts of capital to fuel growth but do not yet want to go the IPO route. Growth investments typically participate in later stage venture capital rounds and normally only seek minority control. As such, most target companies in today's markets share the following characteristics:

- Control remains in the hands of founders
- Organic revenue growth is close to 20%
- EBITDA is positive or is expected to be so within 12-24 months
- Company is either unlevered or leverage remains limited

In the period between 2013 and 2018, growth equity fundraising grew at a 11% CAGR, which is the second highest growth rate among private market segments and significantly above the total private equity fundraising CAGR of 6%

Figure 5: Public US IPOs vs. mega-rounds, 2017-2018[7]



Sources: Ritter, 2018 and PricewaterhouseCoopers & CB Insights, 2018 & 2019.

Thus, the structural backdrop that has led to the rise of the mega-rounds has created a large investment opportunity in late-stage growth companies. The rapid emergence of the segment has led Cambridge Associates to describe it as an investment that "offers a combination of the better aspects of both: upside return potential similar to venture but with the lower losses of buyouts"[8]. Growth investors that can differentiate themselves via their sourcing network, ability to overcome information asymmetries, and capacity to identify and drive high growth trends, are able

to make the most of such opportunities.

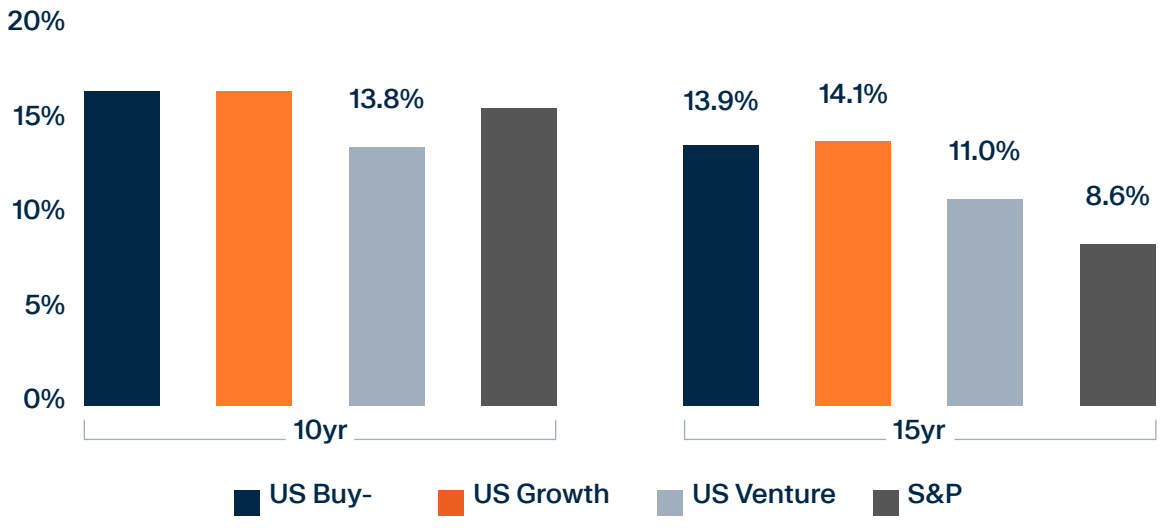
As a result, investors have been greatly receptive towards growth equity funds. In the period between 2013 and 2018, growth equity fundraising grew at a 11% CAGR, which is the second highest growth rate among private market segments and significantly above the total private equity fundraising CAGR of 6%[9].

Looking forward, Probitas Partners' annual survey of LPs showed US Growth Equity funds as one of the most sought after targets for increasing allocations, second only to US Middle Market Buyouts[10].

HISTORICAL AND RECENT RETURNS

How have investors done who have accessed growth equity via funds? As per Cambridge Associates Q1 2019 figures, the pooled returns of the last 10-15 years for buyout and growth funds are similar, with pooled venture capital funds' performance slightly lagging. However, both buyout and growth funds show an outperformance against the S&P 500 when looking at the 15-year period ending Q1 2019.

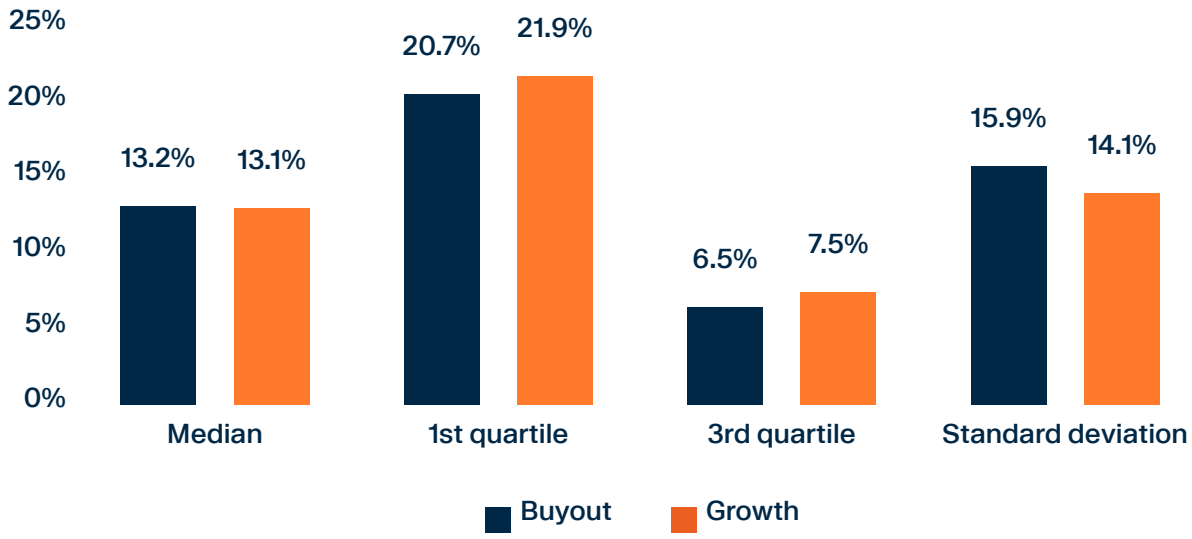
Figure 6: Long-term Pooled Returns[11]



Source: Cambridge Associates.
Note: 10 year and 15 year horizon pooled data ending Q1 2019.

Nonetheless, the recent trends in IPO markets and mega-rounds seem to have benefitted growth funds more than their buyout counterparts. Looking at vintages between 2011 and 2016[12], the median fund performance has been approximately equal to buyouts, whilst outperforming in terms of top quartile returns. At the same time, the standard deviation of returns across vintage years has been lower, attesting to a lower risk profile in terms of volatility.

Figure 7: Bullish 5-year Trend[13]

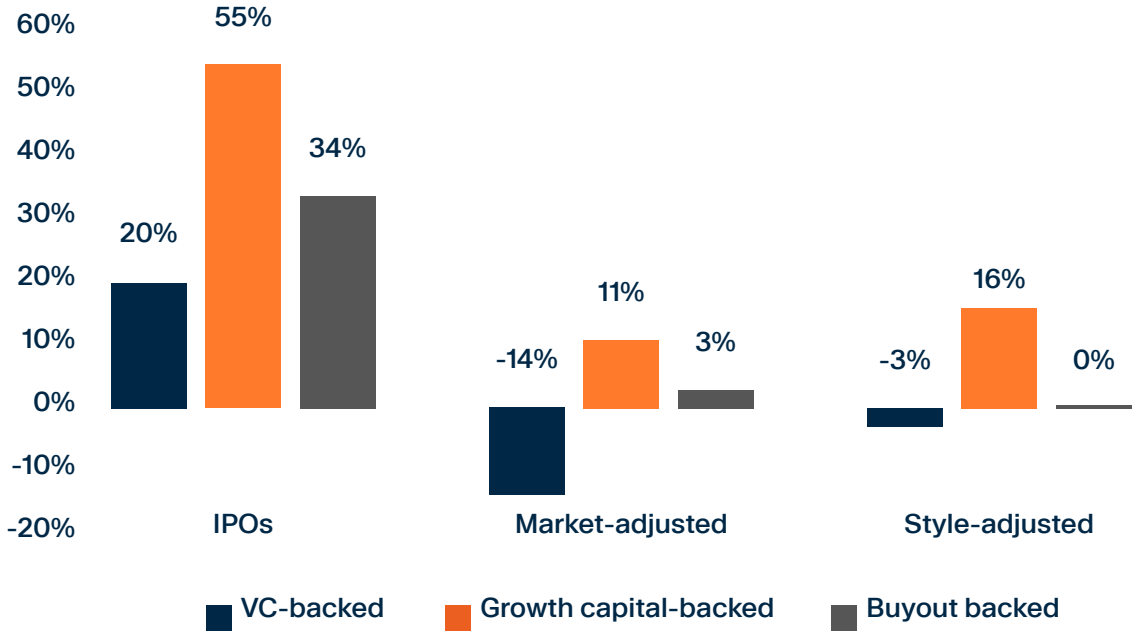


Source: Cambridge Associates.

FIRST GROW, THEN IPO

An analysis of the IPO market between 1980 and 2016 provides a look into how growth capital-backed companies have outperformed their VC- and buyout-backed counterparts. Public markets are the most receptive to companies that have been backed by growth equity investors, according to a 3-year buy-and-hold scenario. As shown in Figure 8, late-stage start-up companies that managed to raise money in mega-rounds and grow aggressively performed the best in such a scenario. Adjusted for market wide returns and style, growth capital is the only private financing route that has provided a significant relative outperformance post IPO. This is the tail-end value that growth seeks to continue to capture.

Figure 8: Average 3-year Buy-and-hold Return[14]



Source: Ritter, 2018.

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FOOTNOTES

1 Gao, Ritter, and Zhu, 2013.

2 World Bank Data. Listed domestic companies, including foreign companies which are exclusively listed, are those which have shares listed on an exchange at the end of the year. Investment funds, unit trusts and companies whose only business goal is to hold shares of other listed companies, such as holding companies and investment companies, regardless of their legal status, are excluded. A company with several classes of shares is counted once.

3 Ritter, 2018. Market values adjusted for inflation in 2017 US dollars.

4 Share price performance from time of listing to October 25th, 2019.

5 Abelson, Narasin, 2015.

6 PricewaterhouseCoopers & CB Insights, 2019.

7 Public IPO data taken from Ritter, 2018. Mega-round taken from MoneyTree Report Q3 2019. For Q1 and Q2 2017 data, referred to MoneyTree report Q3 2018.

8 Cambridge Associates (Growth Equity), 2019

9 McKinsey & Company, 2019.

10 Probitas Partners, 2019.

11 Cambridge Associates (Q1 2019 Benchmarks), 2019.

12 2011-2016 vintages selected to allow for consideration of relevant fund maturity.

13 Cambridge Associates, 2019. Average figures across vintages. Analysis stopped at 2016 to allow for relative fund maturity.

14 Ritter, 2018. Data for 8,252 IPOs from 1980-2016 is used, with returns calculated through the end of December 2017. Market-adjusted returns are calculated as the buy-and-hold return on an IPO minus the compounded daily return on the CRSP value-weighted index of Amex, Nasdaq, and NYSE firms. Style-adjusted buy-and-hold returns are calculated as the difference between the return on an IPO and a style-matched firm. For each IPO, a non-IPO matching firm that has been CRSP-listed for at least five years with the closest market capitalisation (size) and book-to-market ratio as the IPO is used. All returns include dividends and capital gains.

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