Why Venture Growth Equity Is Eating Your Lunch

The future is as bright as ever for investors allocating to venture growth equity. There will always be risks when investing in venture capital (VC) or any asset class, however these risks are different than those faced 20 years ago, owing to the significantly expanding and evolving addressable market. This generation of disruptive companies is expected to continue growing in scale and importance, and we expect exits to similarly grow in number and value. These tailwinds have fueled investors' interest and ability to fund tomorrow's next leading startups.

Join us in exploring why venture growth equity has become an evolving subsector of VC.

Going Digital at Breakneck Speed

Covid-19 has accelerated the adoption of technology, causing businesses and industries as we once knew them to be transformed forever.

In some sectors, we saw up to five years of projected growth realized in just six to 12 months. It seems that a key attribution behind these unprecedented growth rates is the rapid adoption of technology by all industries, touching markets that once

October 2021

seemed technology agnostic, such as outdoor recreation, law, financial services, consumer apparel and beauty (**Figure 1**).

During the early days of the internet, the prevailing wisdom was that certain industries wouldn't utilize technology. We know today that nothing could be further from the truth. We continue to see digital adoption accelerate and become a necessity of survival for sectors that have historically seen little disruption. We believe that the ability for technology to disrupt, innovate and drive efficiencies to these new sectors brings about a significant opportunity for the venture industry. As a result, it is now evident that technology is a key part of every business, no longer just its own vertical, and instead spans horizontally across every single industry.

Previously, technology was synonymous with the back office, an enabler that supports a business in the background. Today, technology has become the heart and engine of how almost all businesses are run. It is no longer merely a support function; technology touches everything.

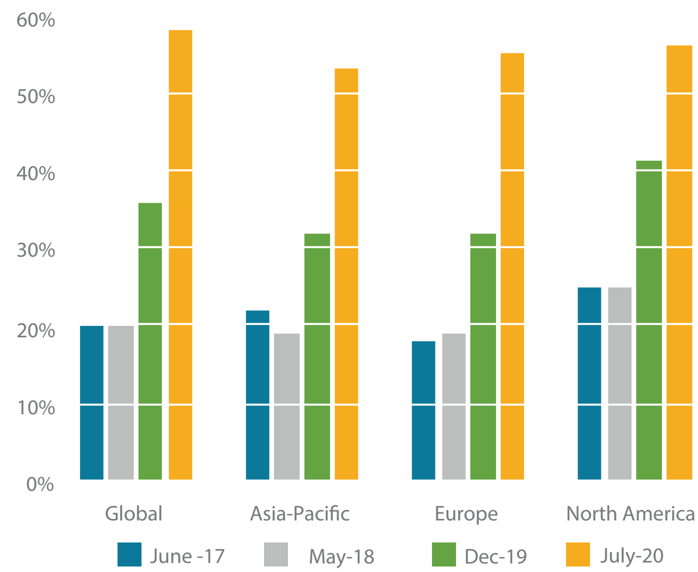
Figure 2 looks at the percentage of budget allocated to technology spend by vertical as of June 2021, highlighting that the wave of industries looking to adopt innovation and technology integration has only just begun. Despite the surge, technology spend is still in the early innings. It is only a matter of time until technology adoption becomes even more necessary for survival.

Covid-19 has also fueled a shift in human behavior, from how new businesses are built and existing businesses are scaled to how companies are financed and how basic consumers behave. We believe many of these shifts are here to stay.

The Great Democratization Migration

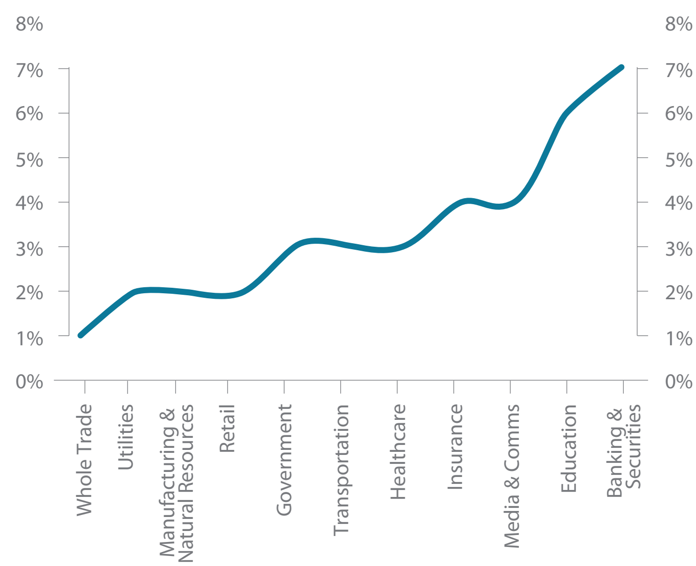
This brings us to the great democratization migration. These changes could not have transpired without the wave of decentralization outside of Silicon Valley. VC has become more global as founders and companies are setting up operations and achieving significant outcomes in nontraditional hubs. Remote work has led to a flood of relocations among major figures in both technology and VC. Companies have been on the move as well, with firms like Oracle, HP Enterprise and 8VC decamping for Texas, and Palantir moving to Colorado.

FIGURE 1 | AVERAGE SHARE OF DIGITAL CUSTOMER INTERACTIONS



Source: McKinsey & Company, October 2020.

FIGURE 2 | PERCENTAGE OF BUDGET ALLOCATED TO TECHNOLOGY SPENDING



Source: Deloitte via Francisco Partners, June 2021.

Not to mention the global coverage, also fueled by technology. The lower cost of capital, remote work, technology adoption, access to global talent and typically lower customer acquisition costs have all led to increased efficiencies, abstracted the complexity of building a business and brought about opportunities that were once thought to be impossible.

Covid-19 has brought about a new reality, one that is already paving the way for a new breed of entrepreneurs who see the world differently than their forebearers. Entrepreneurs are innovating and scaling at an unprecedented pace. The future belongs to the startup ecosystem, and we believe this is just the beginning. As investors look to allocate capital, picking a venture manager with global reach and scale is more important than ever.

Human Ingenuity Has Always Tackled Problems During Difficult Times

The power of VC is truly tested during periods of uncertainty, and Covid-19 is no different. To quote Laurance Rockefeller:

> ***"How we treat our land, how we build upon it, how we act toward our air and water will in the long run tell what kind of people we really are."***

VC is uniquely positioned to capitalize on these words. Venture capitalists can propel innovation, job creation and positive societal change. We are humbled by the role our industry has played and will continue to play in creating jobs by financing venture-backed companies.

We have witnessed some of the most iconic inventions and company creations during difficult times, and we believe constraints can focus the mind and provide fertile ground for creativity. In 1817, a global famine led a German inventor to devise a "mechanical horse" that later became the bicycle. Notably, the printing press was born from a pandemic, the ambulance from the Napoleonic wars, the field of epidemiology from a cholera pandemic, the refrigerator from the Long Depression, and ENIAC, the world's first computer, from World War II. Google and PayPal followed the aftermath of the dot-com bust. More recently, Lyft, Dropbox, Pinterest, Uber, Twilio, Slack and Airbnb were founded during the global financial crisis.

Although we recognize the battle is far from over, we can see the essential role that innovation through venture-backed companies will play in addressing climate change. There is no question that tech-enabled businesses will be the driving forces of the future working to combat the current threats to our environment.

We know that crisis creates necessity, and the mother of invention has never proven to be truer than in 2021.

We know that crisis creates necessity, and the mother of invention has never proven to be truer than in 2021. The quality of technology companies and the speed at which they are growing is unprecedented. The fuel required to support this tech boom is an attractive catchment for venture growth equity.

Defining the Rise of Venture Growth Equity

Venture growth equity has historically been a clouded category of capital perceived to sit at the intersection of VC and traditional private equity, leading to what many would call a sizable gap in the market. But, the evolving market opportunity has seen venture growth equity seamlessly morph into its own segment of private capital. The surge of technology adoption, companies staying private longer and increased late-stage capital rounds have resulted in significant opportunity for venture firms to either back their winners more meaningfully or gain exposure to high growth, high margin companies with an attractive risk-adjusted return profile. Venture growth equity is being recognized as an important milestone in the development of a fast-growing tech business.

The entrepreneurs seeking growth equity are in a fortunate position. Gone are the bootstrap days of eating canned spaghetti and applying for every available grant under the sun; they no longer need external capital to survive. A company at this stage has an established product-market fit, a substantial customer base, strong organic revenue growth, proven unit economics and is either profitable or on a clear path to profitability. Entrepreneurs now have a return optimization decision as to whether they continue the steady growth pace by deploying cash generated by revenue or seeking venture growth equity to scale rapidly.

At this point, entrepreneurs are often presented with multiple term sheets from VC firms seeking a position on the cap table. Entrepreneurs are typically not looking for control investors, instead preferring an efficient and swift diligence period and a supportive partner that can add strategic value in scaling their business. Capital has become a commodity. To be a differentiated source of capital and the partner of choice to the best entrepreneurs, it is critical that venture firms look to be more than a pure capital allocator. At StepStone, we are extremely proud of our dedicated Portfolio Venture Impact program that focuses exclusively on creating unique value for our fund managers and portfolio companies by providing events, strategic introductions, quality deal flow, market insights and executive recruiting.

A Risk-Return Profile That Is Hard to Ignore

The dynamics at play have presented an opportunity for investors to look at venture growth equity as an allocation that offers the most attractive risk-adjusted return profile for their investment portfolio. In a sufficiently large and growing market, the upside potential of growth-stage businesses can be significant, even on par with earlier-stage VC; however, the companies seeking growth equity are typically high margin businesses achieving growth rates in excess of 70%.

There is a preconceived notion that venture returns can be achieved only in early-stage investing. However, the data suggests that venture growth equity can also provide grand slams that will carry the day by returning a whole fund via just one portfolio company.

Figure 3 suggests that while loss ratios for early-stage VC have held steady at about 50% on average over the last three decades, the loss ratios for late-stage investments have decreased significantly from 59% in the 1990s to 15% in the 2010s.

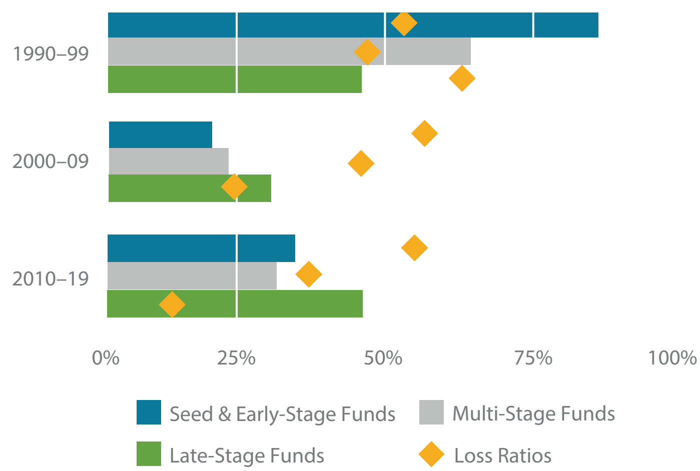
Manager Selection Has Never Been More Critical

Just as picking the right venture capitalist is critical for entrepreneurs, choosing the right manager for investors is crucial. In contrast to early-stage investing, finding the "golden nugget" is not the issue; rather, jostling through the crowded field of term sheets to be the investor of choice comes with its own challenges. We believe the key is to avoid the competition in the first place. This is where an effective and scalable flywheel is critical to identifying category-defining tech companies before they become widely known to the public, thus limiting price negotiation and avoiding a competitive process.

VC remains a game of outliers, with a handful of massive outcomes generating the majority of returns each vintage. The dispersion of returns is greater in VC than in any other asset class. The commonality between the top VC managers who continue to monopolize late-stage returns is simple: access. Access to data, information and relationships all lead to a better mousetrap.

When done right, venture growth equity investing requires an effective sourcing and diligence platform in which relationship and data advantages become a prerequisite for achieving venture returns. If you think about the public equity universe, access to information is theoretically equal. The beauty of private markets can be that, in effect, not everyone has equal access to information. We recognize the name of

FIGURE 3 | GROSS IRR & LOSS RATIOS BY ERA



Source: StepStone Private Markets Intelligence, 2019.

Note: Gross IRR will ultimately be reduced by management fees, carried interest, taxes and other fees and expenses.

the game is providing our investors with access to blue-chip managers, but scaling and identifying emerging managers that show promise are also important. We believe that trusted relationships lead to better outcomes, and this philosophy has helped us access investment opportunities that have yielded outsize venture returns.

VC Returns at the Expense of Public Investors

The number of US public companies has declined more than 50% since its peak in 1996, despite a rise in the total number of companies. Said simply: Companies are staying private longer. Investors are now looking to private markets to access a portion of the market that was formerly available to them via the public small and mid-cap growth segment.

Historically, we would expect category-leading tech companies to raise between $1 billion and $5 billion at IPO. Today $30 billion–50 billion is the norm.

Figure 4 highlights the historic and current dynamic at play. Once upon a time, top venture-backed companies such as Amazon, Google and eBay entered the public markets early enough for public shareholders to reap the returns while private investors were taking more risk.

In 1997, Amazon's IPO market cap was $430 million with quarterly revenue of $17 million, which came three years after it was founded. Google followed in 2004 with a near-record market cap of $23 billion at IPO and was the ripe age of six years old. A public investor holding through today would have certainly enjoyed a venture-sized return for a venture-timed bet.

Fast-forward to today and the forementioned scenario is more fantasy than reality. While venture-backed companies continue

FIGURE 4 | HISTORICAL INVESTMENT RETURN PROFILE

	Time to Liquidity (Years)	Avg. Time to Liquidity (Years)	Post-Offer Valuation ($M)	Current Valuation ($M)	Public Return	VC Investors	Return at IPO ($M)
Past							
amazon	1.4	6.0	$429.5	$1,654,761.8	3,852.8x	KPCB	$30.9
Google	5.2	5.3	23,053.1	1,640,720.1	71.2x	KPCB	27.7
ebay	1.2	3.0	715.3	44,939.0	62.8x	Benchmark	37.6
Present							
Uber	8.7	5.1	$75,713.5	$91,978.3	1.2x	Benchmark, Foundation Capital, KPCB, NEA	$11,785.0
airbnb	11.1	6.2	40,626.4	89,448.1	2.2x	KPCB, Founders Fund, Sequoia Capital, Andreessen Horowitz	859.0
UiPath™	5.8	4.6	29,072.6	35,917.3	1.2x	Greenspring Associates, Meritech Capital Partners, KPCB, Accel	534.5

Sources: PitchBook, Thomson Reuters.

to provide investors with some of the highest returns of any investment category, today's top companies are remaining private for five years longer on average. Additionally, these companies are typically raising seven venture rounds before exiting, compared with 5.5 rounds in 2000. All these add up to a longer runway to build value while companies are private, leaving the bulk of returns out of public investors' reach. Venture capitalists have called for their ledgers to be squared, and they aren't looking to slow down any time soon.

It is important to recognize that the magnitude of these exit valuations is not just driven by the public markets, but also company performance as we see revenue growth rates compounding year on year. Venture growth tech companies are scaling at a pace we have never seen before.

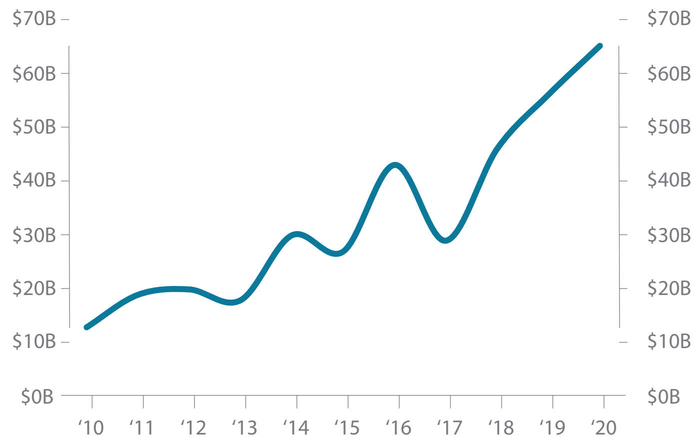
Digitization and Companies Staying Private Longer Has Led to a Requirement of More Capital

The market looks very different today than it has historically, as companies are quickly growing and choosing to fuel the most rapid years of their development with help from the private markets. The need for venture firms to service the evolving growth in this new segment is self-evident.

Figure 5 shows that 2020 was a peak year for venture funds raising capital, totaling $65 billion. Venture firms have acknowledged the market dynamics by raising more capital and coming back quicker. It is conceivable that we will see some venture funds raise more than $10 billion or even $50 billion in the years to come.

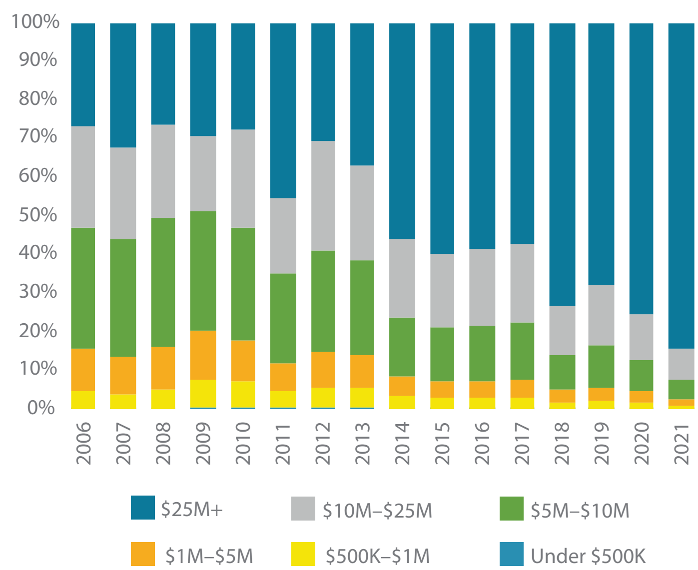
We believe it is now evident that more capital is necessary to build world-class tech companies. The increased capital inflow allows for tech startups to get more bang for their buck as they scale faster and generate higher returns on their business models. The emergence of this new velocity-focused strategy in the venture growth equity asset class will fundamentally change the way that VC is raised, something we are already seeing.

FIGURE 5 | ANNUAL US VC FUNDRAISING



Source: Thomson Reuters.

FIGURE 6 | US LATE-STAGE ACTIVITY BY SIZE



Source: PitchBook, March 2021.

Note: PitchBook data are continually updated; values subject to change.

The Boom of Late-Stage VC Deals

The recent boom in invested capital has been driven by the proliferation of late-stage deals, known as growth equity investments. As shown below, they comprised the highest proportion of deals than at any point since 2010, with 75% of all investment's dollars allocated to this stage in 2021.

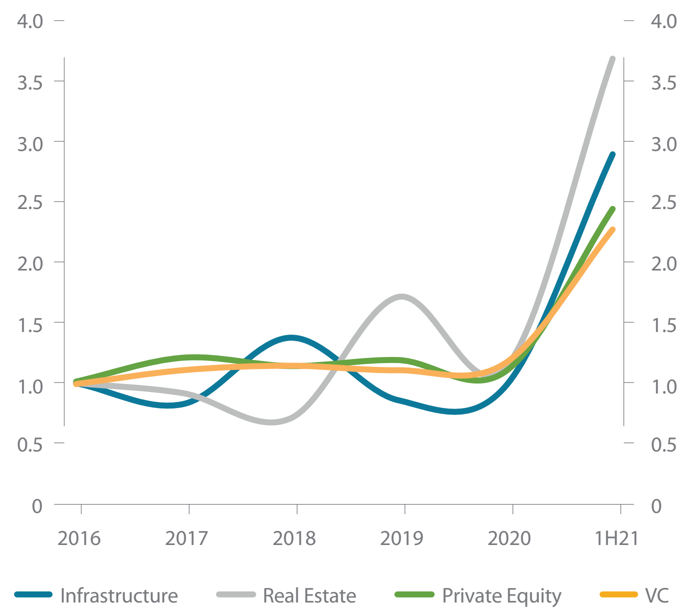
The spotlight on growth equity investments will soon become the norm as companies stay private longer and tech adoption continues to surge. Unicorns were virtually nonexistent as recently as a decade ago, but today the number has grown significantly from a dozen eight years ago to more than 800 today, worth approximately a combined $2.7 trillion **(Figure 7)**.

Robust Exit Market Supports High Entry Valuations

Although we understand VC will always make for snazzy headlines, the notion that high valuations are apparent only in VC could not be further from the truth. Valuations continue to soar across the private markets as shown in **Figure 8**.

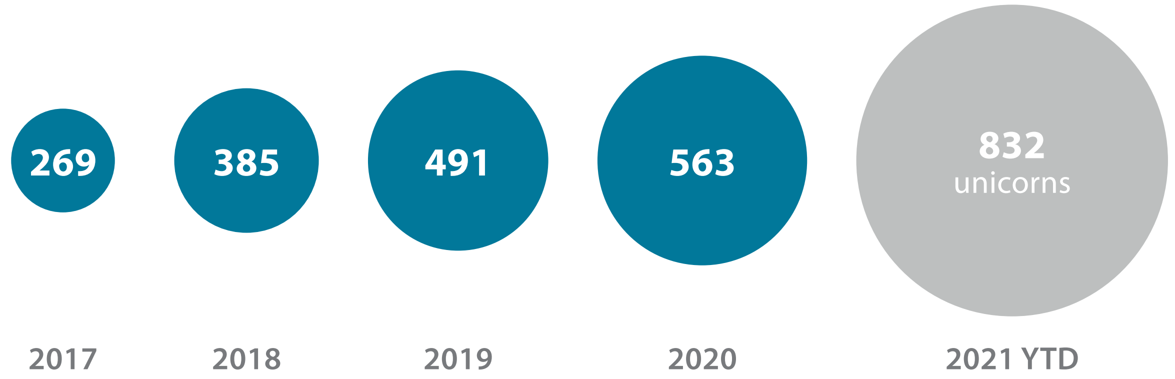
Frothy valuations underpin the trend towards bigger venture funds and bigger deals. Venture firms must invest more capital

FIGURE 8 | PERCENTAGE CHANGE IN MEDIAN VALUATIONS YOY



Source: PitchBook, June 2021.
Note: PitchBook data are continually updated; values subject to change.

FIGURE 7 | GLOBAL UNICORN COUNT



Source: CB Information Services, Inc., September 23, 2021.

to secure their desired ownership levels and remain relevant. This dynamic is not surprising owing to investors' eagerness to deploy capital into attractive, high margin, high growth tech companies, resulting in intense competition among investors and upward pressure on valuations.

On an absolute basis, venture growth equity valuations may be high, but many of these companies would have been public 20 years ago. The upside returns are now being captured by the private markets as venture firms have adapted to capture more of these results in outlier investments by holding private companies longer. There is a new generation of venture-backed companies that is shattering historical norms and setting new precedents.

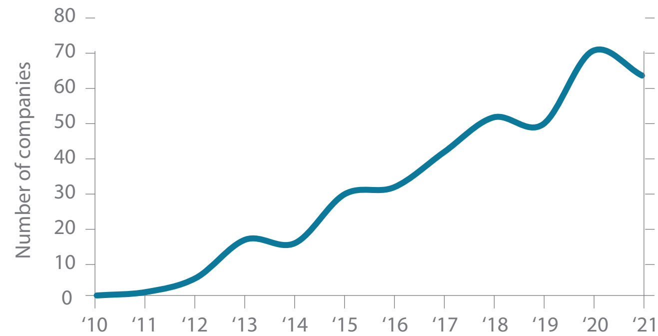
The correlation between both entry and exit valuations provides a useful backdrop for investors who continue to allocate to venture growth equity. We believe that the exit environment for venture-backed companies firmly supports the high entry valuations. **Figure 9** shows the public exit market for venture-backed companies—a good indication of the growing market caps and how sizable these companies are when listing.

Further, the companies that have gone public in the past two years have resulted in a colossal realization of private value. Since 2019, more than $659 billion in venture-backed private value went public in the US via IPO, and another $156 billion did so via acquisition (**Figure 10**).

However, while there were many IPOs in recent years, M&A still account for the bulk of exits for venture-backed tech companies. **Figure 11** shows that in the past decade over 86% of venture exit liquidity has come from M&A activity versus IPOs.

The exit market validation for venture-backed companies continues to be supported by the rising number of strategic acquirers. While the line of traditional strategic acquirers such as Google, Cisco, Salesforce and Microsoft remains robust, the number of nontraditional acquirers continues to grow with the likes of Walmart, PetSmart and Whirlpool. In addition, the market has seen an increase from $1.6 billion to $9.8 billion in the acquisition value of financial buyer M&A transactions from 2006 to 2020, representing growth of greater than 5x according to PitchBook. These growth rates create the rationale that investors can be paying higher prices for companies due to the growing and significant opportunity to exit at much higher levels.

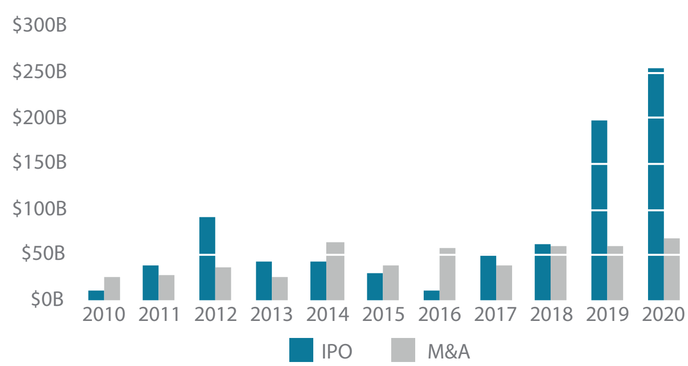
FIGURE 9 | NUMBER OF FORMERLY VC-BACKED PUBLIC COMPANIES CURRENTLY VALUED AT >$5B



Source: PitchBook, June 2021.

Note: PitchBook data are continually updated; values subject to change.

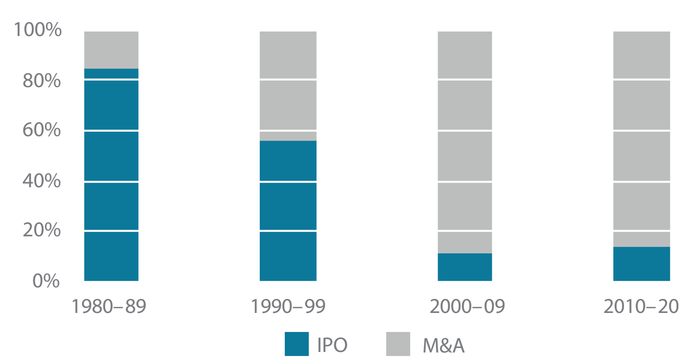
FIGURE 10 | EXIT VALUE



Source: PitchBook, June 2021.

Note: PitchBook data are continually updated; values subject to change.

FIGURE 11 | VC EXITS



Source: PitchBook, December 2020.

Note: PitchBook data are continually updated; values subject to change.

Capital Is Key for Rapid Growth, and Size Matters to Remain Relevant

The competition for the best companies has never been fiercer, and it is crucial for venture firms to keep pace with these market dynamics. To stay relevant, scale is the key ingredient to driving a sustainable flywheel. Capital at scale is required not only to write larger checks, but also to feed the flywheel that ultimately drives enhanced outcomes for investors. More capital to feed primary funds leads to more directs, which leads to more secondaries and so on. This, in turn, allows for a flexible platform that offers multiple entry points for investors to gain and grow exposure through primaries, secondaries and directs in category-leading tech companies.

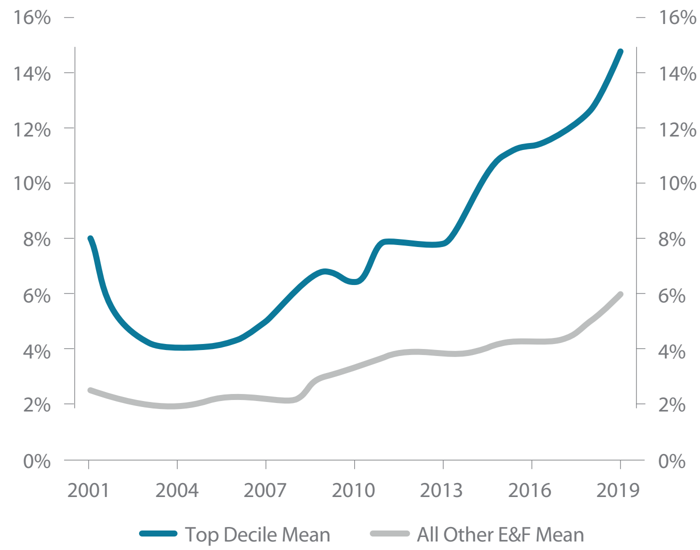
The long hold periods and winner-take-all market dynamics inherent in IT have in many ways shifted the advantage to larger brand-name VC funds that have the capacity to invest in their best companies throughout their life cycle. These larger funds tend to focus on Series A rounds, but often have the flexibility to invest from seed to pre-IPO.

Allocation to Venture

The performance of public equities is diminishing for several reasons, including the shift to private markets, the ephemeral nature of innovation and the likelihood that new entrants will outperform incumbent companies in the new normal. As a result, the significant upside of value is being captured in the private markets, driving investors to become increasingly reliant on allocating to venture and venture growth to achieve portfolio returns for beneficiaries.

> To stay relevant, scale is the key ingredient to driving a sustainable flywheel.

FIGURE 12 | MEAN VC ALLOCATION



Source: Cambridge Associates. Note: Analysis includes 155 institutions that provide asset allocation data for each of the periods listed. The top decile is based on the 20-year Average Annual Compound Return rankings as of June 30, 2019 and includes 15 institutions

Figure 12 illustrates that allocations to VC have been increasing since 2007 among groups such as endowments and foundations (E&Fs). Additionally, of the top decile of E&Fs, allocations have grown from around 5% in 2007 to nearly 14% in 2019. So, those who have chosen to overweight VC have reaped the rewards.

Conclusion

The ability for VC to serve as a driving force for innovation, along with its strong return potential, has made the asset class increasingly more attractive to investors, often at the expense of established industries and public markets. A compelling set of new opportunities will continue to arise over the next several years. They will follow in the steps of other companies born in unusual times such as Dropbox, Pinterest, Uber and Airbnb. The nature of the opportunity has fundamentally changed, and we believe now is an opportune time for investors to get off the sidelines and into the game.

StepStone Group (Nasdaq: STEP) is a global private markets investment firm focused on providing customized investment solutions and advisory and data services to our clients. StepStone's clients include some of the world's largest public and private defined benefit and defined contribution pension funds, sovereign wealth funds and insurance companies, as well as prominent endowments, foundations, family offices and private wealth clients, which include high-net-worth and mass affluent individuals. StepStone partners with its clients to develop and build private markets portfolios designed to meet their specific objectives across the private equity, infrastructure, private debt and real estate asset classes.

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