Know Your Private Equity Strategy
How to Distinguish Between Growth Equity and Late-Stage Venture Capital

KEY ELEMENTS

- Growth equity and late-stage venture capital (VC) are both growth-oriented private equity strategies, but they have significantly different characteristics.

- Late-stage VC companies have high revenue growth rates and demonstrated viability by virtue of user-adoption or sales, with a strong shot at an IPO. Growth equity companies have comparatively lower revenue growth rates but a more established market presence, and are further along in achieving profitability.

- Late-stage venture capital typically comes in organized funding rounds with multiple general partners taking small minority stakes. Growth equity investors also take minority stakes, though typically for at least 25% ownership.

- Late-stage venture capital managers generally target riskier investments and higher returns than growth equity managers, but historically neither strategy, in the aggregate, has hit its return objectives for vintage years 2000-14, and late-stage VC especially has underperformed.

- For purposes of portfolio construction and strategy selection, late-stage venture capital and growth equity strategies should be treated as separate and distinct, with different return and risk profiles.

“Understanding the difference is vital for both manager selection and in structuring an existing private equity portfolio.”

Ashley DeLuce
Private Equity Consulting Group
“Know what you own” is a fundamental tenet for institutional investors. Fund sponsors should understand the characteristics of the assets in which they are invested and are evaluating as possible investments. This better positions them to make informed judgments about their long-term strategies and the construction of their portfolios.

This tenet is especially relevant for investors in private equity given the wide dispersion of returns across private equity strategies. Both growth equity and late-stage venture capital are growth-oriented, for instance, but differ significantly in the types of companies they invest in, the structure of their investments, the way in which they create value, and the trade-offs between risk and return.

With a clear understanding of the two, investors can better determine which strategies suit their objectives, and more effectively evaluate fund offerings and general partners when making new investments. When looking at a particular partnership opportunity, investors need to be able to read between the lines of a general partner’s marketing narrative. In some cases, late-stage VC general partners and growth equity general partners may invest, to varying degrees, in both strategies within the same fund. It is important for investors to look beyond the fund level and evaluate the underlying companies to determine where the investments fall on the strategy spectrum. As the market has evolved, the line between late-stage venture capital and growth equity has become blurred, with managers often having exposure to both types of investments. While this may be related to late-stage VC companies staying private longer, in some cases it is the result of strategy drift, which introduces different risks to a portfolio.

In this paper we take a close look at what distinguishes the two strategies, with an emphasis on the distinctions at the portfolio company level. We examine the differences in company characteristics and investment structuring as well as uses of capital, value creation, risk/return profiles, and exit strategies.

**Attempts to Explain the Differences**

Within the industry, the taxonomy regarding growth equity and late-stage venture capital is unclear and heterogeneous. Large database providers such as PitchBook, Preqin, and Cambridge all define growth equity and late-stage VC differently.

Complicating the issue, the National Venture Capital Association (NVCA) includes growth equity as part of its research focus. Because of that, investors may feel compelled to place the strategy within the venture capital realm, when really it is a unique strategy type that should be evaluated accordingly.

The Securities and Exchange Commission (SEC) offers some guidance about the distinction. Funds can be classified as “venture capital” based on whether they fall under the VC exemption of the Investment Advisers Act of 1940. To qualify, the investment manager must advise solely on private funds that invest in the equity securities of a company to finance expansion and development through successive funding rounds. These funds must market themselves as venture capital funds, they cannot incur leverage greater than 15% of capital commitments, and they cannot invest more than 20% of capital commitments in non-qualifying investments.
But while the SEC’s definition may help classify the fund, it provides significant latitude, so the underlying investments often vary across the strategy spectrum. In Callan’s definitions of the two strategies, we go beyond the fund level to determine whether an investment is properly categorized as growth equity or late-stage venture capital. We look at company type, industry, geography, investment structure, and more to draw clear lines between the two.

### Exhibit 1
A Comparison of the Two Strategies

While both late-stage venture capital and growth equity focus on investments in growing companies, they have many significant differences. Late-stage venture capital targets higher returns than growth equity, with commensurately higher risk, but growth equity has outperformed late-stage venture capital on a cumulative basis across vintage years 2000-14.

<table>
<thead>
<tr>
<th></th>
<th>Late-Stage Venture Capital</th>
<th>Growth Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry Focus</td>
<td>Technology, Consumer, or Life Sciences, primarily</td>
<td>A wide array, including Business Services, Industrials, Consumer, and Financials</td>
</tr>
<tr>
<td>Revenue Growth Targets</td>
<td>30%+</td>
<td>10%-20%+</td>
</tr>
<tr>
<td>Deal Syndication</td>
<td>Multiple investors per company</td>
<td>Single investor or a few investors per company</td>
</tr>
<tr>
<td>Company Characteristics</td>
<td>Active revenue generation and demonstrated traction in the marketplace, with an IPO a potential outcome</td>
<td>Proven business model that is profitable, or very close, looking to accelerate sales and earnings or provide capital to founders seeking a partial or complete exit</td>
</tr>
<tr>
<td>Manager Role</td>
<td>Not highly involved in company operations, so must be able to select the right companies and invest at the right valuation</td>
<td>Take a strong hand in day-to-day operations, which means that industry and operating expertise is vital</td>
</tr>
<tr>
<td>Geography</td>
<td>Primarily Silicon Valley, China</td>
<td>Diverse metro areas</td>
</tr>
<tr>
<td>Investment Structures</td>
<td>Funding rounds with multiple general partners taking small minority stakes, typically less than 25%, with the average investment around $60 million</td>
<td>At least 25% ownership with average investment of roughly $100 million</td>
</tr>
<tr>
<td>Value Creation</td>
<td>Funding designed to spur organic growth and move the company to a potential IPO</td>
<td>Investments geared to creating revenue growth organically and through acquisitions.</td>
</tr>
<tr>
<td>Leverage</td>
<td>Rarely</td>
<td>Rarely</td>
</tr>
<tr>
<td>Risk/Return Target</td>
<td>30% internal rate of return (IRR); 3x-5x TVPI multiple</td>
<td>20%-30% IRR; 3x TVPI multiple</td>
</tr>
<tr>
<td>Loss Ratio</td>
<td>30%-40% expected</td>
<td>10%-30% expected</td>
</tr>
<tr>
<td>Exits</td>
<td>IPO, though financial or strategic sale is also a possibility</td>
<td>Strategic or financial sale more common, but IPO also a possibility</td>
</tr>
</tbody>
</table>

### A Look at the Investment Characteristics

#### Types of Companies

Unlike early-stage VC companies that may be pioneers of new industries and have evolving business models, late-stage venture capital companies are relatively further along in their development. Late-stage VC managers typically invest in companies with active revenue generation and demonstrated traction in the marketplace. Once an early-stage company runs through initial funding rounds and demonstrates viability by virtue of user-adoption or sales, the company begins its transition to a late-stage company.
These companies have typically reached a point where an initial public offering (IPO), or more recently a “private IPO” in which the capital is raised in private placements, is a likely outcome. Late-stage VC general partners provide the final injections of capital needed to ready the company for the IPO, in the hopes that it will boost the company’s IPO valuation.

Late-stage VC managers invest at this key inflection point and then look to quickly exit to earn their return. They seek high top-line growth rates, typically well in excess of 30% annually, to balance the risk profile of these companies. General partners underwrite the companies by evaluating the pace at which they can scale and grow, the market adoption rates of their products or services; and the size and growth of the target end markets. The financing may be used to build out the last pieces of infrastructure or staffing to demonstrate scale, or provide near-term working capital, possibly helping the company turn cash-flow positive. Though these companies typically have IPO potential, they may ultimately be sold to a strategic or financial buyer.

Exhibit 2
The Progression of VC Funding Rounds

Source: PitchBook
Data reflect 10-year averages
Late-Stage Venture Capital Case Study: Splunk

Splunk, a big-data collection and analysis platform, was founded by Michael Baum, Rob Das, and Erik Swan in 2003. While still developing the product, the company received $5 million in Series A funding from August Capital and Sevin Rosen Funds.\(^1\) Officially launched in 2005, the highly innovative product exhibited early success—within a year more than 15,000 users had downloaded the service. In 2006, the company raised an additional $10 million in a Series B round led by JK&B Capital. At this point the company had started generating revenue, and the financing was used to increase user adoption on a global scale.\(^2\)

The next year the company hit 100,000 downloads and 450 customers. Demonstrating such rapid growth, Splunk received late-stage venture capital financing in 2007. The $25 million Series C round helped continue increasing user adoption, specifically by boosting sales and marketing efforts, expanding operations internationally, and bringing on new original equipment manufacturing and channel partners.\(^3\)

In 2010, Splunk received an additional round of late-stage financing for an undisclosed amount from firms like Technology Crossover Ventures, among others.\(^4\) In 2011, Splunk announced intentions to go public. In preparation, the company planned to hire 125 people, including a new chief financial officer.\(^5\) On schedule, the company completed its IPO at $17 per share, valuing Splunk at $1.57 billion. The company was generating $120 million trailing 12 months revenue, though EBITDA margins were still negative at -7.1%.\(^6\)

Splunk is a prime example of a high-flying venture capital company that went through successive funding rounds before an IPO. Though it had not turned a profit by the time of the IPO, its revenues were strong and the company reached a “unicorn” valuation (over $1 billion). The early-stage VC managers helped the company bring its product to market and begin generating revenue, while the late-stage VC managers invested once the company’s technology had been validated and the product had demonstrated some success in the marketplace.

Prior to the IPO the company was expanding at a remarkable pace, with annual revenue growth rates hitting 93% (2010), 89% (2011), and 83% (2012).\(^7\) Such exceptional growth demonstrated to the public markets that the company was worthy of a high IPO valuation. Late-stage VC investors look to take advantage of this kind of growth and invest at this key point in a company’s life. Firms that invested in 2010, like Technology Crossover Ventures, were able to earn their return in only two years, though they may have held on to the public stock for longer. Splunk continued to be successful post-IPO with a market cap of more than $20 billion.\(^8\)

\(^1\) PitchBook
\(^2\) Splunk
\(^3\) Splunk
\(^4\) PitchBook
\(^5\) “Eyeing IPO, Splunk aims to grow revenue 50 percent,” Reuters, June 23, 2011
\(^6\) PitchBook
\(^7\) “Enterprise Data Company Splunk Prices IPO at $17 Per Share; Valued at $1.6B,” TechCrunch, April 19, 2012
\(^8\) Google Finance
Splunk is an example of a company that went through its funding rounds relatively quickly and went public in less than a decade. But the traditional late-stage venture capital model has shifted. Promising companies are staying private longer and continuing to take on more late-stage venture capital. Staying private gives them greater flexibility and allows them to avoid public reporting requirements.

This trend is facilitated by today’s “mega rounds” and “mega funds.” For example, mutual funds and sovereign wealth funds are entering the late-stage venture arena, looking to invest in very large rounds of financing. And Softbank, which is offering a stay-private solution with its near $100 billion late-stage fund, is an example of a mega fund that is deploying generous amounts of capital in companies at very high valuations, enabling those companies to remain private longer and use the capital to scale even further. As a result, investors must be patient in waiting for these companies to finally exit.

**Growth equity** invests in companies looking to accelerate sales and earnings or provide capital to founders seeking a partial or complete exit. With proven business models, these companies have existing revenue streams and are typically profitable—or very close. Though their products and markets are established and operations have been, at least somewhat, institutionalized, the businesses still have runway for further growth and development. Growth equity managers often target companies that are the first or second player in their markets; thus, compared to venture capital, these companies have a more established market presence. Though some may have had venture backing, many growth equity companies have never taken outside institutional capital before.

These companies are not growing as fast as late-stage VC companies. Though still higher than the growth rates targeted by buyout managers, most growth equity managers look for 10%-20%+ in annual revenue growth. Growth equity companies do not necessarily need IPO-potential, as a growth equity manager can still earn its targeted return of a 3x TVPI multiple at this lower growth rate.

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**Private Equity Performance Explainer**

**Internal Rate of Return (IRR):** The IRR calculates the rate of return since inception of an investment based on the amount and timing of capital contributions, distributions, and the current net asset value of the investment. The IRR is a capital- or dollar-weighted calculation and accounts for the timing and size of flows. IRR differs from the time-weighted return (TWR) calculation employed with equity and fixed income investments, where a series of interim period (e.g., quarterly) returns are linked together in an equal-weighted manner to derive a percentage return unaffected by the size of cash flows.

**TVPI Multiple:** Total Value (Distributions + Net Asset Value) as a ratio of Paid-In capital. A TVPI ratio of 1.30x means that the investment has created a total gain of 30 cents for every dollar contributed.
Growth Equity Case Study: Smashbox

Smashbox Cosmetics was founded by Dean and Davis Factor, the great-grandsons of Max Factor, in 1996. For the first 10 years of its life, the cosmetics and beauty products company did not take on any outside capital; rather, it grew slowly and eventually turned a small profit in 2000. In 2006, the founders decided to look for external investment but would only consider an investor that would serve as a value-add partner to the business.  

At a valuation of $61 million, Smashbox sold a 33% stake to TSG Consumer Partners, a private equity firm that specializes in consumer brands. Investing $20 million, TSG helped the company enhance marketing efforts, expand product lines, and shift distribution from department stores to more specialty beauty retailers, like Sephora and ULTA Beauty. TSG also assisted in building out Smashbox’s management team and updating its IT systems. Four years later, Smashbox was sold to Estée Lauder, a larger beauty products company, for $250 million.

So what characterized Smashbox as a typical growth equity company? It was not that the company was so much larger than a late-stage venture capital company. In fact, at an exit value of $250 million, it was actually much smaller than the prior case study, Splunk. Nor was it the use of capital—both the late-stage VC funding and the growth equity capital were used for growth and expansion, whether it be geographic expansion, product line development, or internal upgrades.

Rather, it was that TSG was the sole institutional investor and wrote a large equity check (at least by the standards of 2006) outside of an organized funding round. The company had been organically grown by the founders before taking on outside institutional investment. Though still a minority investor, TSG owned a relatively large stake and was significantly more involved in company operations than a typical late-stage venture capital manager. TSG served as an experienced partner to the management team and was an active participant in steering the company’s growth trajectory. TSG helped the company increase its revenue threefold and boost EBITDA margins from roughly breakeven to 20%.

Although an IPO may have been an eventual possibility, Smashbox was not a high-flyer like Splunk. Splunk went from a $6 million valuation to over a $1 billion valuation, representing a near 300-fold increase. Smashbox’s growth was significantly smaller with its valuation rising from $61 million to $250 million, a roughly fourfold increase. Although Smashbox never hit a unicorn valuation, it was highly successful as a growth equity investment and TSG was able to earn a strong return at this lower valuation.
Industry Focus

Late-stage venture capital typically invests in Technology, Consumer, or Life Sciences companies. According to PitchBook, a private markets data provider, these three industries have received more than 85% of late-stage VC investments over the last five years. These companies may cater to a variety of end markets and/or burgeoning markets, but their products have some sort of innovative technology component.

Growth equity investments are more diverse; with only 38% invested in Technology, Consumer, and Life Sciences over the last five years, the strategy also targets more traditional sectors like Business Services, Industrials, and Financials. To identify potential opportunities, general partners may specialize in several sectors or more niche markets.

Geography

Historically, both early and late-stage venture capital investments have been concentrated in the San Francisco Bay Area, with Silicon Valley at the epicenter. In the past few years, however, venture capital has become a global industry, particularly in China. According to PitchBook, China now accounts for over 30% of capital invested into late-stage venture capital companies, whereas in 2000 it accounted for less than 1%.

Growth equity companies are more geographically diverse and may be headquartered in various metropolitan centers around the world.

Investment Structures

Late-stage venture capital typically comes in organized funding rounds with multiple general partners taking small minority stakes. As these companies have already received venture capital funding from their early-stage investors, late-stage VC managers typically own less than 25% of the company, with the average equity check today around $60 million, according to PitchBook. These ownership percentages may be slightly diluted over time if there are subsequent funding rounds.

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Comparing the Two Companies

<table>
<thead>
<tr>
<th>Smashbox</th>
<th>Splunk</th>
</tr>
</thead>
<tbody>
<tr>
<td>• One investor</td>
<td>• Many investors</td>
</tr>
<tr>
<td>• Larger equity check</td>
<td>• Smaller equity checks</td>
</tr>
<tr>
<td>• Outside of organized funding round</td>
<td>• Multiple organized funding rounds</td>
</tr>
<tr>
<td>• GP was more involved with value creation</td>
<td>• GP's were less involved with value creation</td>
</tr>
<tr>
<td>• More measured revenue growth rates</td>
<td>• Sky-high revenue growth rates</td>
</tr>
<tr>
<td>• More measured rise in valuation</td>
<td>• Huge rise in valuation</td>
</tr>
<tr>
<td>• Not a unicorn</td>
<td>• Unicorn</td>
</tr>
<tr>
<td>• Exited via strategic acquisition</td>
<td>• Exited via IPO</td>
</tr>
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</table>

Similarities

• Both minority investments
• Similar use of capital
Growth equity investors also take minority stakes, though their ownership percentages are higher than their venture counterparts. Looking for at least 25% ownership, growth equity today invests, on average, roughly $100 million into a portfolio company, according to PitchBook. Company valuations of growth equity investments can be just as high as late-stage VC valuations; five-year average pre-money valuations are $404 million for growth equity and $478 million for late-stage venture capital, according to the data service. So, the difference in equity check size primarily relates to the difference in ownership percentage, as average capital invested is higher for growth equity. Growth equity managers are typically acquiring a larger ownership stake in a company, especially when they are the only institutional investor.

Value Creation

Often a late-stage venture capital general partner is active in its portfolio companies as a mentor or possibly a board member, though typically the GP is not highly involved in day-to-day operations. Early-stage VC investors have already done most of the heavy lifting and have transformed the startup into a “real company.” Although some late-stage venture capital managers take board seats or board observer seats, it is not a requirement for them to invest in the company. Especially with today’s “mega rounds,” there are not enough seats on a board to accommodate upwards of 15 to 20 investors. Given that late-stage venture capital managers are not particularly active in company operations, there is an element of “stock selection” to their strategies. To earn their return, these managers must be able to select the right companies and invest at the right valuation.

Late-stage VC funding is used to spur organic growth and move the company closer to a potential IPO. The capital may be used to hire staff, rent office space, expand product lines, or establish marketing, sales, customer support, and human resources departments.

Growth equity general partners take a more proactive approach to their involvement in company operations. While both late-stage VC and growth equity GPs take board seats, growth equity GPs are typically more involved in the day-to-day management of the company’s operations. Growth equity general partners look to stimulate growth by pushing their portfolio companies into new markets, expanding operations geographically, recruiting new talent, enhancing infrastructure, accessing debt markets, or financing acquisitions. Although these value creation levers do not differ significantly between the two strategies, late-stage venture capital primarily focuses on organic growth, while growth equity looks to boost company growth both organically and through add-on acquisitions. Growth equity managers may look to cut costs at the margin but that is not the focus; revenue expansion is the primary source of EBITDA growth. Proactive involvement gives them greater control over a company’s value creation path, making growth equity managers less dependent on selecting the right companies and investing at the right valuations. An IPO is not the ultimate goal; rather, a growth equity manager is more likely to consider a strategic or financial sale.

Leverage

Late-stage venture capital invests in equity securities, and general partners do not apply leverage to their portfolio companies, as these companies do not have significant cash flow to service any debt. Likewise, most growth equity investments are unlevered, though there are some exceptions.
**Risk/Return**

Late-stage venture capital has a higher risk/return profile than growth equity. Managers typically target a 30% internal rate of return (IRR) and 3x-5x TVPI multiple at the individual company level; this higher return corresponds with a higher loss ratio, around 30% to 40% at the portfolio level. Although less risky than early-stage venture capital, late-stage VC performance still relies on a few large winners to offset numerous losses.

As late-stage VC general partners are typically not as highly involved in the day-to-day operations of their companies, successful partners must have well-established sourcing channels to be able to identify potential big winners. Some argue that there is also a degree of luck associated with the “stock selection” aspect of the strategy. When conducting due diligence on portfolio companies, general partners look for companies with the possibility of substantial outperformance to offset the high risk. Consequently, late-stage venture capital funds have a large number of investments per fund. A concentrated venture capital portfolio can be more prone to failure, as a few underperformers may ruin overall performance.

The risk/return objectives of growth equity are lower than late-stage venture capital. Growth equity managers typically target a 20%-30% IRR and a 3x TVPI multiple at the individual company level with a portfolio loss ratio of 10% to 30%. There is relatively greater performance consistency—fewer home runs are counterbalanced by fewer strikeouts. As general partners are not reliant on these home runs to carry the fund’s performance, they do not have to target such high returns when selecting their portfolio companies.

Both strategies target net returns in excess of 20% to 30%, or greater, yet historical performance tells a different story (Exhibit 3). Although performance can vary widely from one manager to the next, as a whole the two strategies have not hit their return objectives. Late-stage venture capital in particular
has underperformed. Although its cumulative TVPI multiple looks similar to growth equity, the net IRRs exhibit a large 3 percentage point difference, meaning that it takes growth equity less time to reach a similar TVPI multiple.

**Implications for Investors**

As promising late-stage venture capital companies are staying private longer, it can be challenging to differentiate between late-stage VC and growth equity. If a general partner defines itself as a growth equity manager, yet it is making late-stage VC investments, an investor needs to be able to identify the higher risks of these investments and potential strategy drift of the general partner. Likewise, if a late-stage VC manager is actually pursuing growth equity investments, an investor should evaluate whether the manager has the necessary skills to invest and create value in these companies. Understanding the difference is vital for both manager selection and in structuring an existing private equity portfolio.

When underwriting a fund offering, an investor’s evaluation will differ depending on whether it is considering a growth equity strategy or late-stage venture capital fund. Especially in terms of the types of portfolio companies targeted and the general partner’s involvement in company operations, the two strategies require different strengths and resources. Investors need to confirm that the manager has the appropriate skillset to successfully execute its strategy.

In portfolio construction, an investor needs to understand the risk and return expectations involved with the various strategy types it is invested in. A portfolio may appear less risky than it actually is if an investor does not fully understand its funds’ underlying investments. For example, what may seem to be a growth equity strategy could actually invest in late-stage venture capital. Such investments may alter the risk and liquidity characteristics of the investor’s private equity program.

Armed with the ability to distinguish between late-stage venture capital and growth equity, investors become more informed limited partners. Knowing the differences in portfolio company characteristics, investment structures, value creation strategies, and risk/return profiles empowers an investor to better assess general partners, fund offerings, and underlying investments, and ultimately to more successfully implement its private equity program.

In other words: “Know what you own!”
About the Author

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Ashley earned a BA in History and Interdisciplinary Studies from the College of William and Mary. She has earned the right to use the Chartered Alternative Investment Analyst designation.
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