Buyouts

Growth Equity Gains Traction With LPs

By Steve Gelsi, Reuters Buyouts

08/12/13 In a move reflecting broad industry trends, the New York City Public Pension Funds shifted its investment focus toward growth capital investments and away from venture capital this summer.

“The returns overall for the venture asset class haven’t been good in the last five years or so,” said Larry Schloss, chief investment officer of the city’s $137 billion pension system.

At the same time, the pension system OK’d a $225 million allocation to Olympus Growth Equity Fund VI, a growth equity and buyout fund based in Stamford, Connecticut, as part its emphasis on growth equity. It is also holding $274 million of dry powder for emerging managers that often specialize in similar investments.

“With a growth capital fund, there are some very good firms that you can put $100 million into that’ll make you buyout-like returns” to help achieve an annualized target of 15 percent, Schloss told Buyouts. He declined to provide any data on specific fund investments.

Irwin Loud, chief investment officer of funds-of-funds manager Muller & Monroe Asset Management LLC, said he’s seeing more demand from limited partners for growth equity deals, while many have moved away from early-stage venture investments.

“LPs looking for growth equity investments want to avoid groups with concept risks; instead they only want to support groups that invest in companies with real customers and real revenue. The focus is on GPs that invest in companies that are near cash flow breakeven or can achieve it in the near term,” he said.

Marking the trend toward growth equity, the $29 billion University of Texas Investment Management Co has stepped up its investments in the asset class in recent years, with $250 million in commitments to five such funds in 2012 and $277 million in commitments to four funds the year before. That’s up from only $140 million in commitments to two growth equity funds in 2010 and $145 million in commitments to five funds in 2009. In 2013, UTIMCO has committed $50 million thus far to one growth fund, Carrick Capital Partners LP.

UTIMCO’s busiest period took place in the financial crisis year of 2008, with $375 million committed to seven growth funds.

In terms of returns, UTIMCO's $5 million contribution to the 1994 Austin Venture IV LP, a U.S. growth fund, earned it an IRR of 73.1 percent and its $15 million commitment to 1997's Austin Ventures V earned an IRR of 31.89 percent. On the down side, its $100 million commitment in 2011 to Northstar Equity Partners III LP, an Asia growth fund, has so far earned an IRR of negative 12.06 percent, although the fund is still quite young.

Overall, domestic growth equity funds provided some admirable returns in a Buyouts fund analysis of vintage years through 2007, based largely on data as of Dec. 31, 2011. Out of eight investment strategies, growth equity funds placed second with a 21.8 percent top-quartile IRR, compared to a 22.4 percent top-quartile IRR for domestic turnaround and distressed debt funds. Median IRR for domestic growth equity funds came in at 7.5 percent, about the middle of the pack.

Fundraising

The Big Apple's move comes as private equity and venture capital firms converge on growth equity deals as a way to generate returns outside of classic venture deals and leveraged purchases of whole companies.

The investments typically help a revenue-generating company step up its expansion through injections of cash in exchange for minority stakes. Pioneered decades ago by firms such as TA Associates, Summit Partners and General Atlantic, growth equity funds now represent a budding asset class of their own.

Now, more private equity shops ranging from Medina Capital or Brentwood Associates on the mid-market side to mega-firms such as Carlyle Group, Goldman Sachs, TPG, Blackstone and Silver Lake compete in the growth equity arena.

Globally, 21 growth equity funds were formed in 2011, up from 19 in 2010 and 16 in 2010, according to data from Cambridge Associates. In a sign of growing popularity of the strategy, the past two years exceeded the average of 18 per year dating back to 1992.

Recent fundraises include Olympus Partners, which recently hit $2.2 billion for its targeted $2.5 billion Olympus Growth Fund VI LP. Besides New York City Pensions, limited partners for Olympus Partners have included Alaska Retirement Management Board, California State Teachers' Retirement System, Rockefeller Foundation and the Virginia Retirement System. Oregon Investment Council committed $75 million to the fund, while a separate $75 million pledge came from the New Mexico State Investment Council and $50 million came from the Kansas Public Employees Retirement System.

NewSpring Capital closed NewSpring Growth Capital III with total commitments of $250 million in May, according to the firm. The fund beat its $200 million target and surpassed the $163 million raised in NewSpring Growth Capital II. Past LPs with the firm include the Commonwealth of Pennsylvania and the Pennsylvania State Employees' Retirement.

The rise of growth equity funds may also reflect the increasing focus by U.S. buyout shops on Asia, where outright purchases of firms are usually prohibited in favor of minority investments.

“An ever-growing number of firms, many with very different historic roots, converge in this sector in search of what the growth equity pioneers originally sought—superior returns by investing in profitable companies with more growth potential than mature companies and lower risk of capital loss than investing in start-ups,” said John LeClaire, co-founder and the chair of Goodwin Procter’s Private Equity Group.

Non-Control Deals On Rise

A total of 161 non-control private equity deals from U.S. sponsors closed in the first half of 2013, not far off from 186 in the first half of 2012, according to Thomson Reuters data. Overall, the deal flow picked up to nearly 400 in 2012 and 2011, from 364 in 2010.

Dollar volume of non-control deals totaled $2.1 billion in the second quarter, about flat with $2.2 billion in the year-ago quarter. For all of 2012, non-control deals rang up $16.3 billion in business, following $19 billion in 2011 and $17.7 billion in 2010.

In the largest non-control deal since 2010, Blackstone Group led an investor group in a $2 billion deal to buy senior subordinated paid-in-kind units convertible into an undisclosed minority stake in Cheniere Energy Partners LP, a Houston-based provider of natural gas storage services and a majority-owned unit of Cheniere Energy Inc. The company is currently deploying capital to build facilities for exporting liquid natural gas from the United States.

A $1.8 billion, the non-control deal for a 19 percent stake in Brazil’s Banco BTG Pactural SA ranked second with backing from limited partners such as Government of Singapore Investment Corp Pte Ltd, China Investment Corp, Ontario Teachers’ Pension Plan Board of Canada, Abu Dhabi Investment Co and private equity firm JC Flowers & Co LLC, among others.

In the past three-and-a-half years, Kohlberg Kravis Roberts & Co stole the show with 35 non-control investments, including $400 million in June, 2010, for a 40 percent stake in Hilcorp Resources LLC, an energy firm.

Warburg Pincus ranks second during that time period with 33 non-control transactions, including a $230 million deal in March, 2010, to buy an undisclosed stake in life insurance firm Primerica Inc from Citigroup, and a $200 million deal on May 29 for a 20 percent stake in Vincom Retail Co Lt of Vietnam from Vingroup JSC.

Carlyle Group and TPG Capital rang up 25 non-control investments since the start of 2010, followed by 18 for the Blackstone Group, Main Street Capital and JumpStart Inc. Those figures do not count investor groups, with a large variety of participants, which accounted for 337 out of more than 1,300 non-control transactions since 2010.

Pine Brook Partners, which raised $1.4 billion for its first fund in 2009, has closed 22 deals, only one of which was a classic buyout. Unlike other growth equity firms, Pine Brook takes

controlling stakes at early phases of company development and teams up with founders. Since it's working in the established areas of financial services and energy, it doesn't face product development and market risks of venture investments.

"Since the credit crisis, we've seen more interest in growth equity partly because these deals don't require acquisition leverage," said William Spiegel, managing director of Pine Brook. "You're making returns by growing cash flows and by creating jobs, not by financial engineering. That's what's attracted a lot of people. Growth equity investing really works in any economic cycle because there are always great entrepreneurs looking for equity to grow their businesses."

Rahul Aggarwal, managing director of Brentwood Associates, said the Los Angeles firm recently made a significant investment in Lazy Dog, a California-based chain of causal restaurants.

"We have a growth bias," said Aggarwal. "If something looks a bit more like a growth equity investments or a buyout, the lines are getting a little blurred in the industry. We're pretty flexible."

Brentwood's fifth restaurant deal in the last decade, Lazy Dog now operates 12 restaurants but could expand rapidly. One of the firm's other investments, Zoes Kitchen, now operates 88 restaurants after starting out in with 19 units in 2007, when Brentwood came on board.

"We see [Lazy Dog] moving beyond the West Coast," Aggarwal said. "If we could get to national presence over time that would be a great outcome….We know about real estate development and there's insight we can offer at the board level about the challenges of growing at an accelerated pace."