KEYNOTE INTERVIEW

A new era for growth equity

The days of a near exclusive focus on revenue expansion are over as the emphasis shifts to profitable growth, say Matthew Hobart and David Trujillo, co-managing partners at TPG Growth

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Q What makes growth equity an attractive investment proposition in the context of the current macro environment?

David Trujillo: Whenever the market resets, such as after the global financial crisis, for example, you tend to see very attractive vintages. It's clear that this has been a reset period for growth-stage companies, at least from a valuation standpoint. Business fundamentals are still strong for the most part, but we are seeing valuations that have adjusted to this new interest rate environment.

There are still ample opportunities to invest behind secular growth themes, but we are now able to do so at lower valuations than would have been possible in 2021. That all suggests an attractive vintage is on the way.

Q What lessons have been learned from growth equity investing over the past decade, particularly as it relates to growth at all costs?

DT: For much of the past decade, businesses have traded off revenue multiples and revenue growth rates, meaning that founders and CEOs have been incentivised to focus almost exclusively on the top line, regardless of what the bottom line and the actual unit economics of the company looked like. With interest rates at zero, money has been virtually free, on a relative basis, and plentiful. That meant that businesses were able to continue raising funds, even if they had been burning cash and failing to show profitability.

That has all changed now. As equity and credit have tightened, that ready supply of capital is no longer available, so everyone has naturally started prioritising profit. Investors want to see that the dollars going in are delivering long-term viable benefits for the business. There has been a total shift away from growth at all costs.

Growth is still important, of course, but the emphasis is on profitable growth, which is precisely what TPG has always focused on. Essentially, 100 percent of our last fund's portfolio companies are either profitable or funded to profitability. In other words, we knew the business would reach cashflow-positive with our financing and without needing to rely on capital markets to get there.

Matthew Hobart: It's also important to note that we have a fairly concentrated portfolio. We prefer to take meaningful ownership stakes in a relatively smaller number of companies in our core sectors, positioning our teams to actively manage and add value through best-in-class business building capabilities and operational expertise.

That approach differs from many others in the growth equity space, some of which often have very large books of investments, effectively making them tech index funds. Operational capabilities create a meaningful difference because in these more volatile times they enable firms like ours to drive transformation and generate alpha rather than being passive investors at the mercy of the market.

Q What is your approach to origination and what do you look for in a target company?

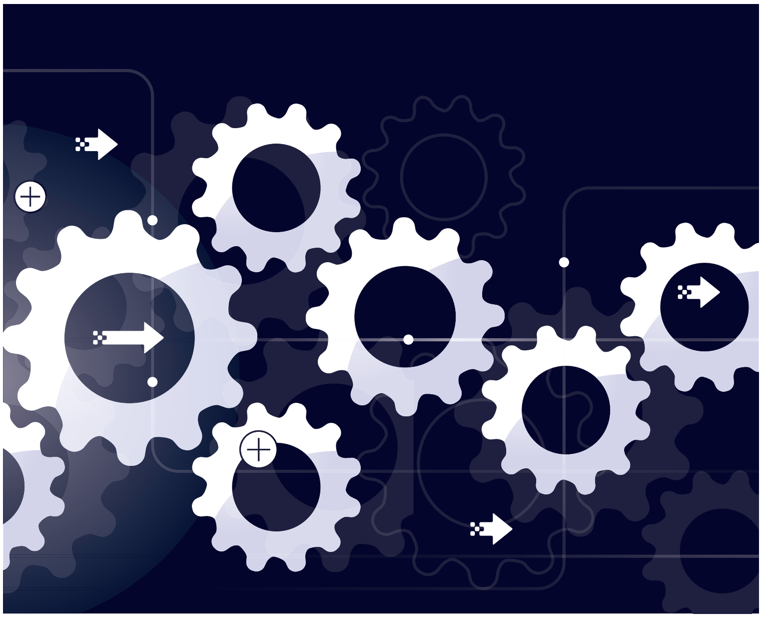
DT: We have four principal sector teams: software and enterprise technology; internet, digital media and communications; healthcare; and business services. We hire directly into those four teams. When people join us as analysts or associates, they build a career in those sectors. Each team has a dozen or so themes that they pursue, meeting with every company in the space and building relationships with the founders and CEOs. This sector-first strategy allows us to build differentiated angles and insights, and ultimately gives us the right to win.

It also means that most of what we do is either proprietary or pre-emptive in nature – we are creating the deal opportunities. That stands in marked contrast to the request for proposal or the FOMO (fear of missing out) style of investing that the industry has gravitated towards over the past decade. That kind of reactive or passive approach is anathema to what we do and what we think will be successful moving forward.

MH: We believe that it will be the unique insights and value you can add after you invest that will be the critical force over the next five to 10 years. We have an operating team of more than 60 individuals who are either experts in their sector or functional experts in pricing and packaging, for example, or sales force effectiveness, supply chain procurement or digital marketing. Those operations professionals, working in close coordination with our deal partners who take seats on the board, can add tremendous value to the businesses we back.

Q Do you expect the emphasis of your value-creation strategy to evolve given the macro context?

DT: Founders and CEOs realise that they will no longer be able to raise money easily, take their company public, and then 'figure it out' from there. They recognise that they are going to need to focus on profitable growth and that they are in for a prolonged period of unpredictability. For many, that will mean learning how to use different muscles and seeking support from a partner that has experience and success over cycles.



Q The growth equity industry has been heavily focused on the tech sector over the past decade. Do you think that will continue to be the case?

MH: There has been a tendency over the last 10 years for growth equity firms to be technology specialists. We have always approached growth equity in a diversified manner, and you can see it in the portfolio balance of our funds over the years. That means we are comfortable moving in and out of sectors at times when they are more or less attractive. That flexibility and nimbleness has served us well since we started our growth equity business 15 years ago and we believe it will continue to be advantageous in the years ahead.

DT: Technology is a secular growth area so the sector will absolutely continue to be a major focus. But I do think that perhaps there has been too much focus on technology at the expense of other sectors over the past five years.

We look at technology in two areas – software and enterprise technology, and also internet, digital media and communications. We didn't get stuck only focusing on technology at a time when technology was expensive. We were able to pivot to other sectors that are also in secular growth mode, principally healthcare and business services. Now that tech valuations have come down, we have been able to pivot back to take advantage of the new environment.

Q How do you expect the exit market to evolve and what is your approach to driving liquidity?

DT: Given the size and stage of the companies we invest in, we generally have a variety of exit opportunities to choose from. While IPOs are market dependent, and the US IPO market has been shut for most of the last 12 months, we were able to take a number of companies public over the last year in India, where our growth franchise has had a longstanding presence.

Meanwhile, strategics are always looking to buy growth-stage businesses and we have companies that not only offer that growth but also offer good unit economics. That profitability is attractive to strategic acquirers.

We are also able to sell companies to other sponsors and, even though debt markets are more constrained at the moment, we have been able to successfully leverage our capital markets teams at TPG to do dividend recapitalisations, which means we are able to continue to return capital to our investors, while maintaining ownership of these businesses.

MH: Aligning with our companies on terms, deal structure and pro forma governance at the time of investment is so critical to creating the optionality David describes. Also important is that in approximately half of our deals we hold a controlling stake, and in the other half, where we are minority shareholders, we nonetheless have significant governance and exit rights, which enables us to drive liquidity how and when we believe is most prudent. That orientation stems from our private equity roots, as opposed to the more common route of growth equity strategies evolving out of venture capital.

"There has been a total shift away from growth at all costs"

DAVID TRUJILLO

"Operational capabilities create a meaningful difference because in these more volatile times they enable firms like ours to drive transformation"

MATTHEW HOBART

Q What key skills and capabilities do you believe it will take to be successful in the growth equity market over the next decade?

MH: I would point to longevity and experience. We are not new to the growth equity market. A lot of dollars have come into the growth equity market in recent years, from public hedge funds, mutual funds, high-net-worth individuals, sovereign wealth funds and venture firms that have raised growth funds, for example. However, those dollars have now largely gone away, and the crowding effect has eased. That has created an attractive competitive dynamic and we are going to keep on doing what we believe has worked really well for us and our investors over the past 15-plus years.

DT: In our experience, a focus on core sectors and themes to create differentiated insights and angles will continue to be integral to success. Once you've created unique opportunities, you need to be able to execute, and that speaks to the importance of being a value-add investor.

The growth equity business is going to be less reliant on sourcing and more reliant on how you can truly help companies after you have invested. It is worth repeating the critical nature of profitable growth. That has always been central to our ethos, but will become absolutely essential in this reset environment. ■