Private market equities: time to turn to growth

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Accelerated growth is rightly prized by investors. Exceptional companies with the right wind in their sails can in some cases grow so fast that even disadvantageous economic conditions cannot knock them off course. A proven product with a strong market fit is one of the most reliable indicators that a company's foundations are solid. Combined with great leadership, it puts a business in a good position to unlock benefits of scale, powering expanding margins and long-term profitability.

However, over a decade of government-distorted interest rates have tempted many to manufacture the *illusion* of growth. Some investors have come to rely on ever-falling refinancing costs to act as their return driver. Their strategies, fuelled by cheap debt and expanding valuation multiples, sailed alongside those powered by increasing demand and widening scale advantages for a time.

Your capital is at risk.

That tide has now turned. Central bank consensus points towards a decade of higher interest rates and tighter money supply, increasing the cost of capital. This is bad news for strategies relying on financial leverage and multiples momentum to set them apart. But by extension, it is also an environment that will allow companies growing at speed from a well-managed cost structure to distinguish themselves.

Engines of growth

The age of operating leverage – delivering value by widening the gap between rising sales and fixed costs – is upon us. While there will still be financial engineering aimed at lowering the cost side of the equation, that model will be under constant pressure in an uncertain rate environment. The clearest path to improving profitability in the coming years will be driven through topline growth. We are already seeing the differentiation in market valuations for companies that are adapting well to the new normal.

This is fantastic news for private growth investors. We invest in companies at growth's inflection point, where value discovery is no longer a question of new product-market fit – the high-risk territory of traditional venture capital. Instead, these companies have transitioned to becoming engines of growth themselves, their leadership teams, cultures and ecosystems driving innovation and adaptability.

These businesses are well-positioned to enjoy years of steep growth. What they need is aligned investors who can support their long-term visions, helping them on the path to not only ultimately going public but also prospering in public markets.

Of course, public markets were originally invented to fund exactly these kinds of businesses. They are still the best places for liquid and cheap equity capital provision. However, companies have increasingly delayed their listings over the last two decades. Thanks to the internet revolution, it has never been easier for private companies to raise capital beyond their immediate networks. The best management teams can now seek and be sought by the best-suited investment organisations. The challenge and the opportunity here, therefore, hinge on access.

This points to the types of opportunities we are most excited about. On the one hand, structural trends coalescing in the form of companies capable of driving exponential growth. On the other, investment opportunities where our reputation as very long-term growth investors gives us unique access to companies that so far have had limited external capital. And ideally, a mix of both.

Structural growth

Many exceptional growth companies have one thing in common: while they are fantastic businesses in their own right, they get an extra push from structural demand growth driven by major societal shifts.

Until recently, software had only lightly touched many parts of the economy beyond communications, retail, and entertainment. Word processors, databases and other off-the-shelf products might be commonplace, but most businesses have yet to fully take advantage of digitisation's potential to generate valuable insights.

In health science, our improving understanding of proteins and DNA promises to unlock countless medical surprises. Cell therapies (which use cultivated cells to address a genetic problem) and gene therapies (which involve changing a patient's DNA on a cellular level) accounted for a combined 10 per cent of the US Food and Drug Administration's novel drug approvals in 2023, up from 6 per cent in 2021.

Tempus AI is an example of a private company taking advantage of this. It has built one of the world's biggest libraries of clinical and molecular data. It uses artificial intelligence to find insights, helping larger pharmaceutical firms develop new drugs and doctors to identify existing therapies that could benefit specific patients. The company is defying the current drought of IPOs, having listed in June this year.

But software isn't the only catalyst for organic growth. The energy transition is set to affect a broad range of power-hungry activities, including heavy industry and transportation.

Northvolt's first lithium-ion battery gigafactory is based in northern Sweden and powered solely by renewables
Image Credit - © Northvolt

Northvolt illustrates how startups can benefit. It makes eco-friendlier battery systems for electric vehicles, as well as energy storage systems for other applications, by powering its factories with renewable energy. In addition to building additional plants of its own to meet demand, it has entered a joint venture with Volvo to construct a site dedicated to making power cells for the car maker's vehicles.

Off the beaten track

We are also excited about opportunities outside of the traditional venture capital ecosystem – and often outside of the US. These companies have been flying under the radar and have grown using mostly their own resources, taking on no or limited institutional capital. This demonstrates their ability to create their own fortune through growth. These companies can also afford to be selective and pick only investors they judge to be the best partners for the next stage of their journey.

A great example is Oddity, a beauty company that uses insights from AI to launch online-only products, which it markets directly to customers. It has built a loyal following, especially among Gen Z customers, and has scaled to profitability with only limited funding from institutional capital. However, when the firm set its sights on a listing, it decided that Baillie Gifford would be the right partner to help it on the next leg of its journey.

Besides the value we can add to growth businesses scaling and professionalising their management, companies are also attracted by our reputation as long-term investors in public and private markets. While this is never a guarantee, we continue to hold Oddity's shares following its listing in July 2023 across a number of growth portfolios.

A recent investment that might follow the same script is Bending Spoons, a fast-growing company based in Milan that even many Italian investors have never heard of. It has built the playbook for acquiring cloud-based software applications with sticky customer cohorts but oversized cost bases. By acquiring products – such as the note-taking app Evernote and Meetup social network – and moving them onto its cheaper and better back-end tech stack and engineering employee base, Bending Spoons can drive faster growth while lowering costs. In the process, it harnesses the magic operating leverage can have on its bottom line.

Time to turn to growth

The times have changed, highlighting that strategies relying on high levels of debt financing are not without cost – and risk – after all.

Not everyone can navigate these waters. But investors would be well advised to put financial leverage and momentum games back in their box for the foreseeable future and turn instead to growth.

We firmly believe that in an environment that has removed the support of cheap leverage, companies that can expand their revenues while reaping the economies of scale to push down unit cost and reap the benefits of operating leverage in the process will deliver superior outcomes for their backers.

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