STEPSTONE

EUROPEAN GROWTH

Overlooked and under-allocated

DECEMBER 2023

Out of the struggles caused by the pandemic and the war between Russia and Ukraine, Europe has faced more scrutiny than other developed markets. But in our experience, private equity performance has not been predicated on macro conditions: Over the last 15 years, the gross returns generated by European fund managers have been in line with those generated by their North American counterparts.[1]

Nonetheless, owing to a weak economic outlook for the region, LPs have shifted capital away from Europe, committing $1 to European GPs for every $3 committed to North American managers over the last five years.[2] Thus, we expect European PE to benefit from lower competition and more favorable deal dynamics in the medium term, which could lift the relative attractiveness of this opportunity.

Past performance does not guarantee future results. Actual results may vary.

[1] According to SPI Research, our proprietary research library, European GPs generated a gross TVM of 2.33x; North American GPs generated a gross TVM of 2.39x.

[2] StepStone Portfolio Analytics and Reporting, Q1 2023.

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Growth investing has emerged as an asset class of its own in Europe. Residing at the intersection of venture capital (VC) and buyout, "Growth" shares characteristics with both. Although it is often viewed as a sub-strategy, our proprietary data suggests that European Growth deserves more attention from institutional investors, owing to its strong risk-adjusted-return profile and limited reliance on leverage to drive returns.

Defining growth investing

Growth investors typically represent the first institutional capital in a founder-owned business. They target growing businesses led by teams that have successfully grown their companies by bootstrapping them rather than relying on VC financing. As a result, these businesses are generally profitable or break-even at entry, since they were built in a capital-efficient manner. Growth investors tend to back companies that are supported by long-term secular tailwinds and are typically in high-growth segments such as technology, consumer internet, fintech and healthcare. Harkening back to a 2022 paper, growth investing can take several forms:

- **Growth equity** represents investments in businesses delivering, or capable of delivering, profitable growth, with a cash injection for a meaningful minority ownership share supporting the business's future development plans.
- **Growth buyout** tends to resemble growth equity, but with an emphasis on control of profitable businesses instead of minority ownership. Because growth-buyout GPs have control, they can take a larger role in selecting management teams and pushing through specific operational and M&A initiatives.
- **Venture growth** is more like VC, sitting in the rounds between early- and late-stage financing. Venture growth companies tend to be unprofitable for at least a few years post-investment, but on the path to profitability and significantly de-risked relative to early-stage investments.

FIGURE 1: DEFINING GROWTH INVESTING

Stage	Early stage VC	Late stage VC	Venture growth	Growth equity	Growth buyout	Buyout
Profitability	Very high cash burn	High cash burn	Modest cash burn	EBITDA +	Modest EBITDA	High EBITDA
Growth rate	>100%	>75%	>50%	>30%	>20%	<20%
Return target	>10x+	>5x	>5x	>3x	>2.5x	>2x
Expected loss ratio	40–50%	25%	25%	<20%	<20%	<20%
Leverage	None	None or modest	None or modest	0–3x EBITDA	2–5x EBITDA	>5x EBITDA
Revenue multiple	>20x	>10x	>8x	>5x	>4x	>3x
Strategy	Find product-market fit	Scale business	Market leadership	Profitable growth	M&A	Cost cutting

Source: StepStone Analysis.

For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.
Target returns are hypothetical and are neither guarantees nor predictions or projections of future performance. Future performance indications and financial market scenarios are no guarantee of current or future performance. There can be no assurance that such target IRRs will be achieved or that the investment will be able to implement its investment strategy, achieve its investment objectives or avoid substantial losses.

The core focus for most European growth managers is on capital-efficient, lower-risk businesses with attractive unit economics that are bootstrapped or have received little external financing. This differs from the hypergrowth, VC-backed companies that drive returns for early-stage investors. Although most European growth managers tend to focus on companies that are closer to the growth equity and growth buyout end of the spectrum, as Europe's VC ecosystem has matured, these GPs have broadened their sourcing strategy to include venture-growth businesses that have attracted institutional VC funding but exhibit a capital-efficient profile.

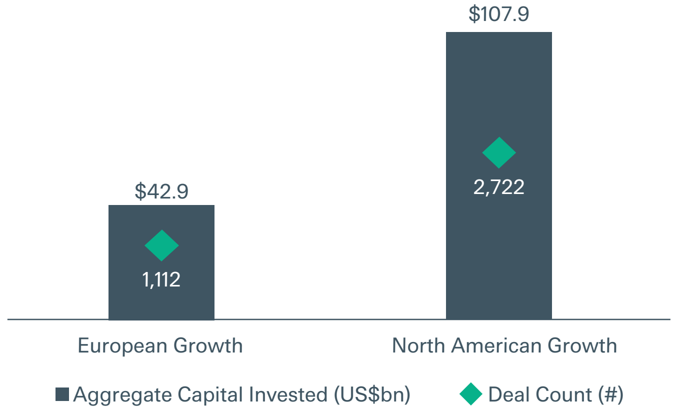
Market sizing and opportunity

North America has led the way in growth deal volume and value historically, with over 2.5x more aggregate capital invested in North America relative to Europe between 2000 and 2020 **(Figure 2)**. The institutional investor landscape for growth investing developed earlier in the US, with several brands emerging in the 1960s (TA Associates, Warburg Pincus) and the 1980s (General Atlantic) and formulating a playbook to develop fast-growing companies. These groups scaled over time to build established global footprints. As these firms scaled, a wave of Growth specialists emerged in the US targeting small and midsize businesses, which has created strong capital availability in North America.

In contrast, Europe's Growth market was slower to develop, and the scarcity of European capital has primed the region to become an attractive playground for the Growth investors that do exist. Although the European Growth market has become deeper, it is still less competitive in terms of dedicated pools of private capital relative to the US, which has contributed to a significant pricing disparity between the two markets.

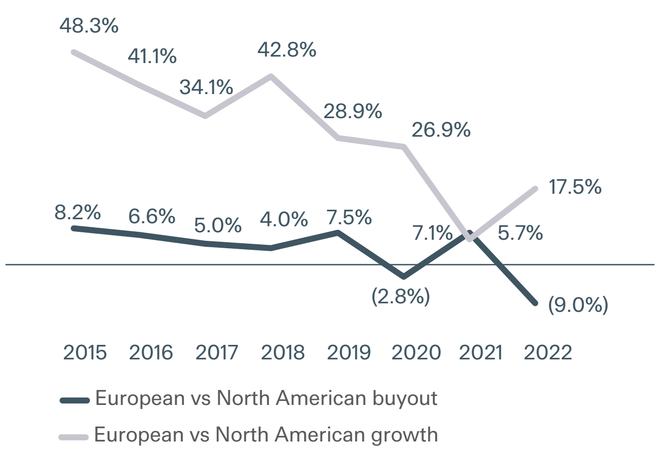
As highlighted by **Figure 3**, European Growth has traded at a discount between 5.7% and 48.3% to North American Growth since 2015. In comparison, European Buyout has traded at a maximum discount of 8.2% to North American Buyout since 2015. While this valuation arbitrage has narrowed in recent years owing to factors such as increased capital supply and competition in Europe, our firm believes this is still an attractive opportunity for investors seeking value in private markets.

FIGURE 2: EUROPEAN VS. NORTH AMERICAN GROWTH MARKET SIZING



Source: SPI Research, as of July 2023. Includes deals between 2000 and 2020.

FIGURE 3: EUROPEAN VS. NORTH AMERICAN GROWTH AND BUYOUT VALUATION GAP

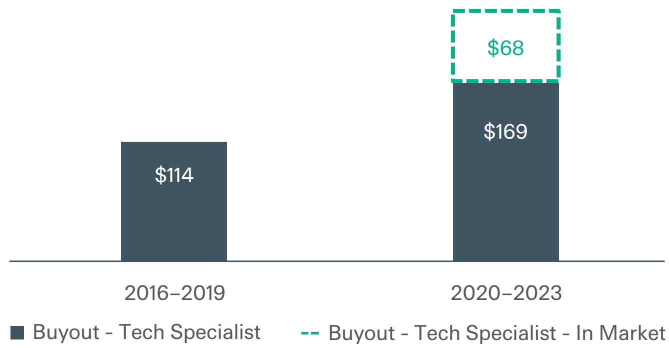


Source: SPI Research, as of July 2023.

One of the key challenges for Growth investors is determining whether each investment has a credible exit path, especially given that target businesses typically range from modestly profitable to near break-even at entry. While these businesses are delivering growth, they often require significant support to deliver it in the sustainable and profitable way that traditional financial sponsors and would-be strategic acquirers look for. Growth investors are positioned to provide that support, and many offer systematic playbooks to deliver strategic and operational improvement plans. These initiatives can include upgrading management teams, professionalizing financial reporting, go-to-market upgrades, or providing M&A support. In an environment where technology adoption remains a key driver of global growth and a key avenue for corporate cost rationalization, there is still significant demand for tech-oriented investments exhibiting strong growth. This is driven by their strong operational performance, high levels of recurring revenue, and resilience through challenging macroeconomic conditions such as the pandemic. Demand for technology investments has led to significant capital inflows into large buyout technology funds. This has created a wall of dry powder in a segment of the market that represents a substantial exit avenue for Growth funds, with these potential acquirers looking at assets on a stand-alone basis, or as add-ons for their portfolio companies.

In our view, the Growth segment in Europe can grow further in light of the digitization of the economy, top-notch education systems and large pools of "cheaper" talent. Europe has 40–50% more professional software developers than the US[3] with developer salaries in Europe continuing to be roughly half of those in the US on average.[4] The maturation of the European tech ecosystem reflects the increasing depth of repeat entrepreneurs and high-quality businesses emerging from the region. We believe that this core target company profile, combined with the limited number of high-quality dedicated Growth players, makes this segment of the European market attractive from a risk-adjusted-returns perspective.

FIGURE 4: CAPITAL RAISED BY TECHNOLOGY SPECIALIST BUYOUT INVESTORS (US$B)



Source: SPI Research, as of July 2023. Includes deals between 2000 and 2020.

FIGURE 5: PERFORMANCE OF EUROPEAN AND NORTH AMERICAN PRIVATE EQUITY

	European growth	European buyout	North American growth	North American buyout
Gross TVM	2.7x	2.4x	2.7x	2.5x
Loss ratio	13%	17%	17%	16%
RAP	2.4x	2.0x	2.3x	2.1x

Source: SPI Research, as of July 2023. Includes 4,254 European and 7,778 North American full-realized deals between 2000 and 2020.

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Note: RAP = Risk-adjusted performance = gross TVM / (1 + loss ratio).

Performance

We have measured the return distributions from more than 12,000 fully realized European and North American private equity transactions completed between 2000 and 2020 **(Figure 5)** to analyze performance across different PE strategies and regions. Based on our proprietary data, European Growth investments have outperformed Buyout strategies in Europe since 2000 and have performed in line with North American Growth investments while delivering

[3] Atomico, The State of European Tech Report 2019 and 2022.
[4] DAXX by Grid Dynamics, What Is the Average Software Developer Salary Around the World 2021.

lower losses. We utilize the risk-adjusted performance (RAP) metric to evaluate the trade-off between deal-level returns and loss ratios, calculated as gross TVM / (1 + loss ratio). This is meant to simulate the Sharpe ratio used for other asset classes. On this basis, European Growth has delivered very strong performance (2.4x TVM) since 2000.

We view this as the most compelling evidence to support an allocation to European Growth, as the historical performance data suggests the strategy has the potential to provide upside to a traditional Buyout portfolio on a risk-adjusted basis. A combination of factors may explain this phenomenon:

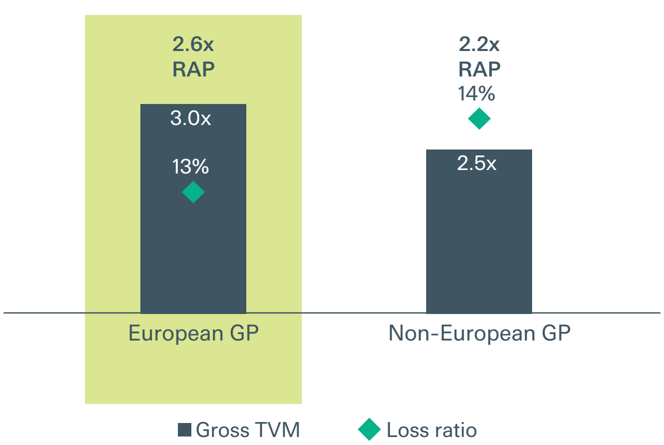
1. Growth GPs have tended to invest more heavily in software and technology, sectors that have delivered strong performance and limited losses;
2. Growth GPs often invest through preferred equity positions, which provide a cushion against a loss of capital without upside restrictions.

For an LP considering an investment in the European Growth space, it's worthwhile to ask whether there is a difference between obtaining exposure through GPs located in Europe and through international (non-European) GPs without boots on the ground or a dedicated European team and fund.

Our proprietary data suggests that GPs based in Europe have outperformed international GPs when completing investments based in Europe. This implies that there are benefits to understanding the nuances of the local market through dedicated on-the-ground resources **(Figure 6)**. We have also mapped the performance of GPs that we view as high-conviction opportunities (marked as "Top Pick" / "Potential Outperformer").[5] These groups have delivered a blended realized TVM of 3.3x, in comparison with the 2.7x TVM delivered by other European Growth GPs.

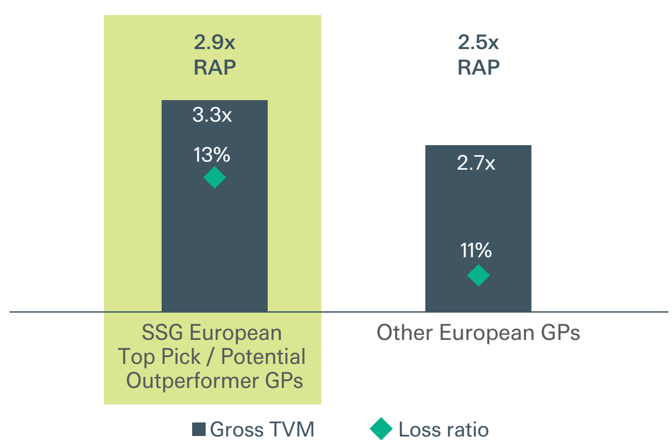
We also tracked the performance of fully realized European Growth investments since 2000 and have divided the data into three separate economic periods of development: pre-GFC

FIGURE 6: PERFORMANCE OF EUROPEAN VS. NON-EUROPEAN GROWTH MANAGERS



Source: SPI Research, as of July 2023. Includes 544 European realized deals between 2000 and 2020.

FIGURE 7: PERFORMANCE OF STEPSTONE EUROPEAN TOP PICK AND POTENTIAL OUTPERFORMER GROWTH MANAGERS



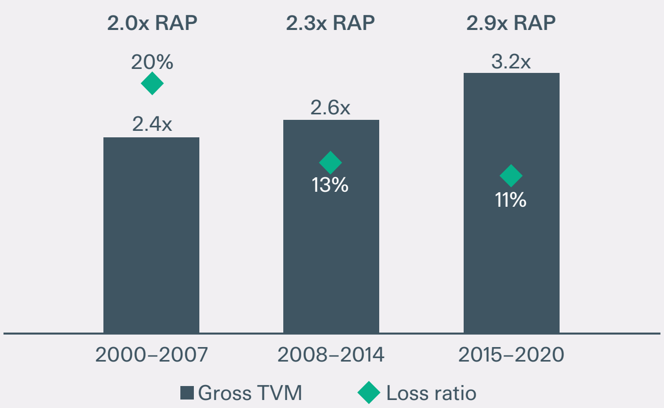
Source: SPI Research, as of July 2023. Includes 348 European realized deals between 2000 and 2020.

For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.
Note: Non-European GPs defined as investment firms based outside of Europe without a dedicated European fund (e.g., a US-based GP without a dedicated European fund).

[5] There can be no assurance made that StepStone will find any opportunities relating to the SSG Top Pick Managers or that they will achieve their objectives or avoid significant losses. The opinions expressed herein reflect the current opinions of StepStone as of the date appearing in this material only. There can be no assurance that views and opinions expressed in this document will come to pass.

(2000–2007), post-GFC (2008–2014) and the Low Interest Rate / Pre-COVID-19 period. We note that European Growth investments have delivered strong performance since 2000 through economic cycles, and performance has continued to improve over time, from a 2.4x gross TVM (2000–2007) to 3.2x gross TVM (2015–2020) **(Figure 8)**.

FIGURE 8: PERFORMANCE OF EUROPEAN GROWTH BY TIME PERIOD



Source: SPI Research, as of July 2023. Includes 544 European fully realized deals between 2000 and 2020.
For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.

Conclusion

Our firm believes that the European Growth market continues to develop while still being less competitive in terms of both price and number of credible and dedicated pools of private capital relative to North America. Hence we advocate that European Growth deserves attention from LPs as part of portfolio construction discussions. The most compelling evidence to support an allocation to European Growth is that historical performance data suggests the strategy has the potential to provide attractive returns with limited losses. Our firm believes that the next few years may represent attractive vintages for investors in European Growth, driven by normalizing entry valuations, the increasing wall of dry powder from large Buyout technology funds, and the strong demand for defensible, high-quality businesses within the GP community. We are further encouraged by the continued acceleration of the digital transformation super cycle in Europe; great disruptive companies are created in all market cycles, and the quality of founders and assets continues to increase in the region. Manager selection remains a core driver of performance, and we believe that carefully selecting high-quality Growth managers with expertise and networks within European markets represents the most effective method of delivering alpha.

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