

Uncovering the Costs and Benefits of Private Equity

Private Equity fees are like snowflakes: abundant, unique, and lacking in transparency.

Private Equity fees are *abundant* in that the headline fee levels are high, especially relative to public index strategies. Private Equity fee structures are *unique* because each Limited Partner Agreement (“LPA”) is closely negotiated between GPs and LPs. The result of these complex and varied negotiations is that Private Equity fees *lack transparency*. This lack of transparency is often driven by the complexity and variability of definitions of fees.

The amount and complexity of fees has received a significant amount of attention in recent months. Institutions are pushing to reduce fee levels and increase transparency. In some cases LPs have had difficulty in calculating how much they actually pay in fees. For a large investor such an exercise is not trivial. The complexity leaves room for unscrupulous GPs to take advantage of their investors; in fact, the complexity can make it difficult even for conscientious GPs to adhere to their own policies and procedures. The resulting confusion can make it impossible to have a rational discussion about the real costs and benefits of investing in the asset class.

This paper will attempt to provide greater understanding about the different conventions used by GPs and LPs in defining how GPs are to be compensated for the services they provide, as well as to answer the question of whether this compensation is generally justified. A subsequent paper will discuss the flurry of recent regulatory actions, as well as steps LPs and GPs are taking to plow through the various issues caused by these fee structures.

Abundant Private Equity Fees

As a starting point, we will present the basics of private equity fee structures. A GP creates a fund governed by an LPA. The GP advises the fund which portfolio companies to invest in, as well as provides active management of that portfolio through to its liquidation. As compensation for these services, the GP is entitled to certain fees. In addition to these fees, LPs agree to reimburse certain types of expenses associated with the management of the fund. The LPA defines these relationships and the split of fees and expenses. LPs and GPs negotiate the terms of each LPA based on the specific risks and merits associated with each fund, as well as the relative negotiating power of LPs versus GPs.

EXPENSES

In **Figure 1**, there are a variety of expense items. StepStone describes “expenses” as those items that are primarily paid to third parties to provide services to the partnership. The definitions of these expenses vary from fund to fund, but generally break down as follows.

» **Organizational expenses** generally include the out-of-pocket expenses incurred when forming the fund and any

related vehicles, such as printing, travel, legal, accounting, and other organizational expenses. These expenses are borne by the fund either directly or by reimbursing the GP up to a negotiated cap.

» **Audit, Tax and Fund Administration Expenses** are examples of annual expenses incurred to provide appropriate monitoring and reporting of the fund’s activities and accounts. The fund bears these expenses.

» **Deal expenses** are the incremental costs associated with the purchase, holding and disposition of investments. The fund capitalizes these expenses in the cost of the deal. For example, the fund pays lawyers and bankers to help consummate the purchase of a private company; the cost basis of the investment includes these expenses. If the deal falls through before it is consummated, then these costs are accrued as “broken deal” expenses, which the GP is usually able to recoup in some manner.

Some deal expenses are paid directly from a portfolio company’s cash flow. A GP may have a portfolio company hire consultants to evaluate a project. The cost of these consultants reduces the short-term profits of the company, reducing cash that would otherwise be used to reduce debt or pay a dividend.

FIGURE 1 | PRIVATE EQUITY FEES AND EXPENSES

	Limited Partners	Offsets	Portfolio Companies
One Time	<ul style="list-style-type: none"> » Organizational Expenses » Broken Deal Expenses 	<ul style="list-style-type: none"> » Transaction Fees » Exit Fees » Break Up Fees 	<ul style="list-style-type: none"> » Deal Expenses <ul style="list-style-type: none"> • Legal • Due Diligence • Consulting • Financing
Annual Fixed	<ul style="list-style-type: none"> » Audit / Tax Expenses » Fund Administration Expenses 	<ul style="list-style-type: none"> » Monitoring Fees » Director Fees 	
Asset Based	<ul style="list-style-type: none"> » Management Fees 		
Performance		<ul style="list-style-type: none"> » Carried Interest 	

Source: StepStone analysis.

Note: Carried interest is considered an offset because it is paid from proceeds from sales and dividends from portfolio companies. All fees and expenses must be first repaid before the fund pays any carried interest.

FEES

StepStone describes the GP's compensation for its role as advisor to the fund as "fees." These fees break down into three broad categories: management fees, other fees, and carried interest. Some of these fees are paid by the fund to the GP by calling additional capital from the LPs. Some of these fees are paid to the GP either directly by portfolio companies, or out of the proceeds of the sale of these assets. The LPA governs how much the GP is entitled to, and from what sources the GP may collect this compensation.

The description of management fees is deceptively simple: typically 1-2.5%, charged as a percentage of committed or net invested capital. However, the rate can change over the course of the partnership and the base against which the rate is applied can also vary. This management fee structure makes it very difficult to compare to other asset classes over time.

What does this mean on a practical level? To analyze this, we conducted a bottom line analysis ("BLA"). We reviewed the 2014 financial statements for 191 funds with vintage years ranging from 1998 to 2015, representing a variety of different private equity strategies. We found that the effective rate of management fees across this sample was about 1% of commitments, or 1.8% of NAV. In other words, management fees appear to contribute about 180 basis points to the difference between gross returns and net returns—the gross-to-net spread ("GTN").

The effective fees LPs pay are not the 2% typical management fee on committed capital, but instead about half of that. The difference is driven by three factors: larger funds charge less than 2% management fees; offsets reduce management fees paid by a significant amount; and fees paid in the later years of a fund are much lower as a percentage of committed capital because they are paid on remaining cost.

GPs charge other fees at the portfolio company level. These include transaction fees, exit fees, monitoring fees, directors' fees and breakup fees, to name a few. The GP's rationale for charging these fees to portfolio companies is that these are services that the companies would typically have to pay for if they were not owned by a Private Equity fund. LPs argue,

however, that the GP is already being paid for these services through their management fees. As a result, they request that any such fees received by the GP are netted—or "offset"—against management fees payable to the GP.

Of course LPAs address this "offset" process in a multitude of ways as a result of thousands of negotiations over the years. More recently ILPA has released guidelines around how various fees and expenses should be accounted.¹ This is to gain consistency in calculations and accounting. We believe that best practice is for management fees to be reduced by 100% of monitoring and transaction fees received. In addition, LPAs should require the GP to report all fees received. This addresses accounting and consistency issues by encouraging GPs not to charge these fees in the first place.

In our BLA, other fees increase the fees the GP charged to the fund by about 10-15% of management fees. In other words, not all other fees offset management fees, so the GPs end up charging the funds about 10-15% more than they would under a 100% fee offset agreement.

The sum of this analysis is that Private Equity fees that LPs are actually paying are closer to 1% of commitments than 2%. The impact on the GTN is close to 200 basis points all in. In other words, Private Equity fees are indeed high, but perhaps not quite as high as some might have thought.

StepStone's analysis shows that average effective management fees are closer to 1% rather than the average sticker price of 2%.

¹ More on this topic in the follow-on to this paper.

CARRIED INTEREST AND WATERFALLS

The GP also receives a share of profits—known as carried interest—that is typically 20%, but can be higher or lower. The timing and calculation methodology of the carried interest is set out in the distribution waterfall. Before a GP can receive carried interest, they typically have to return *all* contributed capital (cost, management fees, and expenses), and generally meet a preferred return.

The preferred return is a minimum annual internal rate of return—most commonly 8% for buyout funds—that the LPs must achieve before the GP shares in profits. In effect, the preferred return ensures that the GP shares in the profits of the fund only to the extent that the investment has performed above the minimum required return. Once the preferred return is met, there is often a catch-up in which the GP receives the majority or all of the profits until they reach the agreed upon profit-split. The catch-up can be 0%—meaning that the GP only shares profits in excess of the preferred return—or between 50% and 100%, another term that varies from LPA to LPA.

The GP must deliver at least the preferred return on not only invested capital, but all fees and expenses, before they can collect their share of the profits. **Figure 2** shows the level of gross returns, in IRR and Total Value Multiple (TVM), that a GP must achieve on a fund with a 2% management fee, an 8% preferred return and a 20% carried interest share, assuming varying duration of the assets and catch-up provisions from the LPA. This demonstrates the power of the preferred return in ensuring that GPs only make money when the LPs make money. In order for a GP to get a full share of carry on a fund with an average duration of 5 years—a typical duration for a buyout fund—the GP must achieve a gross TVM of 1.8-2.0x, depending on the catch up provision.

Distribution waterfalls broadly fall into two categories: deal-by-deal—sometimes referred to as “American”—and whole fund—also known as “European.” In the deal-by-deal waterfall, the GP may take carry as each asset is sold—after

return of capital, allocable expense and preferred return for that investment—rather than having to return cost, expenses and preferred return for the whole fund. To the extent that the GP receives more than its contractual share of profits, the “Clawback” defines how the GP will be responsible for paying back to the LP what they are owed. GPs prefer the deal-by-deal waterfall because it gives them the option of taking carried interest earlier in the fund’s life. They argue that this helps them retain professionals, as well as fund a larger GP commitment.

In whole fund waterfall, the GP must first return *all* investment cost, fees, expenses and the preferred return before they are allowed to participate in carried interest. LPs often prefer this form of waterfall as it drives even greater alignment between LP and GP; reduces the GTN; and reduces the potential for a Clawback liability to arise.

These two types of waterfalls define a spectrum rather than a binary choice; negotiations between GPs and LPs have resulted in a myriad of variations on these themes.

Preferred returns are a powerful way to ensure alignment of interest between LPs and GPs under both American and European distribution waterfalls.

FIGURE 2 | GROSS RETURNS NEEDED FOR GP TO GET FULL CARRIED INTEREST SHARE

IRR Basis

Duration of Invested Capital	Catch-up Percentage					
	50%	60%	70%	80%	90%	100%
1.0	15.6%	14.3%	13.5%	12.9%	12.5%	12.2%
1.5	15.5%	14.2%	13.4%	12.9%	12.5%	12.2%
2.0	15.3%	14.1%	13.3%	12.8%	12.5%	12.2%
2.5	15.2%	14.0%	13.3%	12.8%	12.4%	12.1%
3.0	15.1%	13.9%	13.2%	12.7%	12.4%	12.1%
3.5	15.0%	13.8%	13.1%	12.7%	12.3%	12.1%
4.0	14.9%	13.8%	13.1%	12.6%	12.3%	12.1%
4.5	14.7%	13.7%	13.0%	12.6%	12.3%	12.0%
5.0	14.6%	13.6%	13.0%	12.6%	12.2%	12.0%

TVM Basis

Duration of Invested Capital	Catch-up Percentage					
	50%	60%	70%	80%	90%	100%
1.0	1.16x	1.14x	1.13x	1.13x	1.13x	1.12x
1.5	1.24x	1.22x	1.21x	1.20x	1.19x	1.19x
2.0	1.33x	1.30x	1.28x	1.27x	1.26x	1.26x
2.5	1.42x	1.39x	1.37x	1.35x	1.34x	1.33x
3.0	1.52x	1.48x	1.45x	1.43x	1.42x	1.41x
3.5	1.63x	1.57x	1.54x	1.52x	1.50x	1.49x
4.0	1.74x	1.67x	1.64x	1.61x	1.59x	1.58x
4.5	1.86x	1.78x	1.74x	1.71x	1.68x	1.67x
5.0	1.98x	1.89x	1.84x	1.81x	1.78x	1.76x

Source: StepStone analysis.

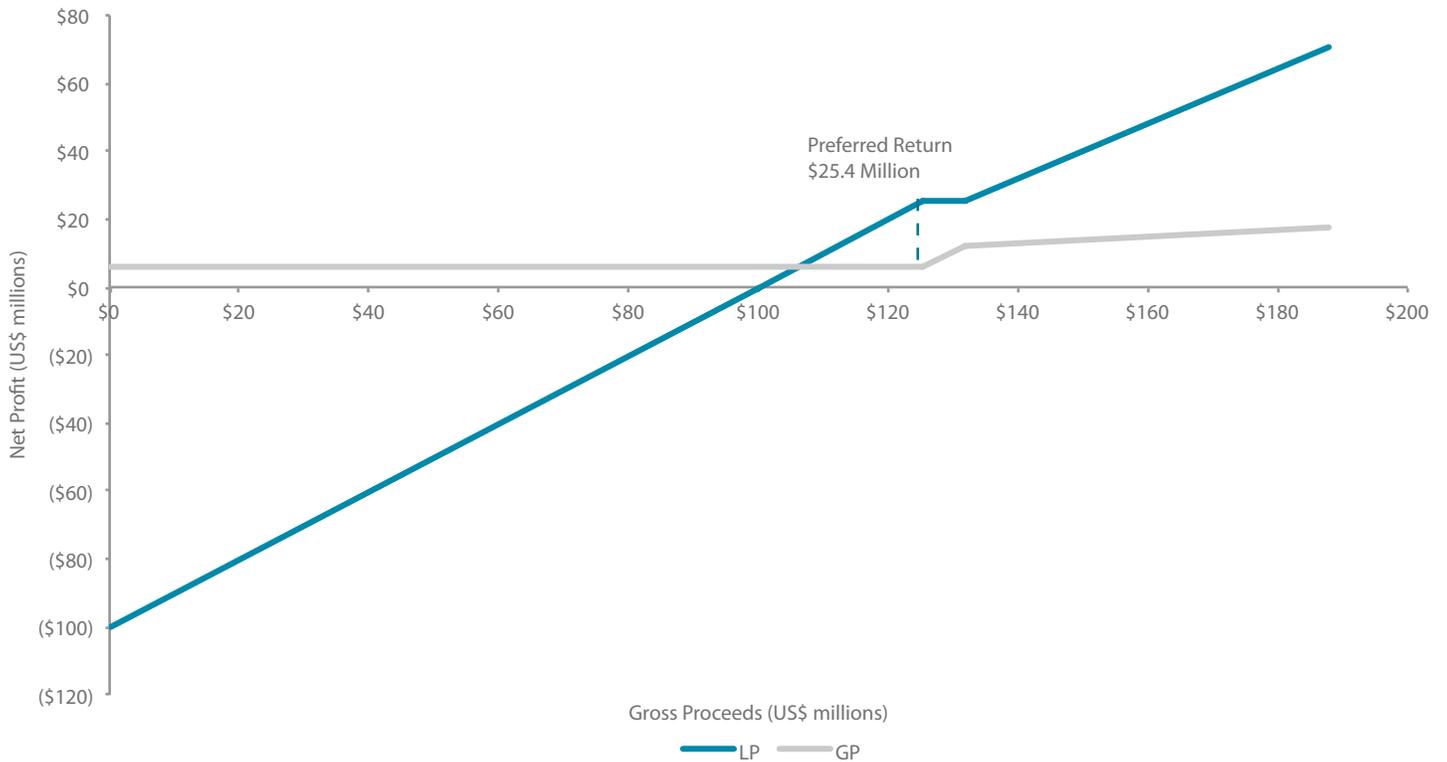
ILLUSTRATIVE EXAMPLE

In a hypothetical scenario, an LP commits \$100 million to a fund with a 2% management fee on committed capital, an 8% preferred return and a 100% catch up. The LP pays in their commitment at the beginning of the first year, and – for simplicity – the GP invests the money in a single investment that is realized at the end of the third year for double its investment cost.

Figure 3 shows, for different levels of gross proceeds from the sale of the fund’s assets, how much goes to the LP (blue line) and how much goes to the GP (gray line). Before any proceeds are received (\$0 on the x-axis) the LP has contributed \$100 million; the GP has received \$6 million in management fees, and invested \$94 million into the portfolio company. At the end of year 3, the GP sells the asset for \$188 million, doubling its investment. The proceeds are divided up as follows.

- 1 \$100 million to the LP as return of contributed capital.
- 2 \$25.4 million to the LP, as the preferred return (8% compounded over 3 years).
- 3 \$6.4 million to the GP, as the catch-up. At this point, the profits of \$31.8 million have been distributed, 80% (\$25.4 million) to the LP and 20% (\$6.4 million) to the GP.
- 4 The remainder, \$56.3 million, is split 80% to the LP (\$45 million) and 20% to the GP (\$11.3 million).
- 5 In total, the LP receives \$170.4 million, or a net TVM and IRR of 1.7x and 19%.² The GP receives \$6 million in management fees and \$17.6 million in carried interest.

FIGURE 3 | ILLUSTRATIVE DISTRIBUTION WATERFALL



Source: StepStone analysis.

² The gross to net spread is 0.3x (2.0-1.7) and 660 basis points (26.0% - 19.4%).

To assess the annual impact of carried interest over the life of a fund, we used StepStone’s proprietary pacing model to simulate a buyout fund with a variety of different fee and return profiles. Carried interest was responsible for 400-500 basis points of GTN for gross returns of 13-26%. This is roughly double the amount received from management and other fees over the life of a fund. In other words, two thirds of a GP’s compensation comes from fees tied to performance.

When assessing the cost of Private Equity, it is critical to keep this performance component in perspective. The GP certainly has the opportunity to earn a very large amount of profits from investing in Private Equity; to maximize their profits, they need to deliver high net returns to LPs. This alignment of interest is a key element of the model. If someone complains about the amount of carried interest they are paying their GPs, it is important to look at the returns those GPs delivered. It might be more problematic if GPs earned *no* carry at all.

Private Equity Alpha is Important to LPs

Given the complexity and the expense associated with Private Equity, why bother to invest in the asset class at all? LPs that have been investing in the asset class for a long time continue to do so. In fact, many have increased their allocation to Private Equity over the years. These investors come from a range of different institutions, from pension funds to foundations and endowments, sovereign wealth funds, insurance companies and family offices. To quote Abraham Lincoln, “you can fool all the people some of the time and some of the people all of the time, but you cannot fool all of the people all of the time.” In other words, such a broad array of sophisticated investors must be getting value for the fees they bear to invest in Private Equity.

Private Equity investors see the asset class as a critical tool in helping them to meet their long-term goals. US public pension funds targeting 7-8% returns find meeting these return objectives a challenge in today’s markets. They are not alone. Globally, investors are being challenged: family offices,

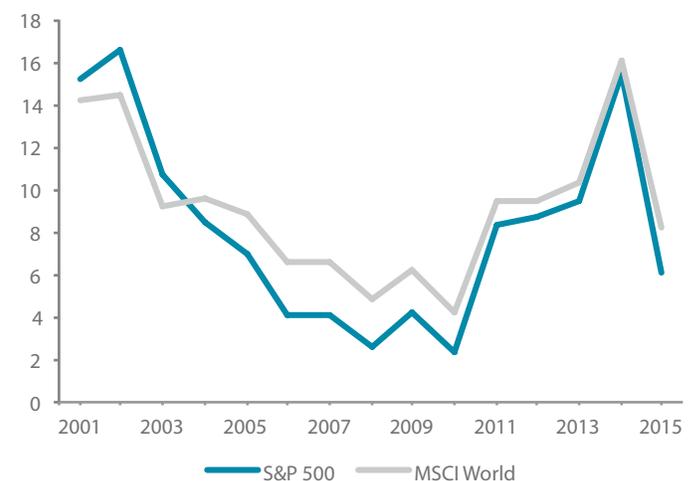
insurance companies and public pensions are seeking to meet growth as well as liquidity requirements. As life expectancy increases, all investors must account for funding ever longer liabilities.

Zero Interest Rate Policy complicates the traditional portfolio mix for institutional investors as it is causing all assets to be repriced. Low interest rates force investors to pursue more risk. Risk assets like equities have been rerated, while fixed income is unattractive.

PRIVATE EQUITY HAS HISTORICALLY DELIVERED EXCESS RETURNS

Many institutional investors have turned to Private Equity to address these challenges. Over the past 15 vintage years, top quartile Private Equity has delivered an average of 6.9% excess return relative to the S&P 500, and 8.4% relative to the MSCI World as shown in **Figure 4**.³ These are net returns, meaning that investors enjoy this outperformance even after paying the high fees outlined above.

FIGURE 4 | TOP QUARTILE PRIVATE EQUITY EXCESS RETURN



Source: Burgiss, S&P 500, MSCI World, StepStone analysis.

³ Academics have used a number of different methods to dollar weight public indices for the purposes of comparing Private Equity performance to listed markets. The state of the art, used to generate these figures, is explained further in Gredil, Griffiths and Stucke, “Benchmarking Private Equity, The Direct Alpha Method,” Working Paper (2014). In this example we are comparing net Private Equity returns to gross index returns.

Median net returns in private equity have also outperformed listed markets in 11 of the last 15 vintage years, by an average of 99 basis points. Investors that are able to achieve above average performance have been compensated for accepting the illiquidity of Private Equity. Particularly, sophisticated investors that are able to identify top quartile managers in private equity are richly rewarded – 860 basis points on average, relative to the median quartile private equity fund, as shown in **Figure 5**.

Further, academic studies have suggested that Private Equity managers are less subject to mean reversion than public equity managers.⁴ This implies that there is a high return over time for identifying and accessing top performing groups. Even if there were persistence of outperformance in public markets, the reward for identifying such stock-

pickers is small by comparison.

Skeptics are quick to point out that the methodologies used to calculate the above comparison make an assumption that a Private Equity portfolio has the same risk as a public equity portfolio (more precisely, that the Private Equity portfolio has a beta of 1.0). The theoretical debate of whether or not Private Equity should have a beta greater than or less than 1.0 has many strong points on both sides – and is too lengthy a discussion to go into in this paper.

Instead, we decided to look for empirical evidence of the riskiness of Private Equity. We took two different approaches. One measure of an investment's risk profile is to compare the "downside" and "upside" capture relative to a public portfolio. In other words, how much of the change in public markets is reflected in changes in the value of Private Equity.

FIGURE 5 | ANNUALIZED TRAILING 10-YEAR RETURNS (7/1/05-06/30/15)

Net Return to Limited Partners	All US Private Equity ¹	US Stock Funds ²	All European Private Equity ¹	European Stock Funds ²
Top Quartile %	18.7%	9.0%	16.5%	7.7%
Median Quartile %	10.2%	7.9%	5.7%	6.0%
Bottom Quartile %	2.2%	6.9%	(5.7%)	4.9%
Spread (Top-Median) %	8.6%	1.1%	10.8%	1.7%
Spread (Top-Bottom) %	16.6%	2.1%	22.2%	2.8%

Source: Burgiss, MorningStar.

Note: Past performance is no guarantee of future results; real results may vary; there can be no assurance that any investments to be made will produce comparable, or any, investment returns.

¹ Top quartile and bottom quartile private equity returns represent the pooled net of fees IRR of all funds in each respective quartile; the median private equity performance figures represent pooled net of fees average returns.

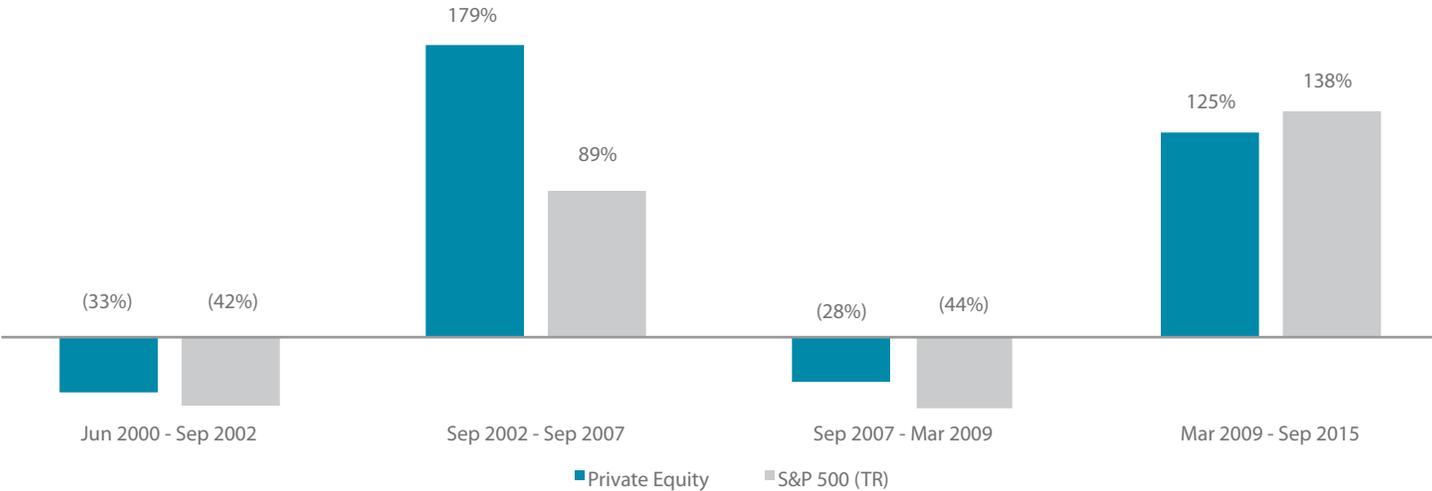
² "US Stock Funds" comprise all US stock mutual funds tracked by Morningstar Principia over the period 7/1/05-06/30/15; "European Stock Funds" comprise all European stock mutual funds tracked by Morningstar Principia over the period 7/1/05-06/30/15.

⁴ See Harris, Kaplan and Jenkinson, "How Do Private Equity Investments Perform Compared to Public Equity?" Working Paper (2015) for a fuller explanation.

StepStone research, illustrated in **Figure 6**, shows that a diversified Private Equity portfolio would have captured just 71% of the losses in the bear markets of 2000 and 2008. In contrast, that portfolio would have captured 146% of the upside in the subsequent recoveries. This asymmetric return profile is highly attractive to investors. Certainly some of the lower downside is attributable to GPs not marking their portfolios down to the same extent the market goes down. However, except in troubled situations, GPs are not forced to sell at the bottom of the market, and therefore are not subject to the fire-sale prices of a market in panic. They *can* sell when the markets show “irrational exuberance,” however, allowing them to monetize any market inefficiencies in a bull market.

Private Equity exhibits an asymmetric return profile due to its ability to stay the course in a bear market and monetize market inefficiencies in a bull market.

FIGURE 6 | BEAR & BULL MARKET PERFORMANCE



Source: Burgiss, S&P 500, StepStone analysis.

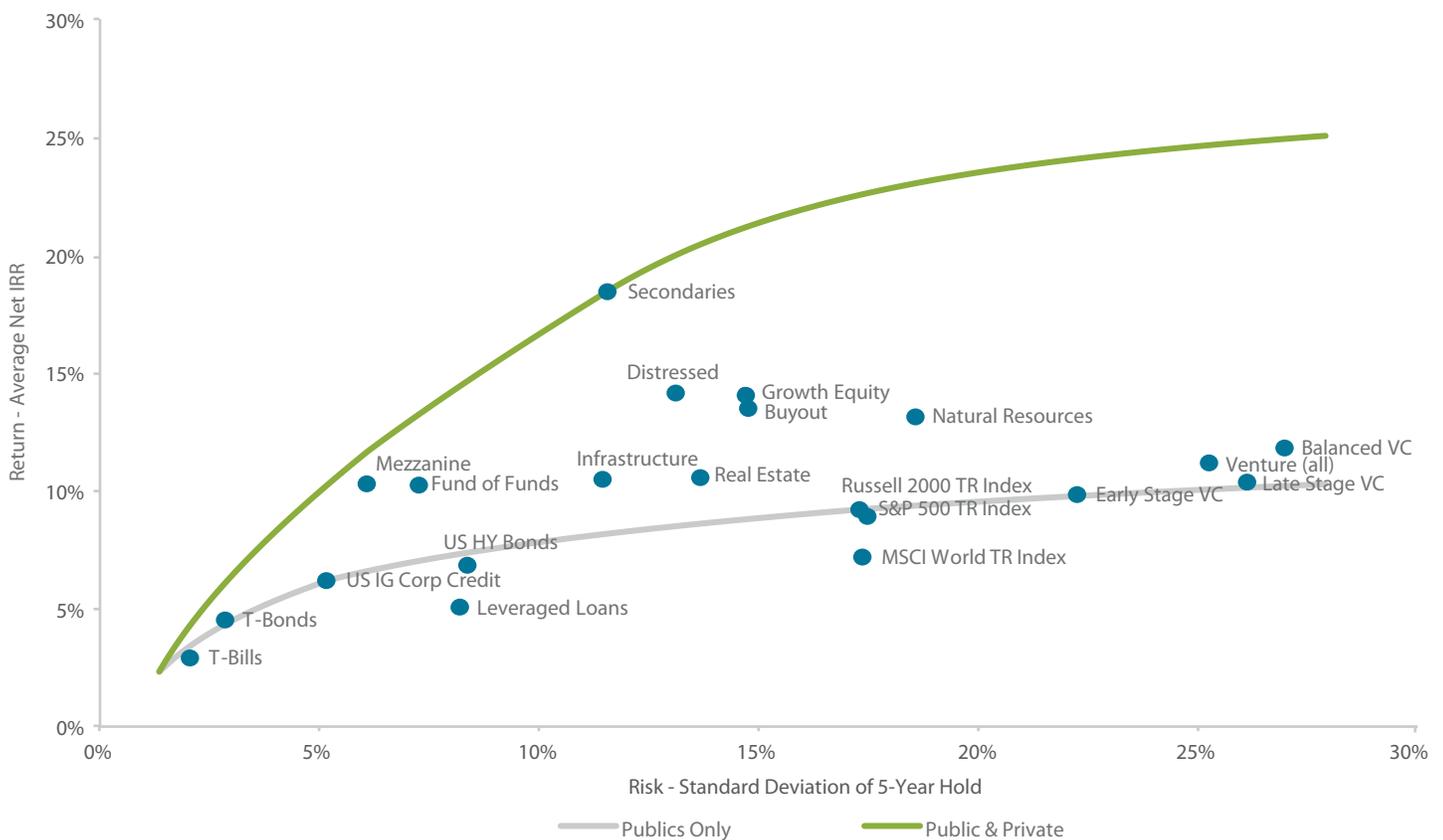
The second approach we took was to construct an “efficient frontier,” incorporating listed and fixed income indices as well as various sub-sectors from unlisted markets, as shown in **Figure 7**. Just as Private Equity GPs are not forced to sell at the bottom, we wanted to check whether merely holding the assets for a long time would narrow the gap in performance, or make the “risk” of Private Equity more apparent.

To do this, we simulated investing in an index every quarter, and holding that investment for 5 years (or until

September 30, 2015, whichever came first), and then selling the investment. Over 20 years (1994-2013) this produces 79 different investments that are similar in timing and duration to investments made by Private Markets funds. For the S&P 500, the average return on these investments was 6.9%, with a standard deviation (“risk”) across the investments of 7.7%.⁵

We plotted the resulting figures against the average and standard deviation of net IRR for all Private Markets funds in the Preqin database for vintage years 1994-2013, broken down

FIGURE 7 | EFFICIENT FRONTIER



Source: Capital IQ, Preqin, StepStone analysis.

⁵ This is not the standard deviation of the daily prices over the 5-year period—which would be more like 15-20%—but the standard deviation of expected returns from buying and holding, for 60 quarters, an investment in the S&P 500, based on the 79 observations available between March 1994 and December 2013.

by sub-sector. To cap the analysis, we plotted the “efficient frontier” of the listed and fixed income indices (“Publics only”) and an estimation including Private Markets strategies (“Public & Private”). These results indicate that Private Markets strategies do entail more risk⁶ than public market strategies, but that investors are more than compensated for this additional risk.

The addition of Private Markets exposures is materially additive to a public markets portfolio by enhancing net returns for a given level of risk. In particular secondaries, distressed, and growth exposures have offered attractive risk-adjusted returns. This analysis used index returns, hence does not incorporate the additional return that an investor could gain from

thoughtful manager selection and portfolio construction. StepStone has observed that for clients with even relatively modest exposures (sub 10%) that there is a material return enhancement to the overall portfolio. Investors appreciate the compensation for risk and the asymmetric return profile—which means they get a return boost when other parts of the portfolio are flagging.

Conclusion

As has been shown, Private Equity fee loads create a material GTN and much complexity. These issues beg the question, “Are the net returns from private equity worth the effort?” For many LPs the answer is yes. It is a qualified answer, however. In order to realize the outperformance, LPs must have access to resources that can consistently identify managers that will outperform the median. The evidence suggests this is possible. Even if we relax the requirement to beat the median, Private Markets still add value to a portfolio. Combining Private Markets assets into a broader portfolio materially enhances the risk-adjusted return outcome. In addition, our experience (and research) suggests that Private Equity offers a very attractive asymmetric return profile – falling less than listed indices in bear markets, and rebounding more than listed markets in the recovery. Like all LPs, we wish that Private Equity were less expensive – but we are willing to do the work to minimize these issues because the returns are worth it.

Thoughtful manager selection and portfolio construction remain critical to maximizing returns in Private Markets.

⁶ Standard deviation of IRR is an admittedly imperfect measure of risk. It does not capture liquidity risk. It also fails to differentiate between upside and downside risks. Almost all of the Private Markets strategies exhibit strong positive skewness—the additional standard deviation may be driven by higher upside potential in Private Markets, which is attractive for investors. If we adjust for outliers to reduce the skewness of the Private Markets distributions, the outcome of the analysis is qualitatively similar.

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The Firm creates customized portfolios for the world's most sophisticated investors using a highly disciplined research-focused approach that prudently integrates primaries, secondaries, and co-investments.

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