

# Is small better?

DECEMBER 2023

While most of the world has struggled to navigate its way out of the dislocation caused by the pandemic, Europe has again found itself being more heavily scrutinized than other developed markets.

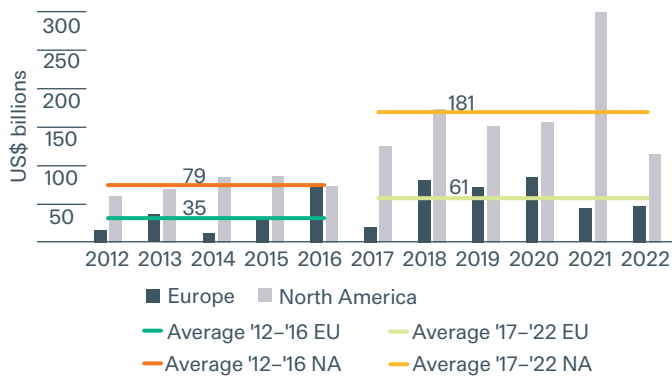
Like the US, it is fighting inflation and attempting to manage the impact of tighter monetary policy. But these challenges have been compounded by the impact of the war between Russia and Ukraine and the ensuing energy shock. More recently, Europe's economic outlook has weakened as demand, both domestic and from key export markets such as China, has weakened.

We believe the correlation between private equity returns and the macroeconomic conditions in which they were generated is often exaggerated. Indeed, despite often facing less favorable macro conditions, realized buyout investments over the last 15 years have generated gross returns in Europe (2.33x/24.1%) approximately in line with the US (2.39x/25.3%) and with a similar level of volatility (17% loss ratio), according to SPI Research.<sup>1</sup>

<sup>1</sup> 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.

Nonetheless, the perceived macroeconomic weakness and uncertainty faced by Europe have led LPs to shift more capital away from Europe. As illustrated in **Figure 1**, LP commitments to North American buyouts are growing at a higher rate. As a result, the average annual commitment gap between Europe and North America grew from roughly \$44 billion to approximately \$120 billion.

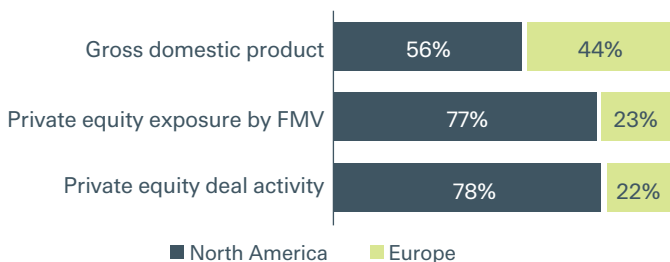
FIGURE 1: COMMITMENTS TO BUYOUT IN EUROPE AND NORTH AMERICA 2012–2022



Source: SPAR Universe Q1 2023 Benchmark, StepStone analysis.

Upon comparing Europe’s PE activity with its share of GDP, it becomes clear Europe is vastly underweighted, as illustrated in **Figure 2**.

FIGURE 2: PRIVATE EQUITY EXPOSURE IN EUROPE AND NORTH AMERICA VS. GROSS DOMESTIC PRODUCT

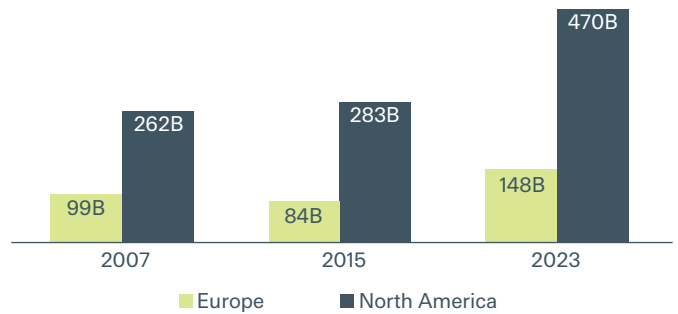


Source: IMF, Thomson ONE, SPAR, StepStone analysis.

Note: 2023 GDP (est.) as provided by IMF, PE Deal Activity based on Thomson ONE deal activity (2009–2021), Private Equity Exposure by FMV according to SPAR Universe Q1 2023 benchmark.

LPs’ higher allocation to North America over the recent years has resulted in a widening dry powder gap. Since 2015, that gap has increased by more than 60%, as shown in **Figure 3**.

FIGURE 3: EVOLUTION OF DRY POWDER BETWEEN EUROPE AND NORTH AMERICA BUYOUTS FUNDS (US\$ BILLIONS)

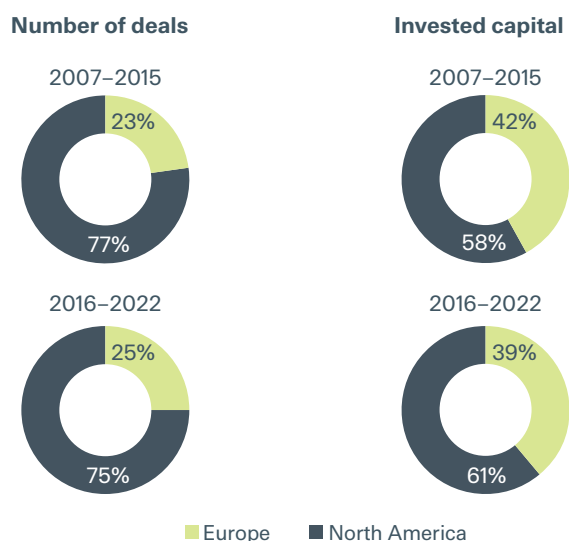


Source: SPAR Universe Q1 2023 Benchmark, StepStone analysis.

We believe that Europe represents an attractive geographical diversification opportunity for LPs looking to de-risk their portfolio without compromising on returns and volatility.

Furthermore, per **Figure 4**, the proportion of PE investments and invested capital in Europe versus North America has broadly stayed consistent over the last 15 years.

FIGURE 4: PROPORTION OF INVESTMENTS AND INVESTED CAPITAL IN EUROPE AND NORTH AMERICA



Source: SPI Research, StepStone analysis.

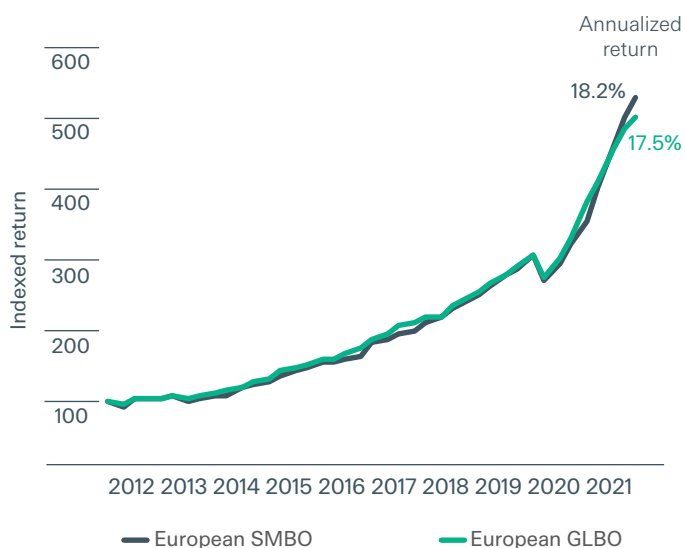
Consequently, the supply-demand imbalance for capital is worse in North America than in Europe. As such, StepStone expects Europe to benefit from lower competition and more favorable deal dynamics in the medium term, which could lift the relative attractiveness of the European PE opportunity.

Against this backdrop of potential supply-demand imbalances having been created prior to the current dislocation, StepStone believes that Europe represents an attractive geographical diversification opportunity for LPs looking to de-risk their portfolio without compromising on returns and volatility.

## Is smaller better?

During a prolonged era of low interest rates and quantitative easing that ran from 2009 to 2022, Europe’s larger private equity funds benefitted from attractive financing and public market conditions, which provided tailwinds to generate strong returns. As illustrated in **Figure 5**, contrary to the popular narrative that smaller funds outperform, between 2012 and 2021 pooled returns from European large and global buyout (GLBO) funds were in line with those from small and middle buyout (SMBO) funds.<sup>2</sup>

FIGURE 5: CUMULATIVE PERFORMANCE 2012–2021<sup>3</sup>



Source: SPAR Universe Q1 2023 Benchmark, StepStone analysis.  
Note: Includes 2010–2018 vintage funds.

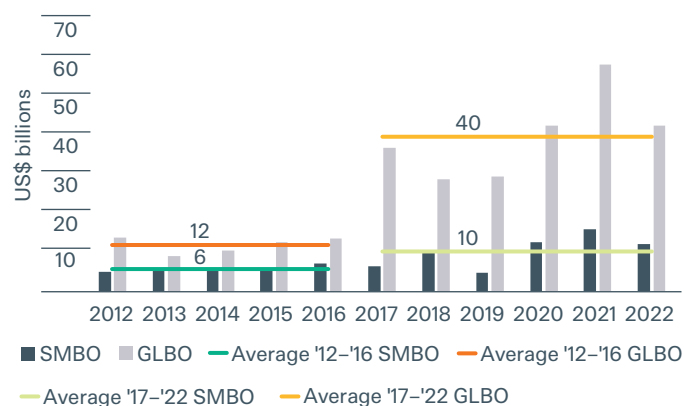
During the post-GFC period, European GLBO funds offered LPs the ability to deploy capital at scale, with good velocity and with a lower economic cost—all while delivering similar pooled returns to European SMBO funds.

<sup>2</sup> We define GLBO as funds with more than €2.5 billion in commitments, SMBO as funds with less than €2.5 billion in commitments.

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This strong performance led LPs to more than triple their average contributions to European GLBO funds, as illustrated in **Figure 6**. Today's level of trailing five-year cumulative LP contributions to European GLBO funds is roughly 4x higher than the equivalent to European SMBO funds.

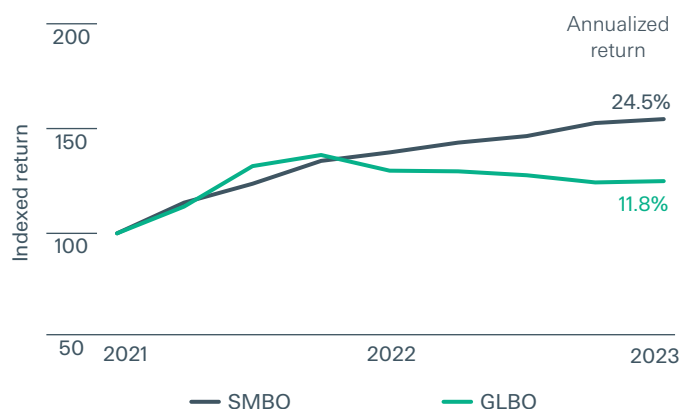
FIGURE 6: YEARLY CONTRIBUTIONS TO EUROPEAN FUNDS



Source: SPAR Universe Q1 2023 Benchmark, StepStone analysis.

However, recent data suggests that 2022 may have been an inflection point. As illustrated in **Figure 7**, European GLBO performance has flattened. This may be due to these funds

FIGURE 7: CUMULATIVE PERFORMANCE 2021-1Q23<sup>4</sup>



Source: SPAR Universe Q1 2023 Benchmark, StepStone analysis, as of March 31, 2023.

Note: Includes 2015–2019 vintage funds.

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<sup>5</sup> Substantially realized means that at least 2/3 of the investment total value is realized.

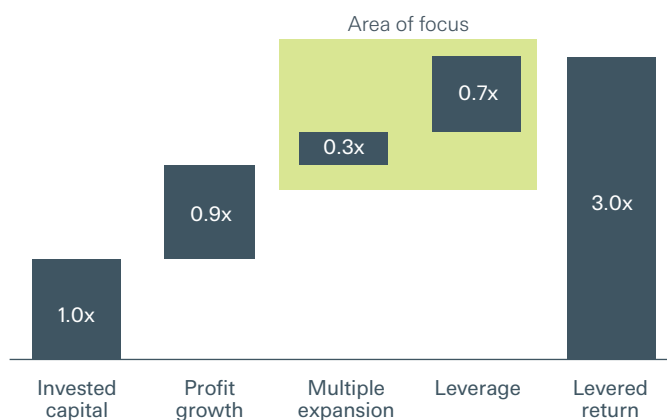
<sup>6</sup> For illustrative purposes only. All information provided is at an industry level, no StepStone investments are included in any of the above metrics. All information provided here is based on research related to third party managers.

having a high correlation to public market valuations and their higher use of increasingly costly leverage. Meanwhile, European SMBO funds have been more resilient to volatile market conditions and more expensive debt. We observed a similar trend in the aftermath of the GFC.

## Drivers of investment returns in European buyouts

To assess European buyout's go-forward return potential, we turned to our Drivers of Investment Returns, an analytical tool that breaks value accretion into three broad categories: profit growth, multiple expansion, and leverage at entry and through recapitalizations. We then applied this framework to the 945 substantially realized European buyout investments since 2010.<sup>5</sup> As seen in **Figure 8**, profit growth has accounted for about 45% of value accreted while leverage and multiple expansion have accounted for the remainder.

FIGURE 8: EUROPEAN BUYOUT DRIVERS OF INVESTMENT RETURNS<sup>6</sup>

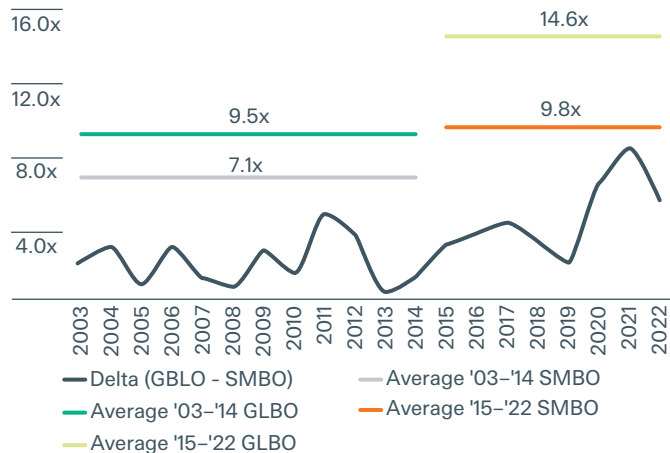


Sources: SPI Research, StepStone analysis.

## MULTIPLE EXPANSION

Historically, purchase price multiples have been considerably lower for small- and middle-market companies (Figure 9). And while the low-interest-rate environment that has characterized much of the past 10-plus years caused valuations to increase for all assets across sectors, entry multiples for small-market companies rose more modestly. Meanwhile, the delta between the purchase price multiples of European GLBO and SMBO funds increased considerably over the last five years. European SMBO funds' lower entry multiples, in combination with small- and middle-market companies' greater ability to implement operational improvements, may put these companies in a better position to exit at a scale and strategic value that can command a higher exit multiple.

FIGURE 9: TEV/EBITDA ENTRY MULTIPLES FOR EUROPEAN BUYOUTS

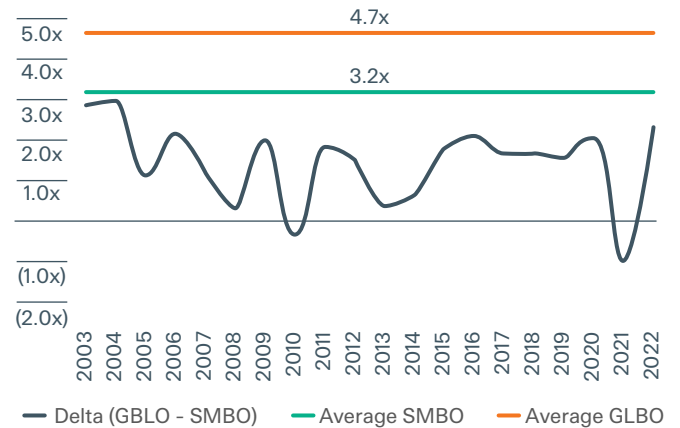


Source: SPI Research, StepStone analysis.

## LEVERAGE

Figure 10 illustrates that European SMBO funds have used considerably less leverage than European GLBO funds. In what could be a prolonged period of higher interest rates, companies with lower levels of leverage and therefore less debt and interest to pay down could benefit from higher free cash flow to reinvest in their businesses or make acquisitions for value creation purposes. This should favor the SMBO segment going forward.

FIGURE 10: NET DEBT/EBITDA ENTRY MULTIPLES FOR EUROPEAN BUYOUTS

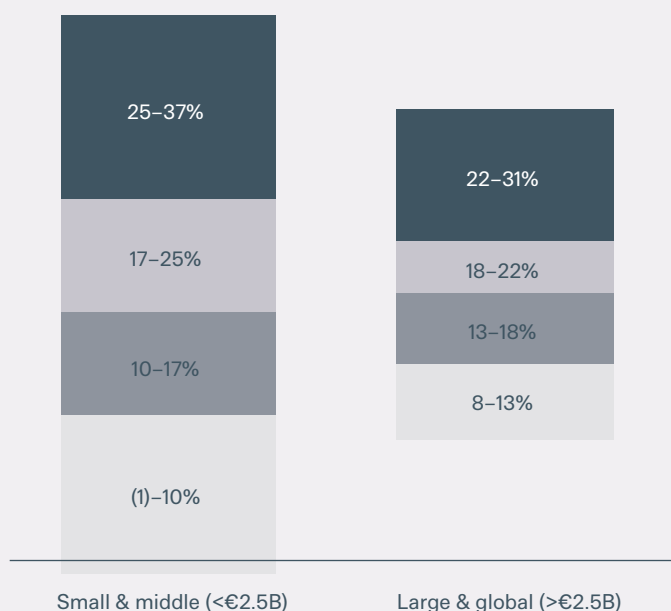


Source: SPI Research, StepStone analysis.

## Challenges and solutions

In contrast to the attractions outlined above, European SMBO also presents LPs with some key challenges to access the segment. Importantly, the European SMBO GP landscape is roughly 11x larger and much more dynamic than the European GLBO GP landscape. Successful manager selection is further compounded by the fact that the return dispersion between first- and fourth-quartile managers is substantially wider than for larger funds, as evidenced in **Figure 11**.

FIGURE 11: NET IRR DISPERSION FOR EUROPEAN BUYOUT FUNDS<sup>7</sup>



Source: Burgiss Private iQ data as of August 2023, StepStone analysis.  
 Note: Includes 2010–2020 vintage funds. IRR for more recent vintages is not considered meaningful.

The importance of manager selection is a common refrain in private markets. Within buyouts, this is particularly critical for European SMBO funds, which have exhibited the highest and lowest return potential within the European buyout universe.

For LPs without dedicated in-house resources, covering the European SMBO funds universe can pose a challenge, and they might feel tempted to default to or stay with brand-name managers, who may lose their appeal over time. More recently, LPs may have migrated toward the larger European buyout funds, given their strong delivery. As we have stated in this paper, conditions for a continued strong delivery by these funds may become more challenging.

By working with a global partner with a large and active sourcing engine and local teams dedicated to cover all regions and segments of the European buyout market, LPs can mitigate some of these challenges.

## Looking into 2024

As LPs ponder their portfolio allocations for 2024, they may feel tempted to flock to familiar managers at the upper end of the market. However, StepStone believes now is the time to lean into European SMBO. Less competition, attractive entry valuations, lower leverage, better value creation opportunities, dry powder upmarket, better potential for multiple arbitrage and a lower correlation with public market volatility are several of the reasons why.

Regardless of market cycles, European SMBO can play a central role in an LP's portfolio, complementing other private equity strategies by providing alternative return drivers and diversification benefits.

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All data is as of October 2023 unless otherwise noted.

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