STEPSTONE

THE NORDIC MODEL

Outperformance in private equity

DECEMBER 2023

In this paper we examine the Nordics. Owing to a conducive environment to PE investing that has helped establish a stable of strong GPs, it is a preferred region within Europe that has delivered outperformance on a global scale.

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.

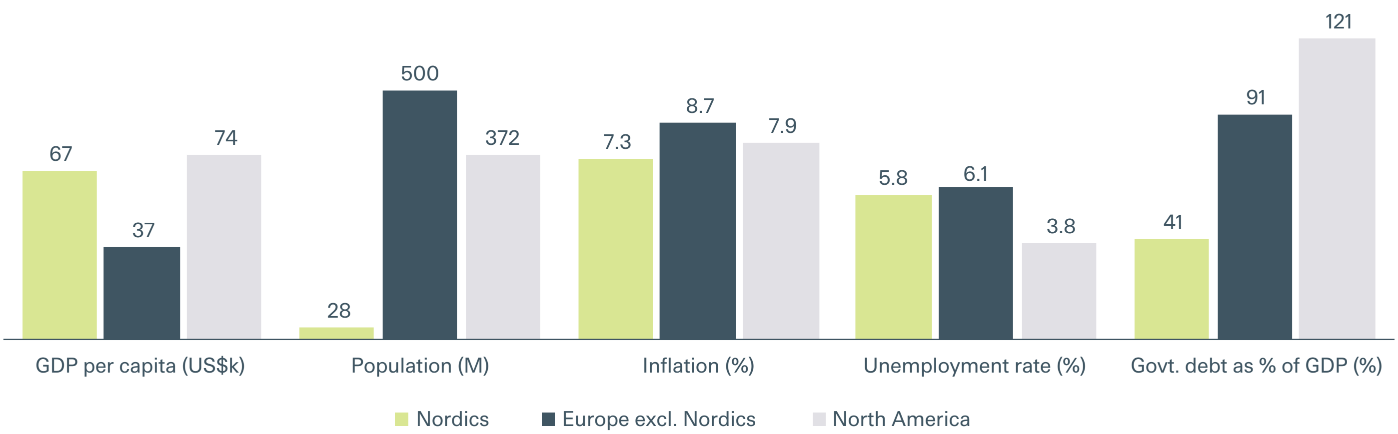
[1] According to SPI Research, our proprietary research library, European GPs generated a gross TVM of 2.33x; North American GPs generated a gross TVM of 2.39x.
[2] StepStone Portfolio Analytics and Reporting, Q1 2023.

The Nordic private equity market has long held a reputation for high quality and perceived outperformance within Europe. This paper leverages proprietary data to substantiate this comparison with the rest of Europe and broaden it to encompass North America—finding performance that benchmarks favorably on a global scale. It also highlights the contributing factors to what we believe is one of the most conducive environments to investing in private equity globally. We believe these factors are likely to persist in the medium to long term, positioning the Nordic private equity market well to continue its outperformance.

Market overview

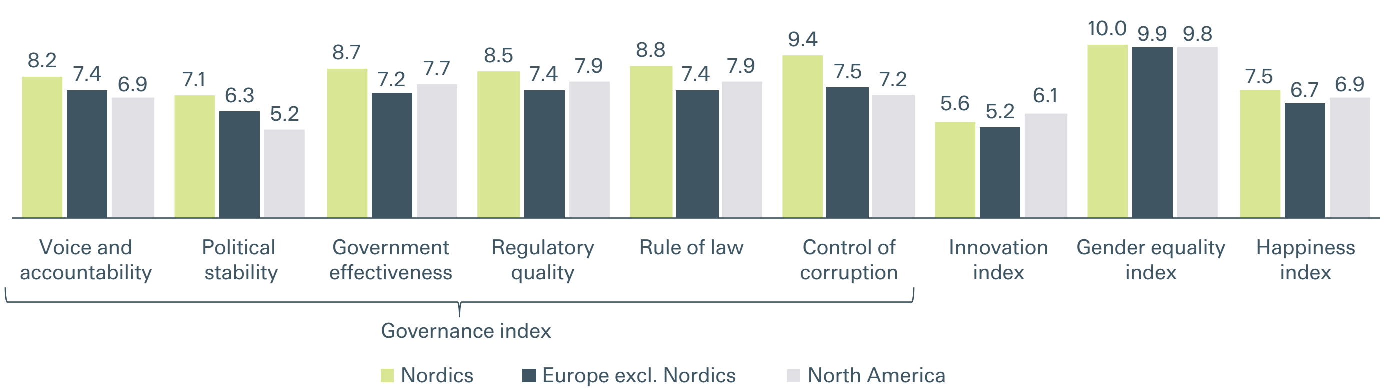
The Nordic region, commonly defined as consisting of Denmark, Finland, Iceland, Norway and Sweden, is home to just 3% of Europe's population. Yet from a macroeconomic

FIGURE 1: MACROECONOMIC INDICATORS



Source: IMF, 2022.

FIGURE 2: GOVERNANCE, INNOVATION, GENDER EQUALITY AND HAPPINESS INDICATORS



Sources: World Bank, 2021; WIPO, 2022; UNDP, 2021; Sustainable Development Solutions Network, 2023.
Note: Averages by region weighted by GDP of underlying countries. Scores from 0 (weak) to 10 (strong).

perspective it has long been seen as a region that has outperformed across several metrics. The "Nordic Model" of economic and social policies has contributed to globally leading rankings in terms of economic stability, transparent governance, a high degree of entrepreneurialism and innovation, gender equality and even happiness.

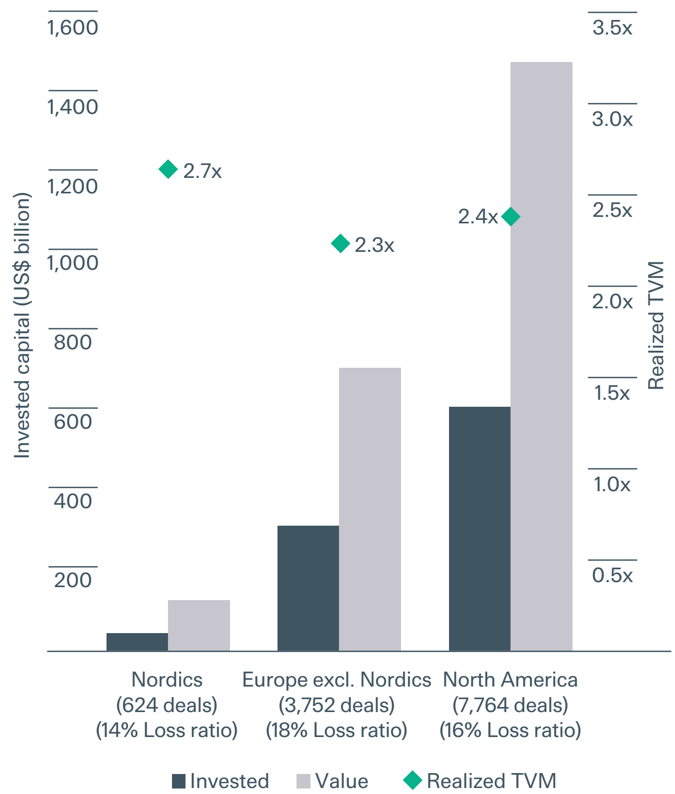
Nordic-based buyout managers often suggest during fundraising that these factors make the region attractive for private equity investors. Various advisors and market participants produce periodic summaries confirming a high degree of investment and fundraising activity, to some extent confirming the success of investors in the region. That some of the most successful pan-European and global buyout firms trace their roots to the Nordics could be seen as a sign of the underlying market's attractiveness. However, owing to the opacity of private equity reporting, data comparing the investment performance of the Nordics with other regions is hard to come by.

Private equity performance

Our firm's global coverage and data science capabilities offer a unique vantage point to observe gross investment performance on a deal-by-deal level and draw conclusions on where LPs could find superior risk-adjusted returns. Using our proprietary private markets library, SPI Research, this paper explores whether buyouts in the Nordics outperform, and, by looking at underlying deal performance, seeks to identify any niches that may offer particularly attractive returns.

SPI Research garners metrics for almost 185,000 private market investments, including roughly 31,000 buyouts of companies based in North America and Europe. To avoid drawing the wrong conclusions because of either investments completed in a different era by professionals who have long since retired, or differing valuation policies of unrealized investments between GPs, this paper focused solely on investments completed in the last 20 years that, as of August 2023, were fully realized. This leaves around 12,000 investments.

FIGURE 3: PERFORMANCE OF REALIZED BUYOUT INVESTMENTS SINCE 2003 BY REGION



Source: SPI Research, August 2023. Currencies converted as at the latest record date.

SPI Research confirms that on aggregate, the returns generated from buyouts of companies based in the Nordics have outperformed buyouts in both the rest of Europe as well as in North America.

This outperformance is not necessarily due to increased selectivity—investments in the Nordic region represent about 5% of the considered investments in Europe and North America, while the region represents 4% of GDP of these markets. Similarly, increased risk taking is not necessarily a reason either—the loss ratio on Nordic investments compares favorably to those in the rest of Europe and in North America.

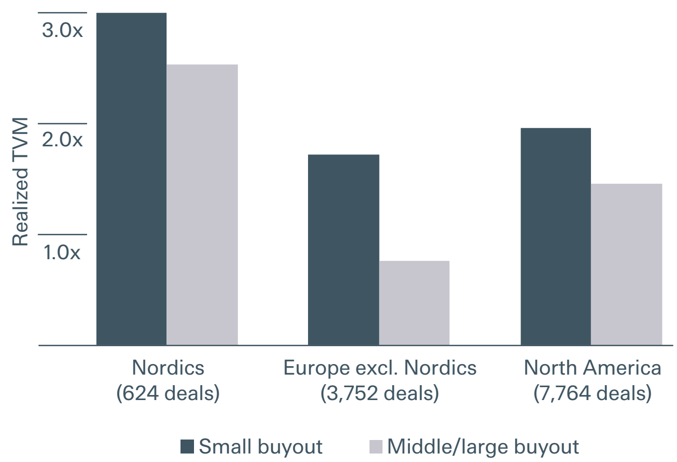
Similarly, outperformance in the Nordics is not limited to a specific segment. As detailed in **Figure 4**, outperformance can be found in both the small market as well as in the middle and large markets.[3] The relative degree of outperformance of small-market investments in the Nordic region is broadly consistent with the degree of outperformance seen in the rest of Europe and in North America.

We examined whether local GPs have an advantage over GPs that are based elsewhere. Local heritage does not seem to be a significant driver of outperformance in the middle and large markets. In fact, non-Nordic GPs have generated a mean/median realized TVM of 2.7x/2.2x compared with the 2.4x/2.5x generated by their Nordic counterparts (the mean figure is skewed by a single investment that generated several billions of dollars in value). In other words, there is no clear evidence to suggest that local heritage is a must-have for outperformance. An explanation could be that while each GP is structured differently, many of the non-Nordic middle- and large-market GPs that operate in the region have the resources to operate local offices, with local investment professionals, and therefore operate as quasi-local GPs when interacting with sellers. Additionally, larger opportunities tend to be acquired through structured processes, with sell-side advisor teams often at least partially based in London, close to the European headquarters of larger pan-European or transatlantic non-Nordic GPs. Owing to an increasingly efficient market, it is rare for GPs at the upper end of the market to win a transaction simply because of local heritage.

However, the story is slightly different in the small market. As detailed in **Figure 5**, Nordic-based GPs have outperformed their non-Nordic counterparts.

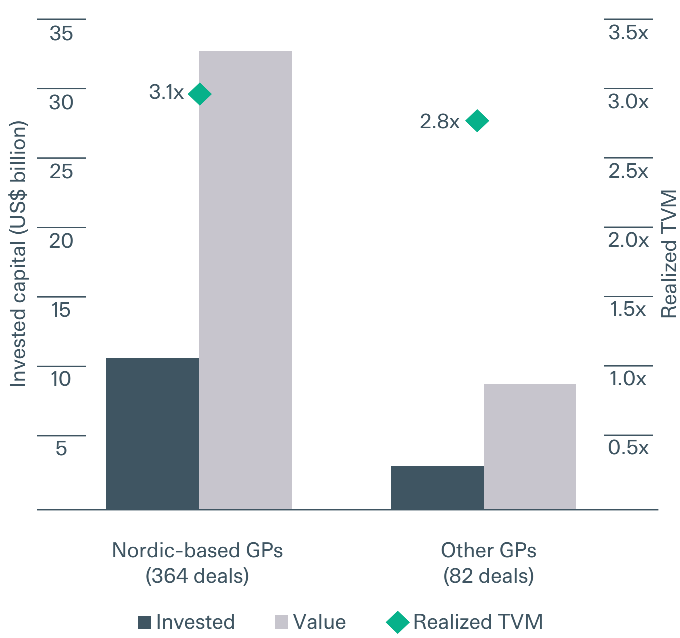
Small-market GPs generally acquire a higher proportion of portfolio companies through primary, and often proprietary, situations. Sellers are often entrepreneurs who in many cases reinvest a significant proportion of capital. As a result, we would argue that a local network and approach are often advantageous to unlock attractive opportunities.

FIGURE 4: PERFORMANCE OF REALIZED BUYOUT INVESTMENTS SINCE 2003 BY REGION AND MARKET SEGMENT



Source: SPI Research, August 2023.

FIGURE 5: PERFORMANCE OF REALIZED SMALL MARKET BUYOUT INVESTMENTS SINCE 2003 IN NORDIC REGION BY HQ OF GP



Source: SPI Research, August 2023. Currencies converted as at the latest record date.

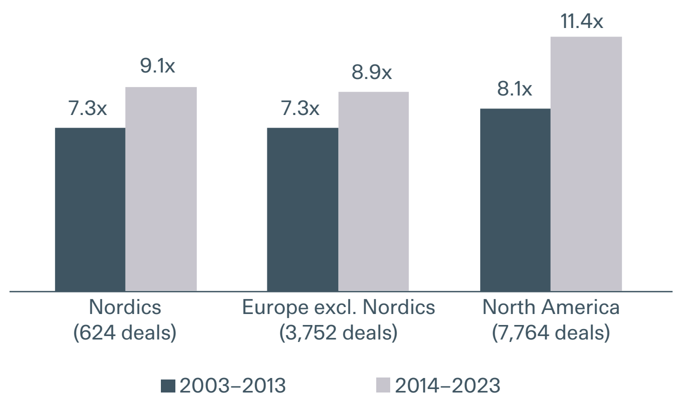
[3] We define the small market as funds with less than US$2 billion in commitments, middle/large funds as those with more than US$2 billion.

Furthermore, the Nordic market is highly suitable for buy-and-build strategies, where local GPs are slightly better placed to outperform. While strong governance frameworks and a high level of transparency allows all GPs, regardless of office location, to explore buy-and-build opportunities, local GPs are generally better placed to drive accelerated acquisition strategies. Our firm has seen local Nordic GPs execute numerous platform investments, making as many as 50 acquisitions that have subsequently generated strong realized returns. We would argue that the pace of add-ons is difficult to replicate without a local presence, which in turn is a key driver of outperformance of local GPs when compared with those with a fly-in approach to small-market investing.

While historical trends are interesting, the key question is whether outperformance can continue. In theory, if markets were efficient, GPs would pay up for assets in the Nordics, and over time, returns would normalize. While the average entry multiple has increased across regions, the increase in the Nordic region is broadly in line with the increase seen in the rest of Europe, and significantly below the increase that has been observed in North America.

To assess Nordic private equity's go-forward return potential, we turned to our Drivers of Investment Returns, an analytical tool that breaks value accretion into three broad categories:

FIGURE 6: WEIGHTED AVERAGE TEV/EBITDA AT ENTRY OF REALIZED BUYOUT INVESTMENTS SINCE 2003 BY REGION

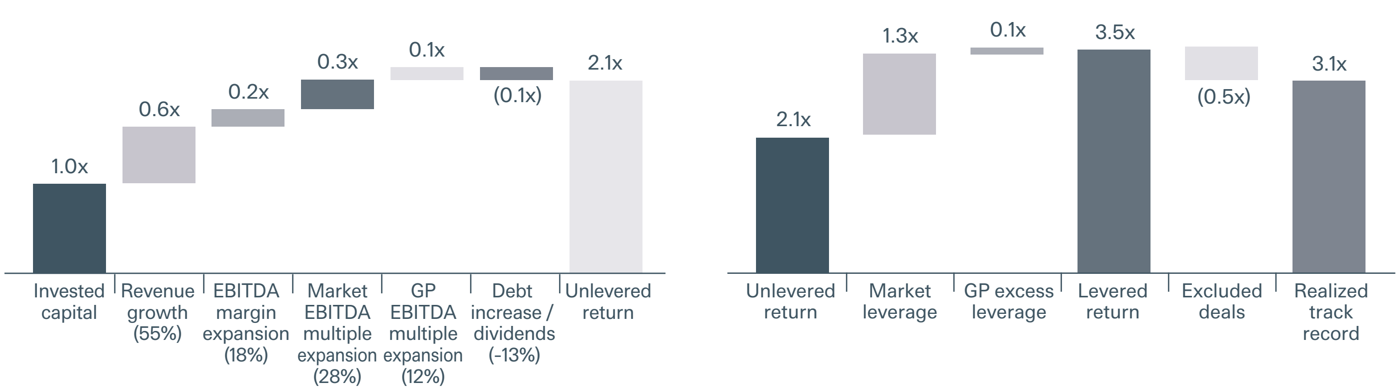


Source: SPI Research, August 2023. Currencies converted as at the latest record date.

revenue growth, multiple expansion, and leverage at entry and through recapitalizations. We then applied this framework to the 573 realized Nordic small- and middle-market buyouts (SMBOs) we track in SPI Research.[4]

As seen in **Figure 7**, revenue growth is the largest unlevered return driver among Nordic businesses. This is promising as we enter a period of valuation uncertainty—during which GPs will place greater emphasis on operational growth to drive returns.

FIGURE 7: DRIVERS OF INVESTMENT RETURNS NORDIC IN SMBOS



Source: SPI Research, August 2023.

[4] Because SMBOs tend to be less dependent on international revenues, we think they more accurately represent local market conditions.

Nordic companies have also been more reliant on leverage to drive returns. Because Nordic businesses have had lower loss ratios relative to other parts of Europe, Nordic banks have been more open to lending to local private equity–backed companies. Although both a lower quantum and higher cost of leverage will affect the private equity market at large, the Nordics' track record and strength of local bank relationships lead us to believe they will be less affected than other markets.

Conclusion

With an existing base of high-quality GPs, strong rankings in both macroeconomic indicators as well as "softer" metrics, valuation increases broadly in line with (if not below) other markets, and a supportive banking system, we believe that buyout investments in the Nordics are well positioned to continue to provide outperformance on a global basis.

LPs and GPs alike should consider increasing their allocations to the region. Investments in the Nordic region have outperformed those in other regions irrespective of company size, and as a result, GPs regardless of headquarters would do well to further explore opportunities in the market. This is particularly the case for larger GPs that operate in the middle-to-large market, with the resources to operate with local models to drive sourcing.

Similarly, LPs should consider allocating more to GPs that operate in the region, particularly those with a local heritage, operating within the small market. A greater allocation to a niche that has generated in excess of a 3.0x realized TVM over the last 20 years is likely to be accretive to most LPs' private equity portfolios.

Our firm is well positioned to track the Nordic market owing to a significant existing portfolio and local networks. Our firm's coverage across the size spectrum of companies and funds gives us a vantage point to monitor capital flows and industry dynamics. It also gives us the market intelligence to identify and select new and promising GPs, including spin-outs. Finally, clients can leverage our platform advantages to gain access to otherwise access-constrained managers.

All data is as of October 2023 unless otherwise noted.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. ACTUAL PERFORMANCE MAY VARY.

We are global private markets specialists delivering tailored investment solutions, advisory services, and impactful, data-driven insights to the world's investors. Leveraging the power of our platform and our peerless intelligence across sectors, strategies, and geographies, we help identify the advantages and the answers our clients need to succeed.

For more information regarding StepStone's research, please contact us at research@stepstonegroup.com.

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