Uncovering hidden value in Europe private equity

Michael Venne: *[00:00:00]* Today, we're talking about unlocking hidden value in Europe's private equity landscape. For a variety of reasons that today's guests will walk us through, many investors hold a more guarded view of Europe's private equity market compared with America's. That capital commitments to European buyout funds haven't grown nearly as much as they have for American funds over the past ten years, suggests LPs are shifting capital away from Europe. But this is curious, considering that over roughly that same time span, American and European buyout firms have delivered very similar levels of performance. Gross investment multiples for the two regions, for example, have differed by less than 3%. The difference between loss rates is even smaller. And I think that's it in a nutshell. Performance similar to American buyouts, but with far less capital chasing those opportunities, which might bode well for investors keen on capitalizing on this market inefficiency. Joining me today to discuss the reasons for this disconnect and areas of the market that we see the most promising are three members of our private equity team based in London: Akhilan Nesaratnam, Carlos Sahuquillo, and Thomas Dupont. Gentlemen, welcome to RPM.

Akhilan Nesaratnam: *[00:01:27]* Thanks, Michael. Pleasure to be here.

Thomas Dupont: *[00:01:30]* Thanks, Michael. Our pleasure.

Carlos Sahuquillo: *[00:01:32]* Thank you. Michael.

MV: *[00:01:33]* Yeah. So to kind of, like, set the stage, we're going to hear from three seasoned investors about four different parts of the market. Now, even though these parts of the market are different, these sectors are bound by a common thread. And that is, they are competitive on a global scale and offer investors an opportunity to diversify their portfolios without necessarily compromising on returns. In other words, contrary to what the headlines might say, there's ample opportunity to find alpha in European private equity. Now, the relationships and the data that make it possible to glean incisive insights, such as the ones that our guests are going to share, take time and resources to cultivate. Akhilan, since you are the longest tenured guest, and not to age shame you here, but could you quickly summarize our firm's history and capabilities as they relate to Europe otherwise?

AN: *[00:02:35]* Thanks, Michael. And, uh, yeah, no offense taken there. Uh, so Stepstones history of of investing in Europe actually predates the founding of Stepstone itself. I think most people know that Stepstone has grown not just organically, but through multiple acquisitions, including two that related specifically to European private equity in parish capital and Green park parish, focusing on primaries and co-investments in Green Park on secondaries, and indeed two of the current partners in our team in Europe, David Jeffrey and Bernard De Backer, worked together at parish. As such as a team, we've got a track record stretching back some 20 plus years. Since then, we've been one of the most active investors in European private equity. Uh, incidentally, since Stepstones founding in 2008, we've actually deployed over $24 billion into European funds and co-investments. We have a team of over 20 investment professionals based in London, with multiple nationalities and geographic specialisms that we believe makes us well equipped to tackle a very diverse European opportunity. I think by virtue of the scale of our client relationships, ranging from single family offices all the way up to sovereign wealth funds, looking at European opportunities, we practically cover the entire European private equity market for our clients, from the very smallest to the very largest funds. What this means is we're privy to unrivaled data across the market that provides trends and helps inform our decisions on, quite frankly, where to deploy capital to the best of our ability. And this data has been crucial to the analysis and conclusions seen in our recently published white papers and also the views that we'll share today.

MV: *[00:04:14]* Thomas, do you have anything to add to that?

TD: *[00:04:17]* Yeah, absolutely. You know, I'm part of the VC and growth team that is based in Europe, and like in all Stepstone on asset classes, we have a global and local approach. So what does that mean in concrete terms? Well, we have, you know, three people dedicated to VC and growth that are based in Europe. But we can leverage really the resources and the knowledge of the global platform with about 150 plus dedicated professionals to VC and growth at Stepstone, and we really work as one team. So, it makes us one of the largest VC growth allocators globally, with around 25 billion AUM. And we can leverage our reputation, you know, our deep networks of relationships to serve our clients really in the best possible way across our, you know, different strategies for primary investing in funds, but also for secondaries, be it direct secondaries, LP interests or GP leads, but also for direct investments and co-investments. And I think our, you know, expertise and rich in VC growth is quite unique. So, GPS are generally looking to have us as a strategic partner of choice, and having insights and data on what good looks like is a huge advantage for us globally and here in Europe in particular when assessing funds and our companies.

MV: *[00:05:45]* No, thank you both for that. And I want to do a little bit more level setting as we're kind of talking about the European private equity, so Europe home to more than 40 countries, but a lot of those countries aren't really active in private equity and either in terms of the number of GPs or deal flow. Carlos, what countries or regions or blocks are we talking about when we say “European private equity”?

CS: *[00:06:12]* Yeah, so when we talk about European private equity, we usually divide Europe into several regions. We have the Nordics where Sweden is probably the more prominent country within the Nordic region; we have the UK; we have the Dutch region where it's mainly Germany and Switzerland; we have the Benelux, which is mainly the Netherlands; we have France; and then we have Southern Europe, which is usually composed of just Italy and Spain. We also do cover Eastern Europe within Stepstone, but there's much less private equity activity in that region. And then within Western Europe where we see more private equity activities, probably in the UK, in the Dach and in the Nordics, and also to some degree, France, and to a less extent in Italy and in Spain.

MV: *[00:07:01]* And I want to double click on something we talked about at the very top of the show, when we say that LPs are allocating more to American private equity managers at the expense of their European counterparts. Can you help me put that into perspective? Is it because Europe's private equity market cap has shrunk, or are we talking about a disproportionate response by investors?

CS: *[00:07:27]* Yeah. So taking a step back, um, what we've seen over the last ten years is that the amount of capital allocated by LPs to the US vs Europe has increased. This has caused an increasing dry powder gap, where, for example, in 2015, the difference in dry powder between North America and Europe was around 200 million, and now in 2023 it was over 300 million. However, when we actually look at the number of and volume of deals, these have broadly stayed consistent between both geographies. What this means is actually that the supply demand imbalance for capital is not much worse in the US than in Europe, because the same number of deals are happening. So, we actually think Europe is undercapitalized and a good opportunity for investors to focus their attention in this market.

MV: *[00:08:13]* So, Akhilan, I want to turn back to you now for the million-pound question. Why does Europe seem to face more headline risk? Now, I know there's a lot to unpack there, so maybe give us maybe the top 1 or 2, maybe 3 answers that come to mind.

AN: *[00:08:31]* Yeah. Sure thing. I'm glad you described that as the million-pound question as opposed to the million-dollar question. Perhaps million-euro question is more apt. But you're right. The headline risk from our international client base is often the first hurdle. I think, firstly, is geopolitical turmoil that we see in Europe, the ongoing war in Ukraine. Secondly, the underlying growth statistics which have shown weaker underlying numbers than certainly what we've seen in the US and of course, certain parts of Asia. I think the first response I'd make is that private equity performance in Europe has not been hugely correlated to macro factors like this. Europe has faced various issues for the last couple of decades, and yet private equity in Europe has generally delivered attractive returns across cycles, certainly compared to performance seen in in the European public markets. Perhaps the second point I'd make is that Europe should not be treated as this homogenous region. People have spent any time here know the vast differences between the cultures here, and private equity in Europe very much reflects this. The fact is, there are certain niches in Europe that have and we believe will continue to provide outperformance even on a global scale.

MV: *[00:09:41]* All right. So, guys, thanks for helping to set the stage here. Now I want to maybe shift to the topic du jour. We've recently released a series of white papers covering four of the key European sectors that we think investors should consider in their allocation budgets. That's the Nordics, health care, growth equity, and small market buyouts. Now, all of which offer outsized return potential, not just relative to other European comps, but on a worldwide scale. I think each of these topics is interesting enough to merit its own episode, but we dream big and we're going to try to attempt to cover them all. Thomas, we're going to start with you and growth equity. What makes Europe's growth equity market stand out?

TD: *[00:10:31]* Yeah. Well, as you probably know, you know the tech ecosystem is maturing in Europe, but maybe to put things in perspective, growth investing emerged since the 60s in the US, and GP specialists have kept emerging since then with dedicated playbooks there. Uh, you know, in contrast, the European growth market has been much slower to develop. So, you know, I think the combination of one, an increasing pool of attractive tech targets at the growth stage in Europe, and two, the fact that the market is less competitive than in the US. And as a result, valuations are lower than in the US, you know, makes it a very attractive segment in our opinion. And I think to substantiate this kind of affirmation, we've looked at the returns of over 12,000 realized deals from our proprietary database. And it turns out that European growth has outperformed European buyout. Not only generating higher returns, but interestingly, generating lower loss ratios. So European growth provides, on average, higher returns for lower risk. Why is that? One of the main reasons is that, you know, growth GPs have invested massively in software and tech, which have delivered strong performance and, you know, these GPs have systematic playbooks to create value in these segments. And maybe in addition, you know, growth GPs often invest through preferred equity, providing some, some cushion against losses. And by the way, our data suggests also that European growth has also performed in line with US growth but generating lower loss ratios. So overall, you know, our European growth really offers attractive growth adjusted returns. But the next key question that one could ask is, is there a difference between obtaining exposure to European growth through either GPs that are located in Europe or through international GPs without an office in Europe? And our data suggests that GPs that are based in Europe have largely outperformed, you know, those international GPs without boots on the ground. And this implies that there are benefits to understanding the nuances of the local market through local teams that are based in Europe. So, you know, overall, we are making the case for LPs to allocate more to European growth, right? But manager selection is key to deliver alpha and this is really our job.

MV: *[00:13:13]* Carlos, I want to turn to you now because Thomas just had some really like interesting things to say comparing growth to buyouts. You focus a lot on small and mid-market. And since, you know, small market is maybe just a step up from growth along the private equity spectrum, like to go to you and the paper that you helped to write on Europe's small market. In the paper we mentioned that 2022 may have been an inflection point for that market. Can you kind of walk us through that progression and explain why we think that trend is likely to stick?

CS: *[00:13:55]* Yes. So, as I as I mentioned before, um, LPs have been looking to put more capital to place more capital in the US versus Europe. And then actually when LPs have been looking to place capital in Europe has been more on the larger European funds, and this has been the case because the European large funds have performed very well and actually align with the smaller funds. So LPs have seen that by committing to the larger funds you had more stability and it was much easier to identify those European funds. However, over the last 36 months, as you mentioned, there has been a shift where smaller funds have been able to perform strongly, but larger funds have struggled to perform. The two key reasons why we think players will find it more difficult to outperform on a go forward basis are pricing and leverage. So, these larger players have paid increasingly higher prices, and historically, they have been able to realize assets with some multiple arbitrages at exit. We think, seeing such multiple arbitrages at exit going forward will be difficult for these high prices. And also, given the high interest environment we are in, and the higher usage of leverage from larger GPs, we also expect more dilution in returns from a leverage standpoint.

MV: *[00:15:25]* That's interesting. Akhilan turning to you now, and in our paper on the Nordics, in which we describe the private equity managers based in that region are outperforming across the board, including in the small and middle markets that that Carlos just described. Now, part of that the story is a strong economy and high marks in several governance indicators, both of which are precursors to a healthy investment environment. I guess the thing that I want to tuck into is scalability. The Nordic economies are comparatively small, as is their share of overall private equity activity. How much room is there to grow? How much can LPs actually like budget to accessing to investing in Nordic private equity?

AN: *[00:16:19]* Yeah, it's a great question. I mean, the Nordic countries have proven their ability to think internationally and scale. I guess that would be my first sort of argument. The fact is that the Nordic region is very fragmented. I mean, as a whole, it's home to just around 28 million people, the largest country within that, Sweden has just 10 million people. This means that Nordic companies with ambition have had to incorporate internationalization as a growth lever fairly early on in their lifespans, and that's been the case for decades. There are numerous examples of huge international companies with humble Nordic beginnings. In Sweden you can think of Ikea, H&M, Volvo, and more recently, Spotify. In Denmark, of course, there is Novo Nordisk, which, you know, depending on the market cap on the day is or can be Europe's biggest company. It actually exceeded Denmark's GDP last year. And of course, Norway has the world's largest sovereign wealth fund, which is the single largest investor in the global equity markets. The argument we'd have is that this Nordic market is a hub of innovation that really punches above its weight. It makes sense to access these companies early before they become the globally leading mega cap businesses of the future. But there will remain a large cap presence in these economies, and I think we've seen that with global private equity firms choosing to deploy their resources, looking at large companies based in the Nordic region as well.

MV: *[00:17:48]* Lastly, there's health care. And not only have private equity managers specializing in that sector outperform the public market comps, that is the MSCI Europe Health Care Index, but they've also outperformed broader European private equity. Now in in our paper we discuss some of the subsectors responsible for this outperformance. Thomas, since some of these themes do relate to venture growth, I do want to hear your thoughts. But before I do, Carlos, walk us through the trends that that may explain why this sector has performed well to date.

CS: *[00:18:24]* Yeah, so, there are many reasons that influence why healthcare has outperformed. We think that some of these are due to the digitalization and innovation trends that are benefiting the market overall, but that having a hands-on investor like a private equity owner can help identify those growing subsectors and help the companies pivot and grow. For example, we're looking at European health tech investments. Before 2010, European private equity had barely done any health tech deals. And the ones that were done were mediocre or produced mediocre results. Since 2010, there has been a deal volume growth in this sub sector given the digitalization trends in the market, which have boosted the both the number of private equity deals and the returns on both an absolute basis and a realized basis.

MV: *[00:19:14]* So. All right. Thanks, Carlos. So, we've covered how kind of the healthcare market got to where it is today. Thomas, talk to us about why we think the outperformance is going to persist into the future.

TD: *[00:19:27]* Yeah. So, you know, we've just talked about health care, you know, where the convergence between data, AI applications and biotech really bodes well for, for this segment over the long term. But I think we're generally encouraged by the acceleration of the digital transformation supercyclic in Europe. That is touching absolutely all sectors, as you know. So, you know, in particular, focusing on the growth segment in Europe, this segment can grow further in light of this digitization of the economy. You know, also leveraging the top-notch education systems that we have in Europe and really the large pools of cheaper talent. I think it's worth mentioning that Europe has 40 to 50% more professional software developers than the US. And importantly, you know, developer salaries in Europe continue to be roughly half of those in the US on average. An important point as well is that, you know, disruptive companies are created in all market cycles, and the quality of founders and assets continues to increase in Europe. So, you know, these trends are naturally following the growth segment. And we believe that the next few years are likely to represent kind of attractive vintages for investors in European growth. And this is in the context of normalizing entry valuations, but also on the back of the increasing role of dry powder from large buyout tech funds that are sitting above the growth segment. So, you know, these buyout tech GPs have appetite for fast-growing, high-quality businesses. And actually, while the valuations have corrected across the tech ecosystem in VC and in the public space, um, the best growth assets continue attracting high valuations at exit, because the new North Star is really the rule of 40 business, which combines growth and profitability. Um, so, you know, overall, we really keep being bullish for this for this segment.

MV: *[00:21:42]* Gentlemen, this has been excellent. Uh, thank you again for your time and insights and hope to see you again soon.

AN: *[00:21:48]* Likewise. No worries at all. Pleasure to be here and hope this was helpful.

TD: *[00:21:52]* Thanks, Michael.

MV: *[00:21:54]* Thank you for listening. For more color on today's conversation, head to Stepstonegroup.com where you can download the four papers we discussed along with the rest of our Thought Leadership library. You can listen to RPM wherever you normally listen to podcasts.