STEPSTONE

1,000 WORDS OR LESS

Introduction to private equity

November 2024

As the US economy has grown, public markets have become increasingly concentrated in fewer, larger companies. In 1996, roughly 8,000 firms were listed in the US stock market. Since then, the national economy has grown by nearly $20 trillion and yet, today, the number of American public companies stands at fewer than 4,000.[1]

This shift presents challenges for thoughtful investors:

1. Fewer hands now direct the path of broad indices;
2. The stock market is less reflective of the wider economy; and
3. More capital is crowding into fewer positions, dampening volatility in tranquil markets and amplifying it in turbulent ones.

Institutions have long valued PE for its alpha potential. They are increasing allocations now to counteract public market concentration, recognizing that PE diversifies factor exposure and provides stability in volatile markets. Moreover, certain innovations are making PE more accessible for individual investors.

[1] Nicole Goodkind, "America has lost half its public companies since the 1990s. Here's why." CNN, June 9, 2023.

What is private equity?

Private equity entails investing in privately held companies that span from start-ups to mature enterprises, across a range of investment strategies and risk-return profiles (**Figure 1**). These are the most common:

- **Venture capital** (VC) offers investors the opportunity to acquire stakes in early-stage companies. VC has the highest potential returns, but the greatest challenges to accessing those returns, and the longest duration.
- The largest and most common strategy, **leveraged buyouts** (LBOs) apply debt or "leverage" to purchase mature enterprises with the goal of making them more efficient and profitable. LBOs have an attractive return profile, and shorter duration than VC or growth equity.
- Often regarded as a hybrid of VC and buyouts, **growth equity** refers to investing in high-growth companies that are at the inflection of profitability. Often, these businesses were "bootstrapped" by founders and are just now experiencing institutional ownership.

PE managers (aka general partners or GPs) are critical to monitoring and advising their portfolio companies. They seek to create value by directly influencing a company's strategy and performance, as well when to exit the investment—whether through a sale to another GP, a corporate or an IPO. Manager selection is one of the most important and difficult aspects of investing in private equity.

FIGURE 1: RETURNS AND DURATION BY STRATEGY

Source: SPI by StepStone as of February 2024.

Note: Excludes immature vintages from 2020 and on. 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.

Past performance is not indicative of future results and there can be no assurance that the investment will achieve comparable results or avoid substantial losses. Gross return will ultimately be reduced by management fees, carried interest, taxes, and other fees and expenses.

Why invest in private equity?

Outperformance

PE has consistently delivered strong returns, surpassing those achieved in public markets over moderate time horizons. PE has outperformed public markets by an average of 514 basis points over the past four decades (**Figure 2**). Unlike public

FIGURE 2: PRIVATE EQUITY FUNDS DIRECT ALPHA OVER MSCI WORLD TR

	NUMBER OF FUNDS	POOLED	25TH PERCENTILE	50TH PERCENTILE	75TH PERCENTILE
Totals	4,037	5.14%	(6.49%)	1.89%	8.99%

Source: SPI by StepStone, as of March 31, 2024. Includes all funds going back to 1970 through 2024.

markets, where investments are passive and more subject to market volatility, private equity allows investors to implement strategic improvements, drive operational efficiencies and leverage long-term growth potential.

Diversification

LBOs have lower correlation with a traditional 60/40 portfolio than the S&P 500 (**Figure 3**). Although buyouts tend to move in the same direction as public markets, their returns are not fully driven by public market dynamics. This partial independence allows PE to add stability to a portfolio and may reduce the impact of market downturns.

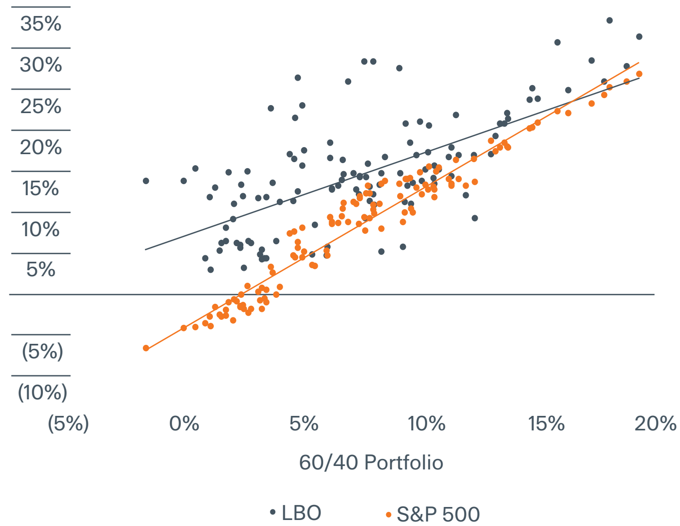
Capital preservation

Additionally, private equity has demonstrated resilience during economic downturns, preserving capital more effectively than public markets. Over the last four crises, PE valuations on average have fallen by roughly half as much as public equity markets (**Figure 4**).

Investment structures

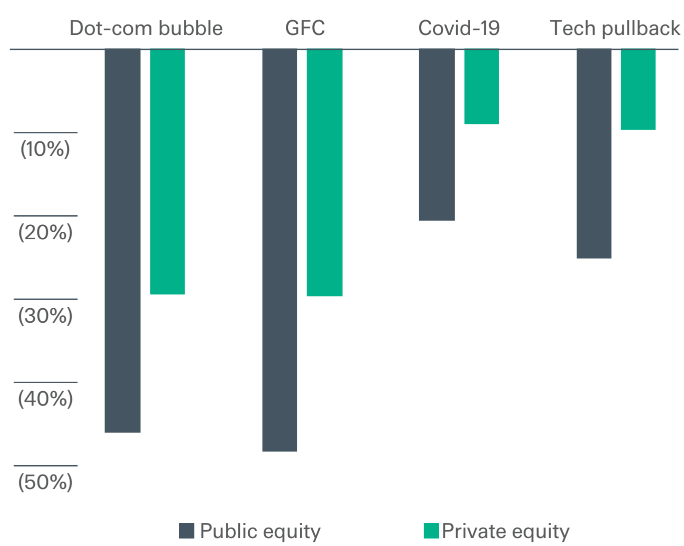
Primary funds (aka commingled or closed-ended funds) are blind pools of capital whereby an investor (aka a limited partner or LP) commits capital upfront, before the fund manager has identified any assets to invest in. Once the GP finds an asset to invest in, the LPs contribute a portion of their committed capital. The invested capital is typically held for around five years—a bit less for LBOs, a bit more for VC. This uncertainty around the timing of when capital is contributed and returned makes liquidity management a challenge for investors. However, by committing to many funds every year, investors can have relatively predictable cash flows from their PE portfolio. Owing to high commitment floors, investing in primaries is typically only available to institutions and high-net-worth investors.

FIGURE 3: CORRELATION WITH 60/40 PORTFOLIO: LBOS V. S&P 500



Source: Burgiss and S&P Dow Jones indices as of March 31, 2024.

FIGURE 4: MAX DRAWDOWN IN ECONOMIC CRISES



Source: CapIQ and SPI by StepStone as of May 2024.

Note: "Public equity" represents the average of S&P 500 TR and MSCI World TR.

Co-investments allow investors to invest alongside a GP—often on a "no fee, no carry basis." This allows them to gain critical insights into the strength of the asset and the GP's investment team. Co-investors must move quickly, and often deploy specialized teams to execute deals. Co-investment without a primary fund portfolio is very difficult, as it significantly reduces deal flow.

Secondaries refer to purchasing stakes in an individual company or a primary fund, often at a discount. The sales process can be GP- or LP-led. Because the manager has already put capital to work improving the asset(s), the buyer may be purchasing the asset(s) when cashflows are trending upward.[2] In addition, these transactions usually take place after the investment period, when fees are trending lower. Like co-investments, investing in secondaries requires teams with advanced financial skills and access to proprietary data.

Evergreen funds have emerged as a convenient and efficient way for individuals to access PE. Because these structures draw and deploy investors' capital continually, they can effectively compound that capital and resolve some of the liquidity challenges that other structures can present. Though initially conceived with the individual in mind, institutions are increasingly using evergreens in their PE portfolios.

Evergreens have many advantages including lower minimum investments, higher liquidity, and simpler taxes. However, their fees are higher than other retail products, including mutual funds.

Conclusion

As investors navigate a shrinking and increasingly concentrated stock market, private equity stands out as means for investors to potentially generate high returns, diversify their portfolios and preserve capital during economic downturns.

Each PE strategy offers benefits and considerations, from potential high returns and enhanced diversification to varying levels of liquidity and fee structures. For newer investors, partnering with an experienced private equity manager is essential to understanding this rich and varied asset class.

Private equity allows investors to implement strategic improvements, drive operational efficiencies and leverage long-term growth potential.

[2] In industry parlance, we say on the upswing of the "J curve."

This document is for informational purposes and is meant only to provide a broad overview for discussion purposes. This document does not constitute an offer to sell, a solicitation to buy, or a recommendation for any security, or as an offer to provide advisory or other services by StepStone Group LP, StepStone Group Real Assets LP, StepStone Group Real Estate LP, StepStone Group Private Wealth LLC, StepStone Group Private Debt AG, StepStone Group Europe Alternative Investments Limited and StepStone Group Private Debt LLC, their subsidiaries or affiliates (collectively, "StepStone") in any jurisdiction in which such offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. The presentation is being made based on the understanding that each recipient has sufficient knowledge and experience to evaluate the merits and risks of investing in private market products. Information contained in this document should not be construed as financial or investment advice on any subject matter. StepStone expressly disclaims all liability in respect to actions taken based on any or all of the information in this document. This document is confidential and solely for the use of StepStone and the existing and potential investors or clients of StepStone to whom it has been delivered, where permitted. By accepting delivery of this presentation, each recipient undertakes not to reproduce or distribute this presentation in whole or in part, nor to disclose any of its contents (except to its professional advisors), without the prior written consent of StepStone.

Expressions of opinion are intended solely as general market commentary and do not constitute investment advice or a guarantee of returns. All expressions of opinion are as of the date of this document, are subject to change without notice and may differ from views held by other businesses of StepStone.

Some information used in the presentation has been obtained from third parties through various published and unpublished sources considered to be reliable. StepStone does not guarantee its accuracy or completeness and accepts no liability for any direct or consequential losses arising from its use. Thus, all such information is subject to independent verification by prospective investors.

All information provided herein is subject to change.

All valuations are based on current values calculated in accordance with StepStone's Valuation Policies and may include both realized and unrealized investments. Due to the inherent uncertainty of valuation, the stated value may differ materially from the value that would have been used had a ready market existed for the portfolio investments or a different methodology had been used. The long-term value of these investments may be lesser or greater than the valuations provided.

StepStone Group LP, its affiliates and employees are not in the business of providing tax, legal or accounting advice. Any tax-related statements contained in these materials are provided for illustration purposes only and cannot be relied upon for the purpose of avoiding tax penalties. Any taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Prospective investors should inform themselves and take appropriate advice as to any applicable legal requirements and any applicable taxation and exchange control regulations in the countries of their citizenship, residence or domicile which might be relevant to the subscription, purchase, holding, exchange, redemption or disposal of any investments. Each prospective investor is urged to discuss any prospective investment with its legal, tax and regulatory advisors in order to make an independent determination of the suitability and consequences of such an investment.

An investment involves a number of risks and there are conflicts of interest. Please refer to the risks and conflicts disclosed herein or in relevant disclosure documents associated with potential investments.

Each of StepStone Group LP, StepStone Group Real Assets LP, StepStone Group Real Estate LP, StepStone Group Private Wealth LLC and StepStone Group Private Debt LLC is an investment adviser registered with the Securities and Exchange Commission ("SEC"). StepStone Group Europe LLP is authorized and regulated by the Financial Conduct Authority, firm reference number 551580. StepStone Group Europe Alternative Investments Limited ("SGEAIL") is an investment adviser registered with the SEC and an Alternative Investment Fund Manager authorized by the Central Bank of Ireland and StepStone Group Private Debt AG ("SPD") is an SEC Exempt Reporting Adviser and is licensed in Switzerland as an Asset Manager for Collective Investment Schemes by the Swiss Financial Markets Authority FINMA. Such registrations do not imply a certain level of skill or training and no inference to the contrary should be made.

In relation to Switzerland only, this document may qualify as "advertising" in terms of Art. 68 of the Swiss Financial Services Act (FinSA). To the extent that financial instruments mentioned herein are offered to investors by SPD, the prospectus/offering document and key information document (if applicable) of such financial instrument(s) can be obtained free of charge from SPD or from the GP or investment manager of the relevant collective investment scheme(s). Further information about SPD is available in the SPD Information Booklet which is available from SPD free of charge.

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

All data is as of November 2024.

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.

STEPSTONE

stepstonegroup.com