Preqin Research Report
Private Equity Investor Survey

August 2009

Private Equity • Real Estate • Hedge Funds • Infrastructure

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Much has changed in the private equity industry in the past year. The global financial crisis has had a massive impact on the asset class, not just on the investments made by fund managers, but also on the institutional investors in private equity funds, their opinions of the industry and their ability to make fresh commitments.

The evidence for this can clearly be seen in recent fundraising figures: in Q2 2009, 89 private equity funds reached a final close securing $79.7bn between them, considerably less than the $194.5bn raised by the 274 funds to hold a final close in the same quarter the previous year.

Despite this, we are beginning to see the first signs of recovery, with capital raised in Q2 2009 representing a 25% increase on the $64bn secured in Q1 2009. Overall, however, fundraising is still clearly far from reaching the levels seen in recent years. But to what extent is this drop in fundraising a result of shifting investor attitudes to the asset class, how permanent is the apparent decline in investor appetite for funds and when are investors likely to return to the market?

Using Investor Intelligence, Preqin's database containing profiles for over 4,000 investors in private equity, we conducted a survey of 100 significant institutional investors over a single week in July 2009 to obtain a unique snapshot of their views of the industry at the current time and to see how active LPs anticipate being in the asset class in the coming months and years.

Impact of the Financial Crisis on Investor Attitudes to Private Equity

We asked investors whether they had made any commitments to private equity funds so far this year, and a considerable 59% informed us they had not, as shown in Fig. 1. Furthermore, 44% told us that their private equity investment plans had changed as a result of the financial crisis. 43% of those investors whose plans had changed went on to tell us they expected to make fewer investments in the next 12 months than in recent years. An additional 9% did not anticipate making any further commitments in the coming year as a result of the current financial climate, as shown in Fig. 2.

Although it is possible to focus on investors that have changed their investment plans as a result of the financial

Fig. 1:

Proportion of Investors to Have Made New Commitments in H1 2009

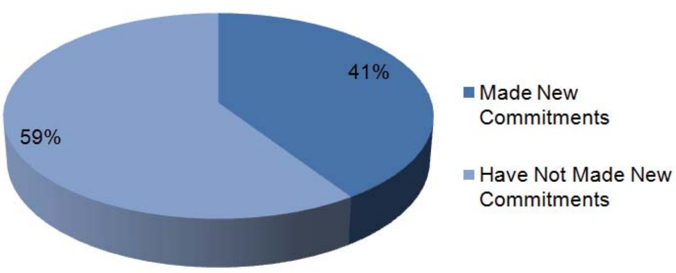


Fig. 2:

If At All, How Have Investors' Private Equity Investment Plans Changed in Light of the Financial Crisis?

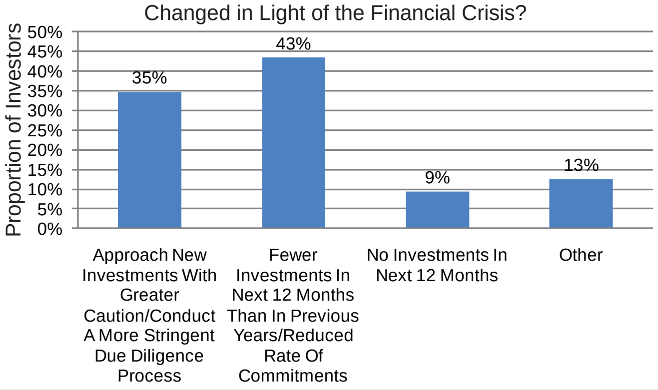


Fig. 3:

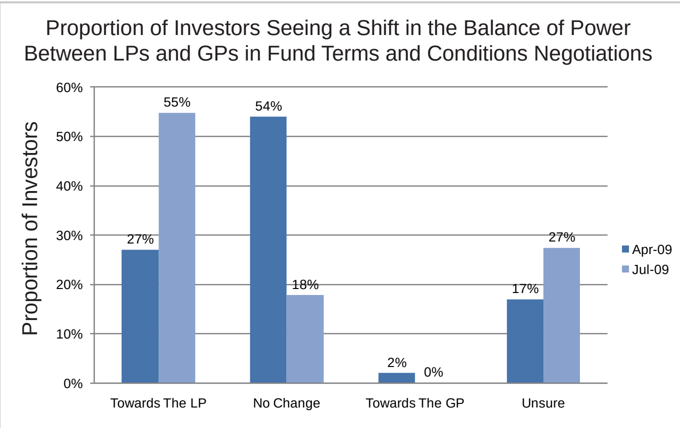
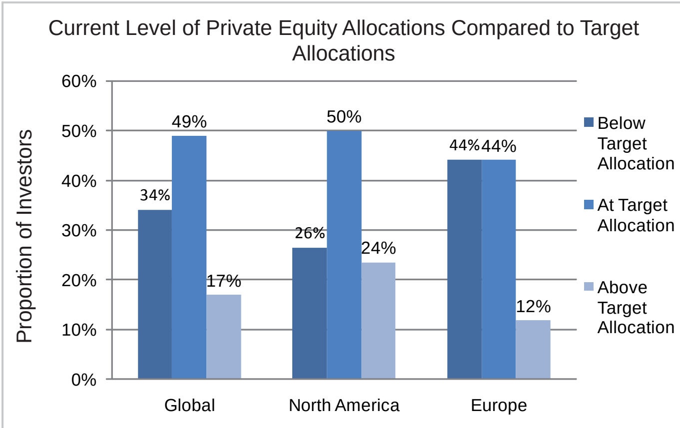


Fig. 4:



crisis, it is worth noting that more than half of investors (53%) told us their plans had not changed significantly as a result of the financial downturn and 41% had already made at least one private equity fund commitment so far in 2009.

With competition amongst GPs for LP commitments particularly intense at present, much has been speculated about the impact this will have had on the balance of power between LPs and GPs during the negotiation of fund terms and conditions. Are GPs now more willing to compromise with LPs on certain fund terms and conditions in return for commitments? We conducted a survey of 50 investors in April 2009 that provided initial evidence of a shift in power towards the LP, with 27% of investors stating that they were able to wield greater influence over negotiations than they had in the past. Just three months later, 55% of respondents to our July 2009 survey felt the balance of power had shifted towards the LP, as shown in Fig. 3. Furthermore, just 18% of investors in July 2009 felt that there had been no definable

Fig. 5:

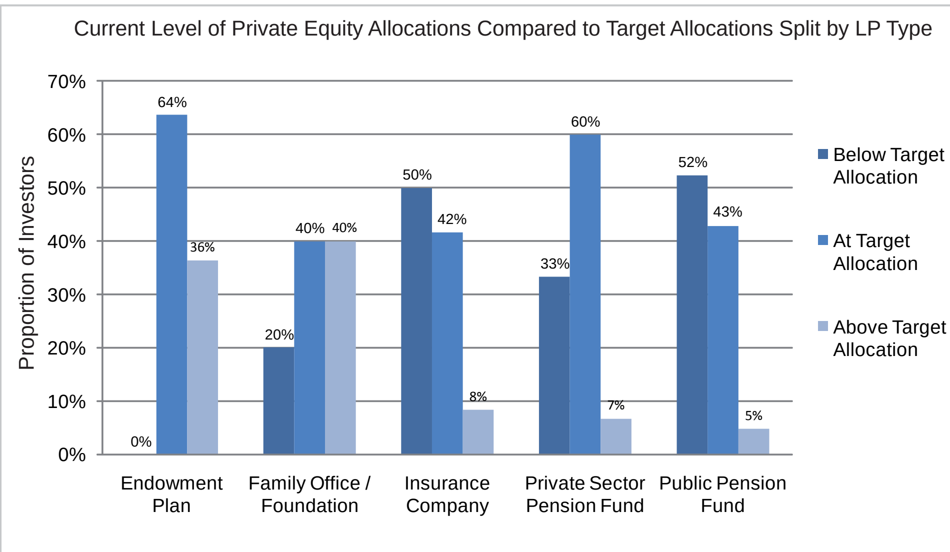
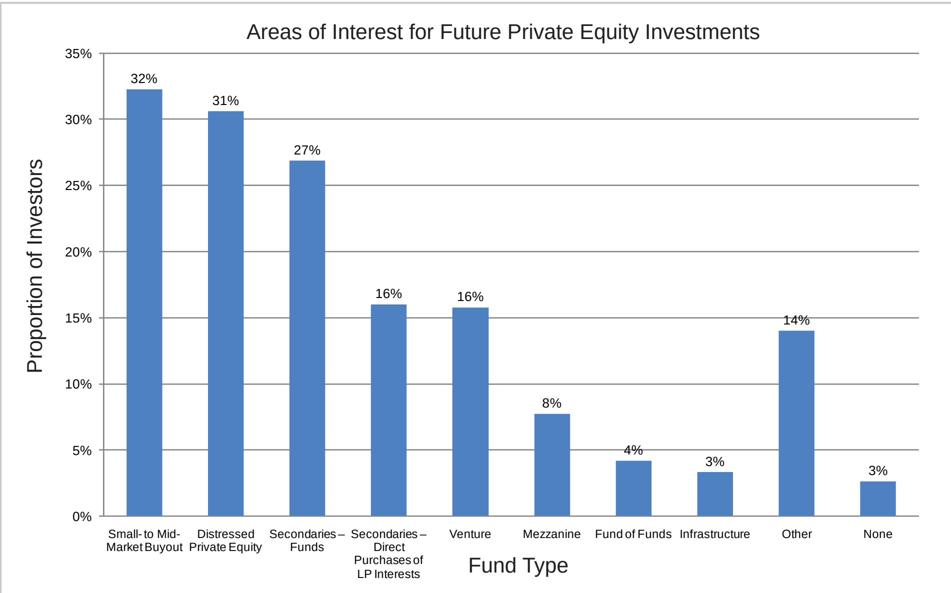


Fig. 6:



change, in comparison to 54% just three months earlier. However, though many investors felt there had been a shift of power towards the LP, most felt that the change had not been overly significant, with many saying it was only GPs operating in certain areas of the market that had become more accommodating of investor demands, whilst “the mid-market and smaller funds are still generally getting 2 and 20,” according to a Nordic asset manager. Perhaps the onus is on LPs to use the situation to their advantage to secure a better deal in relation to the fees charged; a US foundation told us that although GPs with the more attractive opportunities were still unlikely to adjust their terms and conditions, “LPs should certainly be taking the opportunity to push for more on balance.”

Current LP Views of the Private Equity Market

With private equity valuations lagging behind public markets, private equity portfolios did not immediately reflect the new financial situation and, as a consequence, many private equity investors found the proportion of their portfolios allocated to private equity rising significantly as their investments in public equities declined in value. The past six months, however, have seen private equity valuations fall and, as Fig. 4 shows, just 17% of investors are now finding themselves overcommitted to the asset class, whereas a considerable 34% of investors have yet to reach their target allocations.

Furthermore, whilst just 12% of European investors are at present exceeding their target allocations to private equity, almost a quarter (24%) of North American investors informed us that they were above their target allocations. Likewise, 44% of European investors also have yet to reach their target allocations in contrast to 26% of North American investors.

Different types of institutional investor have experienced the denominator effect to varying degrees, as illustrated in Fig. 5, which compares average current and target allocations to private equity amongst different institutional investor types. Some have implemented certain measures, such as raising target allocations to private equity, in order to resolve the issues arising from the effect.

Whereas approximately half of the public pension funds and insurance companies we spoke to informed us that they are currently below their targets, no endowment plans told us they were underallocated to the asset

Fig. 7:

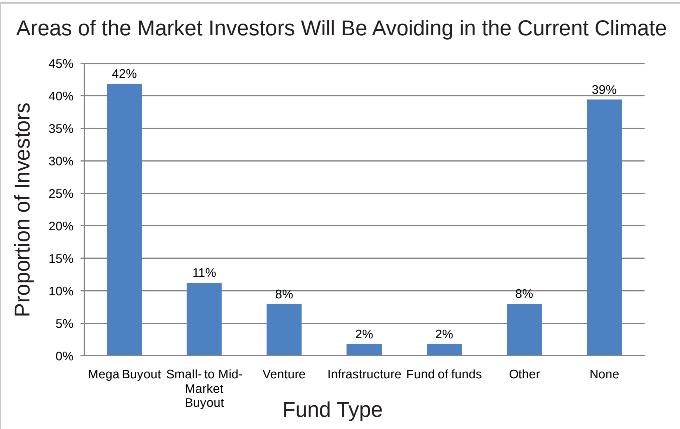
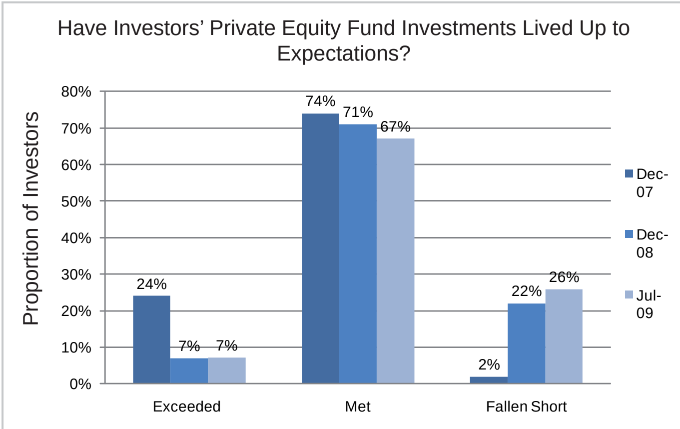


Fig. 8:



class. In fact, a third of endowments told us they were above their target allocations. 40% of family offices and foundations also informed us that they were at present exceeding their target allocations.

The economic downturn has presented a wide range of opportunities to fund managers, and we asked investors what fund types they felt were particularly attractive in the current climate. As illustrated by Fig. 6, approximately a third of investors believe small to mid-market buyout funds are particularly appealing. 31% of investors told us that distressed private equity, including distressed debt, turnaround and other special situations funds, are especially attractive at present. Secondaries funds have continued to draw significant investor interest too, and 14% of LPs found other areas of the market attractive, including cleantech funds and vehicles targeting emerging markets.

We also asked investors which areas of the private equity market they would be avoiding this year that they would have considered investing in previously. 39% of respondents told us there were actually no fund types that they had previously invested in that they would be avoiding in the coming year. However 42% of investors informed us that they would not be seeking to invest in buyout funds in the next 12 months. Although approximately a quarter of these investors told us they would not be investing in small to mid-market funds, none would consider investing in mega buyout funds.

Investors' Expectations for the Valuations of Their Private Equity Portfolios

Fig. 8 shows how investors feel their overall private equity portfolios have lived up to their expectations. It is clear that the recent financial turmoil has had a considerable impact on the way investors view their portfolios, with 26% of respondents to our July 2009 survey informing us that investments have fallen short of their expectations, compared to 22% in December 2008 and just 2% in December 2007. However, 67% of investors still state that private equity has met their expectations, and many reasoned that the long-term nature of the asset class meant that, although their portfolios were not performing as well as they hoped at present, they recognise the consistently high returns private equity has provided over the long term. A Dutch private sector pension fund said that its "private equity investments have lived up to expectations relative to public equity investments," although it is "disappointed with control and risk management and that so much leverage was used." A

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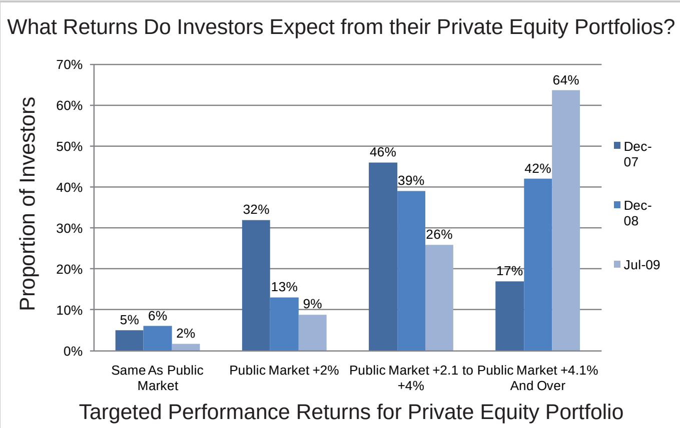
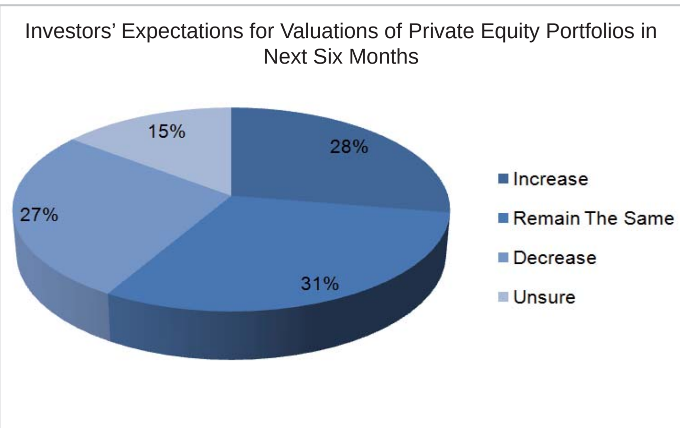
Fig. 9:



US endowment told us that "private equity has helped strengthen [its] portfolio during this financial crisis."

The return expectations of investors have shifted significantly in the past 18 months, as shown in Fig. 9. In December 2007, just 17% of investors expected their private equity portfolios to outperform public markets by a margin of more than 4%, but in the current financial climate, 64% of investors expect returns of this level.

Fig. 10:

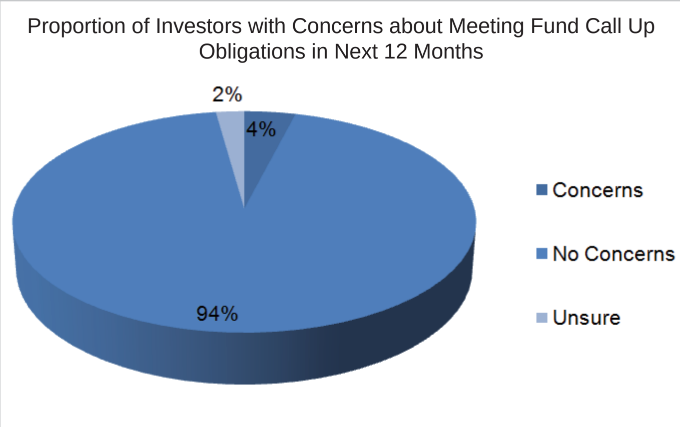


Although the majority of investors are seeking returns from their private equity portfolios that exceed public markets by a considerable margin, the recent global financial turmoil and the changes in assigning values to private equity portfolio holdings following the introduction of FAS 157 have seen private equity valuations fall in the past six months. We asked investors how they expected private equity valuations to change in the next six months, and the results are displayed in Fig. 10. A significant 28% anticipated valuations would start to rise again. A Finnish private sector pension fund told us that the "private equity market is now following the public market with a lag of about six months," and so it is "hoping private equity valuations will increase by early 2010" from their current levels. A further 31% thought valuations were set to stabilise and would remain at their current levels until 2010. 27% informed us that they expected valuations would decrease further. The remaining 15% were unsure how valuations would change in the coming six months; a UK public pension fund told us that, "because of the way portfolio holdings are now accounted for, valuations are now following the public markets," and therefore it is not possible to say how they will fare in this timeframe.

Investors' Future Plans for Private Equity Investment

The past six months have seen a significant drop in the rate of fundraising for the private equity industry and 59% of investors have held off from making further investments so far in 2009. One factor that has caused this delay, at least initially, has been investors' need for liquidity, so we asked LPs whether they had any concerns about meeting capital calls from their portfolio funds in the next 12 months. The overwhelming majority told us they did not, as shown in Fig. 11. Just 4% of investors have definite concerns about being able to respond to fund call ups. The improvement in investor confidence in being able to fund capital calls can be explained in part by the

Fig. 11:



measures implemented by GPs including, according to a Swiss family office, being “slow to call capital and when they do, [being] careful to explain it,” since “GPs have been careful over the last nine months or so, as they are afraid LPs might be defaulting on investments.”

A drop in the rate of distributions from existing private equity holdings has also left many investors without capital to reinvest in the asset class. We asked investors about their expectations for the rate of distributions in the next 12 months. Just under a third expected distributions to decrease further and 41% expected distributions to remain at the same rate. One investor, a US insurance company, told us that it has “no distribution expectations, and anything [they] get back is gravy.” However, 28% of investors anticipated distributions would pick up again following a slow start to 2009 as exit opportunities for portfolio holdings improve.

Future Private Equity Investments

Less than half of the investors we polled had committed to private equity funds in the past six months. But when can we expect more LPs to return to the market and make fresh commitments? As Fig. 13 shows, a considerable 79% of investors expect to make new commitments to funds either this year or next, showing that large numbers of investors can be expected to recommence investment in the asset class in the next 18 months. In fact, more than half of investors are seeking to make commitments before the end of 2009. Just 7% told us they would not be investing further in the next two years. This is encouraging news for fund managers either currently in the market or intending to start fundraising in

Fig. 12:

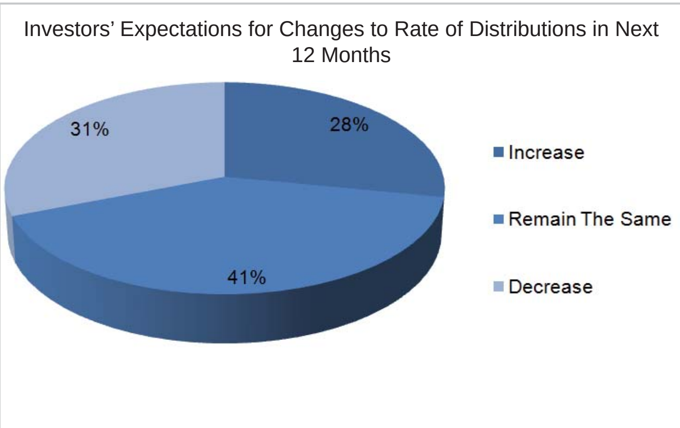


Fig. 13:

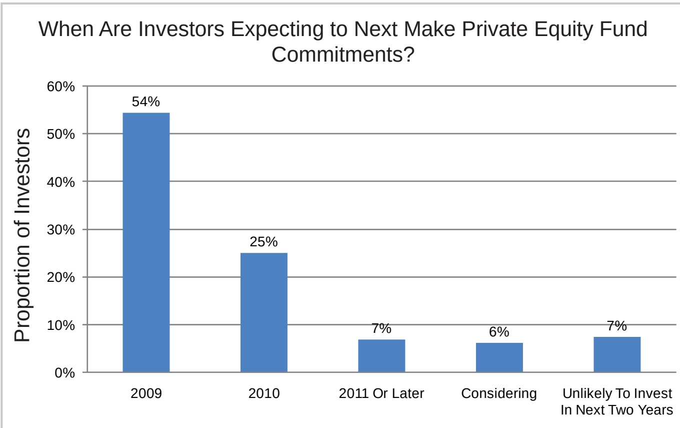


Fig. 14:

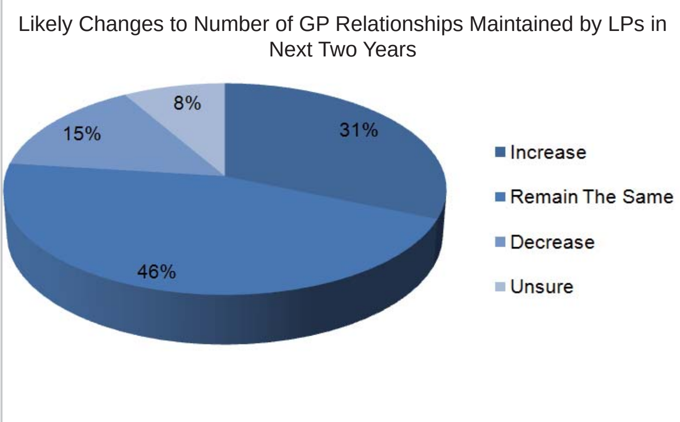
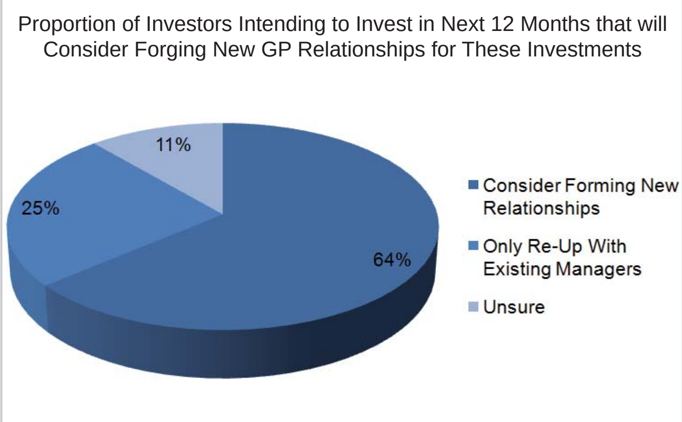


Fig. 15:



the coming months.

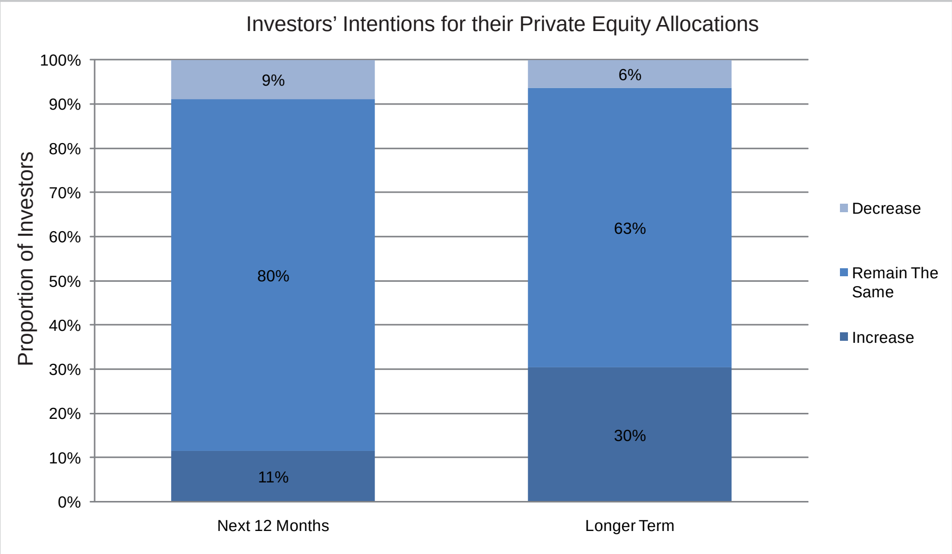
We asked investors whether they anticipated the number of GP relationships they maintain increasing, decreasing or remaining the same over the next two years. 46% intended to maintain the same number of fund manager relationships, though this could involve ceasing to invest with some managers and forging new relationships with others. Just 15% of investors expected to reduce the number of GPs represented in their portfolios. Almost a third, 31%, expected the number of GP relationships they have to increase over the next couple of years.

With many investors currently approaching private equity investments with a greater degree of caution than they have in the past, what are the prospects for managers seeking to establish new relationships with LPs? We asked investors whether they would consider investing with GPs with which they do not already have a relationship in the next 12 months. As Fig. 15 shows, 64% of investors will consider forming new relationships with GPs, compared to just 25% that will only be looking to re-up with existing managers in their portfolios. Although this is encouraging evidence for GPs, many investors stated that a GP they had not invested with before would have to present them with an especially compelling opportunity for them to consider investing.

Finally we asked investors whether they expected their allocations to private equity to increase in the next 12 months and, in addition, whether they foresaw their long-term target allocations increasing over the next three to five years. As Fig. 16 shows, in the short term, investors' allocations to private equity are expected to remain broadly the same, with just 11% of investors informing us that they expected the overall level of their exposure to the asset class to go up, whilst the vast majority, 80%, expected their current allocations to private equity to remain at the same level as a proportion of their overall investment portfolios.

However, it is clear that investor appetite for private equity is still strong and that most LPs still intend to remain active in private equity over the longer term, with just 6% of investors in the asset class anticipating decreasing their target allocations in three to five years. In fact, 30% expect to increase their target allocations over the next few years, showing that, though investors have been holding off from investing in the asset class more recently, as the markets stabilise, actual investor

Fig. 16:



appetite for the asset class will remain strong.

The Challenge for Fund Managers

Although investor appetite for private equity has taken a slight knock following the market downturn, most investors recognise the long-term nature of the asset class and intend to remain in it for the foreseeable future. For fund managers seeking fresh commitments in the year ahead however, the evidence is clear: investors will be returning to the market but will be more cautious and invest at a slower rate than they have in the past. At the same time, more than 1,600 funds are on the road seeking capital, close to record-breaking levels. The challenge, therefore, for fund managers seeking to raise capital in the coming year will be to stand out from all their competitors and to effectively promote their vehicles to the most appropriate audience.

There are many ways in which fund managers can improve their chances of a successful fundraise. Many LPs have informed us that they expect to see greater transparency from prospective GPs and therefore it is essential that managers make sure that all fund documentation is prepared prior to hitting the road. GPs should also be prepared for the fundraising process to take longer than in previous years, with funds that reached a final close so far in 2009 taking a record-breaking average of 18.3 months to raise their capital. Managers that expect to enter the fundraising market in 2010 with their next vehicles should make sure to remain in regular contact with their existing investors this year to put them in the best position when approaching them about fresh commitments next year.

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- Fundraising
- Investor Profiles
- Fund Terms
- Fund Manager Profiles

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