PREQIN SPECIAL REPORT: VENTURE CAPITAL FUND MANAGER OUTLOOK

H1 2018

FOREWORD

Venture capital is a unique strategy with characteristics that differentiate it from buyout, growth equity and other foundational categories of private equity, so much so that some consider the strategy to be an asset class on its own. As the sector with the largest share of private equity fund managers, capital commitments to the space have grown in recent years, with venture capital appearing more commonly in institutional portfolios.

However, concerns remain among venture capital managers regarding performance, the current exit environment and deal pricing/valuations in 2018. Valuations are a common concern in all areas of alternative assets, with public markets at or near all-time highs. Performance is also likely to remain a concern given that deals have become increasingly expensive in the space.

Of the venture capital managers Preqin surveyed for this report, 38% are headquartered in North America, 32% in Europe and 15% in Asia, with the remainder located in Australasia, Latin America, Sub-Saharan Africa and the Middle East. Early stage is the most prevalent primary strategy among respondents (31%), followed by growth (28%) and seed investing (22%). More than 58% of respondents manage less than $100mn in assets, while 7% manage more than $1bn.

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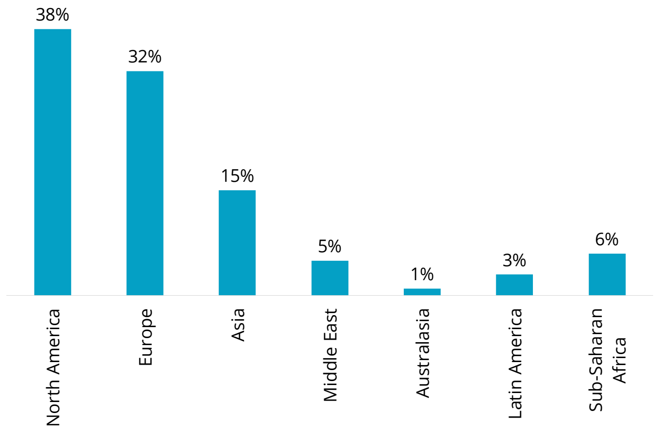
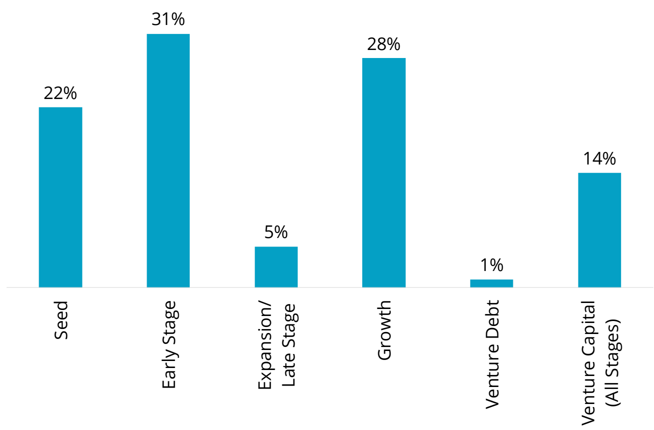
Survey Respondents by Headquarters Location:



Survey Respondents by Primary Venture Capital Investment Strategy:



DEAL FLOW AND COMPETITION

Competition among managers, cheap financing and a global bump in venture capital fundraising are just a few of the reasons why asset valuations have increased steadily in recent years. It is unsurprising that 55% of GPs surveyed at the end of 2017 reported higher pricing for portfolio companies compared to 12 months prior, up 23 percentage points from the proportion surveyed in June 2017 (Fig. 1).

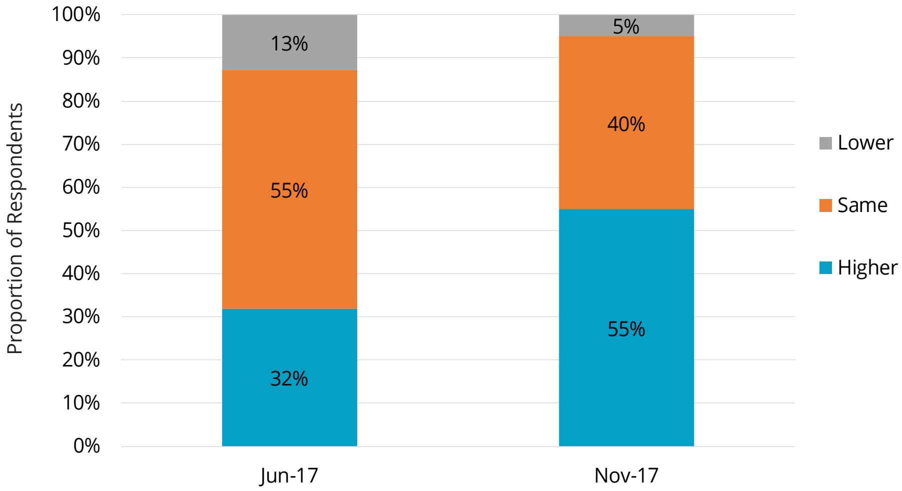
> ***Fund managers are confident that the exit environment will continue to gain momentum in 2018***

Managers are under increasing pressure to keep pace of deal flow and produce the high absolute returns that have historically attracted them to the industry. A larger proportion (17%) of GPs surveyed cited deal flow as a key industry challenge in 2018 compared to 2017. Nearly all managers (98%) stated that the level of competition for transactions is either the same or greater than 12 months ago (Fig. 2). The US remains the most competitive marketplace for venture capital, with the West Coast the main hub for both managers and activity.

High valuations coupled with increased competition have resulted in a larger proportion (27%) of managers finding it more difficult to source attractive investment opportunities compared to 12 months ago (Fig. 3). Just 11% of GPs reported that it was now easier to source deals, while 62% cited no difference in the market. In efforts to consistently find enticing opportunities, fund managers are having to review more investment proposals: the largest proportion (47%) of GPs are reviewing more investment opportunities now than they were 12 months ago (Fig. 4).

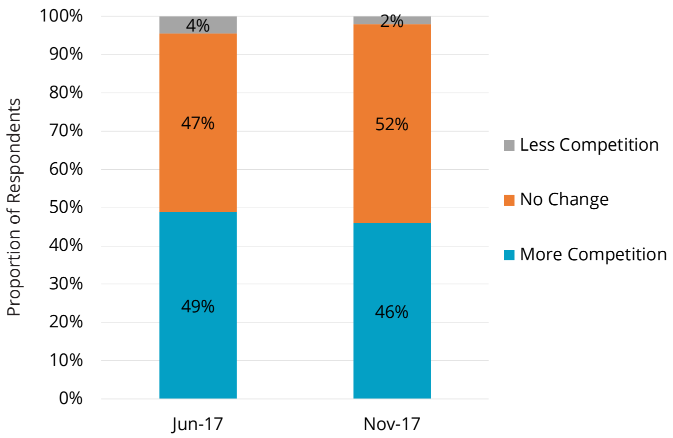
Fund managers are confident that the exit environment, which recovered over the course of 2017, will continue to gain momentum in 2018. The majority (61%) of respondents expect to exit more investments in 2018 compared with 2017, while another 29% expect to

Fig. 1: Fund Manager Views on Portfolio Company Pricing Compared to 12 Months Ago, June vs. November 2017



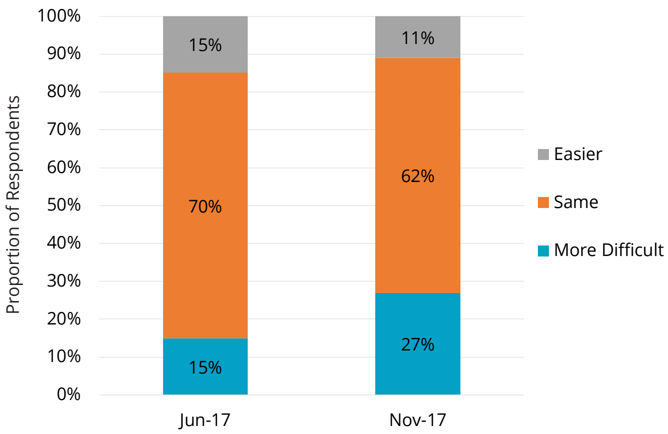
Source: Preqin Fund Manager Survey, June - November 2017

Fig. 2: Fund Manager Views on the Level of Competition for Transactions Compared to 12 Months Ago, June vs. November 2017



Source: Preqin Fund Manager Survey, June - November 2017

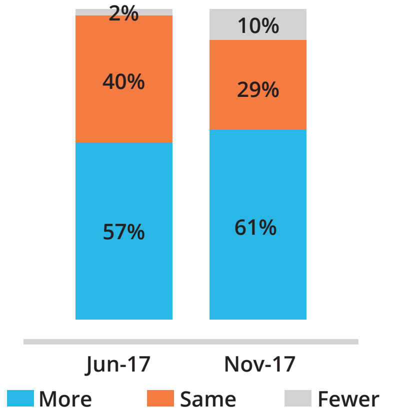
Fig. 3: Fund Manager Views on the Difficulty of Finding Attractive Investment Opportunities Compared to 12 Months Ago, June vs. November 2017



Source: Preqin Fund Manager Survey, June - November 2017

exit a similar number. However, despite managers' increasing confidence in the exit environment, a greater proportion (10%) of respondents plan to exit fewer investments in the coming year than those surveyed in June 2017 (2%).

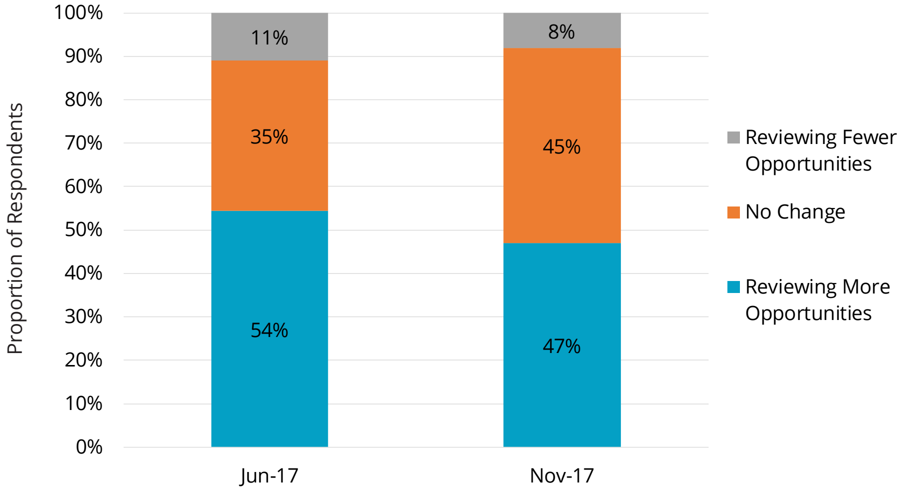
FUND MANAGERS' PLANNED NUMBER OF EXITS IN 2018 COMPARED TO 2017



Fund managers were also asked about levels of competition for transactions at each distinct venture capital investment stage, as shown in Fig. 5. For each stage, the largest proportion of managers saw an increase in competition over the past 12 months, led by 52% for seed investments and 50% for growth transactions. The largest proportion of managers that reported less competition for transactions was 12% for later stage investments, although this proportion remains relatively small.

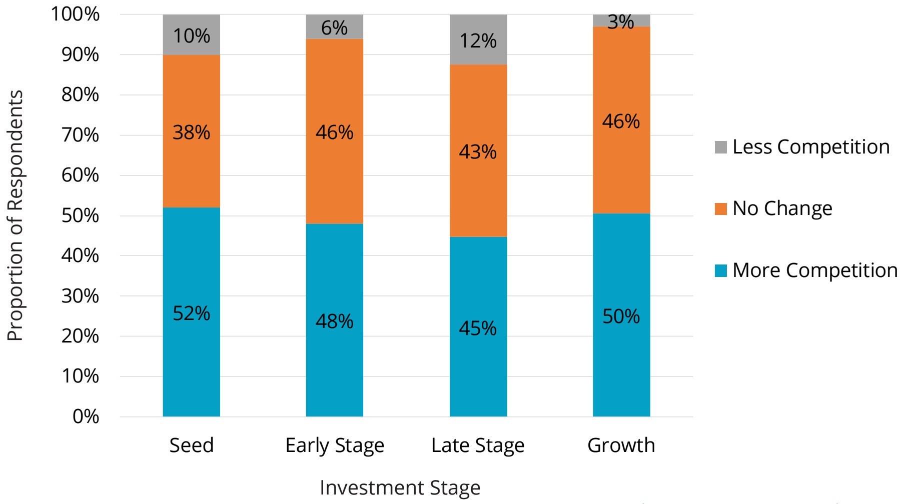
The proportion of fund managers that feel debt financing terms for acquirors have improved has increased by 15 percentage points from those surveyed in June 2017, yet it is still the case that the majority (54%) of fund managers have seen no change in terms (Fig. 6). The cost of debt has played a strong part in the proliferation of alternative investing in a low interest rate environment in recent years. Although interest rates have increased over the course of 2017, just 14% of fund managers feel debt financing terms have worsened in the past year.

Fig. 4: Fund Manager Views on the Number of Opportunities Reviewed per Investment Compared to 12 Months Ago, June vs. November 2017



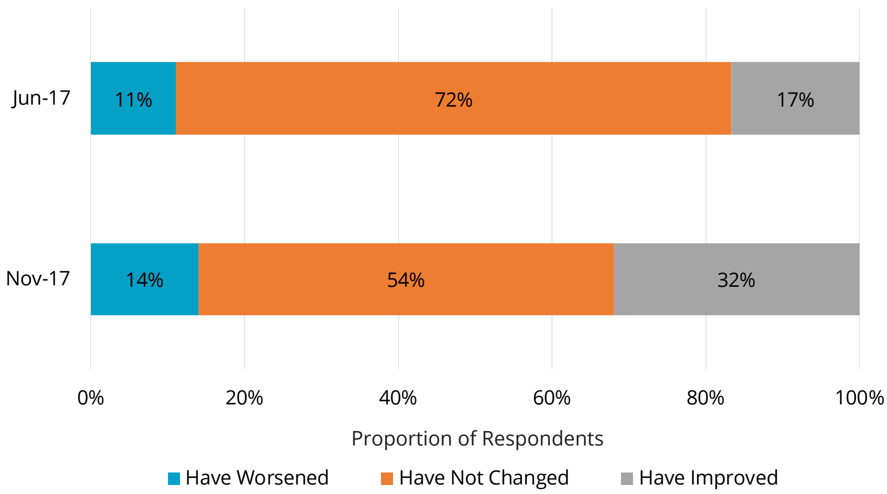
Source: Preqin Fund Manager Survey, June - November 2017

Fig. 5: Fund Manager Views on the Level of Competition for Transactions Compared to 12 Months Ago by Investment Stage



Source: Preqin Fund Manager Survey, November 2017

Fig. 6: Fund Manager Views on How Debt Financing Terms for Acquirors Have Changed over the Past 12 Months, June vs. November 2017



Source: Preqin Fund Manager Survey, June - November 2017

FUND MANAGER VIEWS ON INVESTOR APPETITE

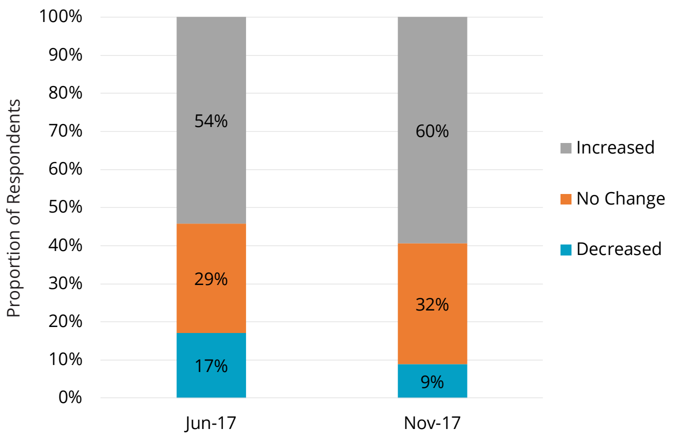
A favourable fundraising environment is likely to continue in 2018 as the majority (60%) of GPs surveyed noted an increase in investor appetite for venture capital over the past 12 months, up six percentage points from June 2017 (Fig. 7).

The investor type from which the largest proportion (61%) of GPs noted an uptake in interest is family offices (Fig. 8). In addition, large proportions of fund managers also noticed increased appetite from fund of funds managers (41%), asset managers (37%) and wealth managers (35%). In contrast, the largest proportion (20%) of fund managers experienced a decrease in appetite for venture capital from banks.

When asked about investors' behaviour by location, 58% of fund managers reported an increase in appetite from Asia-based investors, while just 1% felt their interest had declined (Fig. 9). Considerable proportions of fund managers feel that demand for venture capital has increased from investors based in Europe (46%), North America (41%) and MENA (39%) over the past 12 months. In contrast, the majority (78%) of fund managers have seen no change in venture capital interest from Australasia-based investors, with just 17% having seen an increase in appetite.

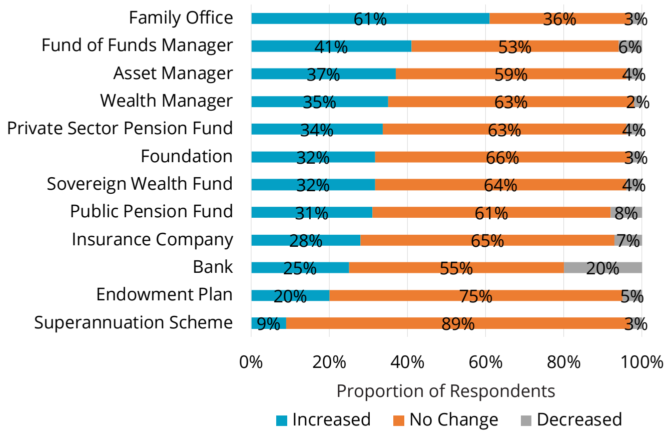
Although GPs reported a slight improvement in the level of competition among fund managers from six months ago, as seen in Fig. 10, the ongoing fight for investor commitments will likely intensify in 2018. Just 26% of investors surveyed by Preqin expect to increase their allocation to venture capital over the long term, which will, in turn, slow the growth of available investor capital.

Fig. 7: Fund Manager Views on How Investor Appetite for Venture Capital Has Changed over the Past 12 Months, June vs. November 2017



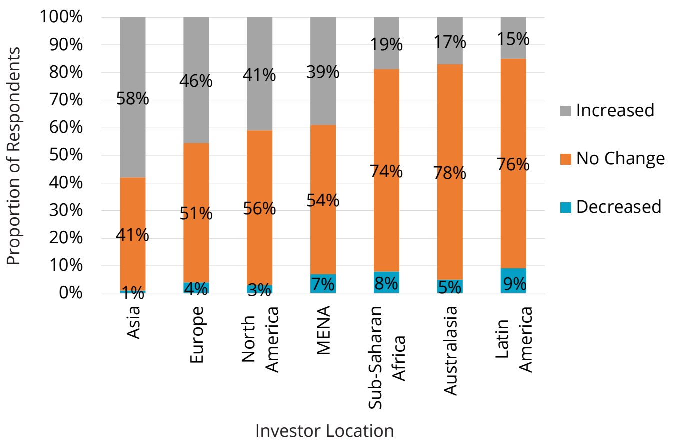
Source: Preqin Fund Manager Survey, June - November 2017

Fig. 8: Fund Manager Views on How Investor Appetite for Venture Capital Has Changed over the Past 12 Months by Investor Type



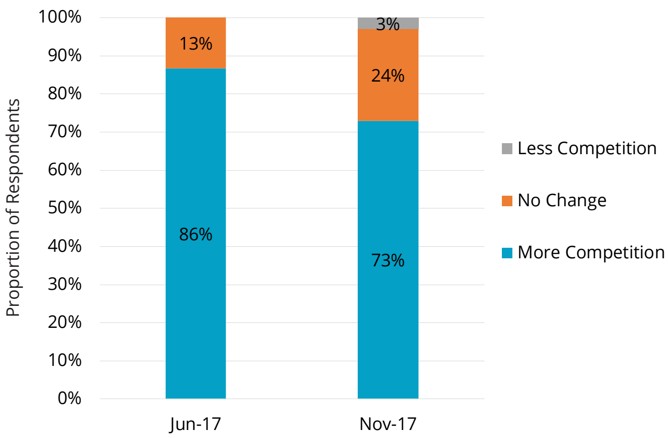
Source: Preqin Fund Manager Survey, November 2017

Fig. 9: Fund Manager Views on How Investor Appetite for Venture Capital Has Changed over the Past 12 Months by Investor Location



Source: Preqin Fund Manager Survey, November 2017

Fig. 10: Fund Manager Views on the Level of Competition for Investor Capital Compared to 12 Months Ago, June vs. November 2017



Source: Preqin Fund Manager Survey, June - November 2017

IN FOCUS: ESG

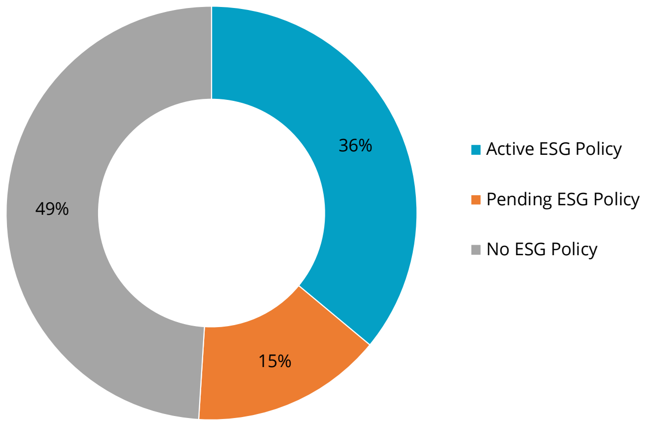
An increasingly competitive environment coupled with evolving LP preferences have pushed GPs to further distinguish themselves in order to successfully fundraise. A significant proportion (58%) of GPs stated a unique fund strategy is most important in differentiating themselves from other managers. With a rising population of LPs concerned with the impact and sustainability of their investments, the importance of environmental, social and corporate governance (ESG) policies is greater than ever.

The majority (51%) of fund managers surveyed either have an active ESG policy or have one pending (Fig. 11). Yet, just under a third (31%) of GPs require portfolio companies to report on ESG or responsible investment activity (Fig. 12). The largest proportion (67%) of managers do not track ESG metrics, while just 13% of GPs report ESG metrics to investors quarterly or more frequently (Fig. 13).

As seen in Fig. 14, Europe-based managers are most likely to consider ESG factors: 61% of respondents either maintain an ESG policy or have one pending, while nearly the same proportion (62%) of North America-based GPs do not consider ESG factors. Under a third of Asia- and North America-based managers have an active ESG policy.

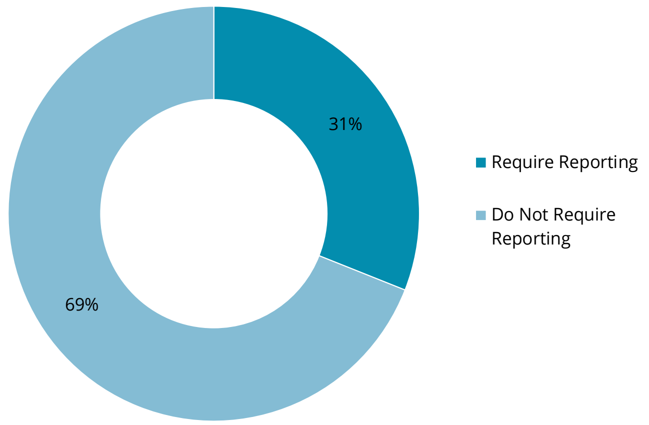
Although a significant proportion of managers consider ESG factors as part of their investment strategy, only a few actively collect and report on ESG metrics. A window of opportunity exists for managers to further differentiate themselves by employing more granular ESG objectives such as mandatory reporting, active engagement with portfolio companies, integration of ESG initiatives with fund strategy, and timely communication with LPs, among others.

Fig. 11: Fund Managers' Policies Regarding ESG Investment



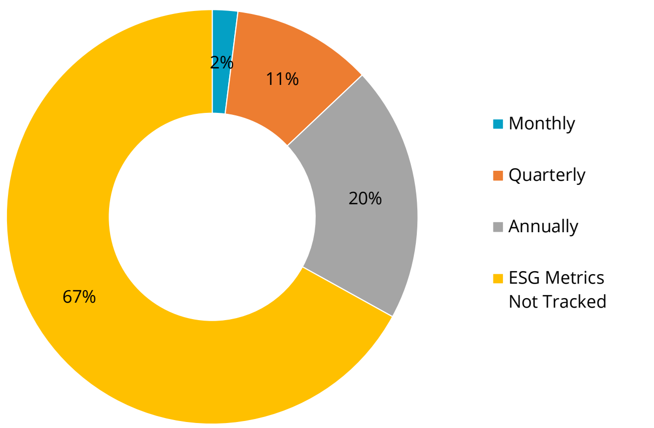
Source: Preqin Fund Manager Survey, November 2017

Fig. 12: Fund Managers that Require Venture Capital Portfolio Companies to Report on ESG Factors



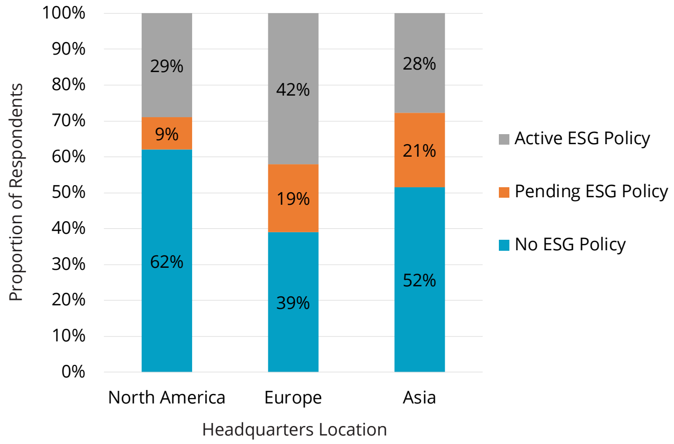
Source: Preqin Fund Manager Survey, November 2017

Fig. 13: Frequency with Which Fund Managers Report to LPs Regarding Their Venture Capital Portfolios' ESG Metrics



Source: Preqin Fund Manager Survey, November 2017

Fig. 14: Fund Managers' Policies Regarding ESG Investment by Headquarters Location



Source: Preqin Fund Manager Survey, November 2017

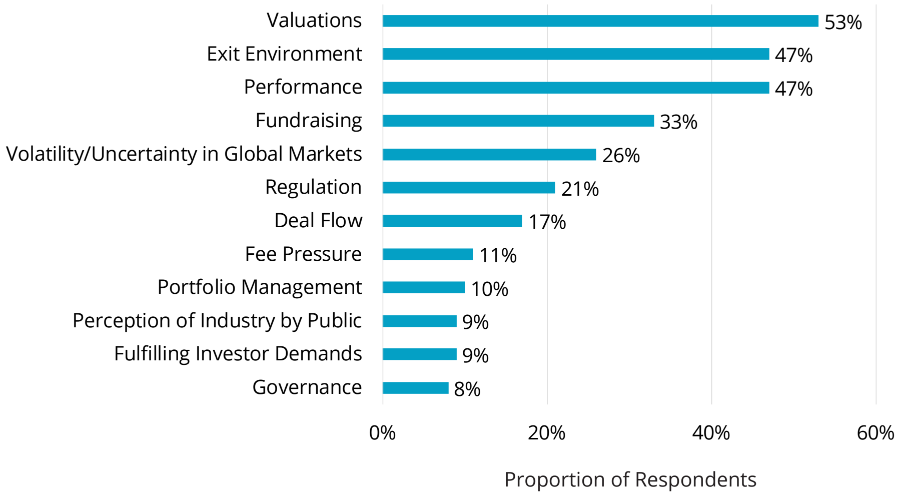
OUTLOOK AND FUTURE PLANS

Deal pricing, the current exit environment and performance are at the forefront of managers' concerns in 2018. The majority (53%) of fund managers cited deal pricing as one of the biggest challenges facing the industry in the coming year (Fig. 15), up 18 percentage points from our survey six months ago. The current exit environment and fund performance follow closely behind, both cited by 47% of GPs as key challenges in the next 12 months.

With the majority (62%) of GPs expressing no concern over their ability to source promising investment opportunities, it is no surprise that 66% of fund managers surveyed expect to deploy more capital in the next 12 months than in the previous year, including 36% that expect to commit significantly more (Fig. 16).

Valuations remain a key industry issue: 46% of GPs have altered their targeted returns for their latest fund launches. Likewise, a greater proportion of GPs surveyed have altered their investment strategies due to increased competition in the space compared to six months ago, although this figure represents just over a quarter of managers surveyed.

Fig. 15: Key Challenges Facing Venture Capital Fund Managers in 2018



Source: Preqin Fund Manager Survey, November 2017

Over the next 12 months, 40% of fund managers plan to offer more co-investment opportunities to limited partners in their funds (Fig. 17), up 10 percentage points from June 2017. The majority of managers plan to offer the same amount of separate account and joint venture rights to limited partners, as reported by 82% and 76% of respondents respectively. When asked about the expected timing of their next venture capital fund launch, over a quarter of fund managers currently have a fund in market as at Q4 2017. A further 38% plan to launch a fund in the first half of 2018.

FUND MANAGER VIEWS ON WHETHER VALUATIONS HAVE ALTERED TARGETED RETURNS FOR THEIR LATEST FUND LAUNCHES

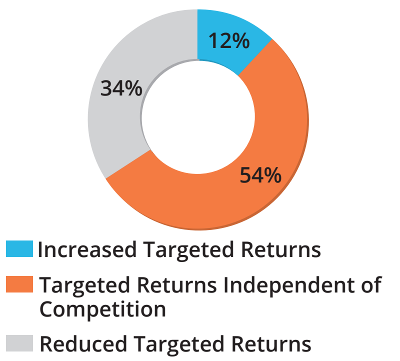
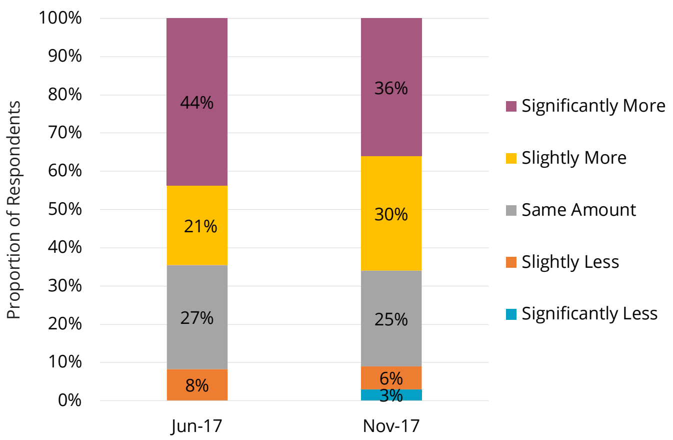
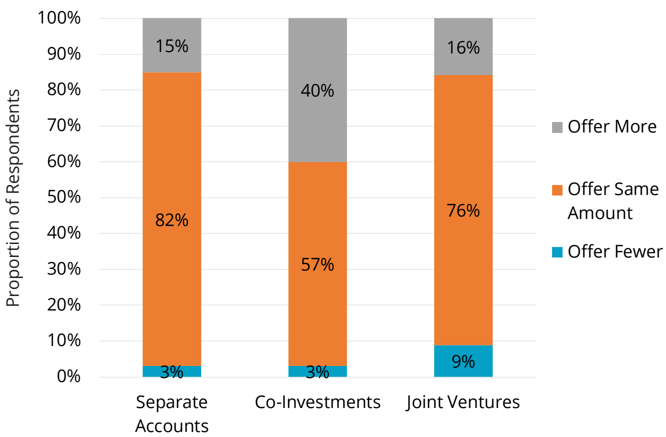


Fig. 16: Amount of Capital Fund Managers Expect to Deploy in the Next 12 Months Compared to the Past 12 Months, June vs. November 2017



Source: Preqin Fund Manager Survey, June - November 2017

Fig. 17: Fund Managers' Plans to Offer Alternative Investment Structures to Investors in the Next 12 Months Compared to the Past 12 Months



Source: Preqin Fund Manager Survey, November 2017

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