Preqin Investor Outlook: Private Equity

H1 2013

The Opinions of 100 Leading LPs on the Market

and Their Plans for the Next 12 Months

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Key Findings:

- 60% of LPs made new private equity commitments in 2012.
- Access to top-performing funds is the biggest challenge for 28% of respondents seeking to operate an effective private equity program.
- 51% of investors are looking to target investments in small to mid-market buyout funds in 2013.
- 27% of investors expect to increase their level of exposure to private equity in 2013.
- 46% of LPs have been approached by GPs asking for a fund extension.
- 85% of investors stated that their private equity portfolio returns have met or exceeded expectations.
- 67% of LPs feel that LP and GP interests are properly aligned.

Investor Intelligence:

Preqin Investor Outlook: Private Equity draws on the results of detailed interviews conducted by our skilled teams of multi-lingual analysts with over 100 institutional investors from around the world during December 2012. The sample of investors was drawn from Preqin's **Investor Intelligence** database, which contains over 6,000 detailed profiles of institutional investors in private equity funds.

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Contents:

Investor Activity in 2012

Private equity fundraising improved in 2012, with the amount of aggregate capital raised by closed funds increasing from $312bn in 2011 to $327bn in 2012, an encouraging sign for the industry. However, the number of funds closed fell from 911 funds in 2011 to 761, indicating LPs are now often placing more capital with fewer managers.

The majority (60%) of LPs we spoke to made new private equity commitments in 2012, as shown in Fig. 1. However, this is a drop from the 66% of LPs that committed capital to funds in 2011 and suggests many investors still remain cautious in the current financial climate.

Investment Activity by Region

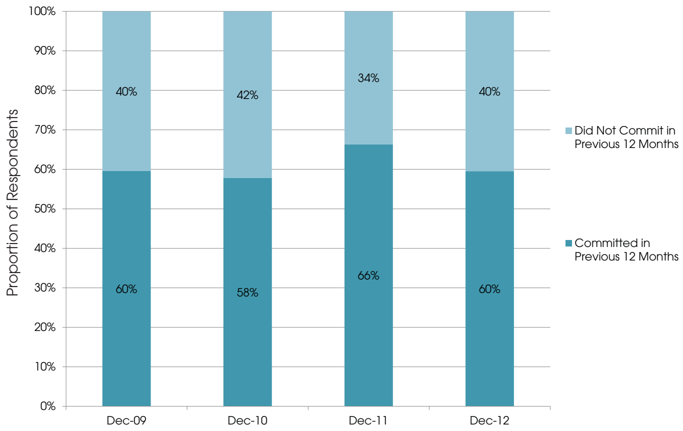
The level of investment activity in 2012 varied among investors in different locations. Certain investors, primarily banks and insurance companies, located in North America and Europe have become increasingly restricted in their investment activities due to stricter regulations, requiring them to re-evaluate their investments in the asset class.

Asia and Rest of World-based investors were the most active, with 67% of the LPs we spoke to in this region making new commitments, as Fig. 2 illustrates. In contrast to tighter regulation in developed markets, LPs based in Asia and Rest of World have seen restrictions on their investments decrease in recent years. Furthermore, investors based in Asia and Rest of World have become increasingly experienced in investing in private equity and now represent a significant source of capital to fund managers.

Investors Above, At or Below Their Target Allocations

The proportion of LPs below their target allocations to private equity has gradually decreased since 2009. As shown in Fig. 3, almost half

Fig. 1: Proportion of Investors that Committed to Private Equity Funds in Previous 12 Months, December 2009 - December 2012



Source: Preqin Investor Interviews, December 2009 - 2012

(45%) of LPs were below their target allocations to private equity in December 2009, following the onset of the global financial crisis. This decreased to 28% in December 2012. The vast majority (57%) of LPs are at their target allocations to the asset class and 15% of LPs are over-allocated to private equity.

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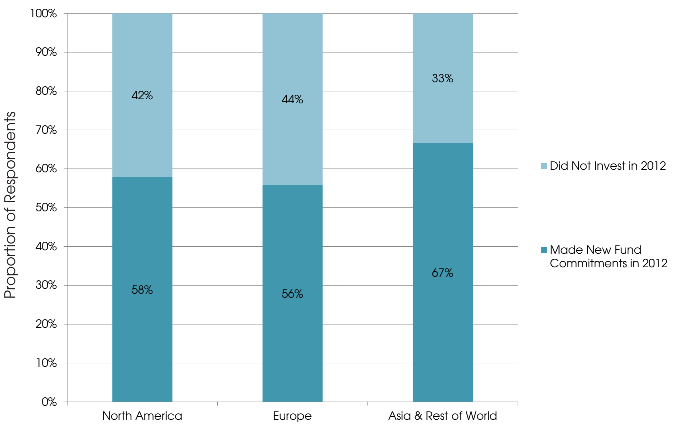
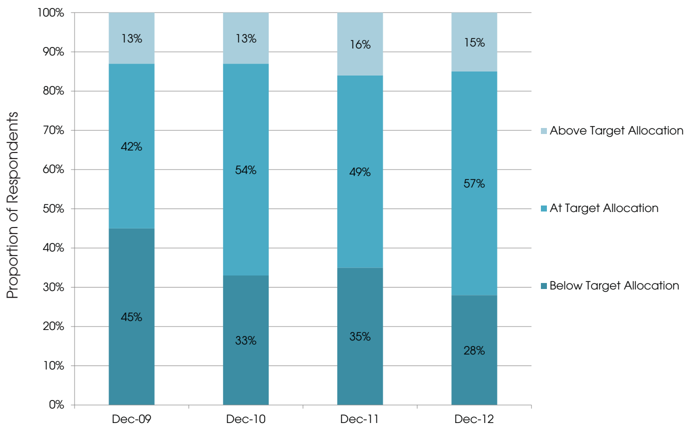
Fig. 2: Proportion of Investors that Made New Private Equity Commitments in 2012 by Location



Source: Preqin Investor Interviews, December 2012

Fig. 3: Proportion of Investors At, Above, or Below Their Target Allocations to Private Equity, 2009-2012



Source: Preqin Investor Interviews, December 2009 - 2012

Investors' Returns Expectations

Eighty-five percent of LPs interviewed feel their private equity portfolios have met or exceeded expectations, demonstrating investor confidence in the asset class despite challenging economic conditions. We asked investors whether they are satisfied with their fund returns and what their returns expectations are for their private equity portfolios.

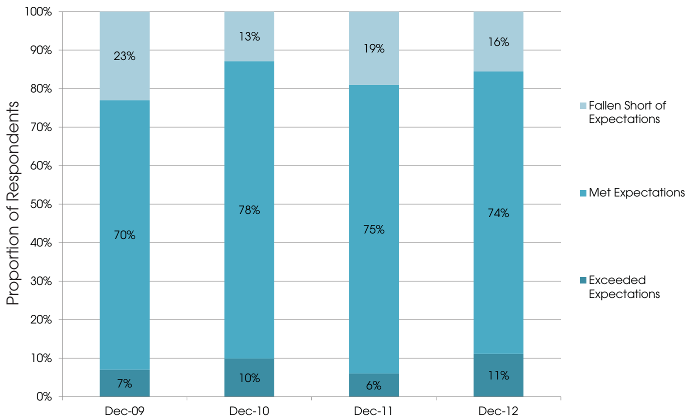
Seventy-four percent of investors interviewed said their private equity investments have met their expectations and a further 11% felt their returns exceeded expectations, as shown in Fig. 4. This is an improvement on the 81% of investors that felt their private equity portfolios had met or exceeded expectations in December 2011, and a substantial improvement from December 2009 when, following the onset of the global financial crisis, almost a quarter (23%) of LPs were dissatisfied with the returns from their portfolios.

"74% of investors interviewed said their private equity investments have met their expectations"

However, it is important to recognize that many LPs still feel the effects in their portfolio from funds raised prior to the financial downturn as one Saudi Arabian investor stated: "We invested in a number of funds with a 2006 and 2007 vintage which have performed particularly badly."

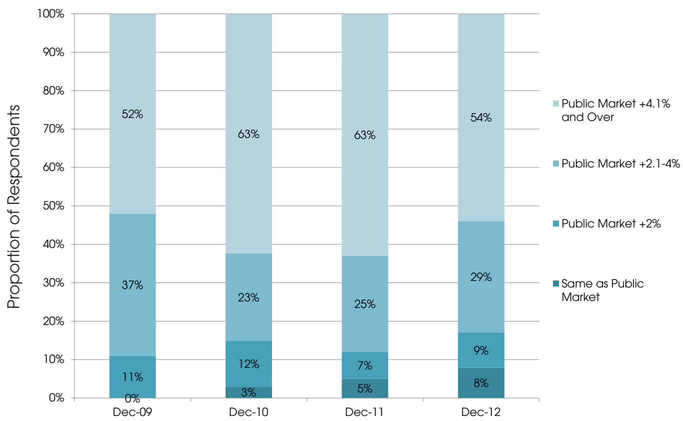
The majority of LPs (54%) expect returns from their private equity investments in excess of 400 basis points over public markets, as demonstrated in Fig. 5, showing LPs continue to view private equity as an asset class that can offer superior performance over the long term. Investors' expectations have fallen in recent years, with 17% of LPs stating they would be satisfied with returns of 200 basis points or less above public markets, compared to 12% in December 2011. While investors may have generally lowered their expectations of the asset class, this may also be partly explained by a general improvement in the performance of public markets.

Fig. 4: Proportion of Investors that Feel Their Private Equity Fund Investments Have Lived up to Expectations



Source: Preqin Investor Interviews, December 2009 - 2012

Fig. 5: Investors' Returns Expectations for Their Private Equity Portfolios



Source: Preqin Investor Interviews, December 2009 - 2012

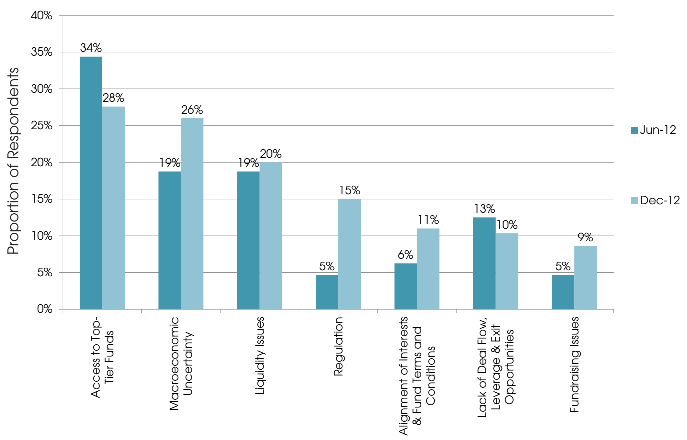
Challenges Facing Private Equity

While an increasingly competitive fundraising environment means that GPs face significant challenges in securing LP capital, LPs face a number of challenges of their own. We asked LPs what particular issues they and the private equity industry as a whole are currently facing.

With the funds of top performing managers still often oversubscribed, gaining access to top-tier managers continues to be the biggest challenge for investors, with 28% of respondents naming this as their main challenge at present. A further 26% of investors quoted the current economic climate and continued volatility as the biggest obstacle in making new investments.

Impending regulatory changes are becoming a greater concern for LPs, with 15% of LPs mentioning this as their biggest challenge within the asset class at the moment, compared to just 5% in June 2012. While the majority of LPs that mentioned impending regulations as an issue were banks and insurance companies relating to the Volcker Rule, Basel III and Solvency II, other LPs also noted the AIFMD as a general concern within the industry.

Fig. 6: Biggest Challenges Presently Facing LPs Seeking to Operate an Effective Private Equity Program



Source: Preqin Investor Interviews, December 2012

Fund Extensions

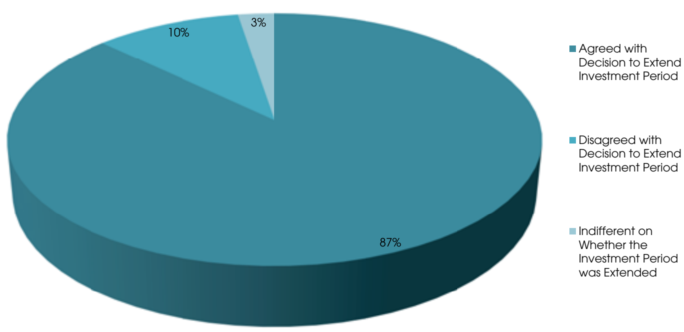
In the current financial climate, an increasing number of fund managers have sought fund extensions in order to have more time to find suitable deal opportunities. Forty-six percent of LPs we spoke to had been approached by GPs asking for a fund extension. As shown in Fig. 7, a substantial 87% of LPs that had been offered an extension agreed with the fund manager's decision. One Israeli insurance company said: "Around 15 fund managers have asked for extensions, primarily venture capital funds in Israel; we said yes as in the end it is the best way to maximize returns."

Public Perception of Private Equity

The attitude of the public towards private equity is another issue faced by the industry. As seen in Fig. 8, the majority (63%) of investors feel that the public's perception of private equity is negative. One US-based endowment plan commented: "Public perception of private equity is unfairly negative, especially in the US as a result of the coverage it attracted throughout the presidential election."

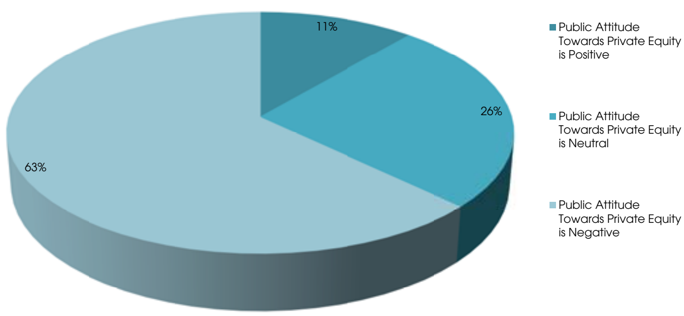
Most investors feel the public's view of the asset class can be improved by fairer reporting in the news and focusing on the positive impact of private equity and the long-term advantages of the asset class. A UK-based public pension fund remarked: "We need to stress the way that private equity is helping to improve the performance of companies and how it is playing a part in the growth of the economy."

Fig. 7: Proportion of LPs that Agreed with Fund Managers' Decision to Extend Investment Period of their Funds



Source: Preqin Investor Interviews, December 2012

Fig. 8: Investors' Views on Public Attitude Towards Private Equity



Source: Preqin Investor Interviews, December 2012

Allocations and Intentions for 2013

A record number of funds on the road and continued uncertainty within financial markets mean that fundraising is likely to remain challenging in the year ahead. We asked investors their intentions regarding their private equity allocations in 2013 and beyond.

LPs' Private Equity Allocations and Commitments in 2013

Despite fewer investors making new commitments in 2012 and continued economic uncertainty, investor appetite for private equity remains strong. The majority of investors (59%) expect to maintain their level of exposure to private equity over the next 12 months, while a further 27% plan to increase their allocations to the asset class in 2013, as shown in Fig. 9. In the longer term, a third of LPs anticipate increasing their allocations to private equity, compared to 28% of LPs in December 2011.

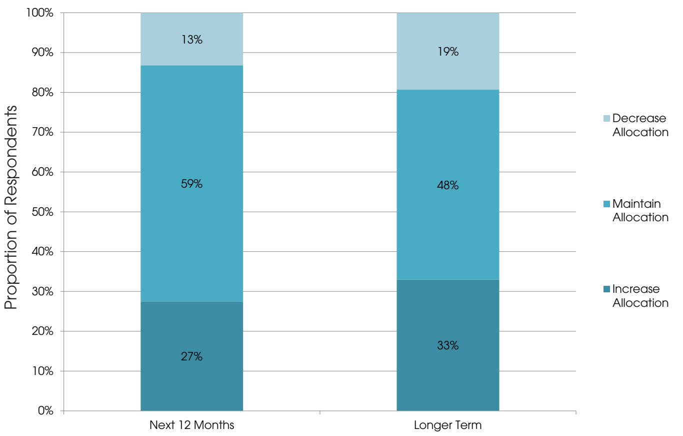
Over half (53%) of the LPs we spoke to expect to make their next private equity commitment in 2013, while just over a third of investors (34%) remain uncertain, preferring to take a more opportunistic approach. Seven percent of investors plan to take a break from new commitments in 2013 but make new commitments in 2014, while a further 5% do not anticipate making new commitments to private equity funds before 2015.

Almost a quarter of investors (24%) plan to commit more capital to private equity funds in 2013 compared to 2012, with a further 10% planning to return to the asset class after not making any new commitments in 2012, as displayed in Fig. 10. The majority of LPs (52%) plan to commit the same amount of capital in 2013 as in 2012.

New GP Relationships

Over the coming year, almost a fifth (19%) of LPs expect to only re-up with existing GPs in their portfolio, as Fig. 11 illustrates. These LPs may only be making a limited number of new commitments, and re-upping can save both time and resources. However, automatic re-ups are becoming less common, and in 2013, over half (52%) of LPs plan to work with a mix of existing managers and GPs they have not previously worked with.

Fig. 9: Investors' Intentions for Their Private Equity Allocations



Source: Preqin Investor Interviews, December 2012

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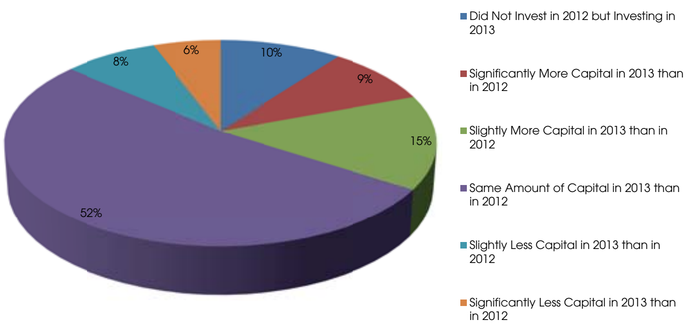
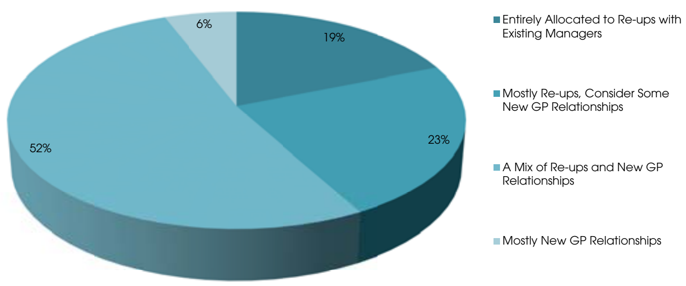
Fig. 10: Amount of Capital Investors Plan to Commit to Private Equity Funds in 2013 Compared to 2012



Source: Preqin Investor Interviews, December 2012

Fig. 11: Investors' Intentions for Forming New GP Relationships Over the Next 12 Months



Source: Preqin Investor Interviews, December 2012

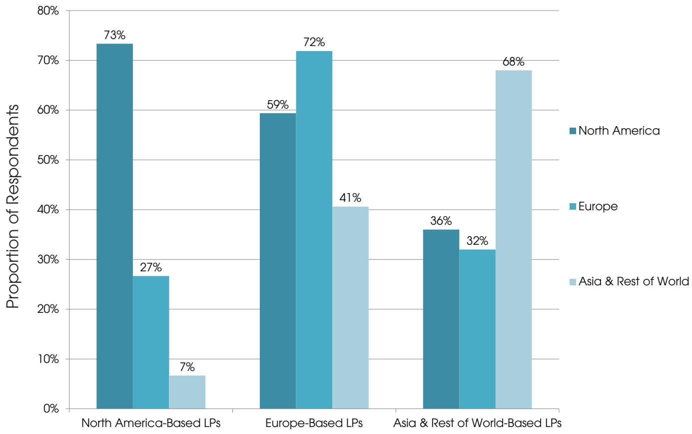
Key Geographies and Strategies over the Next 12 Months

With such a large choice of investment opportunities in the current saturated fundraising market, investors may find it challenging to select the best funds. We asked investors which regions and fund types are the most appealing to them and where they anticipate placing their capital in the next 12 months.

Regions Targeted by LPs in the Next 12 Months

As Fig. 12 illustrates, the majority of LPs view the region in which they are based as presenting favourable investment opportunities. North America continues to attract the most investor interest, with 73% of North American and 59% of European investors stating this as a region they will be targeting over the next 12 months. Despite recent volatility within European markets, investors still view Europe as presenting attractive investment opportunities, with one UK-based public pension fund commenting: "[We] would still invest in the region. Due to the long-term nature of the asset class, the current climate is not necessarily a good indicator of the potential worth of an investment."

Fig. 12: Regions Targeted in the Next 12 Months by Private Equity Investors



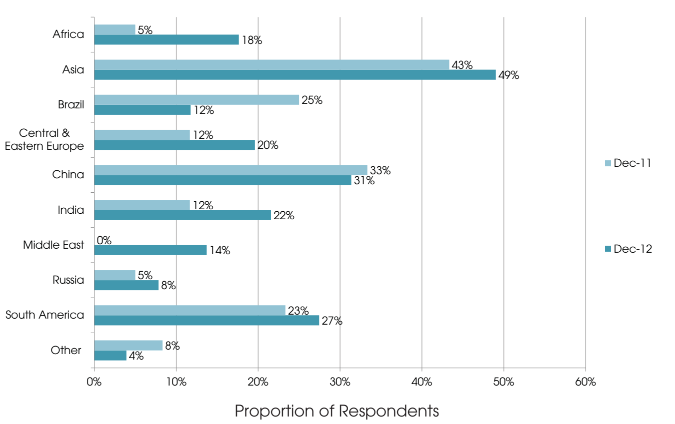
Source: Preqin Investor Interviews, December 2012

Investor Appetite for Emerging Markets

There continues to be significant investor appetite for emerging markets-focused investments, with 60% of LPs currently investing in emerging markets, and a further 14% considering doing so in the near future. Fig. 13 shows that Asia remains the most attractive region within emerging markets, with almost half (49%) of LPs naming Asia as presenting the best opportunities. However, interest in China specifically has fallen, with 31% of LPs naming the region as the most attractive in December 2012, compared to 51% in December 2009, with investors concerned about slowing growth rates in the region.

South America is also increasingly attractive to investors, with 27% of LPs naming the region as the most attractive at present. Brazil specifically, however, has seen the largest drop in the proportion of investors viewing it as presenting the best opportunities, from 25% of investors in December 2011 to 12% in December 2012.

Fig. 13: Countries and Regions within Emerging Markets that Investors View as Presenting the Best Opportunities*

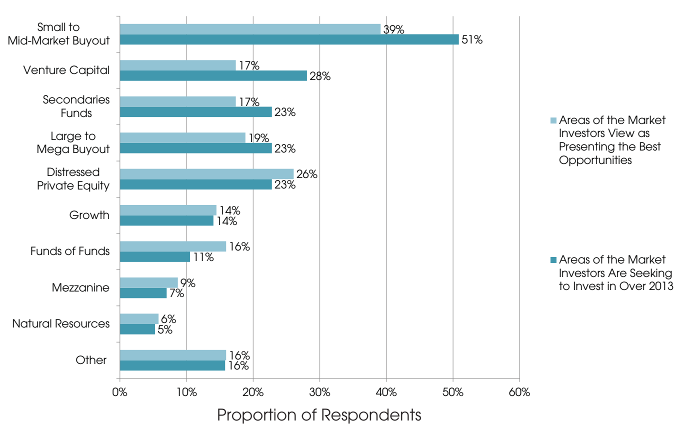


Source: Preqin Investor Interviews, December 2012

Fund Type Preferences

Investors continue to view small to mid-market buyout funds as presenting the best investment opportunities, with just over half (51%) of the LPs looking to make new commitments in 2013 anticipating committing capital to funds of this type, as illustrated in Fig. 14. Interestingly, investor appetite for large to mega private equity buyout funds has increased, with 23% of investors targeting this fund type in 2013, compared to 16% in 2012.

Fig. 14: Investor Attitudes Towards Different Fund Types at Present



Source: Preqin Investor Interviews, December 2012

Respondents were not prompted to give their opinions on each country/region individually; therefore the results display the countries and regions at the forefront of investors' minds at the time of the survey.

Fund Selection

Investors are conducting increasingly stringent fund selection processes. We examine what proportion of investors conduct due diligence on opportunities themselves versus those that employ an investment consultant, how many LPs consider a GP's ESG policies before making a commitment and whether LPs find being a first-close investor attractive.

LPs' Due Diligence Methods

Fifty-seven percent of investors interviewed use an in-house team to conduct due diligence, while 18% employ an external investment consultant, as shown in Fig. 15. The remaining 25% use a mixture of both. Those using both an in-house team and an external consultant are likely to employ an investment consultant to advise on a specific part of their portfolio, such as international investments or exposure to niche strategies.

ESG Policies

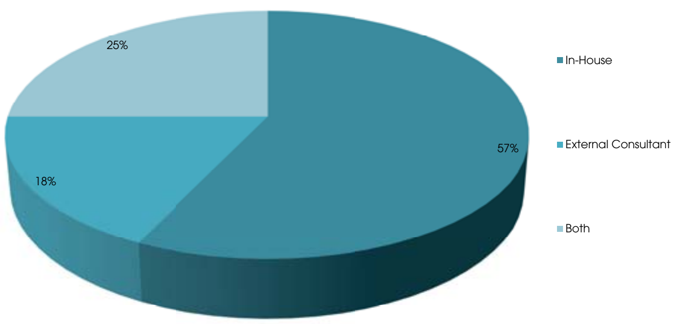
When conducting due diligence many investors look at the fund manager's environmental, social and governance (ESG) policies, potentially influencing whether they decide to commit capital to the fund or not. Investors' views on ESG polices differ widely across regions. Eighty-one percent of European respondents look at the ESG policies fund managers have in place before making a commitment. This drops to 59% for Asia and Rest of World-based investors and to 52% for investors located in North America (Fig. 16). One Israeli investor commented: "We already have so much compliance to go through to make investments without adding more."

Investing Before a First Close and First-Time Fund Managers

Attracting LP capital before a first close is beneficial to fund managers, as it demonstrates that the fund has support and the GP can begin investing in favourable opportunities. Likewise, investing before a first close can be beneficial to LPs, with many looking to gain co-investment rights or reduced fees as a result of backing a fund early. Forty-one percent of LPs will commit to a fund before a first close, as shown in Fig. 17. A further 23% stated that they will consider doing so, although many will only undertake such investments with existing managers in their portfolios.

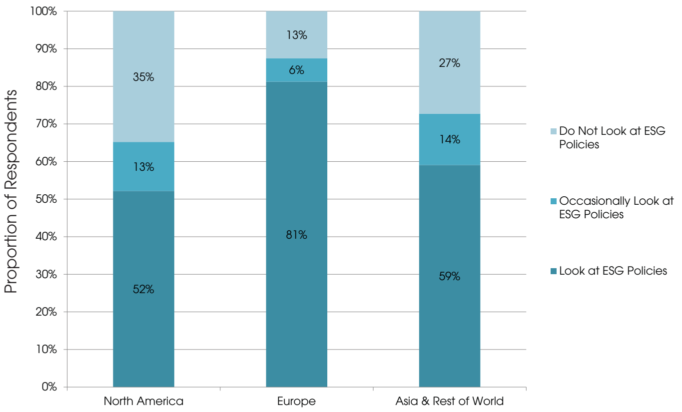
First-time fund managers are likely to continue to find securing capital commitments a challenge, with many LPs preferring to commit to more established managers with proven track records. However, LPs are becoming slightly more positive towards emerging managers. Forty-six percent of LPs will consider investing in first-time funds in 2013. Although 50% of LPs will not invest in first-time funds over the next 12 months, this represents a lower proportion than the 55% that would not consider doing so in December 2011.

Fig. 15: Breakdown of Due Diligence Methods Used by LPs



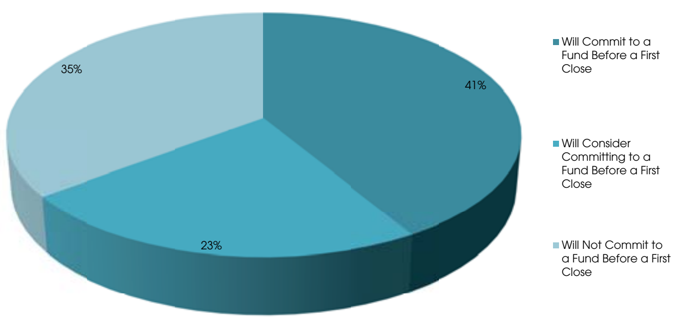
Source: Preqin Investor Interviews, December 2012

Fig. 16: Proportion of LPs that Look at a GPs' ESG Policies Before Making a Commitment by Location



Source: Preqin Investor Interviews, December 2012

Fig. 17: Proportion of Investors that Will Commit to a Fund Before a First Close



Source: Preqin Investor Interviews, December 2012

Alternative Methods of Accessing the Asset Class

With the private equity industry continuing to evolve, LPs are increasingly looking at alternative methods of accessing private equity to the traditional commingled fund structure in order to gain more control over their portfolios.

Direct Investments and Secondary Activity in 2013

Twenty-seven percent of investors we spoke to invest directly in companies on a proprietary basis, while 36% look to participate as co-investors in deals alongside their fund managers. Direct and co-investments are likely to grow in 2013, with 52% and 43% of LPs that are active in these areas respectively intending to increase their activity over the next 12 months (Fig. 18).

Furthermore, 23% of LPs directly purchase fund interests on the secondary market due to the numerous benefits it can offer, such as purchasing interests at a discount to NAV, mitigating the J-curve and portfolio diversification. None of the LPs we spoke to that are active in the secondary market are seeking to decrease their activity over the coming year.

Only 29% of investors looking to increase their direct and secondary market investment activity within the market will do so at the expense of their primary fund commitments, as shown in Fig. 19, which is encouraging for managers offering investors exposure to more traditional closed-end funds. However, as increasing numbers of investors look at alternative methods of investment, GPs raising funds using the commingled fund structure may find it more challenging to attract investor capital.

Separate Accounts

Separate accounts are also being utilized by an increasing number of LPs in order to create highly customized portfolios and forge closer relationships with GPs. While such methods of investment are likely to continue to be used primarily by larger LPs, the proportion of LPs we have spoken to that are using separate accounts has increased to 15% from 7% in June 2012.

Fifty percent of survey respondents that have previously invested via a separate account will look to award further mandates in the future, while a further 43% of such LPs will consider doing so, as shown in Fig. 20, demonstrating LPs' continued desire to have more control over their investments.

View and filter investors' regional and strategic preferences, timeframes for their next commitments and known investments on the **Future Fund Searches and Mandates** feature of Preqin's **Investor Intelligence** database.

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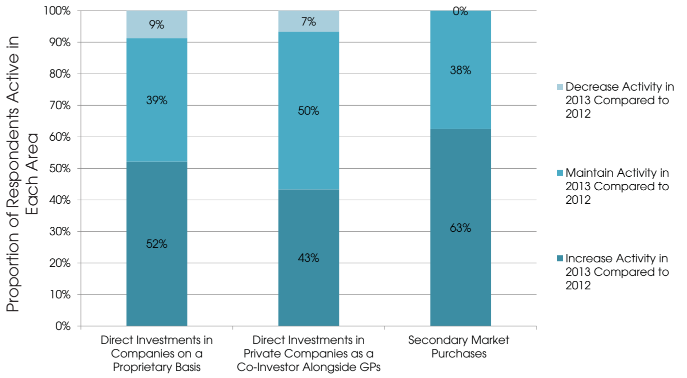
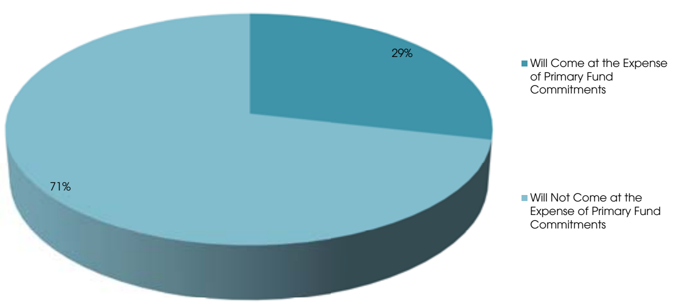
Fig. 18: Investors' Expectations of Their Direct Investment and Secondary Market Activity in 2013



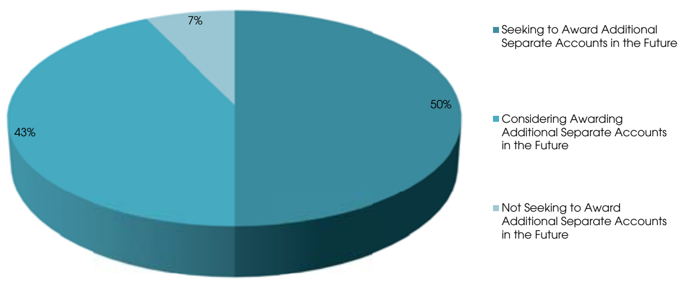
Source: Preqin Investor Interviews, December 2012

Fig. 19: Proportion of Investors Increasing Direct and Secondary Investments at the Expense of Primary Fund Commitments



Source: Preqin Investor Interviews, December 2012

Fig. 20: LPs Investing in Separate Accounts: Proportion Seeking to Award Additional Separate Account Mandates in the Future



Source: Preqin Investor Interviews, December 2012

Improving LP and GP Relations

Sixty-seven percent of investors feel that GP and LP interests are properly aligned, demonstrating that investors are increasingly satisfied with their GP relationships. However, the saturated fundraising market means that fund managers must continue to work to improve their relations with investors in order to attract capital.

Twenty-one percent of LPs plan to reduce the number of GP relationships in their portfolios over the longer term, in order to form more strategic relationships with their GPs, as Fig. 21 shows. A further 38% are planning to maintain the same number of managers, although relationships with GPs that have not performed as expected may be terminated. Forty-one percent of LPs will increase the number of GP relationships in their portfolios, primarily to gain exposure to new strategies or geographies that their existing managers may not offer.

Alignment of Interests

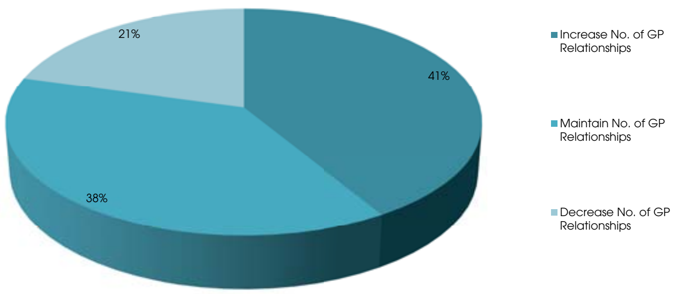
Interestingly, the proportion of investors that feel GP and LP interests are properly aligned has increased in the past year. As Fig. 22 demonstrates, two-thirds of investors feel that GP and LP interests are aligned, compared with 47% of LPs in December 2011 and 44% in December 2010, indicating that GPs are becoming increasingly aware of what LPs expect and are adapting their offerings to this. One UK-based public pension fund stated: "There has been a big push from many LPs to make GPs lower their management fees, and now they have to justify fee levels."

Key Issues in LP and GP Relations

The largest proportion (47%) of LPs that are dissatisfied with the current alignment of interests between GPs and LPs believe management fees are a key issue, as shown in Fig. 23. Forty-two percent named the carry structure as an area of contention. While it is clear that LPs feel that terms involving financial agreements are the areas in greatest need of improvement, non-financial clauses, including the no-fault divorce clause and the key man clause, are still important to LPs.

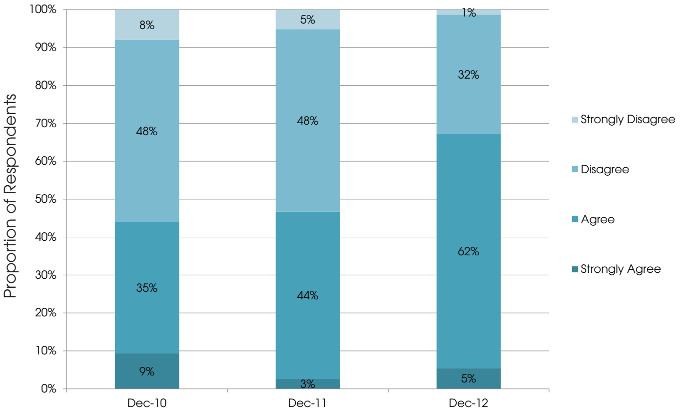
The vast majority of LPs told us the most important thing they look for when making new private equity commitments is the past performance and track record of a GP. However, while track record is a key factor, many respondents stated a range of factors, with one Swedish pension fund stating: "We look at the big picture. We're looking for a manager that will fit in with our team and is aligned with our values and policies. There is not one deciding factor." While LPs want a GP that can deliver strong returns in a challenging environment, investors also seek to invest with managers that follow a strategy that works for their portfolio, and to establish an ongoing relationship.

Fig. 21: Investors' Intentions for GP Relationships over the Next Two Years



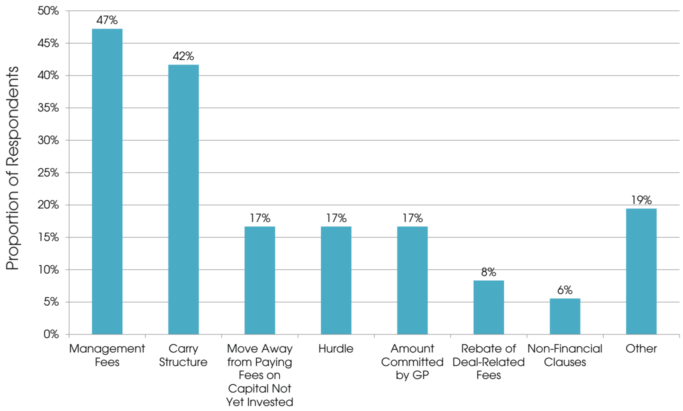
Source: Preqin Investor Interviews, December 2012

Fig. 22: Proportion of LPs that Feel GP and LP Interests are Properly Aligned



Source: Preqin Investor Interviews, December 2012

Fig. 23: Fund Terms Investors Feel Need to be Amended to Improve LP and GP Relations



Source: Preqin Investor Interviews, December 2012

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