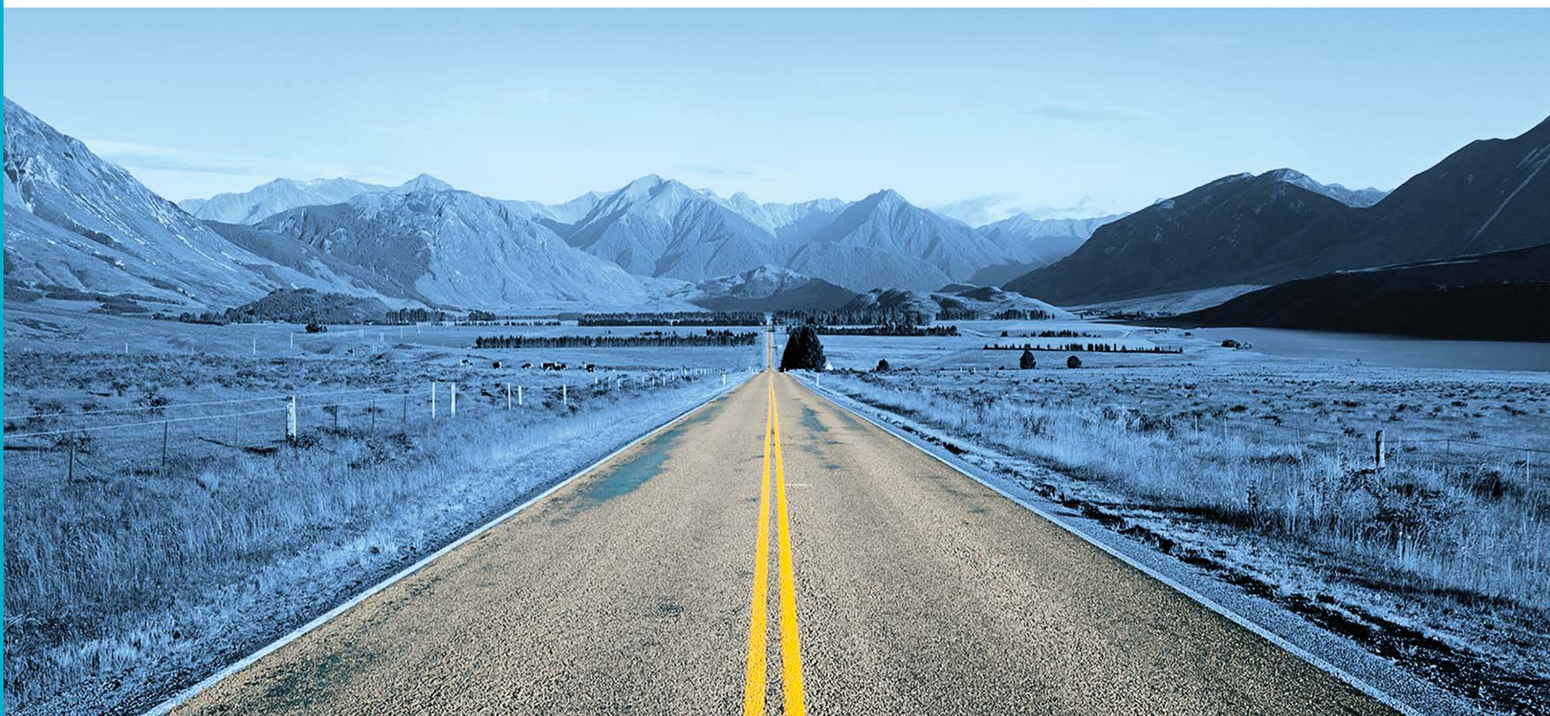
Preqin Investor Outlook: Private Equity

H2 2012

The Opinions of 100 Leading LPs on the Market
and Their Plans for the Next 12 Months



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Methodology

Preqin, the alternative assets industry's leading source of data and intelligence, welcomes you to the H2 2012 edition of Preqin Investor Outlook: Private Equity, a unique look at investors in the asset class, their current opinions of the market and the outlook for fundraising in the year ahead.

Preqin Investor Outlook 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 June 2012. The sample of LPs was selected from Preqin's Investor Intelligence database, the most comprehensive and accurate source of information on investors in private equity funds available today. More information about Investor Intelligence can be found on page 11 of this report.

Speaking directly to institutions located across the globe has enabled us not only to provide in-depth analysis of their current views and opinions, but also to accompany this with direct quotes from key investment professionals, providing readers with a unique insight into the attitudes of the leading investors in private equity.

We hope you find the information included within this report useful and interesting and, as always, we welcome any feedback or suggestions you may have for future editions.

Contents

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Fundraising in 2012

Three hundred and thirty-six funds reached a final close in H1 2012 having secured aggregate commitments of $143bn, down slightly from the $167bn raised by the 434 funds that reached a final close in H1 2011. However, it is encouraging to see that despite on-going problems in the eurozone and wider financial markets, aggregate capital raised by funds in H1 2012 has increased slightly in comparison to H2 2011, when 405 funds reached a final close having secured $135bn in aggregate commitments.

Preqin interviewed over 100 institutional investors in private equity in June 2012 to find out about their private equity exposure and assess their current attitudes towards the asset class. Almost half (47%) of investors we spoke to have made commitments so far in 2012, and 44% expect to next commit capital to a private equity fund before the end of the year, as Fig. 1 displays.

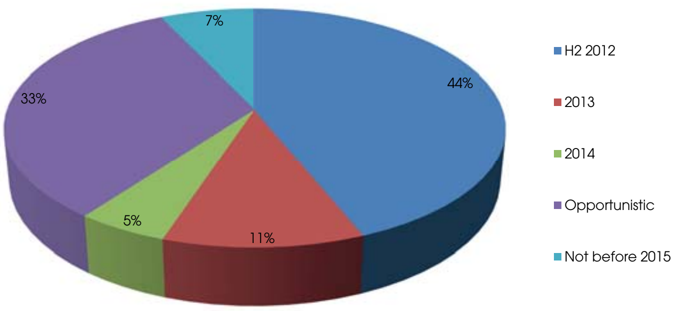
"One-third of LPs are currently below their targeted level of exposure to private equity..."

A further 11% of investors expect they will next commit to a fund in 2013, while a significant third of LPs interviewed are uncertain about the timeframe of their next commitment, but may commit to a new fund within the next 12 months should an attractive opportunity arise. Some investors are uncertain when they will next commit to a fund due to the current instability in wider markets. For example, one Nordic insurance company we spoke to is currently holding off making new commitments due to uncertainty surrounding the future of the euro.

One-third of LPs are currently below their targeted levels of exposure to private equity, as Fig. 2 illustrates, and 48% are at their target allocations to the asset class. This suggests that 81% of investors are likely to continue to make new commitments to private equity funds in the near future in order to maintain or build towards their target allocations to the asset class. Nineteen percent of investors are currently above their target allocations to private equity.

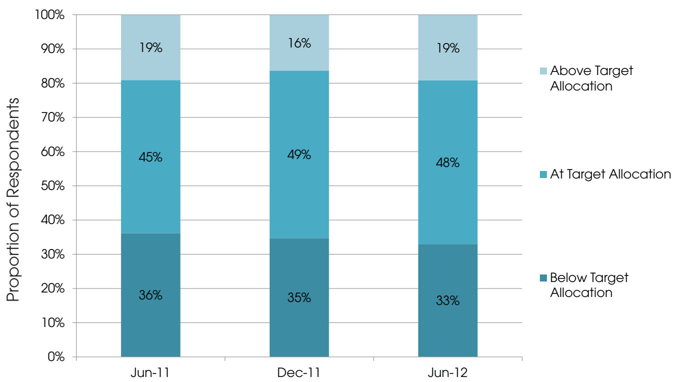
The current level of exposure of LPs to private equity varies depending on their location. Ninety percent of North America-based investors are currently at or below their target allocations to private equity, compared to 77% of European LPs and 73% of LPs based in Asia and Rest of World.

Fig. 1: Timeframe for Investors' Next Intended Commitments to Private Equity Funds



Source: Preqin

Fig. 2: Proportion of Investors Currently At, Above, or Below Their Target Allocations to Private Equity



Source: Preqin

Investors' Returns Expectations

The PrEQIn All Private Equity Index shows that private equity as a whole has consistently outperformed the S&P 500 index since the 2007 financial crisis. Furthermore, many investors have noted that private equity did not experience the dramatic variations in returns that other investment strategies did during recent market volatility. Over three-quarters of investors (79%) that Preqin spoke to felt that their private equity investments have met or exceeded their expectations.

Seventy percent of investors interviewed noted that their private equity investments have performed as expected, and an additional 9% felt that their private equity returns have exceeded their expectations (Fig. 3). One US public pension fund commented: "[We] have had our ups and downs with PE, but on the whole and over the longer term, [private equity returns] have met expectations."

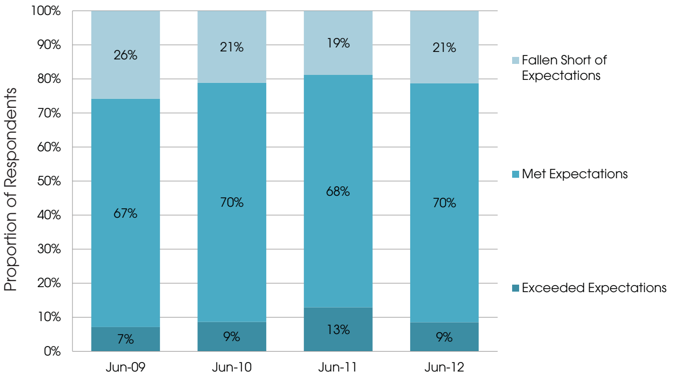
However, 21% of investors felt dissatisfied with the returns from their private equity portfolios. One Malaysian investor stated: "Top-quartile GPs are always over-subscribed, but if [you] invest with other GPs and returns are the same as public markets, why invest in PE?"

"The majority of LPs (65%) expect returns in excess of 400 basis points over public markets..."

As Fig. 4 shows, 99% of investors expect their private equity returns to exceed public market benchmarks. The majority of LPs (65%) expect returns in excess of 400 basis points over public markets, 23% expect returns of between two and four percent over public markets, while 11% of LPs would be satisfied with private equity returns of 200 basis points above their public market counterparts.

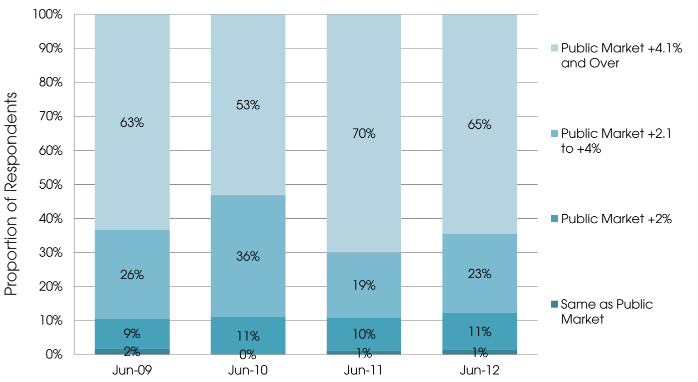
Fig. 4 also shows how investors' expectations have fluctuated over the past few years. In general, between 60% and 70% of investors have expected their private equity portfolio returns to exceed public markets by more than 400 basis points. June 2010, however, saw a slight reduction in confidence, with almost half (47%) expecting returns of 400 basis points or less.

Fig. 3: Proportion of Investors that Feel Their Private Equity Fund Investments Have Lived up to Expectations



Source: Preqin

Fig. 4: Investors' Returns Expectations for Their Private Equity Portfolios



Source: Preqin

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Attracting LP Capital, Due Diligence, and GP Relationships

At present there are 1,878 funds on the road competing for capital, meaning investors are well positioned to be selective when choosing which funds to invest in. On average the investors we spoke to review 42 funds a year, typically committing to only four. In such a competitive market, fund managers must assess their existing LP base to establish how much capital they are likely to receive from these investors and how much capital they are likely to need to source from additional LPs.

Of those LPs that plan on making new commitments over the coming year, just 15% plan to commit capital only to existing managers in their portfolios. As Fig. 5 illustrates, 85% of investors expect to consider at least some new manager relationships over the next 12 months, and 49% expect to commit to a balanced mixture of existing GPs in their portfolios and managers they have not worked with in the past. Over a third of LPs (34%) plan to increase the number of GPs in their portfolio over the long term. Fifty-five percent expect to retain the same number of managers, although they may drop some to make room for new relationships, and just 12% expect their number of GP relationships to decrease in the future.

Conducting Due Diligence

Interestingly, over two-thirds of investors surveyed conduct their due diligence on funds in-house. Sixty-one percent solely use in-house resources, while 12% employ both an in-house team and their external consultant or fund of funds manager. A smaller 27% of investors exclusively outsource their due diligence requirements to external parties.

Attracting Capital before the First Close

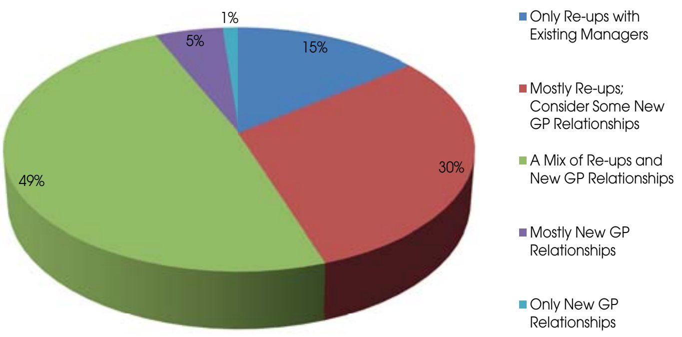
Forty-nine percent of investors would invest in a fund before the first close and a further 16% would consider being a first-close investor. Fund managers often offer incentives to attract LPs to commit early; for example, a European government agency noted: “[Investing before the first close] is attractive as you can be offered preferential rights, for example with regards to co-investment opportunities, and preferential fees and carry.” Additionally, a Malaysian investor told us: “Usually we prefer to invest before the first close with re-ups so that we can negotiate [fund terms] better.”

Some investors will only participate prior to the first close of a fund if they have an existing relationship with the manager in question. One Spanish investor commented: “[We] will only invest [before the first close] if we have previously invested with the manager and know the fund has the capacity to reach a first close and the overall target.”

LP Appetite for First-Time Funds

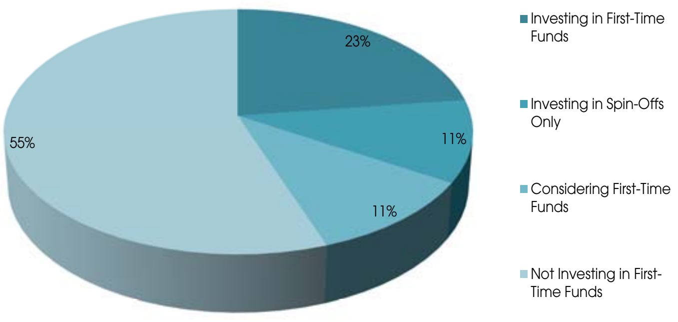
As Fig. 6 demonstrates, just 23% of investors will invest in a first-time fund in the next 12 months. Another 11% would consider investing in a first-time fund should an interesting opportunity be presented, and the same proportion would invest in a first-time vehicle raised by a spin-off team. Fifty-five percent of LPs will not invest in first-time funds and the reasons for this typically revolve around the perceived heightened risk of such investments. One Belgian bank commented, “We rarely look to invest in first-time funds due to the higher risks of underperformance.”

Fig. 5: Investors’ Intentions Regarding Forming New GP Relationships over the Next 12 Months



Source: Preqin

Fig. 6: Proportion of Investors that Will Consider Investing in a First-Time Fund in the Next 12 Months



Source: Preqin

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What Can GPs Do to Stand Out?

The fundraising market remains highly competitive in 2012, and while many LPs are keen to make commitments, they are also likely to be highly selective about where they deploy their capital. We asked investors what GPs can do stand out in the market and have the best chance of securing a commitment from them.

“An attractive investment strategy and a solid, competent, and experienced team.” – A Danish asset manager.

“Track records, performance, deal-sourcing abilities (to find deals before the crowd comes in), and wide connections (for deals).” – A German government agency.

“Low costs, gradual increase in fund sizes, a good track record and strategy.” – A Norwegian government agency.

“Combination of deep industry sector knowledge, ability to source good opportunities and evaluate those opportunities. Track record and also opportunity to co-invest are important.” – A US investment company.

“Consistent track record and their investment approach needs to fit with current requirements.” – A UK public pension fund.

“Implementing the strategy outlined in their PPM and producing good returns.” – A Finnish insurance company.

“The GP needs to be transparent to the LP. They can’t surprise the LP as this will make the LP lose faith. They need to be proactive in estimating possible downturns of companies rather than only telling the LPs once this has happened.” – A Dutch bank.

“Track record, credibility, and the organization must be able to survive if key members leave. Must have the ability to put a coherent track record onto the map - there is now more scrutiny by LPs.” – A Belgian bank.

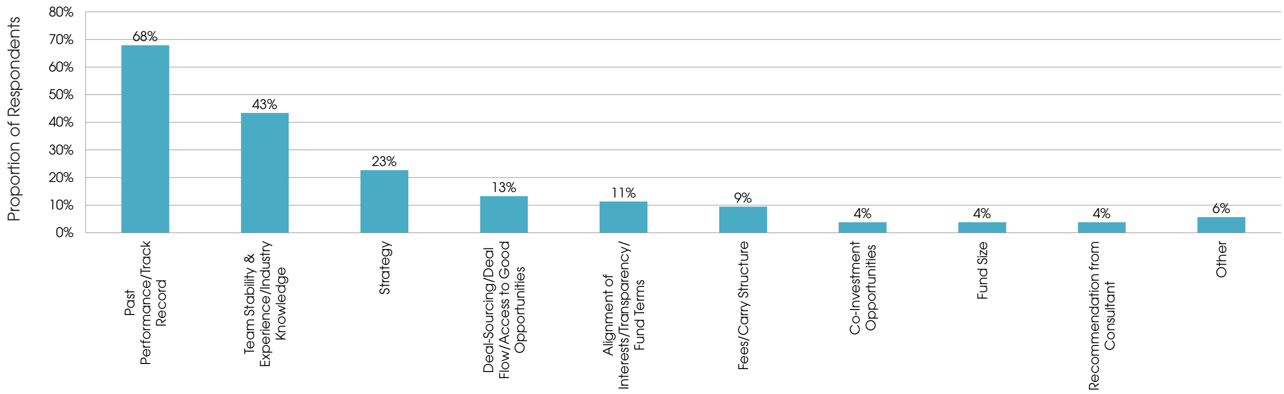
“They must convince our consultant that they are worthy of investment.” – A US foundation.

“We need to know something about the managers; they need a proven track record.” – A Canadian family office.

“GPs need to be transparent about their management fees and when disclosing information to potential LPs.” – A Japanese bank.

“They must be globally diversified, have a strong operating background and must present good co-investment opportunities.” – A US family office.

Fig. 7: What Are LPs Looking for from Fund Managers?



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New Methods of Accessing the Asset Class

As the private equity industry evolves, many LPs are exploring other ways to invest in private equity beyond the traditional closed-end fund structure. In order to add value to their portfolios and reduce the cost of investing in the asset class, investors are increasingly taking advantage of direct and co-investment opportunities, considering secondary market prospects, and awarding separate account mandates to fund managers.

Forty-nine percent of investors we spoke to look to invest directly in private equity. Twenty-eight percent invest directly on a proprietary basis, while 40% look to participate as co-investors in deals alongside their fund managers. Co-investments offer a number of advantages to LPs, including the potential for enhanced returns and lower fees, as well as the opportunity to build stronger relationships and get closer to deal activity. However, co-investing alongside a fund also increases capital risk. This can deter some investors, including one Swiss family office that told us: “We have co-invested in the past but found it changed our risk profile so we will not be looking to do so again.”

Investor appetite for direct investing looks set to continue, as 91% of investors already active in direct and/or co-investing expect to maintain or increase their exposure to these methods of investing in 2012 compared to 2011 (see Fig. 8). Just 9% of investors already actively co-investing expect to reduce their activity; one bank in Switzerland commented: “Our co-investment activity is likely to decrease due to a lack of opportunities.”

Many LPs see the secondary market for fund interests as an appealing way to access the asset class. Such investments can offer many advantages to LPs, including enabling access to funds they may not have been able to participate in during the fundraising process, adding further diversity to their portfolios by giving exposure to funds across historical vintage years, and mitigating the effects of the J-curve. Those LPs that already participate in the secondary market seem satisfied with the strategy; 29% plan to increase their secondary market activity in 2012 compared to 2011, and 71% expect to maintain their activity. None of the investors we spoke to that actively participate in the market as buyers expect to reduce their secondary market activity during 2012.

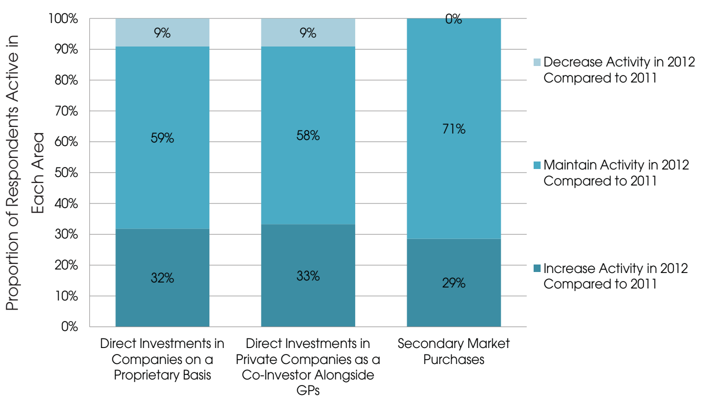
Appetite for Separate Accounts

In recent months there have been a number of reports of large institutional investors allocating capital to separate accounts with GPs. These arrangements can benefit LPs by forging closer relationships with fund managers, allowing the negotiation of better terms, and increasing investment exposure to particular market sectors.

Just 7% of investors interviewed told us they have previously awarded a separate account mandate (see Fig. 9), indicating that LPs cannot always access private equity via this method. One US endowment not investing in separate accounts noted: “We are too small for separate accounts; [we] typically only invest $2mn to $5mn per fund, so a separate account would be pointless.” Portfolio size was mentioned by several investors as a reason for not investing in separate accounts.

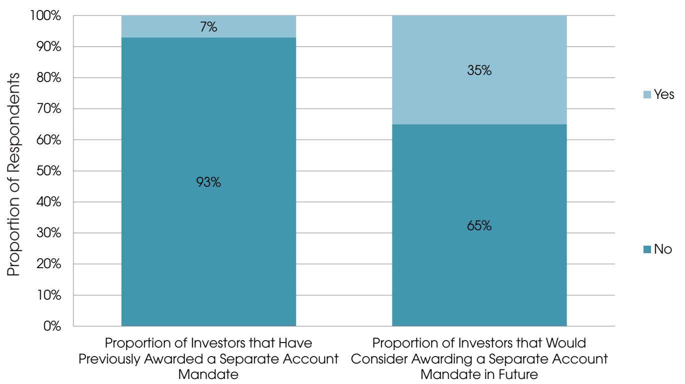
However, over one-third of LPs (35%) interviewed stated that they would consider allocating capital to a separate account in the future, suggesting that as the private equity industry continues to mature, we are likely to see more LPs investing via this route.

Fig. 8: Investors’ Expectations of Their Direct Investment and Secondary Market Activity in 2012



Source: Preqin

Fig. 9: Investor Attitudes to Awarding a Separate Account Mandate



Source: Preqin

Key Geographies and Strategies over the Next 12 Months

In this competitive fundraising environment, it can be difficult for LPs to pick out the best funds to suit their needs. We asked investors which fund types stand out to them as presenting the best opportunities, which regions are the most appealing in the current climate, and where they plan to place their capital over the next 12 months.*

As Fig. 10 illustrates, small to mid-market buyout funds continue to attract the highest level of investor interest, with 49% of LPs naming this fund type as offering the best opportunities and 49% also planning to commit to such funds over the next 12 months.

Venture capital, secondaries and growth vehicles continue to attract attention from investors, with 23%, 19%, and 16% of investors naming these fund types respectively as offering the best opportunities in the current market.

In light of recent macroeconomic issues, particularly within the eurozone, we asked LPs which regions they feel are currently presenting the best opportunities, and if they are avoiding any regions that they may have considered investing in before. The highest proportion of investors (34%) named North America as the most attractive region for investment, 27% named Asia, 26% named Europe and a similar proportion named Rest of World, while 31% did not pick out any specific regions as offering the best opportunities. One UK public pension fund commented: "There are interesting opportunities in all regions so [we] cannot name one region."

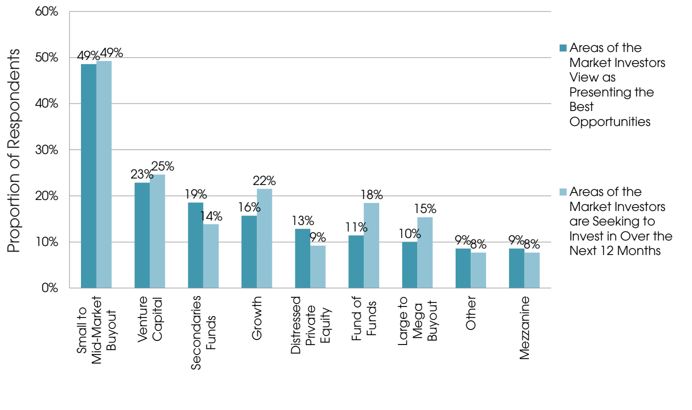
Notably, 24% of investors told us they would not invest in Europe at present and some commented that they would avoid specific regions within Europe, such as one German bank, which will invest in Eastern Europe but wants to avoid Western Europe. Nevertheless, some investors see opportunities in the region. We spoke to a US endowment that commented: "Despite the financial crisis, Europe is presenting some strong investment opportunities if there is a real strong long-term strategy."

Three percent of LPs would not invest in North America, and 2% are avoiding opportunities in Asia and Rest of World. One Swiss bank noted: "[We are] avoiding emerging markets in general; [we] have invested there before but will be very selective in the future." Almost three-quarters of LPs (73%) are not avoiding investment opportunities in any region they have previously invested in.

Appetite for Emerging Markets

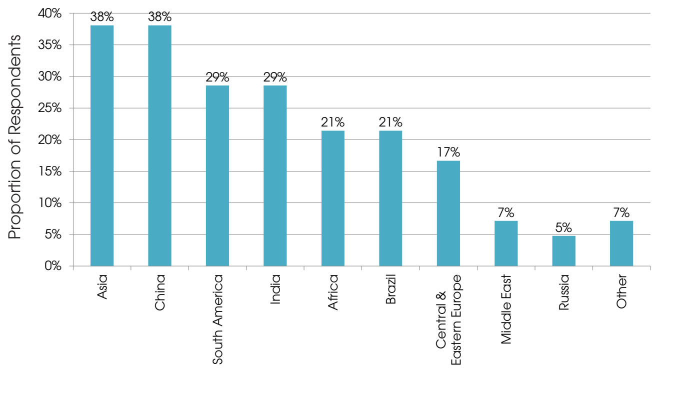
A substantial 72% of LPs will invest or consider investing in emerging markets. Furthermore, 95% of these expect to increase their exposure to these regions over the next 12 months, and none plan to reduce their exposure in the long term. Fig. 11 shows the specific countries and regions within emerging markets that investors view as presenting the best opportunities.* China, and more broadly Asia, remains attractive to the highest proportion of LPs (38%). India and South America are also viewed as offering good investment opportunities, each named by 29% of investors that have an appetite for emerging regions.

Fig. 10: Investor Attitudes to Different Fund Types at Present*



Source: Preqin

Fig. 11: Countries and Regions within Emerging Markets that Investors View as Presenting Attractive Opportunities*



Source: Preqin

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

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Biggest Challenges Facing LPs

We asked investors what particular challenges they are facing in the current climate with regards to their private equity portfolios. Below is a sample of investors' concerns that GPs might consider when approaching investors for new commitments in 2012, with Fig. 12 providing an overview of LPs' main concerns.

"Illiquidity is the biggest issue for us and finding good valuations of funds." – A US foundation.

"Availability of finance and the European macro development. Timing is also challenging." – A German asset manager.

"Selecting the right managers - you need to pick the right people as not everyone is going to be around in the future. Managers need to be able to raise funds." – A German government agency.

"Finding the right GPs as there are so many." – A Dutch asset manager.

"The financial climate in Europe, along with the sovereign debt crisis and changes in regulations have all made it a difficult environment to invest in." – A Finnish insurance company.

"Choosing the correct managers in a saturated private equity market." – A US foundation.

"Finding money – the capital crunch has meant that level of skill needed to find out where money has gone is far higher. It is also hard to get older funds off the balance sheet." – A Belgian bank.

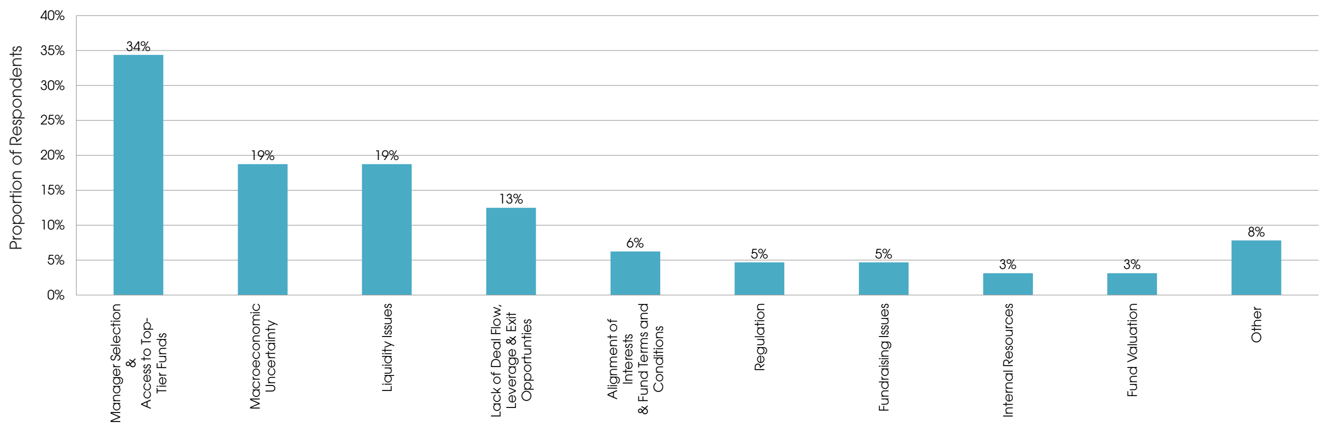
"There is a need to increase the alignment of interests between LPs and GPs. We are also operating in an environment where lack of leverage is dangerous. There are a lot of dollars in the private equity space at present." – A US endowment.

"It is more of an internal challenge than an external investment challenge. Having the internal operational and investment resources available to enable LPs to manage a complex private equity program is difficult at present." – A UK public pension fund.

"Liquidity, not evading current assets, maintaining cash flows." – A US public pension fund.

"Regulations which restrict international investment activity." – An Austrian bank.

Fig. 12: Biggest Challenges Presently Facing LPs Seeking to Operate an Effective Private Equity Program



Source: Preqin

Allocations and Intentions for 2012 and Beyond

Continued uncertainty in financial markets and record numbers of funds on the road mean that fundraising is likely to remain challenging in the year ahead. With many LPs remaining cautious when selecting private equity funds and others exploring new ways of investing in the market, what level of activity can we expect from LPs going forward?

As discussed earlier, aggregate capital raised by funds closed in H1 2012 is up slightly compared to that raised by funds that reached a final close in the latter half of 2011. Encouragingly, almost three-quarters of LPs (73%) expect to commit more or the same amount of capital to private equity funds in 2012 compared to 2011. This suggests that we may see a slight uptick in fundraising by the end of the year in comparison to 2011.

As Fig. 13 illustrates, one-quarter of LPs plan to commit more capital in 2012 than they did in 2011. Those LPs gave various reasons for increasing the pace of their commitments this year, including changes to their investment strategy leading to a bigger allocation to private equity, new mandates available to invest, more opportunities (particularly re-up opportunities) in the market, and building up towards their targeted levels of exposure to the asset class.

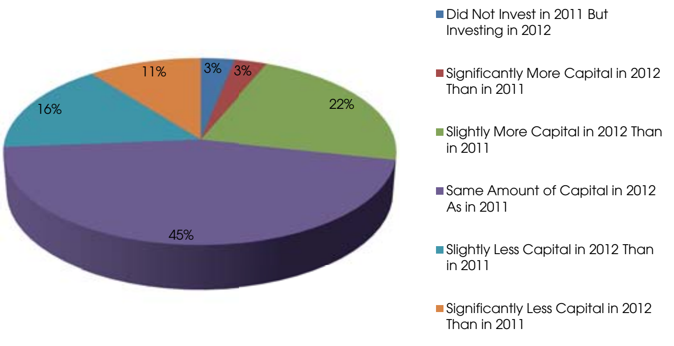
Another 3% of LPs anticipate a return to private equity this year having held off making new commitments in 2011. One Austrian investment company told us: "We have been reluctant since 2009 and now want to commit more capital."

The highest proportion of investors (45%) plan to maintain the pace of their commitments in 2012 compared to 2011. Many of those LPs are at target and investing to maintain their allocation by continuing a set commitment policy, although some mentioned they would invest more if they had the necessary capital available.

Twenty-seven percent of investors expect to commit less capital to private equity opportunities in 2012. A Swedish foundation told us: "We don't have the money to invest right now, so we probably will not do anything for a couple of years at least." A Swedish bank said that regulatory changes are affecting its allocation. Unhappy about increasing transparency in the asset class, one Swiss family office said: "One of the attractions of private equity is that it used to be private; these days people are trying to bring it out in the open and regulate and strangle it. This will have a negative impact on the asset class." Some investors are waiting for a natural rundown of their existing commitments before adding new funds to their portfolio, while others said they are reducing their exposure to funds to focus more on direct investments.

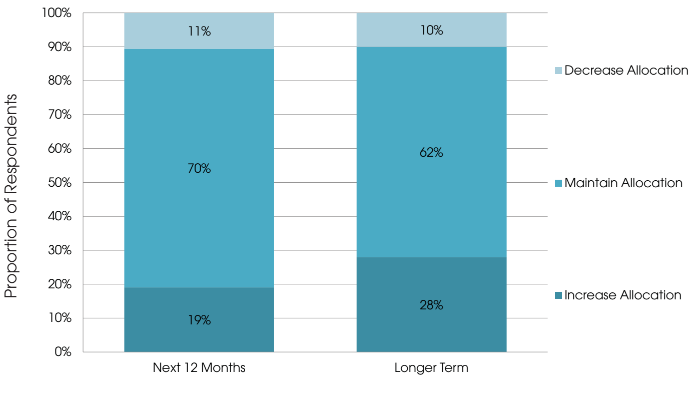
Although there are still investors that remain reluctant to commit fresh capital to funds, and others are exploring new methods of accessing private equity investments such as co-investments and separate accounts, the majority of LPs intend to continue to allocate capital to private equity funds. As Fig. 14 illustrates, 19% of investors expect to increase their exposure to the asset class over the next 12 months, while just 11% expect their private equity fund allocations to go down. Furthermore, in the long term, over one-quarter of LPs (28%) plan to increase their exposure to private equity funds, 62% plan to maintain their allocations, and just 10% expect to reduce their allocations to the asset class.

Fig. 13: Amount of Capital Investors Plan to Commit to Private Equity Funds in 2012 Compared to 2011



Source: Preqin

Fig. 14: Investors' Intentions for Their Private Equity Allocations



Source: Preqin

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- Features all the most important investors in private equity, and their contact details. Investors are arranged by country and region (including US split by census region).

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