Content Includes:

Fundraising Review
We review the past and present private equity fund of funds fundraising environment, including geographical breakdowns.

Separate Accounts
We look at the role of separate account offerings in the private equity fund of funds industry, featuring results from our survey of over 75 investors.

Performance
We examine the performance of private equity funds of funds compared to other fund types, and how different allocation mixes impact their performance.

Investors in Private Equity Funds of Funds
Which investors are looking to commit to private equity funds of funds? What are their opinions on the current market? We explore the answers to these key questions.

Private Equity Funds of Funds as Investors
We analyze the results of our survey of 80 private equity fund of funds managers, including their current investment preferences.

Plus Special Guest Contributor:
David A. York, Top Tier Capital Partners

Preqin Special Report: Private Equity Funds of Funds
March 2014
Foreword

The private equity fund of funds structure is important for investors of all kinds: for smaller LPs, funds of funds provide exposure to the asset class through the guidance of a manager that is more experienced, and for established investors, commingled funds can provide access to niche markets that they lack sufficient expertise to invest in independently.

Preqin Special Report: Private Equity Funds of Funds delves into the multi-faceted world of private equity funds of funds, drawing on data collected directly from hundreds of investors and managers through first-hand contact. It features the latest statistics from Preqin’s Private Equity Online modules, as well as results from dedicated surveys of fund of funds managers and investors across the globe.

An article from Top Tier Capital Partners, a US-based venture capital specialist fund of funds manager, can be found on page 3. The article explores the investment potential held in the venture capital market as the world begins its ride on a new wave of technological innovation, and outlines why the outlook for venture capital investments, which is a common choice for fund of funds managers, is so positive.

Difficult fundraising conditions for private equity funds of funds on the whole have been apparent in recent times, with only $12bn raised by 72 funds of funds closed in 2013, compared to a peak of $58bn secured by 164 vehicles closed in 2007. Historical fundraising by year for these vehicles is shown on page 5, along with deeper analysis of these fundraising statistics.

The challenging fundraising environment has driven the continued evolution of the private equity fund of funds industry. In particular, consolidation of the market, with a number of sales and acquisitions of private equity fund of funds arms, has been occurring. Furthermore, the rise of separate account mandates is a trend that Preqin has been tracking for a while now, with billions of dollars of mandates awarded to private equity fund of funds managers over recent years. Advantages for LPs may include lower carried interest and management fees, more controlling power over deals, and the opportunity to close their position in the account in a shorter time compared to a traditional closed-end private equity fund. Some examples of separate account mandates awarded in the past year are listed on page 7. All this and more can be found in this special research report produced by Preqin. We hope you find the information included useful and, as always, we welcome any feedback and suggestions you may have.

Contents

Reverting to the Mean: Venture Capital Performance in the Era of Lean Startups - Top Tier Capital Partners 3
Review of Private Equity Fund of Funds Fundraising Market 5
Separate Account Mandates 7
Performance of Private Equity Funds of Funds 9
Investors in Private Equity Funds of Funds 11
Private Equity Fund of Funds Managers as Investors 13
Threats to and Opportunities for the Private Equity Fund of Funds Industry 15
Reverting to the Mean: Venture Capital Performance in the Era of Lean Startups
- David A. York, Managing Director, Top Tier Capital Partners

With the convergence of rapid innovation, right-sized amounts of capital, and improved liquidity, the venture industry has reverted to positive cash flow over the past two years. Returns are trending towards the mean of greater than 13% IRR (Internal Rate of Return) for the venture industry as a whole and more than 26% for the top quartile. Yet, this is just the beginning of a new wave of technological innovations in cloud computing, mobile devices, and the “Internet of Things.” Consulting firm McKinsey estimates that by 2025, these trends may have an economic impact of $900bn a year in just the manufacturing sector alone.

Trending to Higher Returns

For the first time since 2001, venture industry distributions in 2011 outpaced contributions – distributions reached $29bn while contributions were $26bn. In 2012, distributions from 560 exits generated $51.4bn. According to Top Tier Capital Partners research, approximately $24bn was contributed to venture funds. Returns are trending towards the mean of greater than 13% IRR (Internal Rate of Return) for the venture industry as a whole and more than 26% for the top quartile.

Returns Driven by Structural Technological Changes

The past decade has seen significant and rapid technological shifts occur in fundamental ways:

Technology: In the technology sector, computing, memory, and storage costs have shrunk dramatically. Data, voice, and video are now an integral part of enterprise communication and consumption. PricewaterhouseCoopers estimates that 2014 mobile Internet revenues, at $259bn, will account for more than 50% of total Internet access spend, overtaking fixed-broadband. The next decade may spawn a new generation of wearable/anywhere computing devices, or the “Internet of Things.”

Enterprise: In enterprise, technological changes have launched pay-per-use models of computing. IDC Market Research reports estimate industry spending in cloud computing services to reach pay-per-use models of computing. IDC Market Research reports estimate industry spending in cloud computing, mobile devices, and the “Internet of Things.” Consulting firm McKinsey estimates that by 2025, these trends may have an economic impact of $900bn a year in just the manufacturing sector alone.

Healthcare: The healthcare sector attracts around 25% of total venture investments and biotechnology and medical devices have been the primary sub-sectors of potential returns. With the passage of the Affordable Care Act (also known as “Obamacare”), tracking of healthcare costs, quality, and patient wellness will change in the coming years. According to McKinsey reports, the potential economic impact of next-generation gene sequencing in healthcare, agriculture, and the production of substances such as biofuels could be $700bn to $1.6tn a year by 2025. About 80% of this potential value could be realized from enhancing care through faster disease detection, precise diagnoses, new drugs, and tailored disease treatments.

These trends of cloud computing, mobility, and wellness have translated into numerous opportunities that have the potential to create venture-like returns. Such disruptions drive rapid revenue growth and value creation for entrepreneurs and investors.

Innovation and the Art of Rapid Value Creation

While technological shifts create numerous opportunities, consider the following areas of greatest impact:

E-commerce and shopping: E-commerce companies like One Kings Lane, Fab.com and Zulily were launched only a few years ago, yet are now considered to be the hottest startups of the age. One Kings Lane, which offers home retail flash sales, has reportedly attracted 4 million members and reached $200mn in revenues in four years. Similarly, Fab.com has over 2.5 million users, 40% of which are mobile users and heading towards $100mn+ revenues. Zulily, an e-commerce site for moms, reached more than $400mn in revenues in four years and was valued at $2.6bn at its recent IPO.

Travel and transportation: Airbnb, Uber and Lyft are the new disruptors, changing the way we make travel arrangements. The peer-to-peer sharing economy has two primary underpinnings – social profiles and mobile accessibility. In just four years, over 9 million guests are reported to have made reservations using Airbnb. Like Airbnb, Uber is a four-year-old venture backed company, which allows consumers to hire a black car service using their smartphone. The company raised the largest round in 2013 at $361.2mn and is valued in the private markets at $3.5bn as reported in Forbes. Lyft, a ride sharing company, completed one million rides in just over a year from launch. Preqin’s Buyout Deals Analyst online service shows Lyft has raised $60mn from venture firm Andreessen-Horowitz.
Media and entertainment: Increasing bandwidth speeds and mobility are impacting media channels (audio, video) and entertainment at a rapid pace. The gaming industry generated approximately $60bn in revenues in 2012 according to PricewaterhouseCoopers. Content creation, monetization, and distribution channels have been reinvented to meet changing demands. Consumption of content across multiple platforms (Android, iOS) and devices (TV, tablets, smartphones) at various locations has become the norm, creating a new wave of investable opportunities. Companies like Netflix, Roku, Hulu, and Amazon.com have started to create and/or distribute content.

Education and wellness: Course creation, distribution, and student-teacher engagement have gone through changes with growth in cloud and ed-tech developments. These trends allow for asynchronous engagement, anytime, at each student’s own pace, across geographic barriers and time zones. Venture-backed companies like Coursera (online education platform) and Chegg (textbook rentals) have brought efficiencies to the education marketplace. With the augment of low power blue-tooth devices, health and wellness trends have also created new opportunities for tracking individual health patterns. Companies like Fitbit and Jawbone are seen as category creators in the consumer digital health arena.

Other sectorial shifts have also occurred in enterprise software, finance and web security. These trends continue to evolve and create a new set of venture opportunities, yet the present times and new venture model have minimized investor risk with lower points of failure.

Lean Startups and the Era of Capital Efficiency

Today, less capital is required to start companies and by parsing it out over multiple milestones, capital can be more efficiently deployed.

Capital efficiency: The amount of capital required to start a company today has dropped 99% as compared to 20 years ago. Due to the advent of computation, network and storage available as utilities, a technology startup can be launched with as little as $5,000.

Lower points of failure: Thanks to capital efficiency, the points of failure in any startup’s trajectory can now be optimized by venture investors. In the past, it would take several million dollars to reach a meaningful point of inflection. Venture firms have fine-tuned the amount and timing of capital invested into technology companies to maximize returns.

Towards Improved Venture Returns

Smaller institutional capital flows into the venture industry, plus a vibrant exit market, imply better returns and vintages going forward.

Concentrated fund activity: The number of venture funds greater than $50mn has dropped by 51% between 2000 and 2012. Average fund sizes declined from $194mn (2000) to $150mn (2012). Upper quartile vintage returns are trending towards 26% IRR.

Stronger exit markets: Liquidity for venture investors has significantly improved since the 2008 financial crises. In 2012, 560 US venture capital exits generated $51.4bn of value, compared to 331 worth an aggregate $18.1bn in 2008. Between 2011-2013, a total of 183 venture-backed IPOs raised over $41.6bn. Per NVCA reports, the post-IPO valuation step-up is as high as 18X in the same time period, increasing returns for later stage venture capital funds as well. Similarly, in 2012, $28.4bn was generated across 454 US venture capital trade sales. The top 30 acquirers of technology companies, which include Google, Apple, and Cisco, have over $450bn of cash on their balance sheets.

Cash flow positive: As described earlier, the venture industry is net cash flow positive, a trend which is anticipated to continue over the coming years.

These three vectors - concentrated fund sizes, improved exit markets, and positive distributions - create the possibility of improved returns for venture capital investors.

Conclusion: Why VC? Why Now?

Critics of venture capital often fall prey to rearview mirror analysis, where past performance is seen as an indicator of the future. The 1999-2000 Dotcom Era coupled with the 2008 financial crisis created challenges for the industry. Returns plummeted and the pendulum swung to the other extreme as investors shied away. Contrarian and consistent investors have found that venture can generate meaningful returns. A capital efficient startup universe, right-sized venture funds and strong public markets have the potential for superior returns. Several indices such as pre-IPO pipeline and market sentiment are healthy as returns are reverting to the mean. The three axes of innovation, capital flows, and liquidity are converging to create an environment conducive to generating attractive risk-adjusted returns. We believe the venture industry has recovered from an era of despondency to an era of hope.

David York is CEO and Managing Director of Top Tier Capital Partners, a venture capital specialist building niche-focused funds of funds.

For more information please visit: www.ttcp.com
Review of Private Equity Fund of Funds Fundraising Market

In a wider fundraising environment where private equity launches have experienced the most success in terms of amount of aggregate capital committed since 2008, Preqin’s dedicated survey of 80 private equity fund of funds managers revealed a less encouraging picture for funds of funds. One telling statistic is that a significant 37% of firms took a longer time to complete fundraising for a new fund of funds, indicating the challenges that commingled fund managers face in securing capital from investors.

The Annual Fundraising of Private Equity Funds of Funds

As seen in Fig. 3, the annual fundraising of private equity funds of funds from 2010 to 2013 has been fairly steady with regard to both the number of funds holding final closes and the aggregate amount of capital garnered. Since the fundraising peak in 2007 however, when 164 private equity funds of funds secured commitments of $58bn, there has been a marked drop in fundraising. In fact, 2013 was the lowest year for both number of funds of funds that reached a final close and also for the annual aggregate capital raised since 2003.

However, there are still several notable active private equity funds of funds that were successful in attracting investor interest. Guochuang Kaiyuan Fund of Funds, raised by China Development Bank Capital, was the largest fund of funds vehicle that closed in 2013. The fund secured commitments of CNY 15bn ($2.4bn), significantly exceeding its CNY 10bn target. Portfolio Advisors Private Equity Fund VII was the second biggest vehicle that closed in the year, and it secured capital commitments of $1.1bn, 22% over its $900mn target.

Fundraising by Geographic Focus

Of the private equity funds of funds that held a final close in 2013, the majority (57%) had a primary geographic focus on opportunities in North America; a significant proportion of vehicles closed in every year shown in Fig. 4 had a focus on North America. Historically, European opportunities were consistently the second most sought after by funds of funds, but 2012 brought in a proportional shift of focus to opportunities in Asia and Rest of World regions. Fig. 4 shows a quarter (26%) of private equity funds of funds that closed in 2013 primarily targeted vehicles with a focus on Asia and Rest of World, second to the 58% accounted by North America but nine percentage points ahead of Europe.

Fundraising Outlook

There are currently 164 private equity funds of funds in market seeking investor capital. The largest fund of funds in market is Abbott Capital Private Equity Fund VII. This fund is seeking LP capital commitments of $1bn, and has a highly diversified investment plan, looking to target buyout, venture capital and special situation vehicles around the globe.

Fig. 3: Annual Private Equity Fund of Funds Fundraising, 2000 - 2013

Source: Preqin Funds in Market

Fig. 4: Breakdown of Private Equity Fund of Funds Fundraising by Primary Geographic Focus

Source: Preqin Funds in Market

Data Source:

Preqin’s Funds in Market online service features details of all 164 private equity funds of funds currently in market and over 1,500 closed historically.

Fund profiles feature key information on final close size and original target size, investment preferences, known investors, key contact information, and much more.

For more information, or to arrange a demonstration, please visit:

www.preqin.com/fim
Identify and evaluate alternative investment opportunities on Preqin Investor Network.

Preqin Investor Network focuses exclusively on helping investors make alternative asset allocation and investment decisions, and is already used by over 5,400 investment professionals. Use the Investor Network to:

- **View** all private equity, real estate infrastructure and hedge funds currently open for investment
- **Track** fund-level past performance for managers with a fund open for investment
- **Connect** with fund managers
- **Benchmark** terms and conditions by fund strategy, geographic location and fund size
- **Access** valuable market analysis and performance benchmarking research

Signing up to Preqin Investor Network is easy – to register for free, please visit:

www.preqin.com/pin

New York
+1 212 350 0100

London
+44 (0)20 7645 8888

Singapore
+65 6305 2200

San Francisco
+1 415 635 3580
Separate account offerings have long played a part in the private equity fund of funds industry. The tougher fundraising environment for commingled private equity fund of funds vehicles has meant that the capital derived from separate accounts is becoming of increasing importance in the investment activity of private equity fund of funds managers.

For the investor, a separate account presents many benefits including greater flexibility, more involvement in the investment decision making, better terms and a more favourable fee structure for the LP. However, separate accounts are not necessarily widely utilized among investors in private equity funds of funds. As shown in Fig. 5, of the investors in funds of funds surveyed for this report, just 16% indicated that they had ever awarded a separate account mandate to a fund of funds manager.

An Exclusive Choice?

Fig. 6 shows that of those investors surveyed that have never awarded a separate account mandate, 23% would consider doing so in the longer term. An underlying reason behind this statistic might be the fact that separate account mandates tend to be relatively large in size relative to the commitment to a traditional fund of funds vehicle, to make it worth the while of the fund of funds manager and also to ensure that the diversification benefits are not lost. The average size of all private equity fund of funds separate accounts profiled by Preqin is more than $250mn, beyond the scale of the average investor in a fund of funds vehicle.

From the manager perspective, therefore, separate accounts can be valuable vehicles, particularly in the face of the current challenging fundraising market for private equity funds of funds, as discussed on page 5. Of the fund of funds managers surveyed for this report, 24% indicated that they invested more from separate accounts in the past 12 months compared to the previous 12 months (Fig. 7). Furthermore, two-thirds of fund of funds managers surveyed expect their activity from separate accounts to be as important or more important (in terms of

**Fig. 7: Change in Level of Investments by Private Equity Fund of Funds Managers from Separate Accounts in the Past 12 Months**

Source: Preqin Private Equity Fund of Funds Manager Survey, January 2014

**Fig. 5: Proportion of Investors that Have Ever Awarded a Separate Account Mandate**

Source: Preqin Investor Survey, January 2014

**Fig. 6: Proportion of Investors that Have Never Awarded a Separate Account Mandate that Intend to in the Future**

Source: Preqin Investor Survey, January 2014

**Fig. 8: Expected Importance of Separate Accounts to Investment Activity of Private Equity Fund of Funds Managers in the Next 12 Months (In Terms of Capital Expended)**

Source: Preqin Private Equity Fund of Funds Manager Survey, January 2014

Source: Preqin Ltd. / www.preqin.com
capital expended) as their activity from commingled vehicles (Fig. 8); 18% indicated they expected to invest more from separate accounts compared to commingled vehicles.

The Diversity Within

Separate accounts vary in their size and scope. Fig. 9 lists some examples of the mandates that have been awarded in 2013. Mandates can have a specific focus on a particular market niche, such as Indiana Public Retirement System’s $150mn mandate to AlpInvest to make Indiana state-focused primary and direct investments on their behalf. On the other hand, separate account mandates can be much broader in their remit, such as with Texas Permanent School Fund State Board of Education’s $900mn mandate to Neuberger Berman, through which the fund of funds manager will invest globally – through primary, secondary and co-investments – on behalf of the sovereign wealth fund.

Of the active private equity fund of funds managers profiled by Preqin, 51% are known to offer separate account services. Our data notes that for larger and more established fund of funds managers in particular, separate accounts often form a significant portion of the total activity of these managers. Fig. 10 lists 10 notable fund of funds managers, the majority (80%) of which are US based, with Australia-headquartered Macquarie Investment Management and France-based Amundi Private Equity Funds also managing large amounts of separate account capital.

### Fig. 9: Sample Separate Account Mandates Awarded in 2013

<table>
<thead>
<tr>
<th>Investor</th>
<th>Manager</th>
<th>Mandate Size ($mn)</th>
<th>Mandate Geographic Focus</th>
<th>Mandate Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indiana Public Retirement System</td>
<td>AlpInvest Partners</td>
<td>150</td>
<td>US Regional</td>
<td>Indiana Investment Fund II is a follow-on vehicle to Indiana Investment Fund I, a mandate managed by Credit Suisse Customized Fund Investment Group on behalf of the Indiana Public Retirement System. This mandate is to make Indiana-focused investments; about 67% of the separate account would be invested in opportunistic Indiana-related direct investments and 33% in Indiana-related general partners.</td>
</tr>
<tr>
<td>KEVA</td>
<td>Grove Street Advisors</td>
<td>200</td>
<td>Country-Specific</td>
<td>LGPI (Finland KEVA) III was created for Kuntien Eläkevakuutus (KEVA - the Finnish Local Government Pensions Institution) by Grove Street Advisors. It was designed to follow a similar strategy to its predecessor, which aimed to provide KEVA with exposure to US venture capital opportunities.</td>
</tr>
<tr>
<td>Los Angeles County Employees’ Retirement Association (LACERA)</td>
<td>JPMorgan Asset Management - Private Equity Group</td>
<td>100</td>
<td>Country-Specific</td>
<td>JPMorgan Asset Management - LACERA 2013 is the second separate account managed by JPMorgan on behalf of Los Angeles County Employees’ Retirement Association (LACERA). JPMorgan will invest a further $100mn with smaller, lesser known managers and in some cases, first-time funds with personnel with experience working in more established firms.</td>
</tr>
<tr>
<td>New Jersey State Investment Council</td>
<td>Siguler Guff</td>
<td>300</td>
<td>Regional</td>
<td>The New Jersey Developing Markets Private Equity Program is a $300mn New Jersey State Investment Council separate account managed by Siguler Guff, with a focus on developing markets outside of Asia. The separate account invests up to 100% in primary or secondary funds and up to 50% in co-investment opportunities.</td>
</tr>
<tr>
<td>Texas Permanent School Fund State Board of Education</td>
<td>Neuberger Berman</td>
<td>900</td>
<td>Multi-Continental</td>
<td>Neuberger Berman/Texas Permanent School Fund II is the second separate account mandate awarded to Neuberger Berman by Texas Permanent School Fund State Board of Education. The mandate is worth $900mn; Neuberger Berman has full management responsibility for secondary and co-investments on behalf of the pension fund, but will share responsibility for the primary investments portion of the mandate with staff from the pension fund.</td>
</tr>
</tbody>
</table>

### Fig. 10: Leading Private Equity Fund of Funds Managers by Separate Account Assets under Management (AUM)

<table>
<thead>
<tr>
<th>Firm</th>
<th>Firm Location</th>
<th>Total Discretionary Separate Account AUM ($mn)</th>
<th>Proportion of Total Assets in Separate Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hamilton Lane</td>
<td>US</td>
<td>18,900</td>
<td>73%</td>
</tr>
<tr>
<td>Pathway Capital Management</td>
<td>US</td>
<td>14,507</td>
<td>54%</td>
</tr>
<tr>
<td>BlackRock Private Equity Partners</td>
<td>US</td>
<td>9,300</td>
<td>55%</td>
</tr>
<tr>
<td>Pantheon</td>
<td>UK</td>
<td>7,675</td>
<td>28%</td>
</tr>
<tr>
<td>Macquarie Investment Management</td>
<td>Australia</td>
<td>5,306</td>
<td>81%</td>
</tr>
<tr>
<td>Grove Street Advisors</td>
<td>US</td>
<td>4,800</td>
<td>100%</td>
</tr>
<tr>
<td>Abbott Capital Management</td>
<td>US</td>
<td>3,981</td>
<td>53%</td>
</tr>
<tr>
<td>Neuberger Berman</td>
<td>US</td>
<td>3,600</td>
<td>22%</td>
</tr>
<tr>
<td>Amundi Private Equity Funds</td>
<td>France</td>
<td>3,554</td>
<td>51%</td>
</tr>
<tr>
<td>Morgan Stanley Alternative Investment Partners</td>
<td>US</td>
<td>3,500</td>
<td>36%</td>
</tr>
</tbody>
</table>

Source: Preqin Investor Intelligence
Funds of funds are an important part of many investors’ portfolios, and can give investors access to top-tier fund managers and increased diversification within the private equity asset class across fund types and geographic regions. A recent Preqin survey of over 75 investors in private equity funds of funds discovered that 71% of respondents felt that returns from their private equity fund of funds investments either met or exceeded their expectations. With performance data for over 900 private equity fund of funds vehicles, Preqin is able to highlight the performance of the fund of funds industry in comparison to other fund types and examine the selection skills of fund of funds managers.

Horizon IRRs give an indication of the performance of each fund type over a defined period of time. The horizon IRRs shown in Fig. 11 are calculated using cash flow data for over 2,400 private equity funds, of which 255 are private equity funds of funds. Compared with buyout, mezzanine and distressed private equity funds, fund of funds horizon IRRs are lower in the one-, three-, five and 10-year horizon, returning 7.9%, 11.1%, 5.3% and 8.2% respectively, as of June 2013. However, funds of funds show higher horizon returns than venture capital funds during these timeframes.

The median net IRRs and quartile boundaries for each vintage year, as shown in Fig. 12, highlight the spread of returns achieved by private equity fund of funds managers. Across all vintage years, all quartile boundaries are in the black, with the top quartile IRR boundary ranging between 6.1% (2010) and 15.9% (2009).

Synthetic IRRs for Funds of Funds of Different Allocation Mixes

For a private equity fund of funds manager, deciding on how capital will be allocated, in some cases to diverse fund types, is an important consideration in order to maximize returns, and it is vital to be able to gauge the relative success of their chosen strategy. Using cash flow data for over 2,400 funds, we have been able to create a synthetic private equity fund of funds benchmark, which adapts to various different allocation mixes between venture capital and buyout funds. The synthetic benchmarks show how funds of funds of different allocation mixes should perform if they achieve their median performance according to their allocation mix. The methodology takes into account the fact that funds of funds generally commit to underlying funds over a range of vintages and assumes that each fund of funds makes commitments over a three-year period. It is also assumed that 50% of commitments are made in the first year, 30% in the second year and 20% in the third year. Fig. 13 shows that after the dot-com crash of the late nineties, funds of funds with a higher allocation to venture capital generated much lower returns for funds with vintage years between 1998 and 2008, whereas the different allocation mixes show similar median returns for more recent vintage years.

Private Equity Fund of Funds Managers and Fund Selection

Fund of funds managers often cite their superior fund selection and due diligence capabilities, and claim to have access to top-tier fund managers that in the past may have been inaccessible.
for many private equity investors. Preqin’s Investor Intelligence online service holds data on almost 8,000 fund investments made by private equity fund of funds managers. By examining this data, we can provide insight to help determine whether the selection skills of fund of funds managers translate into superior returns to the investor. Fig. 14 shows the quartile breakdown of underlying fund investments made by private equity fund of funds managers. The chart shows that 52% of underlying fund investments made by fund of funds managers are in the top or second quartile, while 29% and 19% ranked in the third and fourth quartile respectively. With more than half of underlying fund investments made by fund of funds managers achieving greater than average returns, can we determine which private equity fund of funds managers are selecting the best fund investments?

To answer this, for each fund of funds manager’s known underlying fund investments, we have assigned a score of one to each direct fund ranked in the first quartile, two to a fund ranked in the second quartile and so on. An average score is then calculated, which determines each manager’s position within the table, with only fund managers with at least 10 known fund investments included. Fig. 15 shows that Private Advisors is currently top of the table, with an average score of 1.90; almost 45% of its known underlying fund investments currently generate top quartile returns.

Outlook

With increasing investor sophistication and transparency within the private equity industry, it is important for fund of funds managers to generate superior returns in order to justify the double layer of management fees intrinsic to commingled vehicles. With substantial amounts of capital emanating from the fund of funds sector (1,102 private equity fund of funds vehicles have raised an aggregate $288bn in the last 10 years), as well as 164 private equity funds of funds in market as of March 2014 seeking an aggregate $33bn and almost three-quarters of investors satisfied with the returns from their fund of funds investments, it is clear that private equity funds of funds still continue to be a key part of many investors’ portfolios.

### Industry-Leading Private Equity Performance Data

Preqin’s Performance Analyst online service is the industry’s most extensive source of net-to-LP private equity fund performance, with full metrics for over 6,600 named vehicles, including over 870 private equity funds of funds. Use Performance Analyst to benchmark a fund’s performance against its peers, assess returns by region, fund type and vintage year, view past performance for specific managers and funds, and more.

For more information, or to arrange a demonstration, please visit: www.preqin.com/pa

### Fig. 14: Quartile Ranking Breakdown of Underlying Fund Investments Made by Private Equity Fund of Funds Managers

<table>
<thead>
<tr>
<th>Quartile Ranking</th>
<th>First Quartile</th>
<th>Second Quartile</th>
<th>Third Quartile</th>
<th>Fourth Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>19%</td>
<td>21%</td>
<td>29%</td>
<td>31%</td>
</tr>
</tbody>
</table>

Source: Preqin Performance Analyst

### Fig. 15: Top 10 Private Equity Fund of Funds Managers by Average Underlying Fund Quartile Ranking

<table>
<thead>
<tr>
<th>Firm</th>
<th>No. of Underlying Funds with Performance Data</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Average Quartile Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Advisors</td>
<td>29</td>
<td>44.8%</td>
<td>34.5%</td>
<td>6.9%</td>
<td>13.8%</td>
<td>1.90</td>
</tr>
<tr>
<td>Franklin Park</td>
<td>12</td>
<td>25.0%</td>
<td>58.3%</td>
<td>16.7%</td>
<td>0.0%</td>
<td>1.92</td>
</tr>
<tr>
<td>VenCap International</td>
<td>15</td>
<td>46.7%</td>
<td>20.0%</td>
<td>26.7%</td>
<td>6.7%</td>
<td>1.93</td>
</tr>
<tr>
<td>Greenspring Associates</td>
<td>68</td>
<td>35.3%</td>
<td>36.8%</td>
<td>22.1%</td>
<td>5.9%</td>
<td>1.99</td>
</tr>
<tr>
<td>Akina</td>
<td>30</td>
<td>43.3%</td>
<td>26.7%</td>
<td>13.3%</td>
<td>16.7%</td>
<td>2.03</td>
</tr>
<tr>
<td>Danske Private Equity</td>
<td>32</td>
<td>34.4%</td>
<td>31.3%</td>
<td>25.0%</td>
<td>9.4%</td>
<td>2.09</td>
</tr>
<tr>
<td>Utah Capital Investment Corporation</td>
<td>21</td>
<td>33.3%</td>
<td>38.1%</td>
<td>14.3%</td>
<td>14.3%</td>
<td>2.10</td>
</tr>
<tr>
<td>Fort Washington Capital Partners</td>
<td>48</td>
<td>27.1%</td>
<td>41.7%</td>
<td>22.9%</td>
<td>8.3%</td>
<td>2.13</td>
</tr>
<tr>
<td>Grove Street Advisors</td>
<td>31</td>
<td>29.0%</td>
<td>38.7%</td>
<td>22.6%</td>
<td>9.7%</td>
<td>2.13</td>
</tr>
<tr>
<td>DNB Private Equity</td>
<td>21</td>
<td>28.6%</td>
<td>33.3%</td>
<td>33.3%</td>
<td>4.8%</td>
<td>2.14</td>
</tr>
</tbody>
</table>

Source: Preqin Performance Analyst
Investors in Private Equity Funds of Funds

Funds of funds are seen by many institutional investors as an integral component of their private equity portfolios; they are deemed particularly valuable to smaller and less experienced investors, as these vehicles enable them to gain exposure to the asset class, and specific fund types and geographies. By investing alongside other investors in a commingled fund, investors are able to gain exposure to a wide range of private equity vehicles via a relatively small commitment. Particularly for smaller investors, the typical minimum fund commitment size can prevent investors from gaining access to the managers that present attractive opportunities.

This section of the report focuses on investors in private equity funds of funds, exploring in more depth their attitudes toward and motives for investing in these vehicles. In order to carry out this analysis, as well as learn more about investors’ future fund of funds investment plans, we spoke to over 75 institutional investors that have indicated an appetite for private equity fund of funds investments. Over half of the investors we spoke with (51%) will make or are considering making new private equity fund of funds commitments over the next three years.

Investors’ Motivations for Investing in Funds of Funds

In order to establish the key reasons behind investors’ decisions to include private equity funds of funds in their investment portfolios, we asked what their reasoning is for using fund of funds vehicles to access the private equity asset class; the results are shown in Fig. 16.

The majority (59%) of investors we interviewed stated that the main reason they used funds of funds was to diversify their portfolios. This point of view was shared by a US-based family office, which stated that committing to private equity funds of funds enabled investors to gain access to a wide range of underlying fund types and geographic regions. Twenty-one percent of investors we spoke to highlighted access to specific funds and the same proportion selected lack of internal resources as important driving factors for committing to fund of funds vehicles. Some investors do not have sufficient resources to maintain an in-house team to analyze potential fund investment opportunities and monitor multiple investments on an ongoing basis and so drawing on the capabilities of a fund of funds manager is highly attractive. Access to specific markets and the expertise of fund of funds managers made up 17% and 15% respectively of common reasons investors utilize funds of funds.

In terms of what factors investors assess when choosing a fund of funds manager, past performance and track record is taken into consideration the most; 59% of respondents stated that experience was the most important factor. Strategy, access to good opportunities and fees were also seen as influencing factors for LPs in their decision to partner with a specific GP.

Fig. 16: Motivations for Investors Utilizing Private Equity Funds of Funds

Investors’ Views on Alignment of Interests with Fund of Funds Managers

Understandably, fund terms and conditions are an influencing factor in an LP’s decision-making process when reviewing potential investment opportunities. The increasingly competitive fundraising market is making investors more selective when looking to make new fund commitments, as they are placed in a much more advantageous position to negotiate more ‘LP friendly’ terms and conditions. At the same time, fund of funds managers will need to be more sensitive and aware of investor needs regarding fund terms and conditions to secure commitments and ensure they are successful in their fundraising for new vehicles in the coming years.
Preqin’s survey reveals that there is largely a harmonious relationship between LPs and their fund of funds managers, with roughly two-thirds (65%) of investors we spoke to stating that they believe fund of funds manager and LP interests are properly aligned (Fig. 17). A quarter (25%) of respondents strongly agreed with this statement. Just 10% held the view that there was not an alignment of interest between the two parties.

We also asked those investors that indicated dissatisfaction with the current alignment of interests to detail in which way the relationship could be improved. A substantial proportion (77%) of respondents quoted management fees as being the most significant area in need of improvement. Over a quarter of respondents (27%) believe that the amount of capital committed by the GP needs to be improved in order to improve the alignment. Similarly, 27% of investors that felt their interests were not properly aligned with their private equity fund of funds managers’ were dissatisfied with the carry structure proposed by GPs.

The majority of investors interviewed (71%) stated that they had not seen a change in prevailing terms for fund of funds vehicles in the last 12 months. Further to this, 24% of respondents had felt that there had been an alteration in fund terms in favour of the LP and an 85% majority of this sample specifically pinpointed more favourable management fees were apparent in recent times.

### Timeframe for Next Fund of Funds Commitments

Of the investors we spoke to, 22% intended to make their next fund of funds commitment within H1 2014, while a further 16% anticipated making a new commitment before the end of 2014. These statistics present a slightly dubious outlook for managers currently looking to raise a fund of funds; only 38% of investors are anticipating a commitment to a fund of funds vehicle within the year, 22% of investors were undecided about the timeframe of their next fund of funds commitments and a further 22% of respondents are no longer actively investing in such vehicles at all.

Preqin’s study also took into consideration investors’ intentions for their fund of funds allocations over the next three to five years. Thirty-six percent of LPs expected to maintain their current exposure to funds of funds within their overall private equity portfolios going forward, while 20% expected to increase their allocations. As 71% of respondents stated that their fund of funds commitments had either met or exceeded expectations, one would expect investor appetite for fund of funds vehicles to be fairly strong, with many LPs looking to invest in these structures in the coming years. However, clashes over fund terms and high management fees may be obstacles to both LPs wanting to utilize funds of funds to access the private equity asset class and GPs looking to secure third-party capital commitments for their vehicles.

---

**Looking for Investors for Your Private Equity Fund of Funds Vehicle?**

Preqin’s Investor Intelligence features detailed profiles of over 2,100 investors that have previously invested in, or have a preference for, private equity funds of funds.

Profiles feature contact information of key decision makers, specific investment preferences, current and target allocations, known previous commitments, and much more.

The Future Fund Searches and Mandates feature on Investor Intelligence is the perfect tool to pinpoint those institutions that are seeking new fund of funds investments now. Search for potential new investors by their current investment searches and mandates, including fund structure, fund strategy and regional preferences.

For more information, or to arrange a demonstration, please visit:

www.preqin.com/ii
Private Equity Fund of Funds Managers as Investors

This section of the report analyzes the responses to our survey of 80 fund of funds managers, focusing on exploring their role as limited partners. Despite challenging fundraising conditions, fund of funds managers remain an important investor group and their views can provide some insight for private equity fund managers looking to raise new funds.

Private Equity Fund of Funds Managers’ Views of Different Fund Types

Fund of funds managers were asked to state which private equity fund type(s) they feel present the best investment opportunities in the current climate. The results show that the most cited fund types were small to mid-market buyout and growth (Fig. 19). This was also the case when the question was posed to private equity fund of funds managers in October 2012. However, the more recent survey in January 2014 revealed a greater proportion of managers selecting large to mega buyout funds (17% in January 2014 compared to 9% in October 2012), which is perhaps a reflection of comparatively easier access to leverage and stronger exit opportunities in that segment. Private debt funds were selected by almost a fifth (19%) of respondents in January 2014; the private debt space has ballooned in interest in recent times, with finance packaging of deals, particularly in the mid-market space, presenting a compelling investment opportunity with relatively high yields in a low interest rate environment.

Geographic Preferences

With regard to the geographic regions private equity fund of funds managers believe to be offering the best investment opportunities at present, the majority (70%) look favourably upon North America (Fig. 20). Following the decline in investor appetite in Europe linked to the 2011 sovereign debt crisis, levels of interest in the region are returning, particularly for distressed opportunities, and a healthy 47% of private equity fund of funds managers surveyed indicated they felt the continent is currently presenting the most interesting investment opportunities. Economic regions outside of North America, Europe and Asia, which include Africa, Latin America and other frontier markets, were named by 10% of respondents.

Allocation to Secondary Market Purchases and Co-Investments

The secondary market has grown in importance for private equity funds of funds, with several managers implementing the purchase of fund stakes in their fund of funds investment strategies. Over the coming year, a significant 54% of private equity fund of funds managers surveyed expect to increase their activity on the market, and 33% are looking to maintain their current exposure (Fig. 21). The increase in the level of activity suggests recognition of the increased opportunities in secondaries, as well as a rise in investor appetite for exposure to this market.
Co-investment opportunities also appear to be of growing interest to fund of funds managers. Fig. 22 shows that 88% of the private equity fund of funds managers that Preqin spoke with are planning to increase or maintain their current allocation to these opportunities during 2014. While a threat may exist to the private equity fund of funds industry in an increasingly sophisticated investor base seeking to go alone in primary investing, the level of experience and expertise of the average investor is much less in secondary investment and co-investments. Private equity fund of funds managers will play a key part in bridging that gap and, therefore, it is likely those investment types will be of increasing importance in their repertoire.

Private Equity Fund of Funds Managers’ Views on GPs’ ESG Policies

A GP’s environmental, social, and governance policies (ESG) can play an integral role in the due diligence process before an investor commits to a fund. There is a held belief that ESG policies of a GP can contribute not only to managing risk, but enhancing the performance of portfolio companies. The results of Preqin’s survey show that the ESG policy of a GP plays a part in the decision-making process among the majority of private equity fund of funds managers. Fig. 23 shows that of the fund of funds managers which Preqin spoke to, 73% stated that they check fund managers’ ESG policies before making a commitment.

Looking for Fund of Funds Managers to Invest in Your Vehicle?

Preqin’s Investor Intelligence online service tracks in-depth data on over 340 active private equity fund of funds managers, including key contact information, funds managed, known investments, and much more.

Use the Funds of Funds Search feature to pinpoint fund of funds managers most likely to be interested in your offering. Filter potential fund of funds managers for your vehicle by fund size, the proportion of their capital allocated for investment in specific fund types and regions, their future investment plans, and their attitude towards first-time fund managers.

For more information, or to arrange a demonstration, please visit:

www.preqin.com/ii
Threats to and Opportunities for the Private Equity Fund of Funds Industry

When asked what presented the best opportunities for private equity fund of funds managers in the coming 12 months, four main themes emerged from the responses of the fund of funds managers surveyed (Fig. 24). Half of all respondents indicated that the capability of providing investors with access to a niche offering presented opportunities in the fund of funds industry. One respondent stated, “given the excess supply of private equity funds available, funds of funds have the opportunity to narrowly focus on a sector, industry, geography, or other strategy to attract like-minded investors. It is no longer simply about choosing the best managers in a broad based PE portfolio, but now choosing the best managers within a specific segment can create a successful focused FOF offering.” Separate accounts were also highlighted by a notable proportion of respondents (31%) as a key opportunity in the industry, in line with the rising levels of separate account activity as discussed earlier in this report.

When asked what presented the greatest challenges in the fund of funds industry, the issue most commonly named was returns, selected by 47% of respondents (Fig. 25). Concern over the performance of underlying managers backed and the performance of the private equity industry as a whole relative to public markets are possible factors behind such sentiment. A fifth of respondents cited a concern over investors electing to access the asset class directly as a threat to the fund of funds industry, as these LPs would not need the services of a fund of funds manager. One respondent stated: “The fund of funds industry’s greatest challenge remains the ability to generate a sufficient rate of return given the fee layers involved,” while another believes the greatest threat to the industry comes from “repetitive and over-diversified funds that fail to offer investors a specialized program.”

Preqin’s analysis clearly demonstrates that the fund of funds industry still has a part to play in the wider private equity industry in acting as a gateway for smaller and inexperienced investors to access the asset class. This base of investors has expressed overwhelming satisfaction with the performance of funds of funds. However, as the industry continues to mature and investors become more sophisticated, a growing number have and will continue to choose to go direct, particularly in an attempt to avoid the double layer of fees characteristic of funds of funds. The reality is that capital raised for private equity fund of funds vehicles is at its lowest levels. This has led to a shake-out of the industry that has been observed in the last few years. The managers that are able to survive are those that can move away from reliance on the traditional model of raising commingled funds, offering services to suit the needs of a more sophisticated investor universe.

That includes offering customized mandates, exposure to niche industries, and an increased emphasis on secondaries and co-investments. We will wait and see how the industry evolves and how the players within will respond and adapt.

**Fig. 24:** What Private Equity Fund of Funds Managers Consider to be the Greatest Opportunities in the Industry in the Next 12 Months

**Fig. 25:** What Private Equity Fund of Funds Managers Consider to be the Greatest Challenges in the Industry in the Next 12 Months

For more information about Enhanced Fund Listings and Preqin Investor Network, please visit: [www.preqin.com/efl](http://www.preqin.com/efl)
With global coverage and detailed information on all aspects of the private equity asset class, Preqin’s industry-leading Private Equity Online services keep you up to date on all the latest developments in the private equity universe.

**Source new investors for funds and co-investments**

Find the most relevant investors, with access to detailed profiles for over 5,200 institutional investors actively investing in private equity, including future fund searches and mandates, direct contact information and sample investments.

**Identify potential investment opportunities**

View in-depth profiles for over 2,100 unlisted private equity funds currently in the market, including information on investment strategy, geographic focus, key fundraising data, service providers used and sample investors.

**Find active fund managers in private equity**

Search for firms actively targeting private equity investments. View information on key contacts, firm fundraising and performance history, and applied strategies of the firm when investing in portfolio companies and assets.

**See the latest buyout and venture capital deals and exits**

View details of more than 88,000 buyout and venture capital deals, including deal value, buyers, sellers, debt financing providers, financial and legal advisors, exit details and more. Identify forthcoming exits and expected IPOs.

**Benchmark performance**

Identify which fund managers have the best track records, with performance benchmarks for private equity funds and performance details for over 6,600 individual named funds.

**Examine fund terms**

Use our unique Fund Terms Calculator to model fee changes and see: what are the typical terms that a private equity fund charges? What are the implications of making changes to different fees? How do these fees vary between fund types and geographies?