Preqin LP Survey Special Report
Cautious Optimism Amid the Turmoil

November 2008

Private Equity • Real Estate • Hedge Funds • Infrastructure

Preqin LP Survey Special Report
Objectives
Methodology

Objectives:

Investors have seen all asset classes suffer during the recent market turmoil, and the long-term outlook remains highly uncertain. In order to assess the impact on institutions' private equity programs, and their future intentions for the asset class, Preqin's LP Survey team has undertaken a survey of current LP opinion and sentiment.

LP Sample and Methodology:

Preqin's LP Survey team polled 100 investors during September and October 2008, covering a representative sample of small, medium and large institutions globally. 51 institutions were from North America, 43 from Europe (of which 13 UK, 12 Scandinavia and 18 mainland Europe), and 6 were from the rest of the world. 31 were public pension plans, 20 fund of funds, 15 endowments and the remaining 34 were spread across asset managers, insurance companies, family offices, private sector pension plans, investment companies, banks and sovereign wealth funds. The sample did not include individuals.

The institutions ranged from those with assets under management of less than $500 million to those with $50 billion and more under management. Aggregate AUM for the 100 institutions polled totalled $1.7 trillion. In terms of their allocations to private equity the institutions ranged from those with less than $50 million to those with $5 billion of private equity investments and more (of which there were five.) The aggregate private equity allocation of the 100 institutions was approximately $93 billion.

In other words, the survey covered a representative sample of institutions investing in private equity worldwide, oriented towards the middle and larger end of the size spectrum. The survey was conducted at a time of heightened anxiety for investors, while the current market turmoil was unfolding.

For more information on Preqin's LP Survey service, please see page 6 of this report, or email survey@preqin.com for further details. For more information on Preqin, including contact details, please see page 7, or visit our website:

www.preqin.com

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Return Expectations

Return Expectations:

Unsurprisingly, the prospect of achieving excellent target returns is the primary motivator behind most institutions investing in private equity, with 81% of the institutions polled claiming this to be important or very important to their decision to invest.

These institutions recognize that the past five years have been a period of unusually high returns for private equity investors, and there has been much commentary in the private equity press and general financial press that this level of returns cannot be expected to continue indefinitely. It is therefore not surprising that a majority of the institutions polled expect returns over the next five years to be lower than those over the past five years, with most institutions expecting gross IRRs to decline by between 0 and 500 Basis Points (see Fig. 1.)

(The weighted average expectation appears to be for gross IRRs to be around 150 Basis Points lower.)

Despite the general expectation that future returns may not be as high as those in the recent past, and indeed a recognition that many investments made during 2006 and 2007 may prove to be very difficult, there is also a widespread appreciation that historically funds that have had their investment periods during market downturns have often been among the best-performing vintages. With stockmarkets currently on multi-year lows, and sellers' price expectations declining, there is widespread recognition among the GP community that we may be entering a very attractive time at which to be making private equity investments.

This is not lost on LPs who, despite recognizing that returns may find it difficult to match those of recent years, are nevertheless reasonably bullish about prospective returns from private equity investments over the coming five years (see Fig. 2.)

The median expected gross IRR is in the 15% - 20% range, and the average expectation among LPs polled is for 17.4%.

Fig. 1: LP Return Expectations, Next 5 Years Vs. Past 5 Years

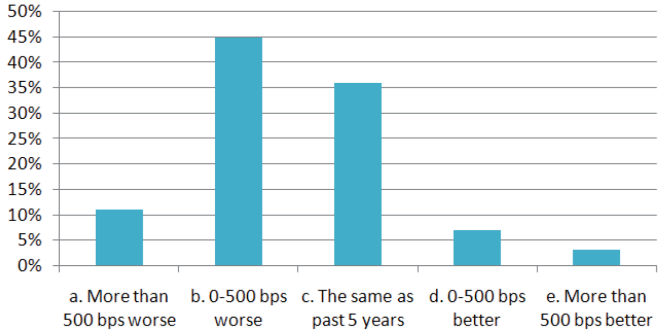
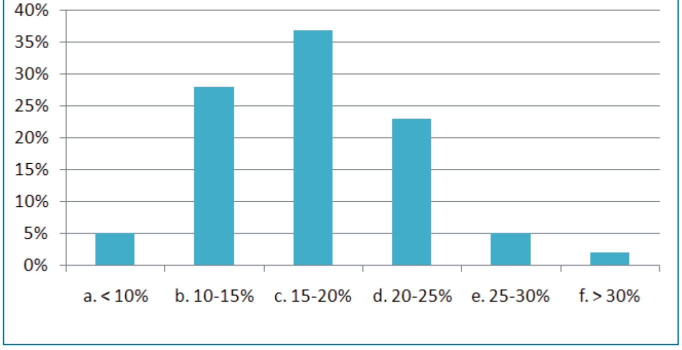


Fig.2: LPs' Return Expectations - Gross IRR for Next 5 Years



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Future Fund Commitments

LPs Approaching Target Allocations

Future Fund Commitments:

We polled investors on the fund strategies that they currently commit to, and those that they intend to commit to in the future. Interestingly, a very high proportion of all investors (86%) intend to continue allocating to the strategies that they already invest in, particularly the core traditional areas of buyouts (including small, mid-market and large buyout funds) and venture. Our survey found little evidence of LPs moving away from these areas.

It was particularly interesting to see the fund strategies where we found new LPs intending to allocate to them in the future who are not currently invested in these strategies, especially the following:

- Distressed debt
- Secondaries
- Mezzanine
- Real estate
- Fund of funds

With a positive balance of more significant LPs interested in investing in these fund strategies, they look set to grow. While we were not surprised to see distressed debt, secondaries and mezzanine among the areas likely to grow, it was interesting to see real estate and fund of funds included in the list.

Most LPs Approaching Target Allocations:

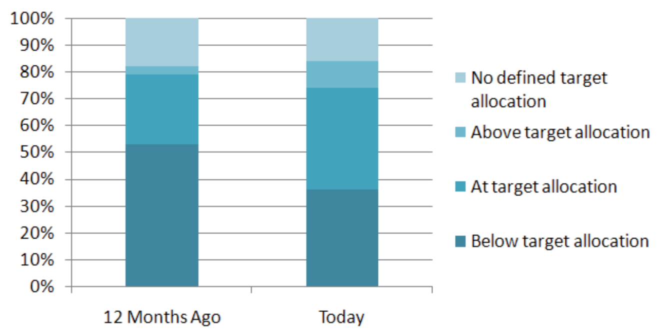
The tremendously strong fundraising markets of 2004 – 2007 benefited from the rapid pace of distributions from previous vintages: LPs committed to new funds in an attempt to reach their target allocations, but such was the pace of distributions back to them from their existing funds, they were generally not getting any closer to their targets. As a result, many LPs increased their rate of commitments, fuelling the fundraising boom.

This virtuous circle obviously could not last indefinitely, and in 2008 it has clearly ground to a halt. Distributions have slowed to a trickle, and many LPs are now approaching or, in some cases, above their targets. Fig. 3 shows how LPs' commitments vs. target allocations have evolved over the past 12 months to October 2008. In 2007, just over half of all LPs (53%) were under their target commitments to private equity, while in 2008 that figure has declined to only 36%. A year ago only 29% of all LPs were at or above their target commitments, now nearly half of them (48%) are.

This shift in actual vs. target allocations will clearly have major implications for private equity fundraising over the medium term, with the clear result being a relative decline in the market over the next couple of years.

However, it is important to maintain perspective in the light of the current extreme conditions in global financial markets.

Fig. 3: More LPs Now At or Above Target Allocation



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Impact on Private Equity Fundraising
Consultants Playing a Growing Role

Impact on Private Equity Fundraising:

While some commentators are predicting several years of very depressed fundraising markets, Preqin sees things differently. The final quarter of 2008 and early 2009 are indeed likely to be very depressed – after all, few investors will be making 10-year commitments to any investments in the immediate current market, so private equity fundraising will inevitably be impacted. However, over the medium term the prospects for PE fundraising are reasonably strong:

- While a higher proportion of LPs are now at or above their target allocations, a significant proportion (36%) are still below their targets;
- As stated previously, most LPs have reasonably bullish expectations for PE returns over the medium term, so the established trend for more LPs to enter private equity for the first time, and for existing LPs to increase their allocations, looks likely to continue;
- The well-documented 'denominator effect', whereby LPs are constrained from making commitments to new PE funds because of the decline in value of their other invested assets, may last for some time, but is unlikely to be permanent: with many financial markets at multi-year lows, and listed stocks trading on very inexpensive multiples, a market recovery is likely at some time; and
- Finally, private equity GPs see many opportunities for investment in the current markets, so a record number of new funds are currently out on the road. Over 1,600 new funds worldwide are on the road, with aggregate targets in excess of $900 billion. LPs looking to invest have many opportunities to consider.

Preqin's conclusion from the evidence is that fundraising will likely be depressed in 2008 and 2009, but we expect a good recovery thereafter.

Unfortunately, none of this means that fundraising will be easy for GPs: 2008 and 2009 will clearly be difficult, and even after that the record number of new funds on the road will make things extremely competitive for GPs raising their funds.

Consultants Playing a Growing Role:

LPs use a variety of methods to make their investment decisions when committing to new PE funds. Taken across the sample as a whole, 52% of the LPs polled rely primarily upon their own internal resources to make their investment decisions, while 32% of them relied primarily upon external consultants (or 'gatekeepers') , with the balance of 16% using a combination of internal and external resources to make their decisions.

As might be expected, the reliance placed upon internal vs. external resources is partly a function of the size of each LP's private equity program. Almost half (48%) of the LPs polled with PE programs of $100 million or less rely primarily upon external consultants, while this proportion falls to only 17% for LPs with programs of $1 billion or more.

Interestingly, the role and position of external consultants in advising LPs looks secure: 91% of the LPs polled said they were likely to continue using their existing approach to making investment decisions, while 7% considered it likely that they would increase their use of consultants, and only 2% thought it likely that their use of consultants would decrease.

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Focused Firms in Strongest Position

Manager Selection: Trust and Alignment

Focused Firms in Strongest Position:

PE firms pursue many different strategies, from those with a very focused 'pure play' strategy focused on single type of fund, to those who straddle many different fund strategies, and aim to offer LPs more of a 'one stop shop'. When asked if they would generally prefer to invest with a 'one stop shop' or a firm with a 'narrow focus', or one that was 'somewhere in the middle', 40% of LPs preferred a narrow focus, 39% opted for something in the middle, and only 21% of LPs preferred a 'one stop shop'. The preference for firms with a narrow focus was especially strong among European LPs.

When asked for their reasons for this preference LPs stated that they saw the most important advantages of investing with a 'pure play' firm were a focused investment strategy, and the perceived smaller risk of 'style drift' from the manager.

Key Factors in Manager Selection: Trust and Alignment

Preqin asked LPs how they rated various factors when selecting managers, rating these as 'very important', 'important', or 'less important. We scored each factor on a scale of +1 to -1, with a score of +1 meaning that all LPs rated the factor as 'very important', and -1 meaning that all LPs felt the factor was 'less important'.

Fig. 4 shows the results of the poll, and ranks the factors according to their perceived importance among LPs. Perhaps unsurprisingly, the ability to demonstrate a track record of strong returns is the most important factor of all, the 'sine qua non' for LPs – the GP absolutely needs to be able to demonstrate this.

Interestingly, the various 'technical' aspects of a GP's proficiency and strategy – reporting standards, their deal sourcing network, whether they have a strong focus on operational aspects etc. – rate low down the list. Conversely, it is the 'soft' or 'relationship' factors that rate much higher – the depth of the team, the perceived alignment of interest, the general experience of the GP etc., which rate very highly.

Perhaps the importance that LPs ascribe to these 'soft' factors should not be surprising: committing to a 10-year PE fund has often been likened to a marriage, so the relationship, trust, and alignment are bound to be of paramount importance.

GPs hoping to raise new funds in today's challenging and competitive market would do well to remember these lessons, and keep them front of mind when developing and executing their entire LP relations and fundraising strategy.

Fig. 4: LP Rating of Importance of Factors When Selecting Managers

Factor	Score (Importance)
Track record / prior returns	+0.8
General PE experience	+0.8
Alignment of interest	+0.6
Depth of team	+0.6
Team dynamics / stability	+0.4
Specific industry experience	+0.2
Operational focus	+0.2
Reporting and monitoring	+0.2
Deal sourcing network	+0.1
Fund terms and conditions	+0.1
Co-investment opportunities	-0.6

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Summary

Preqin LP Survey Services

Summary:

LPs fully understand the challenges facing markets generally, and private equity in particular. Despite this, they are cautiously optimistic of the prospects for private equity, and appear set to continue the longer-term trend of making increased commitments to the asset class.

They assess new fund commitments carefully, and place particular emphasis on trust and alignment of interest with the GP when doing so. Private equity firms should bear this in mind when developing and implementing their LP relations and fund-raising strategies.

Preqin LP Survey Services:

In addition to conducting regular LP surveys for its own research purposes, Preqin also undertakes research and surveys on behalf of GP clients, and also maintains the world's most comprehensive database of LP profiles, used by its clients to assist them in targeting and connecting with the best LP prospects for their new funds.

Our LP Survey service enables fund managers, advisors and other private equity professionals to gauge the reaction of the investor community to new vehicles and strategies. Our team of analysts can either identify appropriate contacts to approach, or will work with a list of survey participants provided by the client.

- Gauge the reaction of institutional investors to fund strategy, geographic focus, size and more.
- Assess the satisfaction of your current LPs, highlighting area where their expectations are being met, and where improvement is needed.
- Excellent way to contact existing LPs and evaluate satisfaction with performance and ascertain potential interest in a follow on fund.

More info: please email survey@preqin.com

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About Preqin:

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Our customers can access this market intelligence in four different ways:

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Approach:

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Our information is drawn from as many sources as possible, with our large teams of dedicated analysts working to ensure that our research is far reaching, detailed and up to date.

A large proportion of our research and data is exclusive to Preqin, and is not available anywhere else.

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