PREQIN SPECIAL REPORT:
PRIVATE EQUITY FUND MANAGER OUTLOOK

H1 2018
FOREWORD

The private equity industry continues to grow and evolve, presenting new opportunities and challenges for fund managers as they go into 2018. Preqin surveyed over 350 private equity fund managers in November 2017 to gauge their views on a wide range of topics, including the key issues affecting the industry, deal flow, the exit environment, investor appetite and future fundraising plans.

After years of rising prices, valuations remain the number one concern facing private equity fund managers. Fifty-eight percent of surveyed fund managers believe that pricing for portfolio companies is higher than 12 months ago and consequently 30% reported that they are finding it more difficult to find attractive investment opportunities. While many fund managers remain confident in their ability to innovate and find value, a significant proportion (36%) reported that they are reducing the targeted returns for their funds due to current valuations.

Despite these challenges, there remain many sources of optimism for GPs. Fund managers predict an improvement in the exit environment in the year ahead, with 39% expecting to see increased exit activity across the industry, while 56% expect their firm to make more exits than last year. Investor demand also remains as strong as ever, with 67% of fund managers noting an increase in investor appetite for private equity over the past 12 months. This is contributing to a strong fundraising environment and a healthy pipeline of funds coming to market: 24% of surveyed managers are already in market with their next fund, with a further 36% planning to begin raising new funds in 2018.

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The continued success of the private equity asset class in recent years, with strong returns and distributions to investors, has helped to drive increased investor interest in the asset class and growing levels of assets under management (AUM). It has, however, also brought its own challenges as higher levels of dry powder held by private equity firms have increased competition for assets and helped to drive up pricing.

In November 2017, Preqin surveyed over 350 private equity firms globally to record their views on the key challenges facing the industry. For the third consecutive year, high company valuations were identified by the largest proportion of respondents as the biggest challenge in 2018 (Fig. 1), both globally and in each major region.

The raised valuations being paid for portfolio companies have become increasingly clear to fund managers over the past year. Fifty-eight percent of fund managers surveyed reported that pricing for portfolio companies had increased compared to 12 months ago – this is 22 percentage points higher than the recorded response in 2016’s survey. High valuations feed into the second major concern among fund managers: performance. While rising valuations increase the likelihood that fund managers will be able to earn favourable returns on their current investments, they reduce the opportunity for firms to acquire new assets at sufficiently affordable prices to generate the high returns that investors have come to expect. Accordingly, 36% of fund managers reported that they are reducing their targeted returns for future funds due to high valuations in the market, compared to only 11% that plan to increase their targets (Fig. 2).
DEAL FLOW AND COMPETITION

Distributions continue to outstrip capital calls, causing high LP liquidity and increased investor appetite for private equity investments, which in turn creates competition among managers. As Fig. 3 illustrates, 92% of respondents have stated that finding attractive investment opportunities is just as difficult or harder than 12 months ago – although the reality is that, regardless of competition, GPs will have to continue to put the record levels of accrued dry powder to work.

A side effect of the difficulties fund managers are facing when sourcing attractive investment opportunities is the need to review more of them: 46% of respondents reviewed more opportunities per investment in 2017 compared to 2016 (Fig. 4). Furthermore, nearly half (49%) of fund managers have seen an increase in competition for transactions compared to 12 months ago (Fig. 5). An average of 49% of surveyed GPs saw an increase in competition across all stages of venture capital investment over 2017. However, a significant 12% and 13% of managers saw a decrease in competition for seed and late stage investments respectively. The majority (56%) of respondents cited increased competition in growth funds, while just 4% noted a decrease. Mid-market buyout transactions appear to have experienced the highest level of increased competition of any investment type, as cited by 64% of managers.

The majority of fund managers surveyed, irrespective of location, are planning to invest more capital in private equity assets in the year ahead compared to 2017 (Fig. 6). Notably, 86% of fund managers based in Rest of World regions are set to increase their investments in 2018, including 57% that will invest significantly more capital.
Although the number of buyout and venture capital exits has dropped in recent years, as shown in the 2018 Preqin Global Private Equity & Venture Capital Report, our latest survey results show that fund managers surveyed by Preqin predict a strong exit environment in 2018. Thirty-nine percent of surveyed fund managers predict increased exit activity over the next 12 months, compared to only 11% that expect activity to decline (Fig. 7).

In terms of where these exit opportunities will come, fund managers predict increased activity across all exit types but particularly through trade sales: 51% of fund managers predict increased numbers of trade sales over the next 12 months, compared to only 4% that expect to see fewer (Fig. 8). In contrast, fund managers were split on the prospects for the IPO market in 2018, with 37% expecting to see more IPOs and 20% foreseeing a slowdown in IPO activity.

In terms of their individual firms, fund managers matched their broader predictions for the market as a whole, with 56% of fund managers planning to make more exits in 2018 than they did in 2017, including 8% that plan to make significantly more (Fig. 9). By comparison, only 9% of respondents foresee making fewer exits over the next year.

Fig. 7: Fund Manager Expectations for the Exit Environment in the Next 12 Months

Fig. 8: Number of Exits Fund Managers Expect to See in the Industry over the Next 12 Months by Exit Type

Fig. 9: Fund Managers’ Planned Number of Exits in 2018 Compared to 2017

Fig. 10: Number of Buyout and Venture Capital Exits Globally, 2007 - 2017
FUND MANAGER VIEWS ON INVESTOR APPETITE

The results of our latest fund manager survey indicate that investor demand for private equity has increased over 2017. Two-thirds of fund managers reported an increase in investor appetite – up nine percentage points on 2016 survey results – with just 8% of GPs reporting a decrease (Fig. 11).

As in 2016, this increased demand has come from family offices in particular, as identified by 63% of fund managers (Fig. 12). GPs also reported a noticeable increase in demand from fund of funds managers (42%), asset managers (37%) and private sector pension funds (36%).

A significant proportion (20%) of fund managers identified banks as having shown a decrease in appetite – a direct impact of regulatory changes such as the Volcker Rule.

As the Asian private equity market matures, appetite from investors based in the region has increased: half of GPs identified an increase in demand from Asia-based LPs, the largest proportion of any region (Fig. 13). Even in the most mature private equity markets of North America and Europe, fund managers continue to see increased appetite from large proportions of investors.

The continued growth in investor appetite will be welcome news to fund managers; yet, with a record 2,485 private equity funds in market (as at February 2018), competition for investor capital remains fierce. Seventy-three percent of GPs reported an increase in competition for investor capital over the past 12 months (Fig. 14). This level has remained consistent over the past few years; however, with 53% of investors interviewed by Preqin in December 2017 planning to increase their allocations over the longer term – the largest proportion recorded – it is likely there will remain opportunities to raise capital going forwards.
The rapid growth of the private equity fund market looks set to continue in 2018, as fund managers continue to bring new vehicles to market. At the time of the survey (November 2017), close to a quarter (24%) of fund managers were already in market with their next fund, while a further 36% were planning to begin fundraising in 2018 (Fig. 15).

Fund managers are not just planning traditional commingled funds, but are also increasingly offering alternative structures to investors – a direct response to an increasingly sophisticated investor universe looking to maximize returns and reduce costs. Co-investment use, in particular, has increased rapidly in recent years: of fund managers surveyed, 52% offered co-investment opportunities in November 2015, while 64% do so as at November 2017. For many fund managers, the benefits, such as building a stronger relationship with investors and gaining access to additional capital for deals, can help outweigh the costs, such as difficulties that may arise in executing deals (Fig. 16).

Thirty-seven percent of surveyed fund managers plan to offer more co-investment opportunities in the next 12 months than they have over the past year, compared with just 4% that plan to offer fewer (Fig. 17). In addition, 18% of fund managers plan to offer more separate accounts over the next 12 months, and 15% intend to offer more joint ventures.

As investors continue to request means to adjust their portfolios to their specific risk/return preferences, demand for these vehicles is likely to increase, and their use likely to become more commonplace as fund managers seek to satisfy investor demand.
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