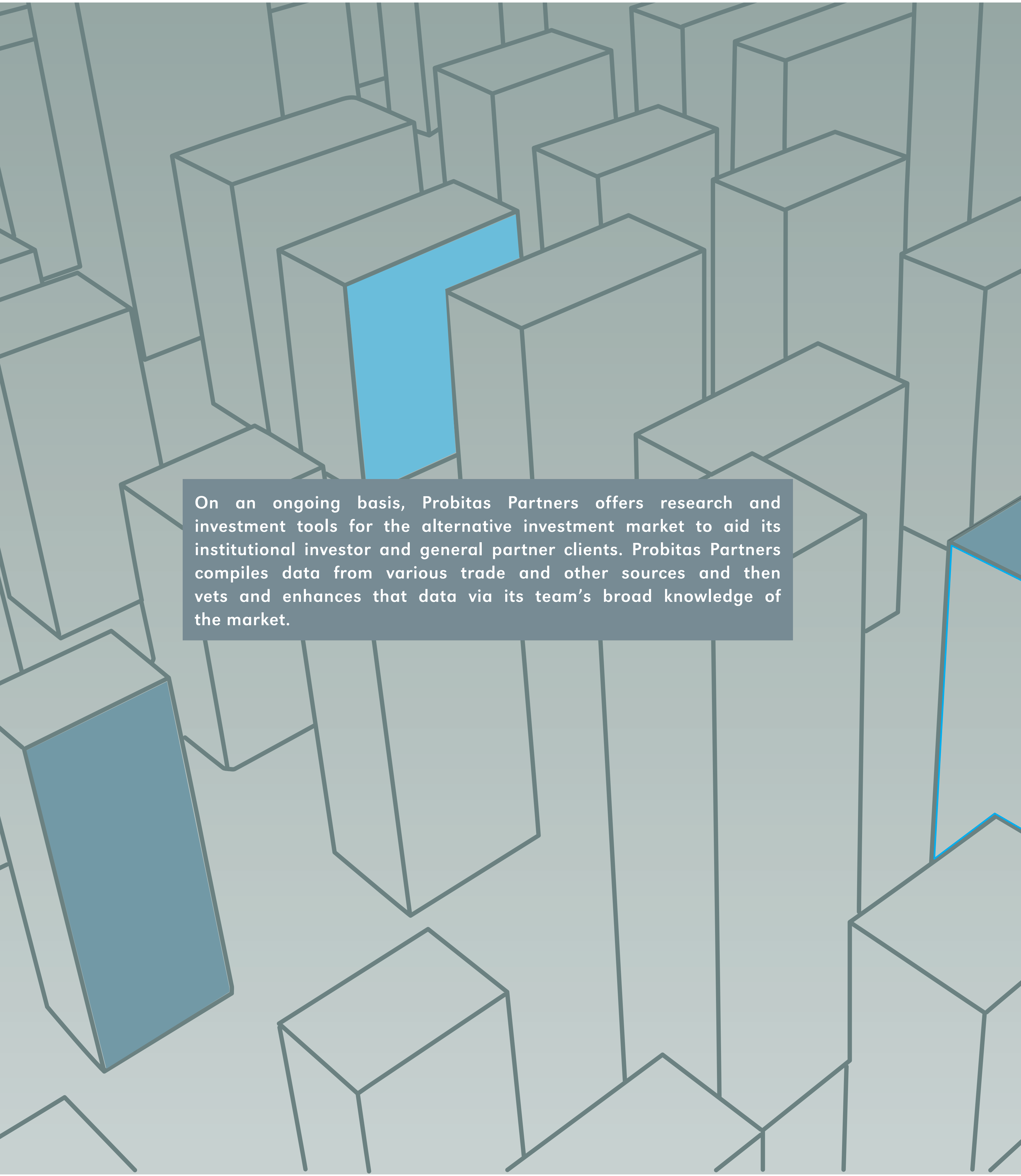
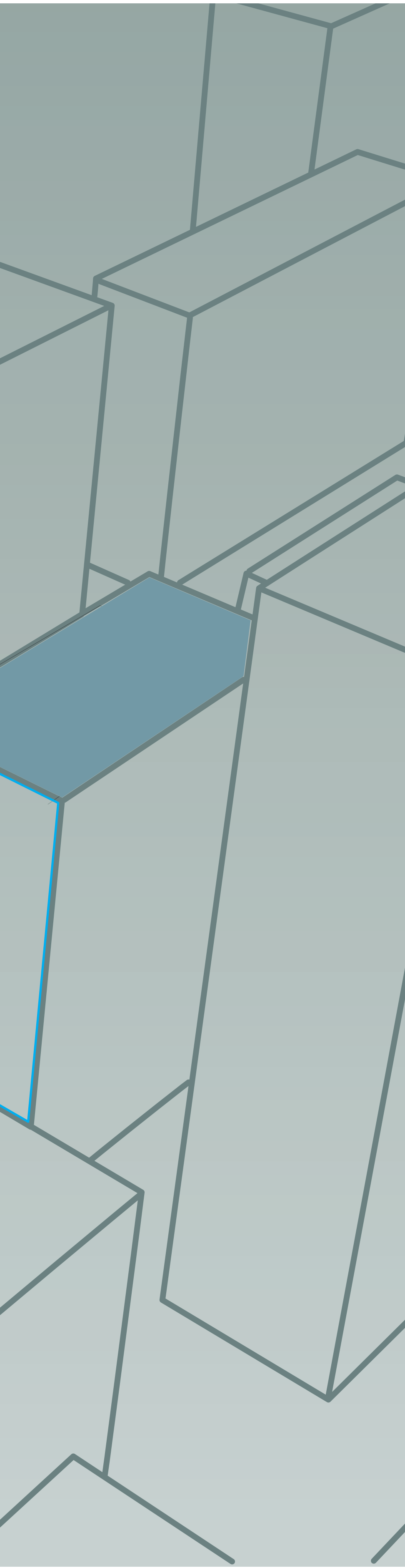
Private Equity Institutional Investor Trends for 2018 Survey

PROBITAS PARTNERS



On an ongoing basis, Probitas Partners offers research and investment tools for the alternative investment market to aid its institutional investor and general partner clients. Probitas Partners compiles data from various trade and other sources and then vets and enhances that data via its team's broad knowledge of the market.



Contents

probity (prō'bĭ·tē)

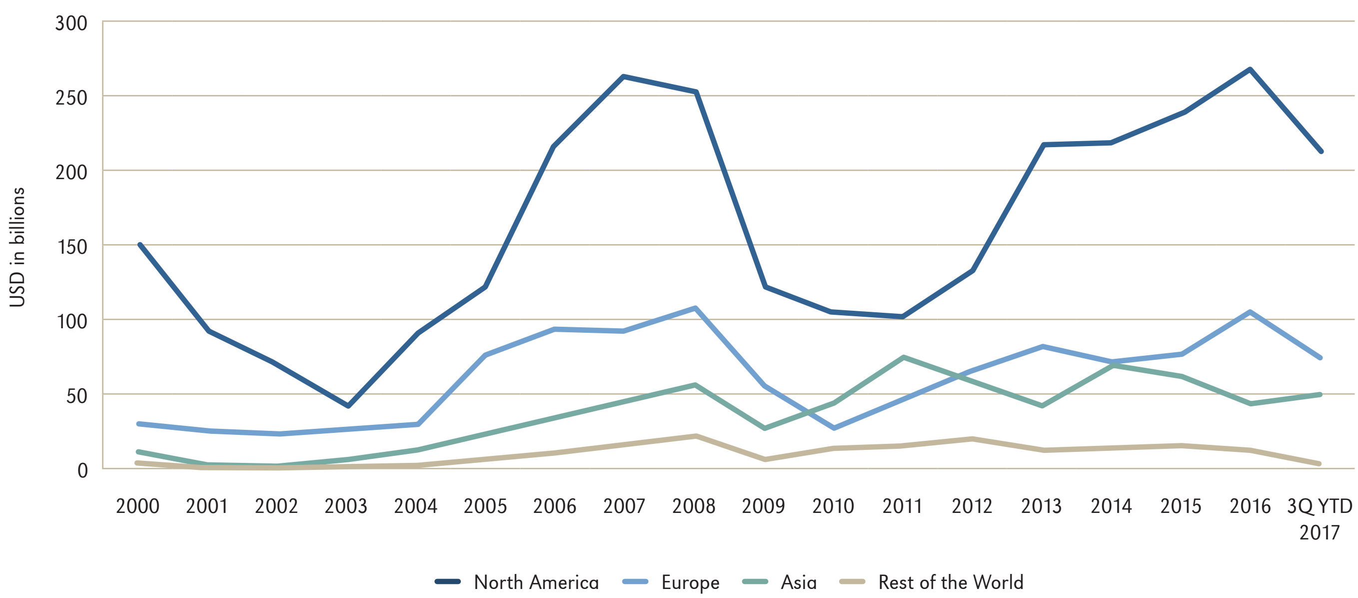
n. [from Latin probitas: good, proper, honest.] adherence to the highest principles, ideals and character.

The Private Equity Fundraising Environment

Global private equity fundraising in 2017 is on pace to not only exceed last year's total but also the peak reached in 2008 at the beginning of the Great Financial Crisis ("GFC"). Mega-buyout funds led the way, with Apollo IX closing on $24.7 billion (the largest buyout fund raised to date), CVC VII gathering commitments of €16 billion and Silver Lake V, the tech-focused fund, closing on $15 billion.

- There are several underlying trends behind the overall numbers in Chart I:
  - North America is by far the largest private equity market, attracting over 65% of the capital raised so far in 2017.
  - The capital committed amounts in the chart do not include commitments to co-investments or to separate accounts, which are more difficult to track accurately.
  - Fundraising has been volatile across market cycles, but as can be seen by comparing North America to Asia, these cycles are affected by local events and are not perfectly correlated.
  - Some of the comparative changes between geographies over time below are driven by changes in cross currency rates — all values in the chart are presented in U.S. dollars.

Chart I Commitments to Global Private Equity Partnerships



Source: PREQIN; Data as of September 30, 2017, does not include funds-of-funds

Private Equity Institutional Investor Survey

Probitas Partners' annual online survey was conducted in late September/early October 2017 to gauge investor perspective and opinions on the private equity market going into 2018. These surveys are meant to both analyze emerging trends and to compare investors' views as they change over time. Ninety-eight responses were received from investment professionals globally, representing such institutions as public and corporate pension plans, funds-of-funds, insurance companies, family offices, endowments and foundations, and consultants and advisors.

Overview of Survey Findings

The following summarizes the top-line findings from the survey:

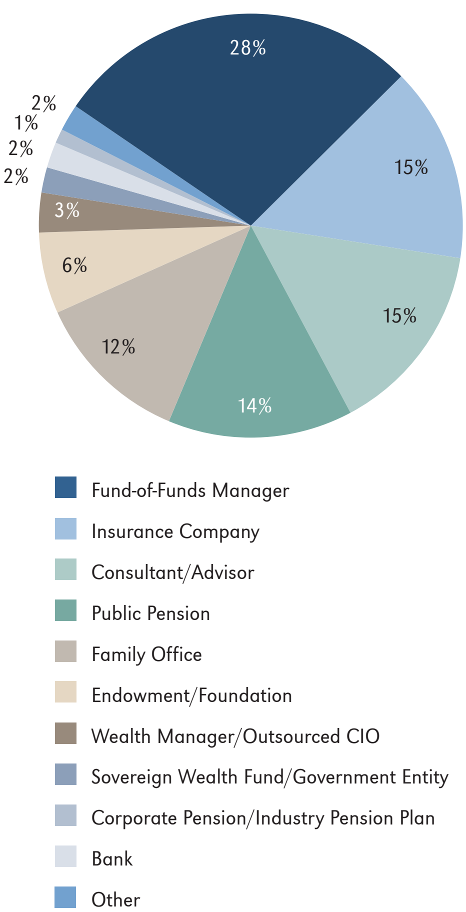
- **Several major trends and issues have persisted over the last three years.**
    - Interest in private equity remains strong with increased global fundraising.
    - However, year-by-year the fear that the market is approaching the top of the cycle has grown.
    - Middle-market buyout funds in North America and Europe continue to be the strongest focus of investors.
    - But investors are increasingly concerned that purchase price multiples in the middle-market are too high.
    - Interest in industry-focused funds continues to grow as investors look for competitive advantage, with strongest investment interest currently in the healthcare and technology sectors.
- **The strong negative sentiment by continental European investors towards investing in the UK after last year's Brexit vote has receded.** Also, both last year and this year, North American investors were strongly supportive of UK-based funds.
- **Interest in emerging markets has fallen.** On the back of continued economic and political issues in key emerging markets countries, more investors feel that the risk/return dynamic for private equity is more favorable in developed markets.
- **After three strong years, interest in venture capital has receded.** Interest in U.S. venture capital, the largest venture capital market, fell this year, and those investors who stated that they do not invest in venture capital increased.
- **As far as terms and conditions, limited partners are most focused on fund managers' capital commitments to their funds**. There is a strong feeling that this is the best way to manage potential conflicts of interest.

Profile of Respondents

- Ninety-eight institutional investors participated in this years' survey, with a number of respondents from funds-of-funds, insurance companies, public pension plans, and family offices (Chart II).
- There were a considerable number of respondents from North America, Europe, and Asia, with Japan being especially well-represented (Chart III).
- As far as overall appetite for private equity, there was relatively little change from last year (Chart IV). Nearly a third of respondents were near their target allocations with less room to back new relationships, and a quarter were under their allocations and actively looking to add relationships.

Chart II Respondents by Institution

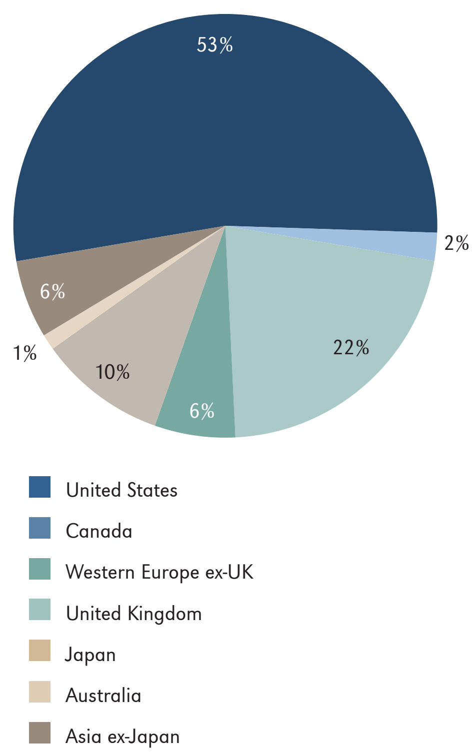
I represent a:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Chart III Respondents by Firm Headquarters

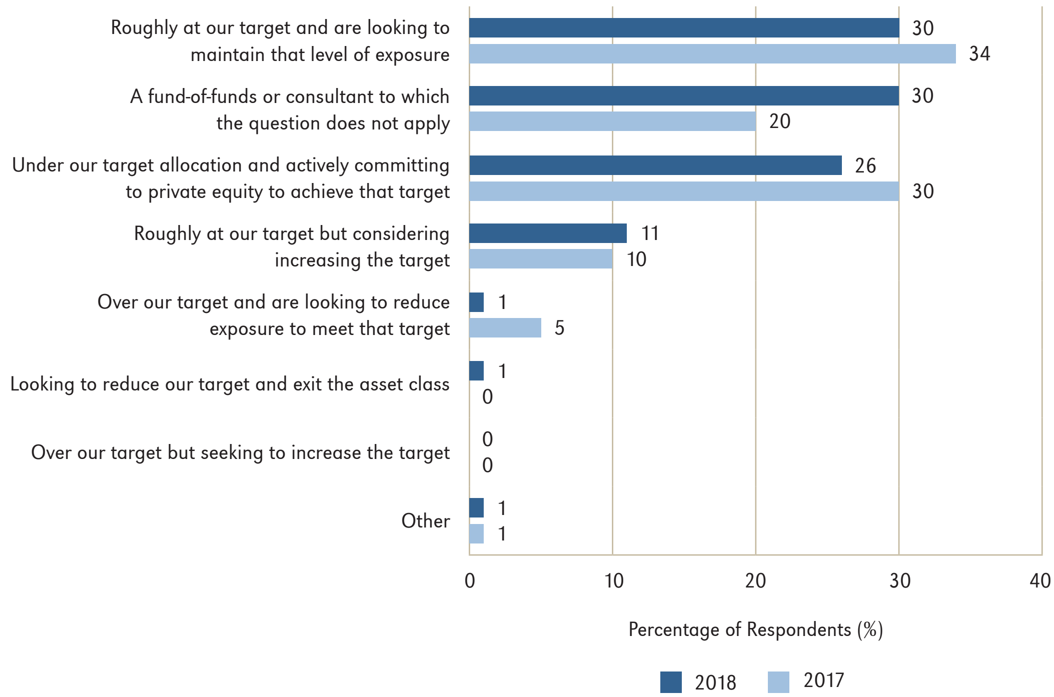
My firm is headquartered:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Chart IV Current and Target Private Equity Allocations

As far as our current private equity allocation, we are:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- As far as investors' primary strategy for targeting funds, "pursuing the best available managers and funds" remains the predominant approach, though that rationale fell slightly from 52% selecting it last year (Chart V).

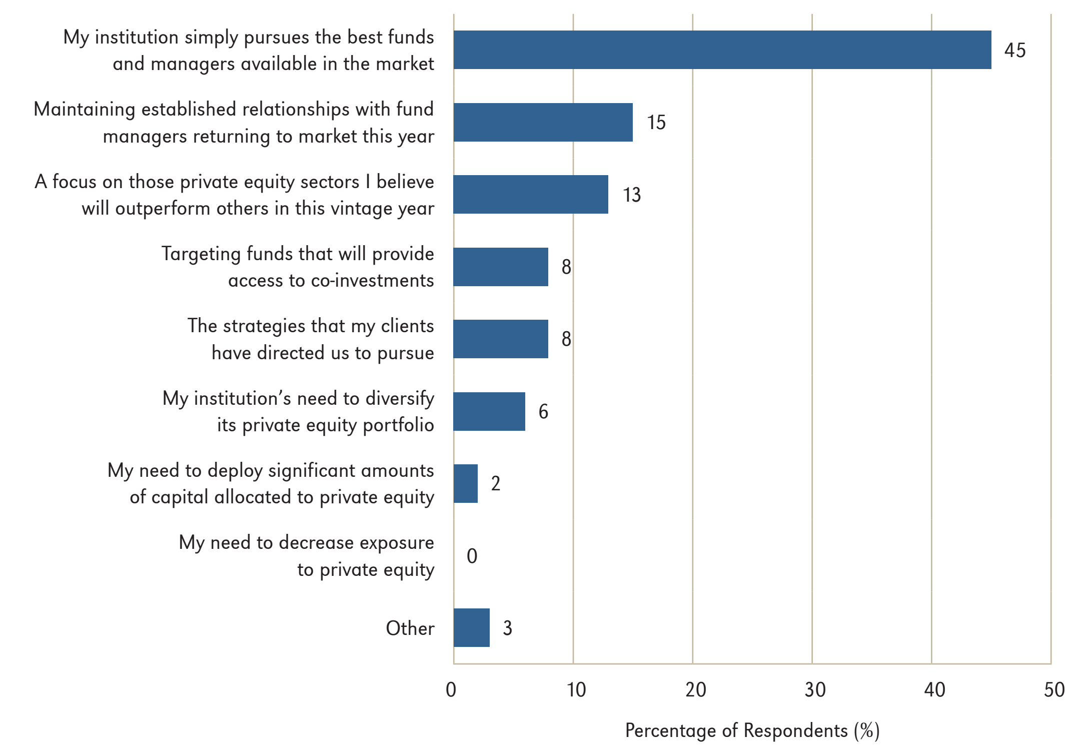
- All the other drivers of targeting specific funds were quite scattered, with no response coming close to targeting the best available managers. No respondents were driven by a need to decrease their exposure to private equity.

- Respondents to the survey represented diverse types of investors from very large to very small (Chart VI).

- Over the past three years, respondents have been most focused on re-ups with fund managers with whom they already have a relationship and have a more limited look at backing new managers (Chart VII). However, this year also saw a modest increase in those actively targeting new relationships.

Chart V Drivers of Sector Investment

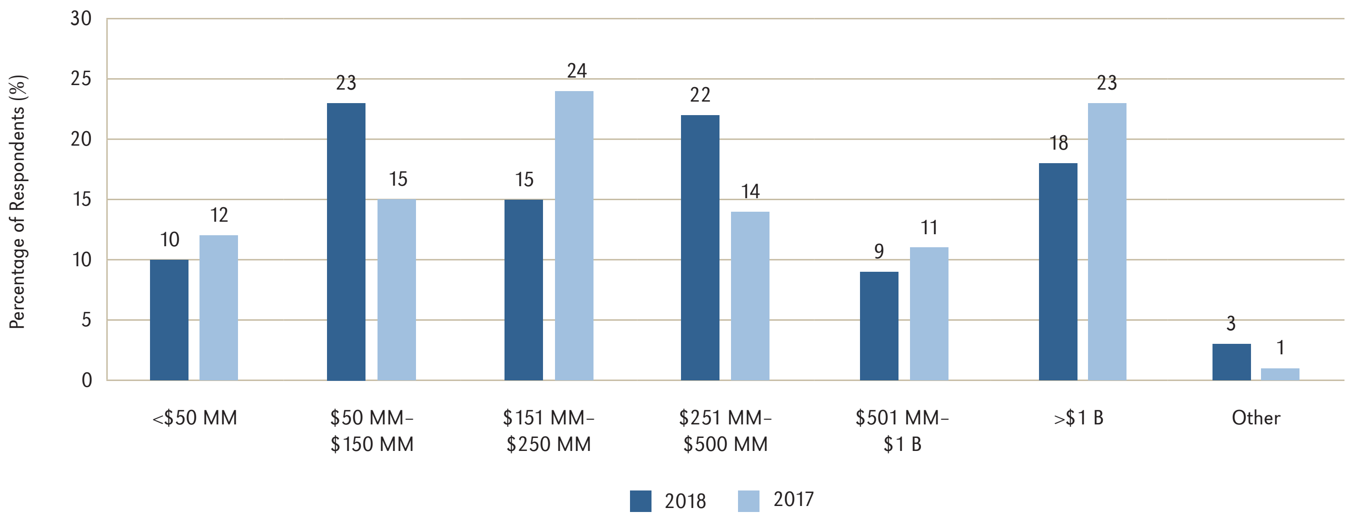
Our sector investment focus in 2018 will be driven by (choose no more than two):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Chart VI Private Equity Allocations

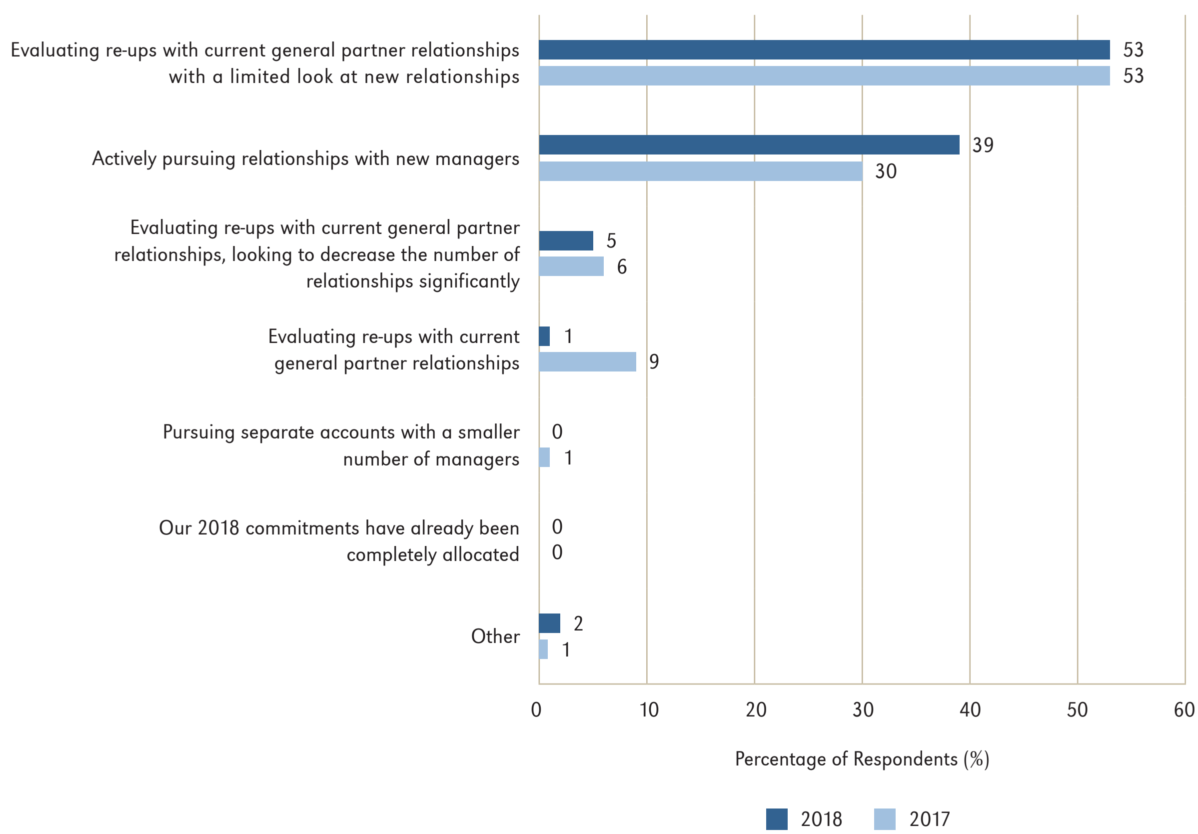
For 2018, we or the clients we advise are looking to commit across all areas of private equity (in USD):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey; Other responses were basically for respondents who had no target

Chart VII Manager Relationships

During 2018, we would expect our primary focus to be:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Sectors and Geographies of Interest

The private equity sectors of interest to investors as we head into 2018 are detailed in Chart VIII:

- U.S. middle-market buyouts, European middle-market buyouts, and U.S. growth capital funds dominate the top five spots — with special situations funds just below in sixth place.
- U.S. venture capital slipped noticeably, falling from 44% of respondents targeting it last year to 31% this year, while interest in distressed debt fell from 32% last year to 22% this year.

Table I compares differences over a longer period of the top five areas of interest from our pre-GFC 2007 survey and this year's survey.

- This year's survey had more options for investors than the pre-GFC survey (including a more detailed breakout of U.S. middle-market buyouts by size), but U.S. middle-market buyout funds and European middle-market buyout funds were clear preferences in both surveys.
- Interest in U.S. venture capital has been more volatile, falling from its high of third place in 2007 to as low as fifteenth place in 2014. It rebounded from 2015 through 2017 before having a small setback this year, falling from fourth to seventh.
- Venture capital funds focused on Europe and Asia continue to be of little interest, as has always been the case in our surveys.

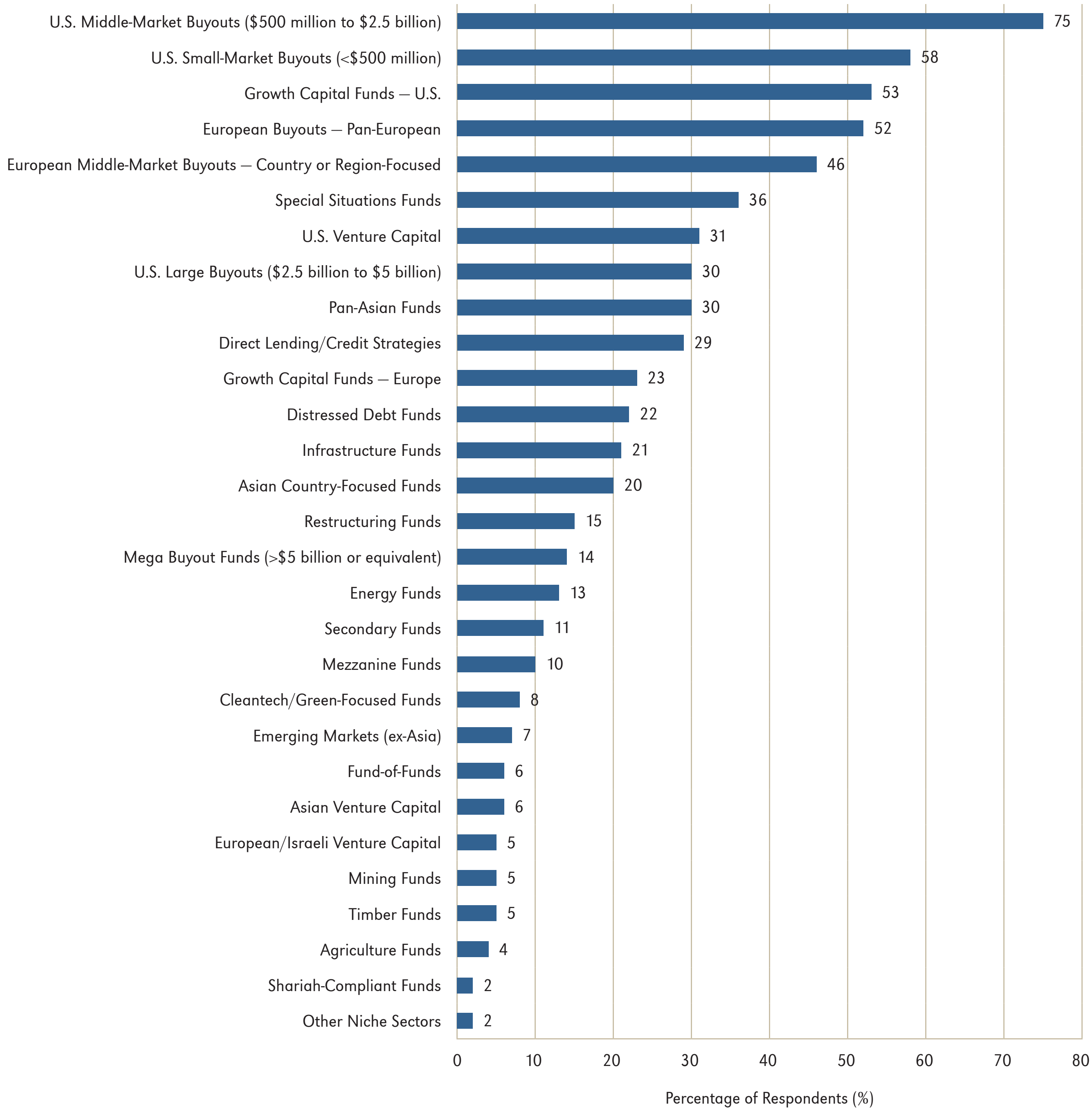
Table I Institutional Investors Focus of Attention Among Private Equity Sectors
Top Five Responses:

2007		2018	
Sector	**% Targeting**	**Sector**	**% Targeting**
U.S. Middle-Market Buyouts	49%	U.S. Middle-Market Buyouts ($500 million to $2.5 billion)	75%
European Middle-Market Buyouts	42%	U.S. Small-Market Buyouts (<$500 million)	58%
U.S. Venture Capital	34%	U.S. Growth Capital Funds	53%
Distressed Debt	30%	European Middle-Market Buyouts — Pan-European	52%
Asian Funds	25%	European Middle-Market Buyouts — Country or Region-Focused	46%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 Survey and 2018 Survey

Chart VIII Private Equity Sectors of Interest

During 2018, my firm or my clients plan to focus most of our attention on investing in the following sectors (choose no more than seven):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

North American investors represent the largest pool of capital investing in private equity globally, and North American investors were strongly represented in our survey. For that reason, it is not surprising that U.S. middle-market buyouts ranked so highly. To avoid "home town" bias in the rankings, Charts IX and X, respectively, detail how European and Asian respondents look at sectors of interest, while North Americans are broken out separately in Chart XI.

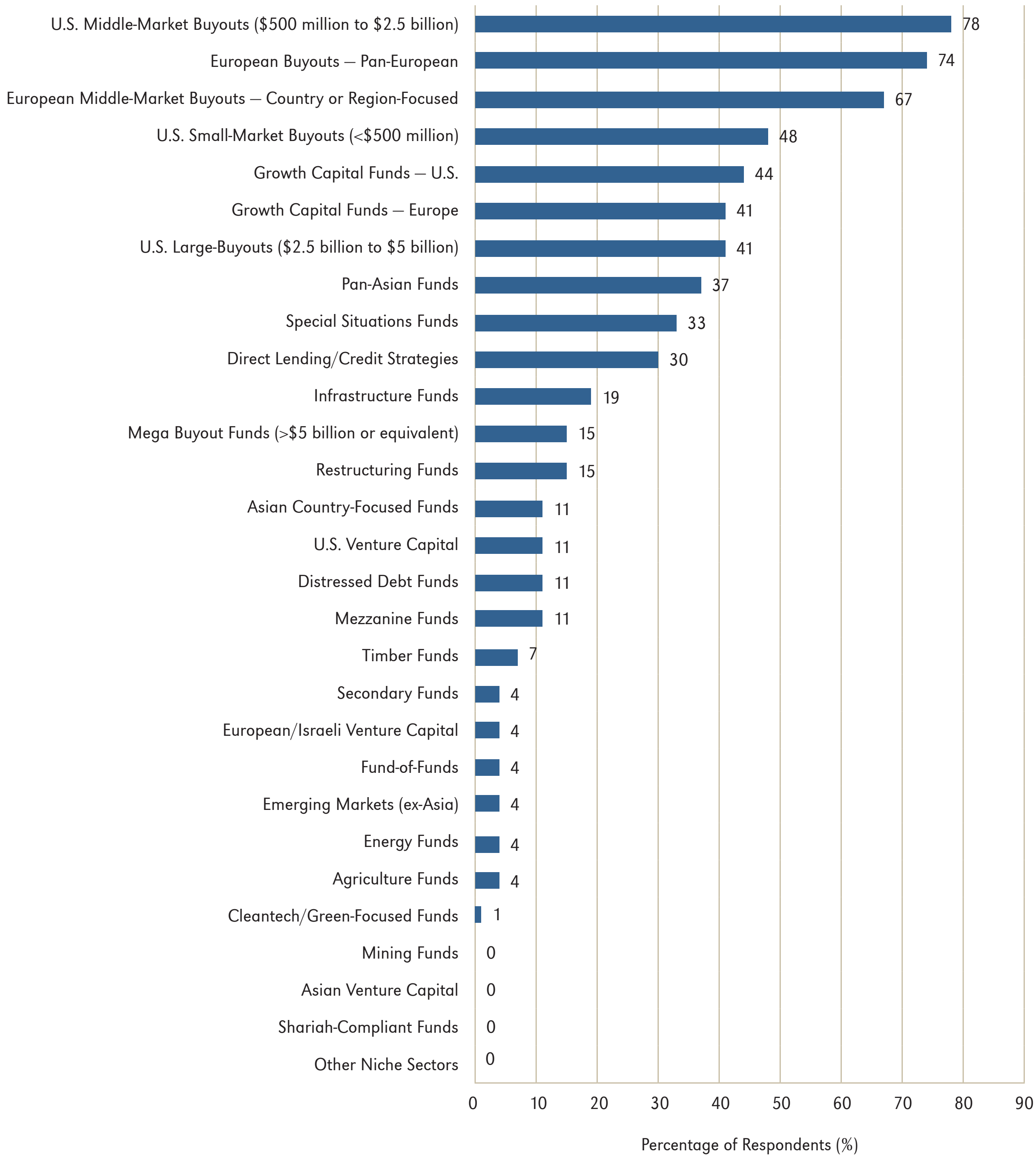
- U.S. middle-market buyouts (funds seeking $500 million to $2.5 billion) was the top-ranked sector of interest for European investors, with Pan-European buyouts and European country-focused funds following closely. U.S. small-market buyouts (those seeking less than $500 million) are of less interest to European investors as they are more difficult to access and diligence.

- Europeans more aggressively target European-focused growth capital funds, with 41% of European respondents targeting the sector compared to 23% of overall respondents.

- U.S. venture capital has always been of less interest to Europeans because the top performing managers in the sector are more difficult for them to access. However, interest by Europeans declined noticeably this year, falling from 21% last year to 11% this year. Interest by Europeans in venture capital elsewhere is not high either, with only 4% targeting European venture capital and no respondent targeting Asian venture capital.

Chart IX Private Equity Sectors of Interest; European Respondents

During 2018, I plan to focus most of my attention on investing in the following sectors (choose no more than seven):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- Investor responses from Asia (Chart X) were dominated by participants from Japan, a market whose local activity in buyouts has recently increased.

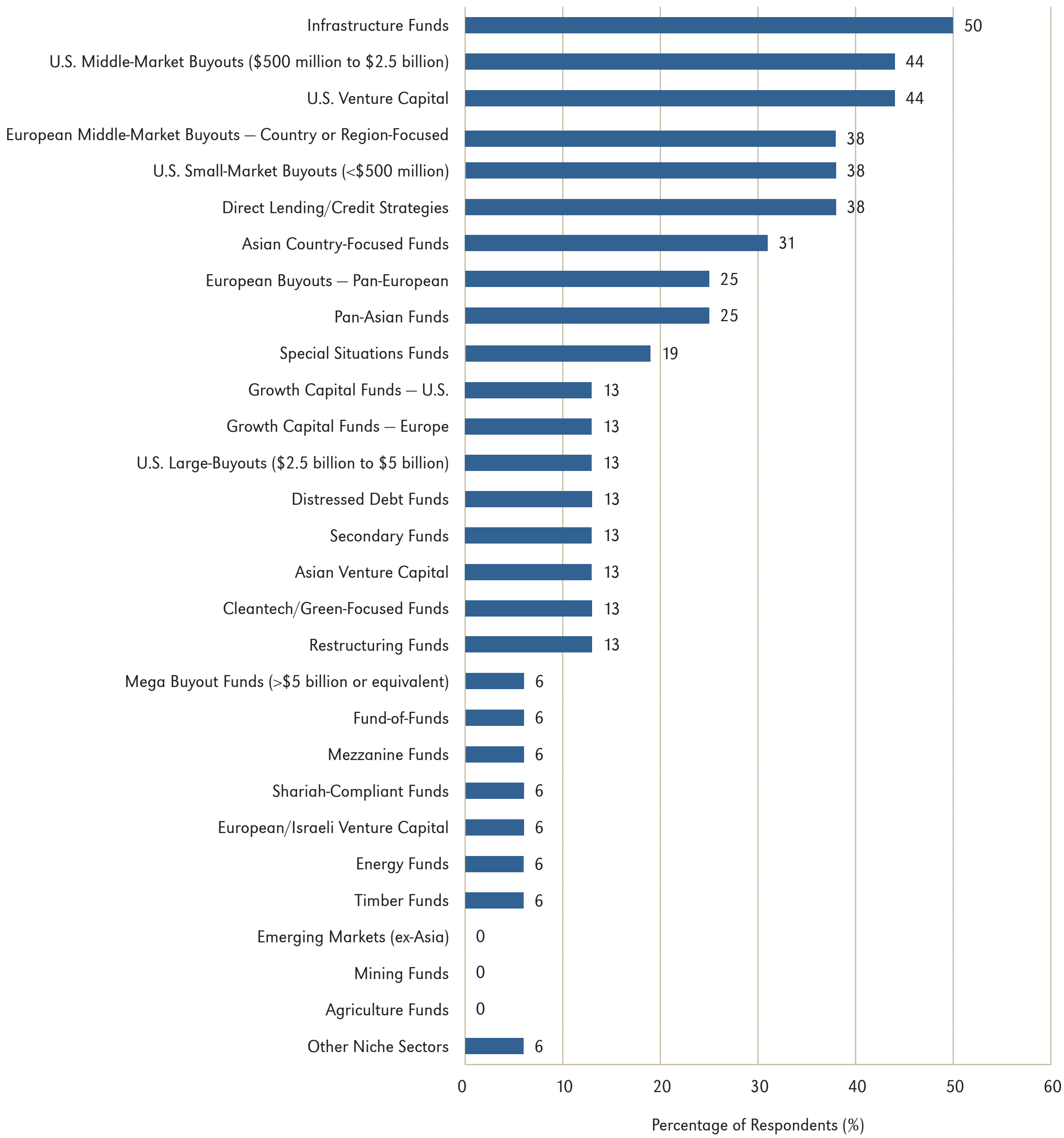
- The leading sector of interest among Asian respondents was infrastructure, driven by the fact that 70% of Japanese respondents selected it. (Certain investors make infrastructure investments out of private equity allocations, which is why this option was provided here.)

- The second-ranked area of focus among Asian respondents was a tie between U.S. middle-market funds (the leader in other geographies) and U.S. venture capital, with much more interest in the latter by Asian respondents than among European investors.

- Unlike the other geographies, local Pan-Asian and Asian country-focused funds do not rate particularly high.

Chart X Private Equity Sectors of Interest; Asian Respondents

During 2018, I plan to focus most of my attention on investing in the following sectors (choose no more than seven):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- The interest of North American respondents is detailed in Chart XI. U.S. middle-market buyouts, small-market buyouts, and growth capital funds dominated investors' interest, though Pan-European buyouts also did well.
- There was significantly more interest in North America in special situations funds than in the other geographies, reflecting the fact that distressed private equity is more established in the United States than in any other country.
- Though U.S. venture capital ranked well among North Americans, interest fell significantly from last year; in 2017 it ranked third with 54% of respondents targeting it, while this year it ranks sixth with only 38% targeting it.

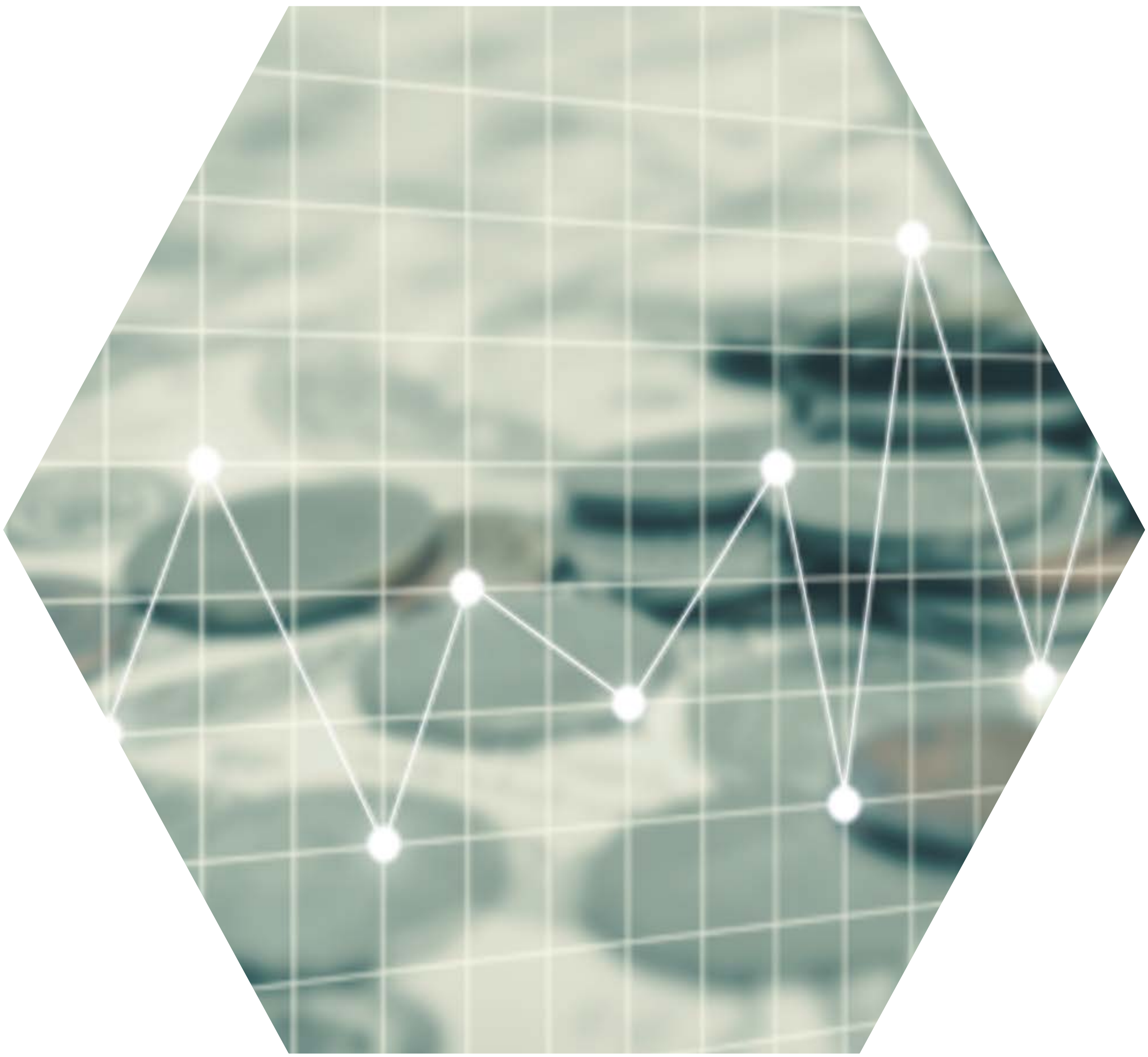
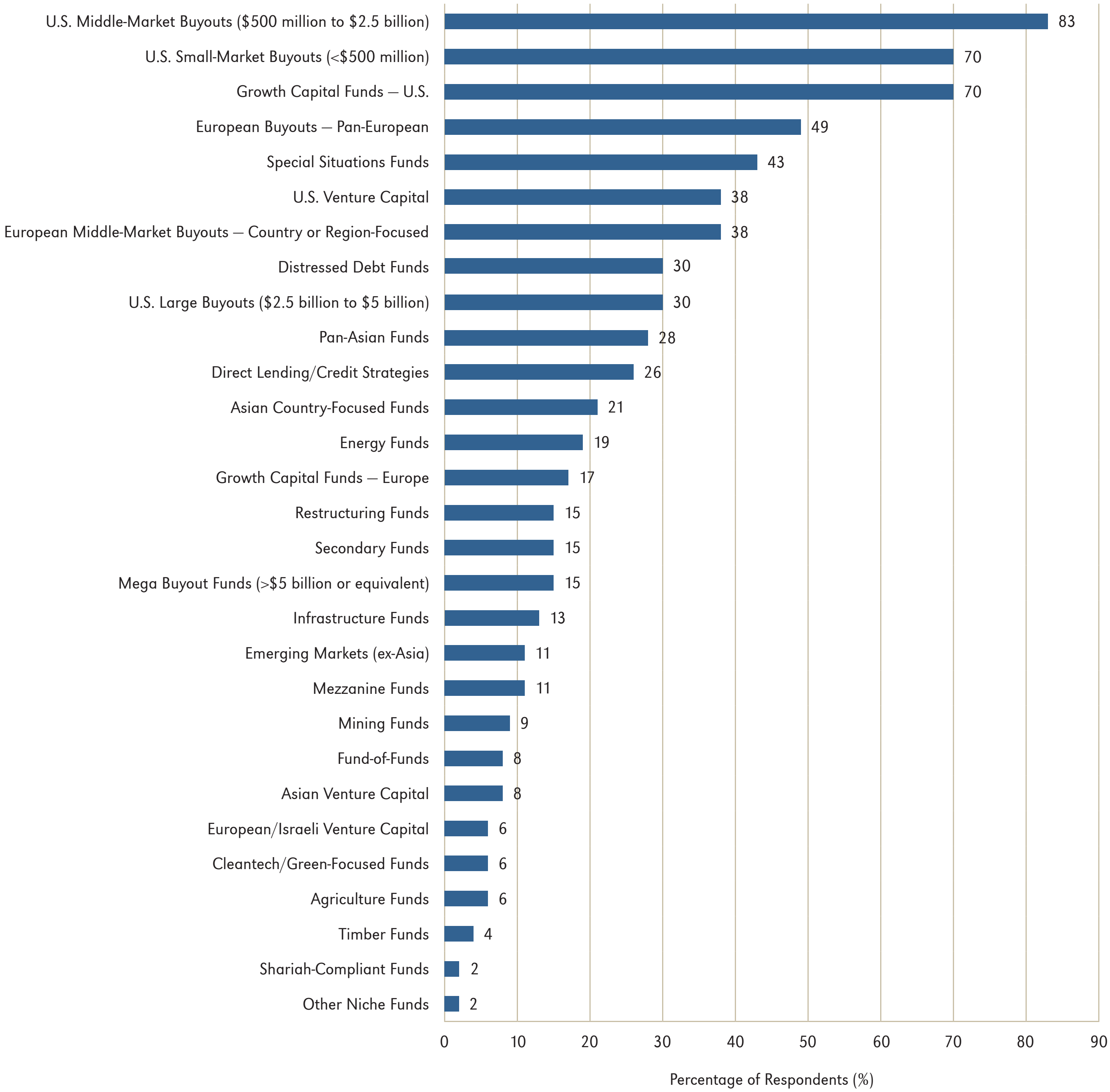


Chart XI Private Equity Sectors of Interest; North American Respondents

During 2018, I plan to focus most of my attention on investing in the following sectors (choose no more than seven):



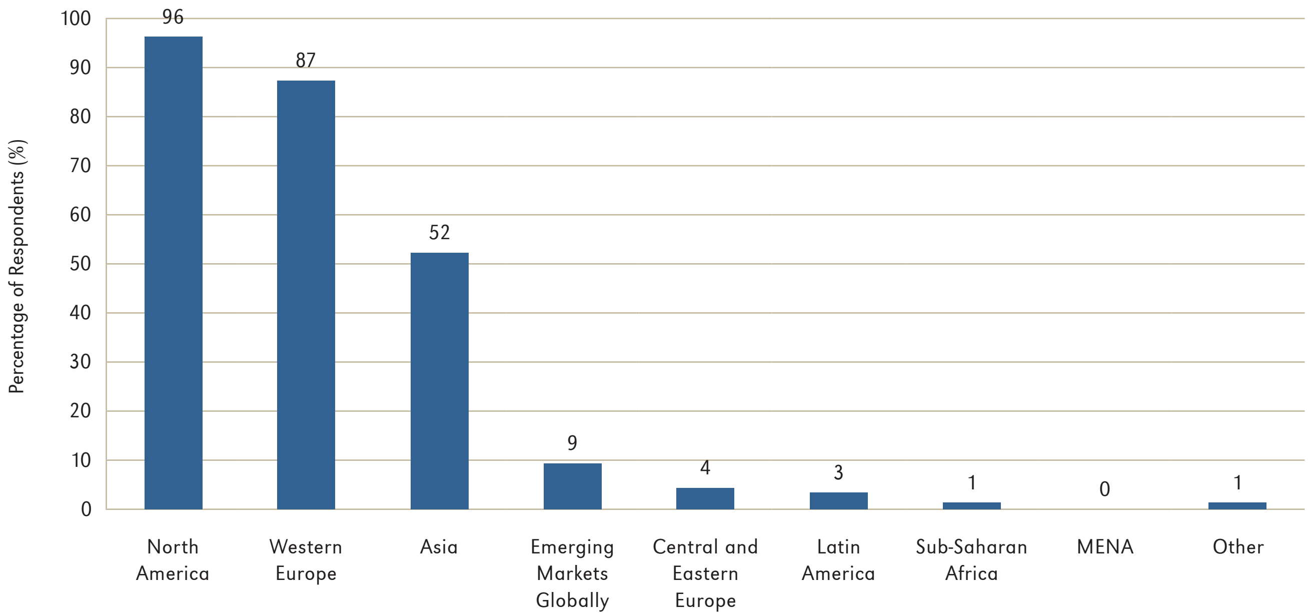
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- North America, Western Europe, and Asia continue to be the leading geographies of interest in private equity (Chart XII).

- Emerging market interest remained low this year after falling last year; interest outside of Asia remains scattered, with no other geography being a leading second choice.

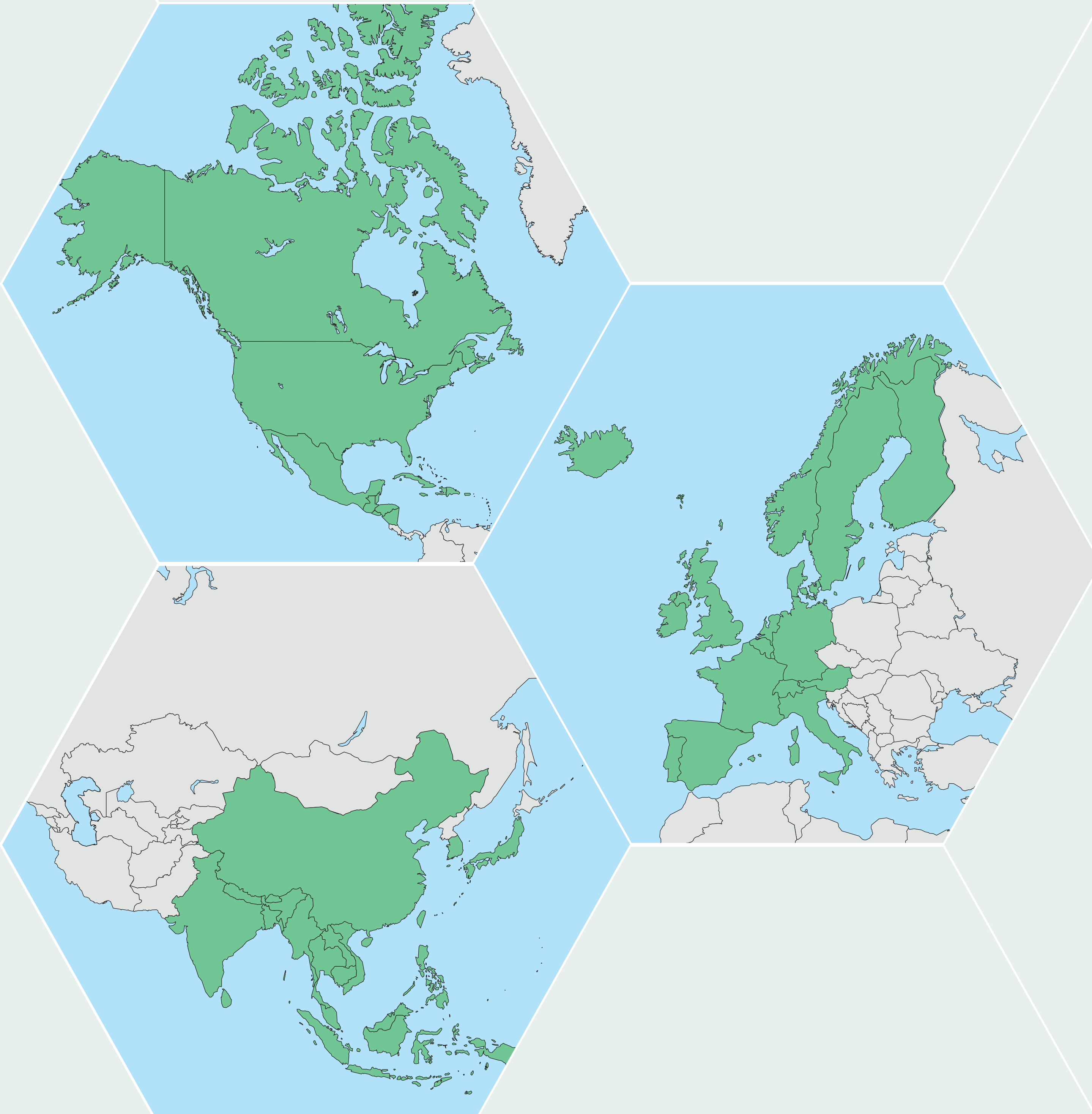
Chart XII Private Equity Geographical Focus

During 2018, I anticipate that the three primary areas of geographical focus for our programs will be:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Emerging market interest remained low this year



- As in our past surveys, the UK, the Nordic Region, and Germany, were the top three geographies of interest in the European Markets. Within those three geographies there were notable changes since last year, however, with interest in Germany falling and interest in the UK increasing (Chart XIII).

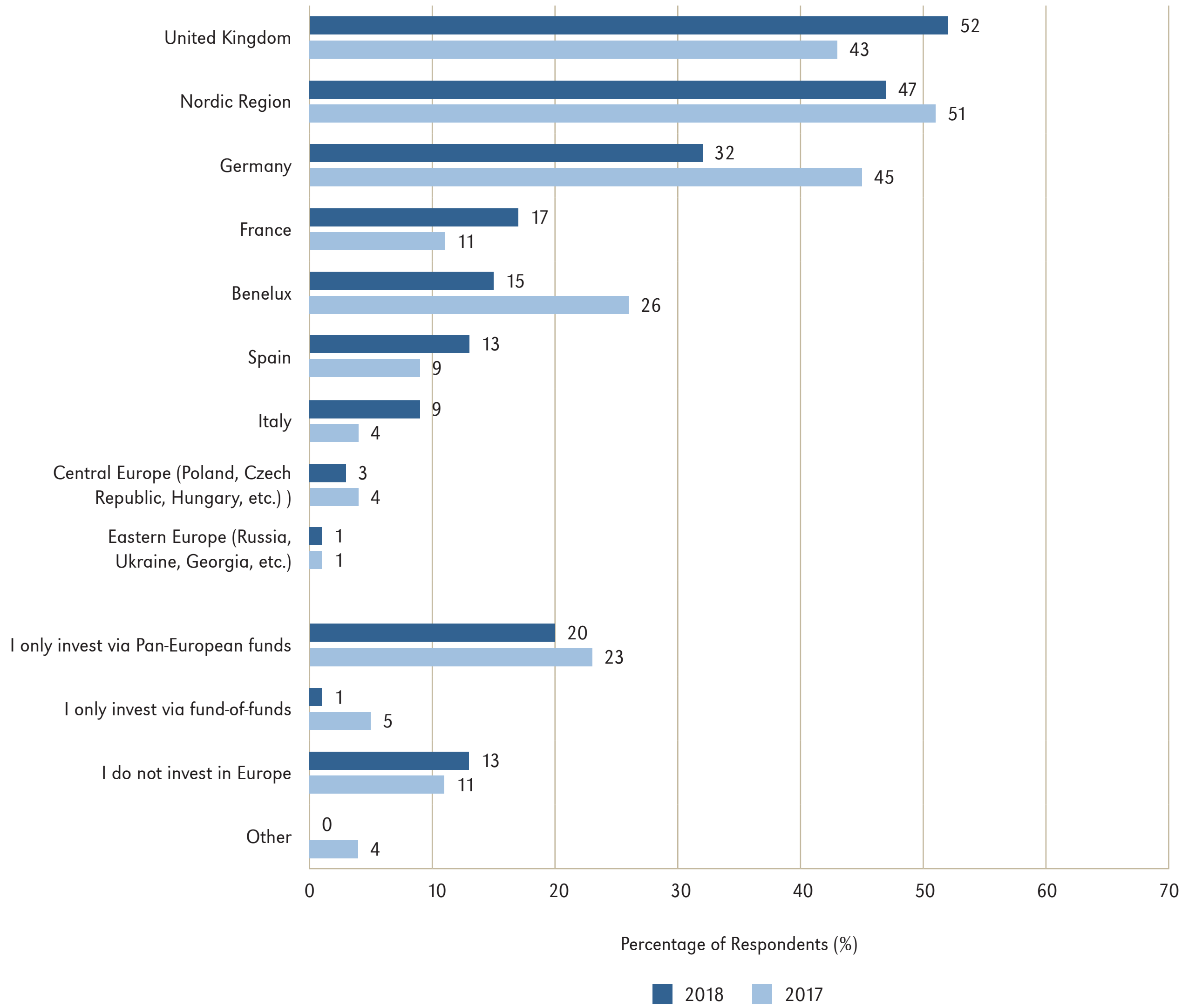
- Last year, after June's Brexit vote, there was a sharp decline in interest in the UK from continental Europe, though strong interest in the UK from North American investors buoyed interest. This year, interest from continental European investors rebounded while interest from North America remained strong, putting the UK back in the top-ranked position.

- Interest in the Benelux fell notably this year, while interest in France, Spain, and Italy increased.

- Interest in both Central and Eastern Europe remained low, impacted by persistent economic and political issues.

Chart XIII Most Attractive European Markets

For European country/regionally-focused funds, I find the most attractive markets to be (choose no more than three):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Chart XIV compares the interest in Asian countries or regions from respondents globally to those respondents based in Asia.

- Interest in China fell significantly from 47% last year to 30% this year, the lowest it has been in some time, on concerns over the economy and historic private equity returns. Interest in India also declined, going from 32% last year to 19% this year.

  One North American investor in the survey noted that overall Asia felt expensive, though they felt India is looking better as an investment destination due to government reforms, while China appears to be becoming more of a buyout market than it used to be.

- Interest in Japan, on the other hand, soared from 12% last year to 30% this year. That change was affected to some degree by an increase in the number of respondents to the survey from Japan, but it also reflects rebounding activity in the Japanese buyout market.

Trends in investor interest in Asia over the last 12 years are highlighted in Table II.

- Investors were equally interested in China, India, and Japan in our 2007 pre-GFC survey. Interest in China surged in the interim, peaking at 55% in our 2011 survey, before falling back to this year's level. Interest in Japan and India has also fluctuated over the last 12 years, though interest in Japan is now as high as it has ever been.

- The only new geography listed in Table II is Southeast Asia. It has only recently begun to attract investor interest over the last five or six years as investors looked to diversify away from a heavy reliance on China, though there remain comparatively few funds targeting the market today.

Table II Which Geographies in Asia Are of the Most Interest?
Top Four Responses:

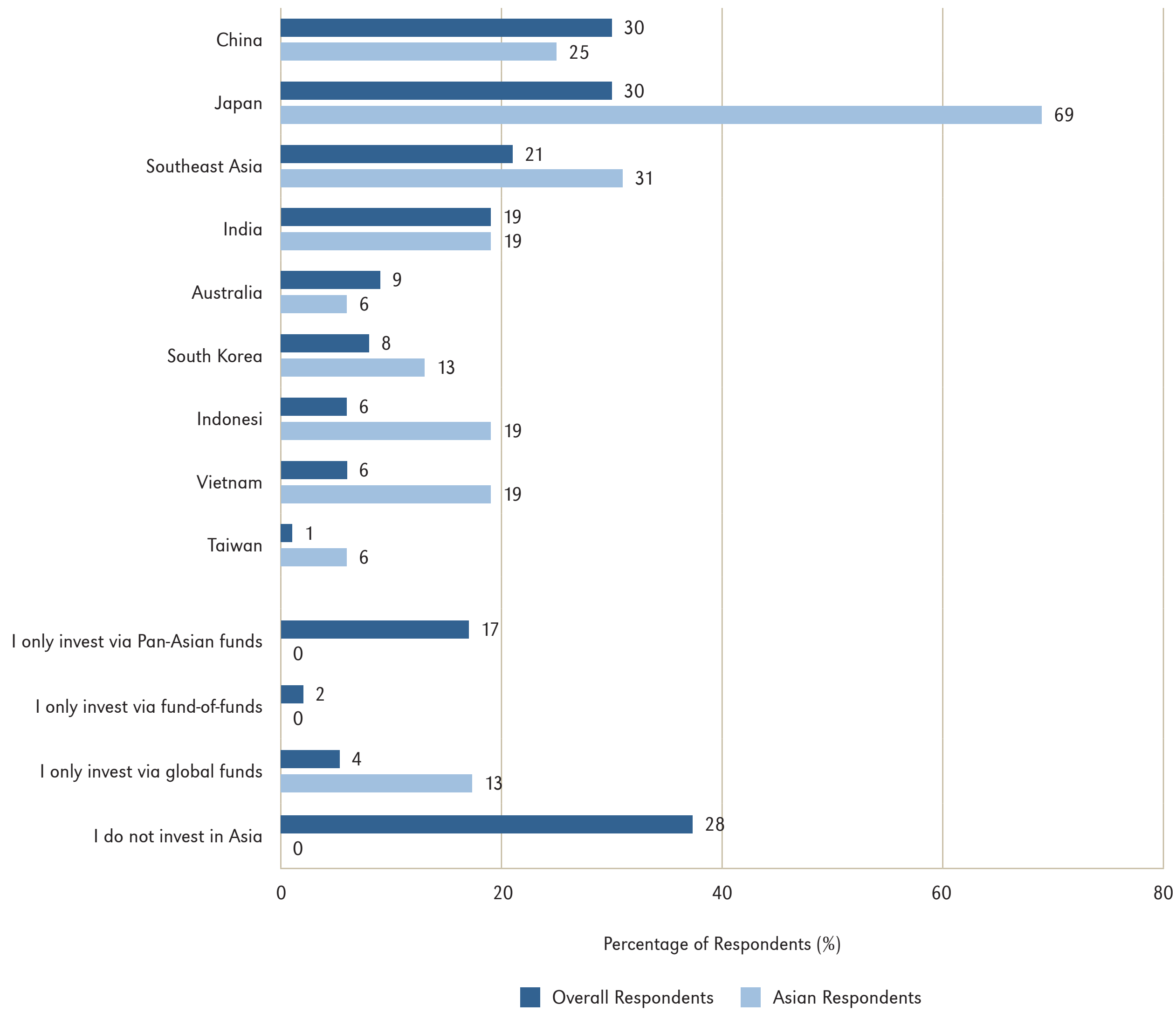
2007		2018	
Country/Region	**% Targeting**	**Country/Region**	**% Targeting**
China	28%	China	30%
India	28%	Japan	30%
Japan	25%	Southeast Asia	21%
I do not invest in Asia	25%	India	19%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 Survey and 2018 Survey

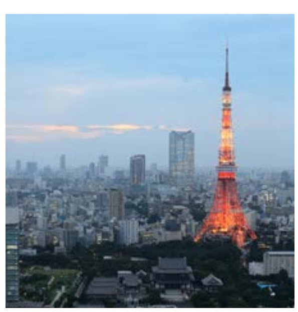
Interest in China fell significantly from 47% last year to 30% this year

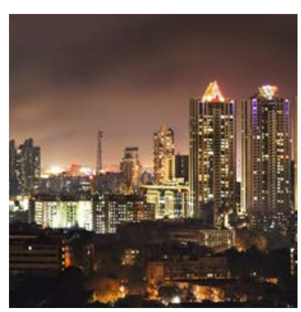
Chart XIV Most Attractive Asian Markets

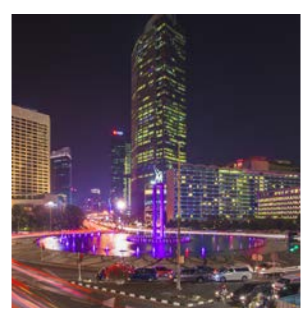
For Asian focused funds, I find the most attractive markets to be (choose no more than three):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey







Emerging Markets

Chart XV switches focus from Asia specifically to emerging markets globally.

- As in the Chart XIV focused on Asia, the most notable change is a significant fall in interest this year in China when compared against other emerging markets, falling from 50% to 31%, though it was still the first-ranked geography.

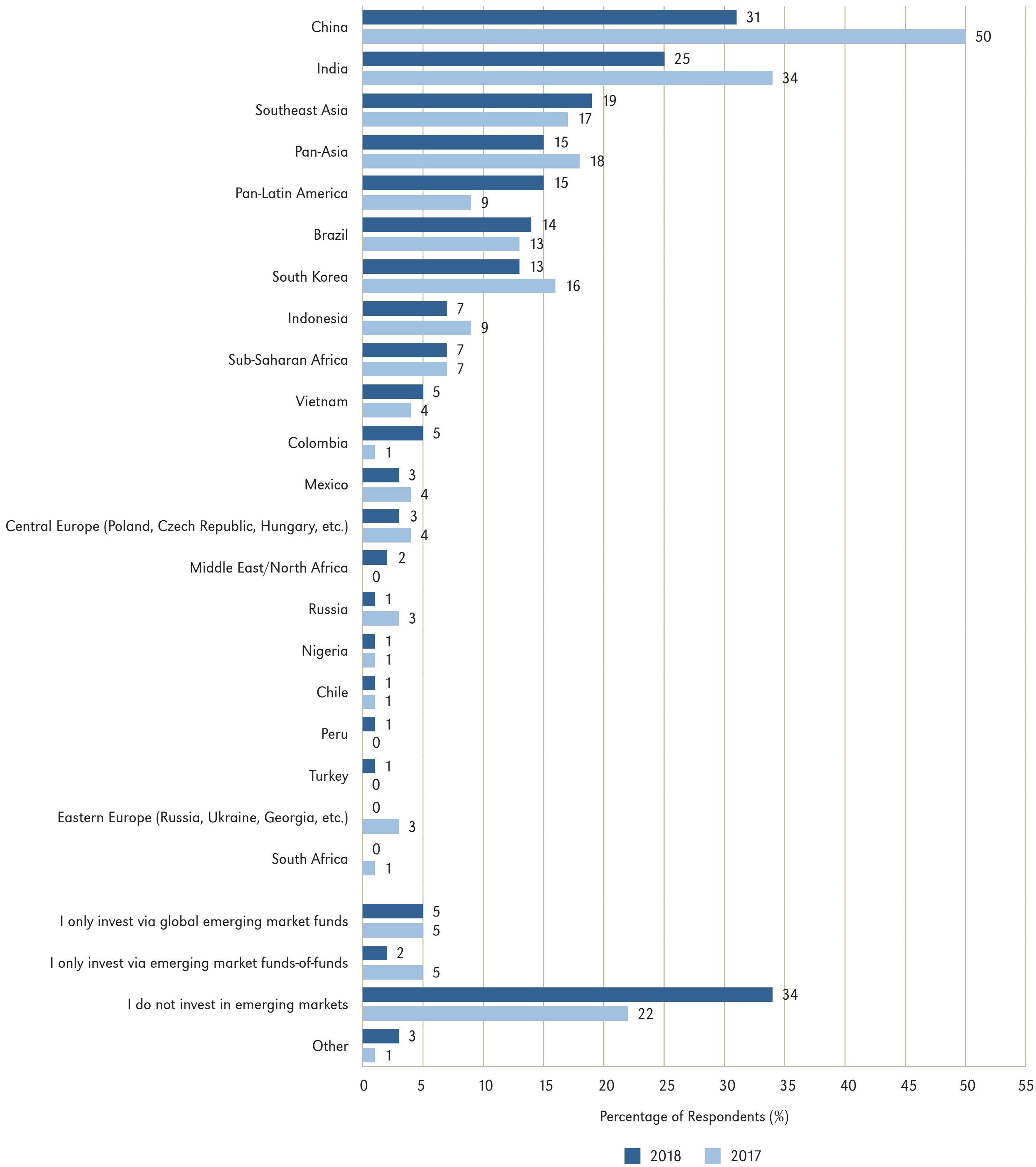
- India remained the second-ranked country of interest, though respondents targeting India this year also fell, from 34% last year to 25% this year.

- Pan-Latin American funds were the only region to show a notable increase in interest from last year, moving from 9% to 15% of respondents, slightly ahead of interest focused solely on Brazil.

- The only other notable shift is that those who say they do not invest in emerging markets increased from 22% last year to 34% this year; in our 2016 survey, only 16% of respondents felt that way, so the lack of interest has doubled in the past two years.

Chart XV Most Attractive Emerging Markets

Which emerging markets do you find most attractive (choose no more than four):



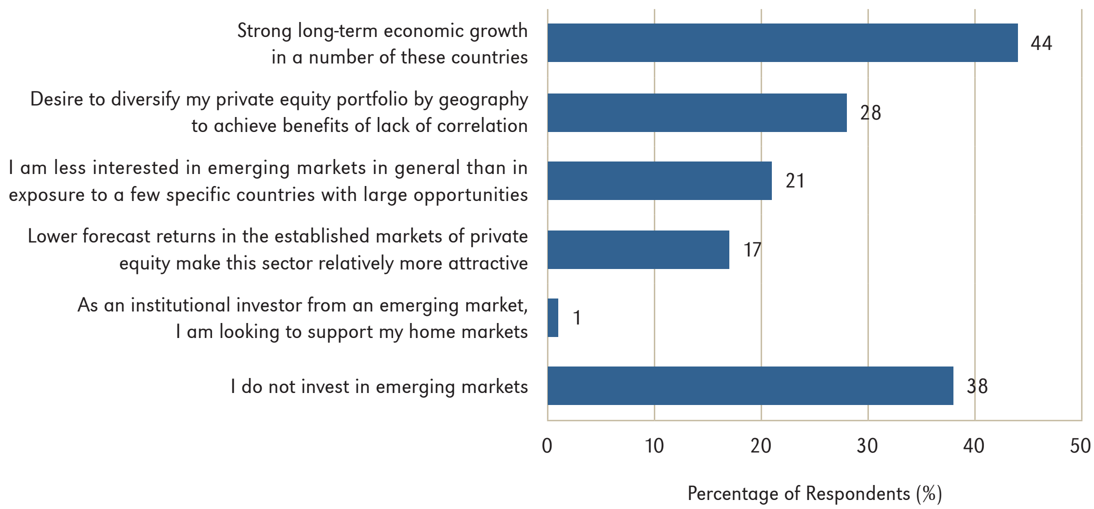
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- Those investors who are interested in investing in emerging markets expect to capitalize on strong long-term economic growth, with that growth driving private equity returns, or are looking for portfolio diversification benefits (Chart XVI).

- Though the number of investors who said that they do not invest in emerging markets increased to 38% this year from 23% last year, those finding the risk/return profile of developed markets more attractive fell dramatically, moving from 73% last year to 43% this year (Chart XVII).

Chart XVI Interest in Emerging Market Private Equity

My interest in emerging market private equity is driven by (check all that apply):

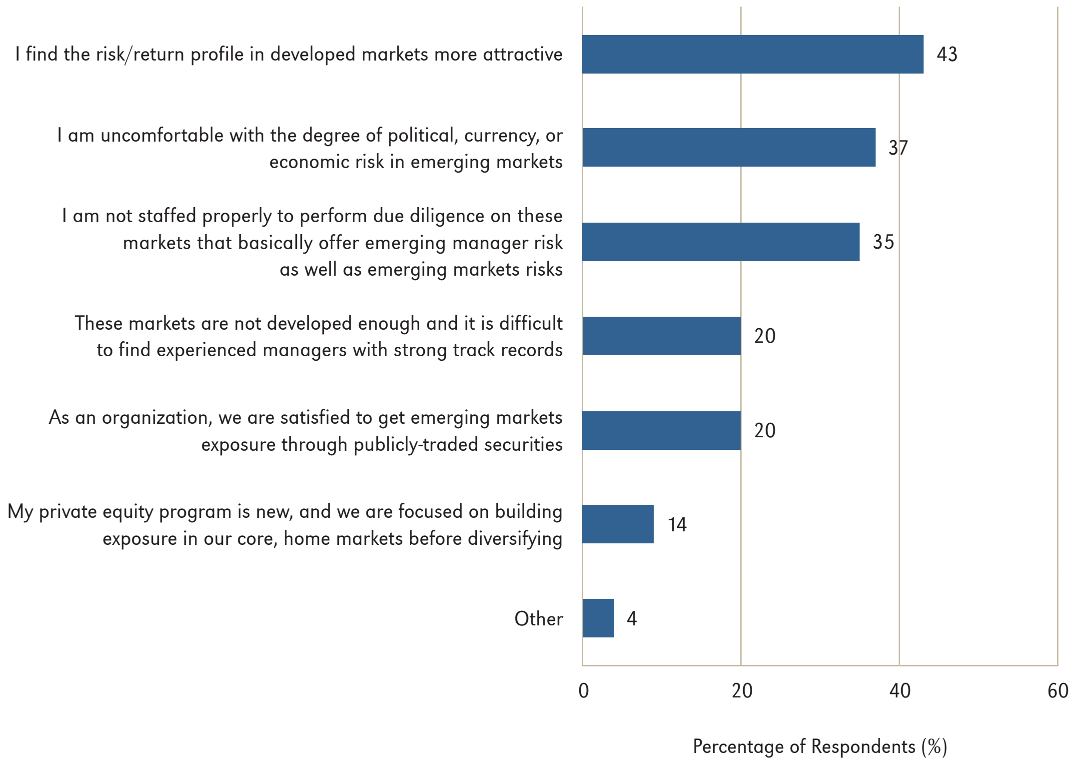


Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

The number of investors who said that they do not invest in emerging markets increased to 38% this year from 23% last year

Chart XVII Disinterest in Emerging Market Private Equity

For those not interested in emerging markets, I am not interested because (check all that apply):



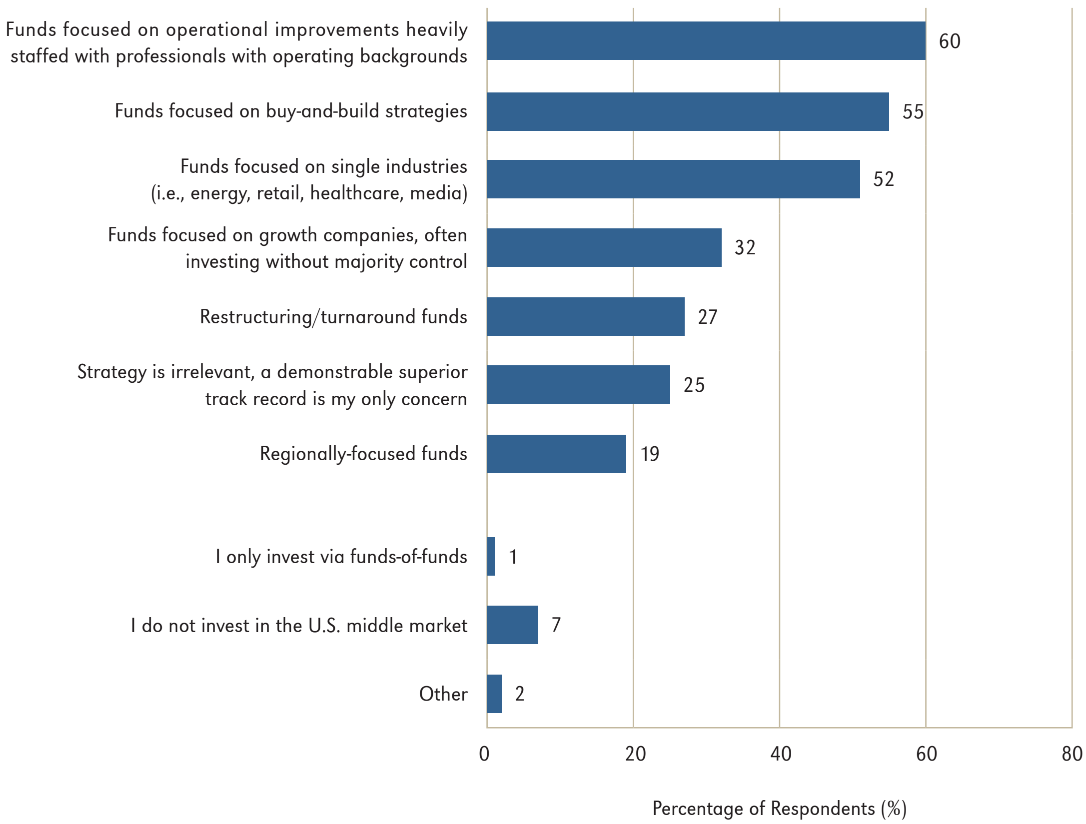
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

U.S. Middle-Market Funds

- U.S. middle-market buyouts are the most popular sector of the private equity market. Funds in the sector seek to differentiate themselves by strategy as well as returns in order to demonstrate competitive advantage. Investors' views of the attractiveness of these strategies can vary tremendously (Chart XVIII).
- Investors continue to focus on fund managers with strategies that drive operational improvements. However, there are a wide variety of ways in which fund managers can execute an operational strategy, with very varied results.
- Interest in buy-and-build and industry sector-focused funds remained strong.

Chart XVIII Most Attractive U.S. Middle-Market Sectors

Which of these sectors/strategies in the U.S. middle market do you find most appealing (check all that apply):



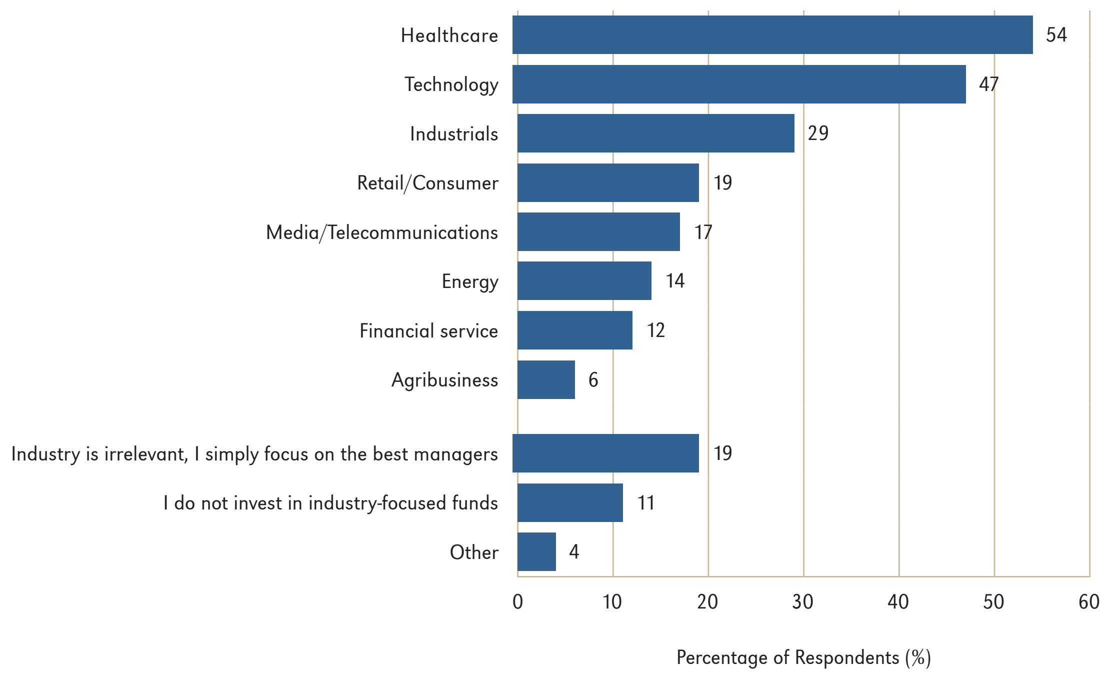
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

- As far as industry sector-focused funds, healthcare and technology remain the dominant sectors of interest (Chart XIX). Energy continues to languish due to industry challenges and commodity prices, while interest in industrials increased notably, from 16% last year to 29% this year.

- North American investors are more focused on industrials than other respondents, while healthcare was of interest in all geographies.

Chart XIX Interest in Industry-Focused Funds

As far as funds focused on single industries, I am most interested in (choose no more than three):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

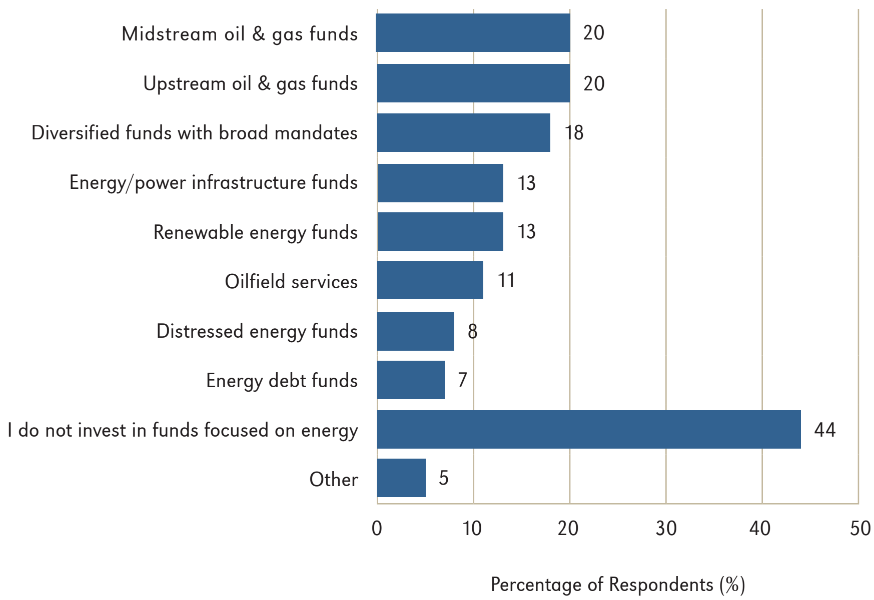
Funds in the sector seek to differentiate themselves by strategy as well as returns in order to demonstrate competitive advantage

- Over the last dozen years, energy has been a sector that has attracted strong interest from North American investors, especially as fracking took off, generating increasing volumes of natural gas and oil. However, challenges in the global oil markets have hit investor interest and the focus on the sub-sectors of energy remains scattered (Chart XX).

- There is much stronger interest among North American and Asian investors in energy, while no European respondents selected it. One European investor added the comment that they were not interested in energy investing due to the cyclicality of the sector.

Chart XX Interest in Sectors within Energy

In the energy sector, I am most interested in (choose no more than three):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

*Over the last dozen years, energy has been a sector that has attracted strong interest from North American investors . . .
however, challenges in the global market have hit investor interest*

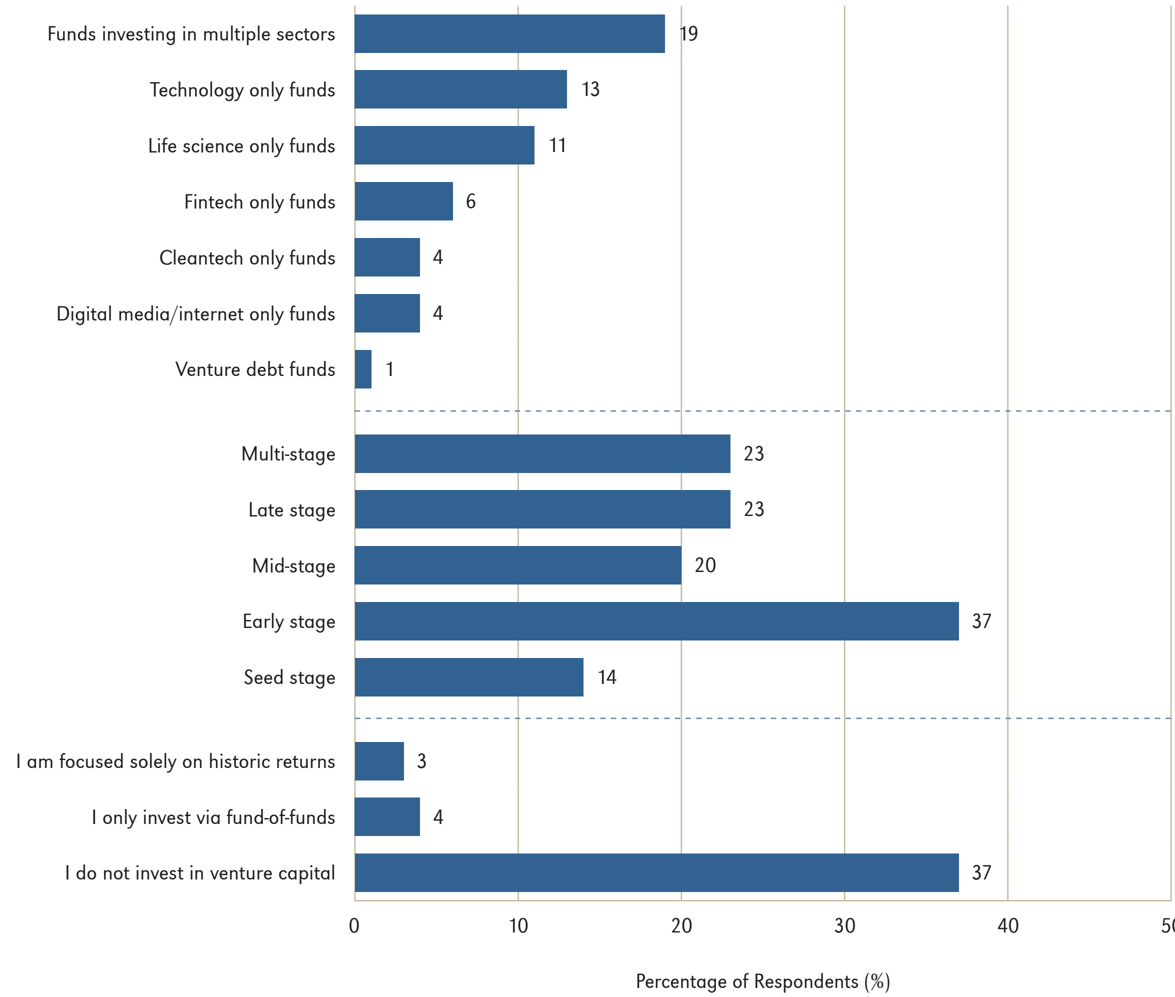
Venture Capital

- Investors are most focused on early-stage funds and funds targeting multiple sectors (Chart XXI) and there is almost no interest in venture debt.
- This year for the first time we asked investors about their interest in fintech-focused and digital media/internet funds; though they did not score strongly, they likely reduced reported interest in technology-only funds.
- There was a slight increase in those stating that they did not invest in venture capital, from 34% last year to 37% this year.
- North American and Asian investors are more focused on venture capital than Europeans.
- A respondent from a U.S. family office had an interesting, detailed comment on why it has little interest at this point:

  Valuations are excessively high in mid- and late stage rounds; deal flow is slowing; investments vs. exits spread near all-time highs; exit activity declining (number of exits and exit value); fund raising declining (number of funds and dollars raised); time to exit increasing, impacting liquidity and leading to extensions to fund life; VC market bump from 2013–2016 appears to be waning.

Chart XXI Most Attractive Venture Capital Sectors

In venture capital, I focus on funds active in the following sectors or stages (choose all that apply):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

---

Valuations are excessively high in mid- and late stage rounds; deal flow is slowing; investments vs. exits spread near all-time highs; exit activity declining (number of exits and exit value)...VC market bump from 2013–2016 appears to be waning

---

Distressed Private Equity

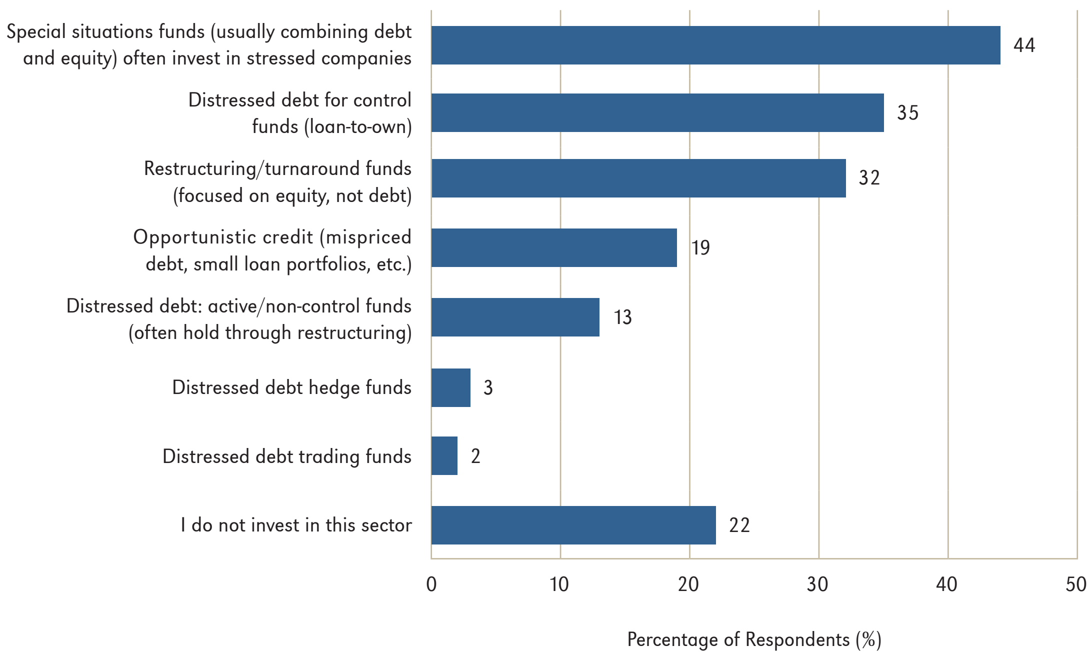
- Distressed private equity investing includes several distinct strategies, some of which incorporate equity as well as debt (Chart XXII). Certain funds pursue two or three strategies within the same fund while large managers often raise multiple funds with separate strategies.

- Investors are most focused on strategies that generate higher multiples of return, such as special situation, distressed debt for control and restructuring/turnaround funds.

- Unlike most other strategies, opportunistic credit funds invest in assets other than corporate debt, including stressed small loan portfolios or asset-backed securities. There are a number of investors who consider these funds simply credit product and allocate capital to them through credit instead of private equity allocations.

Chart XXII Distressed Investments

Within the distressed debt/restructuring sector, I am most interested in (choose no more than two):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

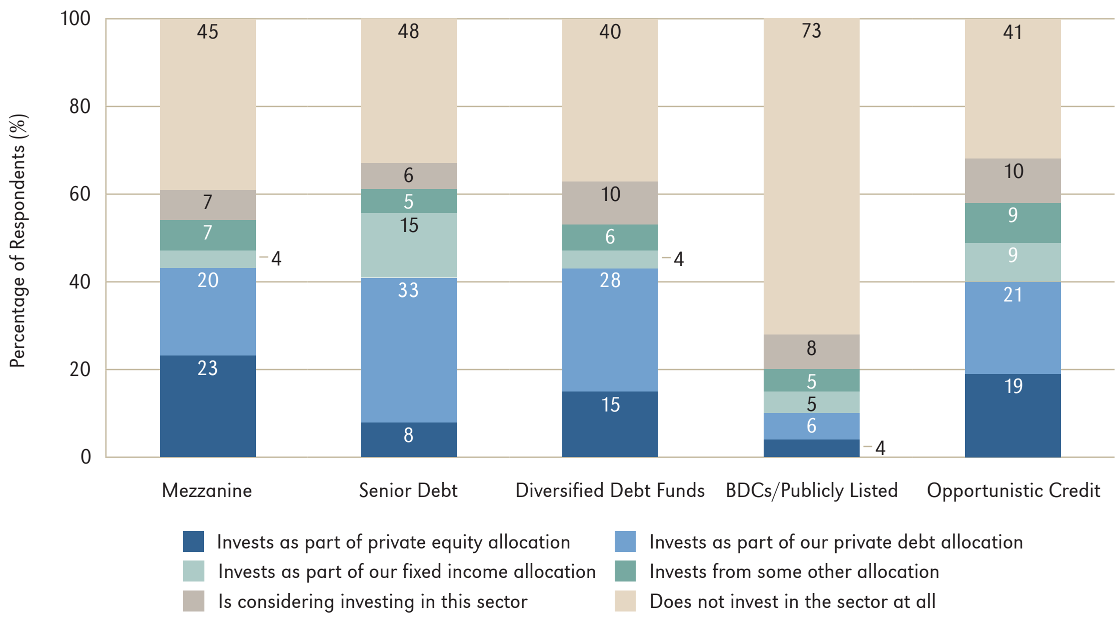
Credit-Focused Funds

- Respondents to the survey are most focused on mezzanine, diversified debt, and opportunistic credit funds (Chart XXIII). Funds focused on senior debt are also of interest, but commitments are mainly made through private debt or fixed-income allocations.

- Publicly listed vehicles such as Business Development Companies ("BDCs") were of little interest either in private equity or private debt allocations.

Chart XXIII Credit

In the credit sector, my firm:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey
Note: Some sectors total greater than 100% of respondents as a few investors had multiple responses

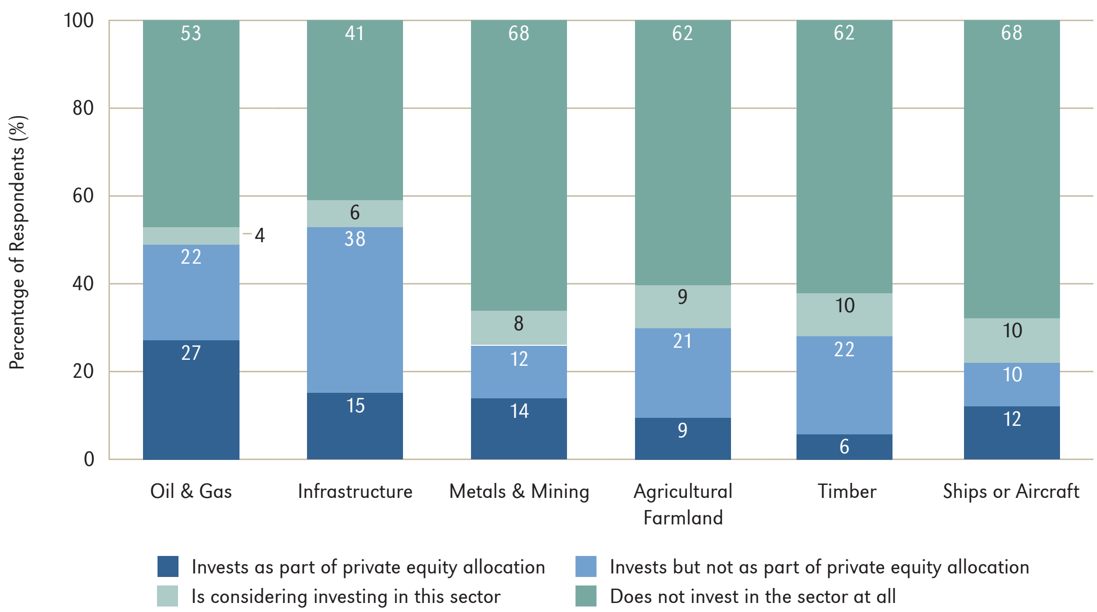
Respondents to the survey are most focused on mezzanine, diversified debt, and opportunistic credit funds

Real Asset Funds

Large investors with significant long-term liabilities have increased their focus on real assets over the last decade.

- The oil & gas sector (for real assets investors, focused on upstream transactions) was of most interest from private equity allocations (Chart XXIV).
- Interest in a number of other sectors, especially infrastructure, comes from outside of private equity allocations.

Chart XXIV Real Assets
In the real asset sector, my firm:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey
Note: Some sectors total greater than 100% of respondents as a few investors had multiple responses

First-Time Funds

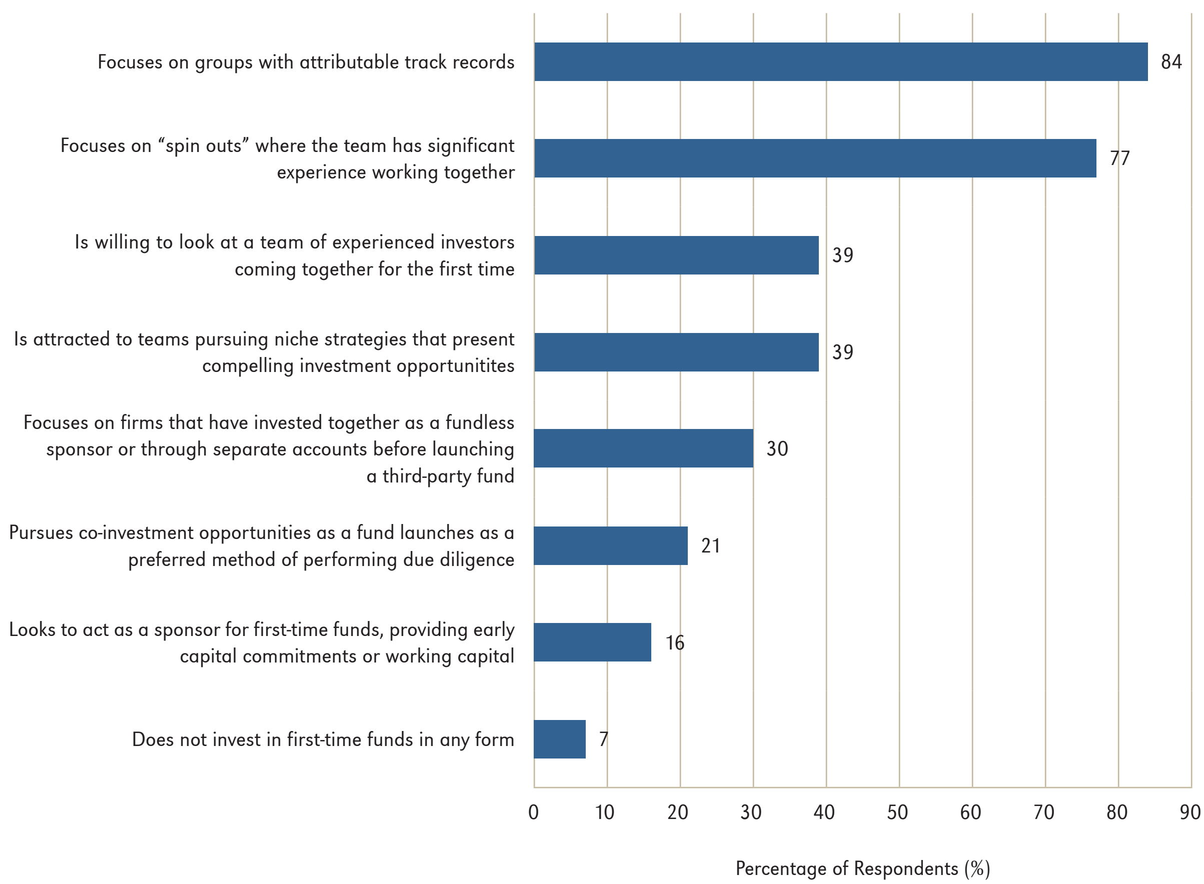
- Many investors have a higher bar for investing in first-time funds, and some investors will not invest in first-time funds under any circumstances (Chart XXV).

- The most important methods of de-risking backing a first-time fund manager are to rely on attributable track records or to focus on "spin out" teams that have a history of working together. However, a number of investors are interested in pursuing managers with unique strategies or those that have proved up their team's ability by acting as a fundless sponsor or through one-off co-investment activity in advance of fundraising.

- A number of investrors made the point that the track record of a first-time fund needed to be not only attributable but very strong to compensate for the added risk undertaken. A U.S. respondent to the survey commented that to gain his attention, a first-time fund needed to have at least 3x gross multiple track record.

Chart XXV First-Time Funds

As far as first-time funds are concerned, my firm (check all that apply):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Secondary Market

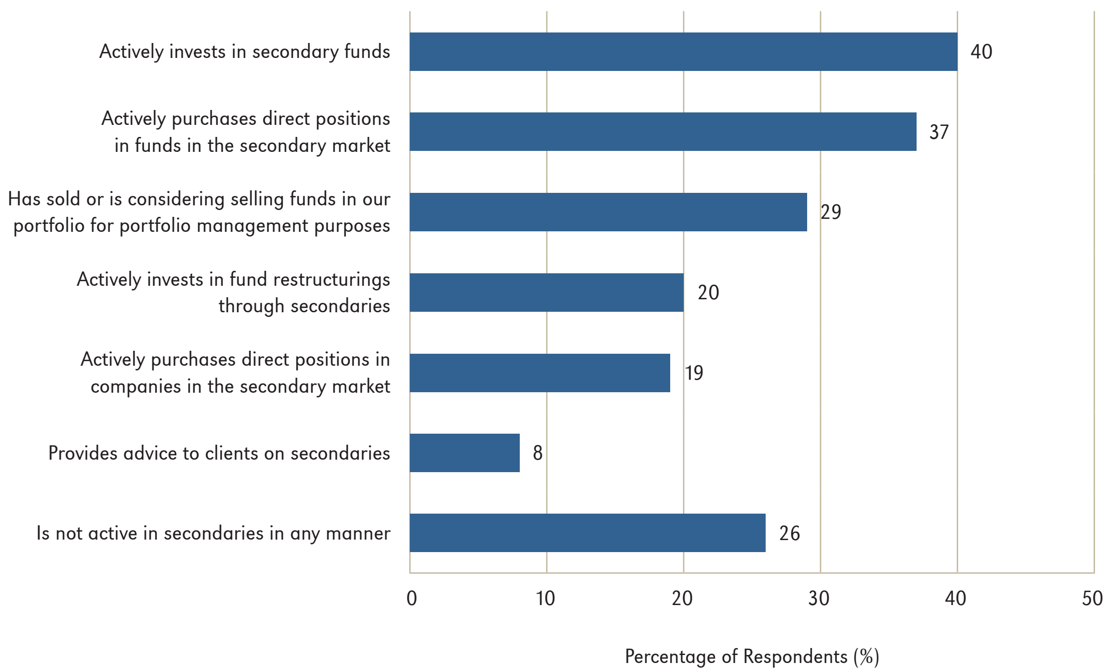
- Fundraising for secondary funds has been very heavy in 2017, driven by large established managers. Looking ahead to 2018, 26% of respondents say they do not plan to be active in secondaries in any manner compared to 17% who felt that way going into 2017 (Chart XXVI).

- Secondary fund restructurings are more difficult to execute but can generate higher returns. They have also attracted the attention of the U.S. Securities and Exchange Commission ("SEC") because of potential conflicts of interest between fund managers and limited partners. Twenty percent of respondents actively target these complex transactions and as a respondent from a Canadian pension plan commented:

  As a buyer of secondaries, we are only looking for general partner restructurings and other complex transactions rather than plain vanilla secondary purchases.

Chart XXVI Secondary Market Investments

In the secondary market, my firm (choose all that apply):



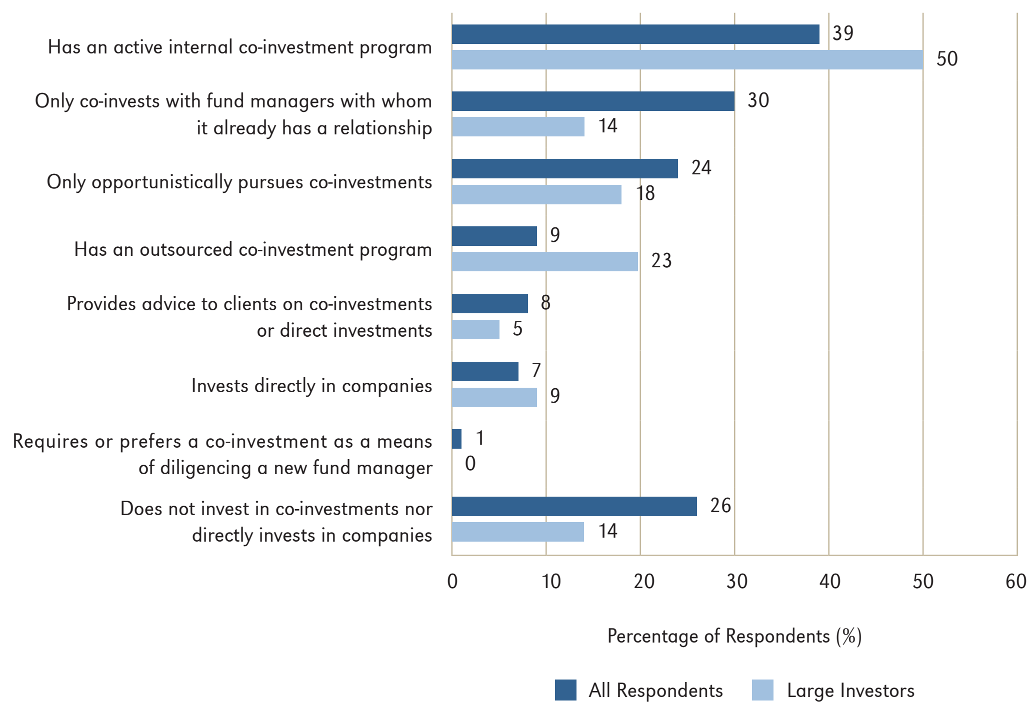
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Co-Investments and Direct Investments

- Investors have become increasingly interested in co-investments over the last decade in a bid to decrease the expense of running their private equity portfolios. That is especially true of large investors who tend to have more resources that they can devote to co-investment programs (Chart XXVII).
- Seventy-three percent of large investors have either an active internal co-investment program or an outsourced program.
- Few limited partners, whether large or small, invest directly in companies; this is a much more resource intensive activity typically requiring highly specialized professionals.

Chart XXVII Directs and Co-Investments

Regarding directs and co-investments, my firm (choose all that apply):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey
Note: "Large Investors" denotes those survey respondents who plan to commit $500 million or more to private equity in 2018

Fund Structures and Key Terms

- The biggest area of focus for investors negotiating terms remains the level of general partner financial commitment (Chart XXVIII). For many investors, it is the key factor that establishes alignment of interest between limited partners and general partners.

- The distribution of carried interest, a cap on fund size and the overall level of fees — always concerns in the past — rounded out the top four issues for investors today.

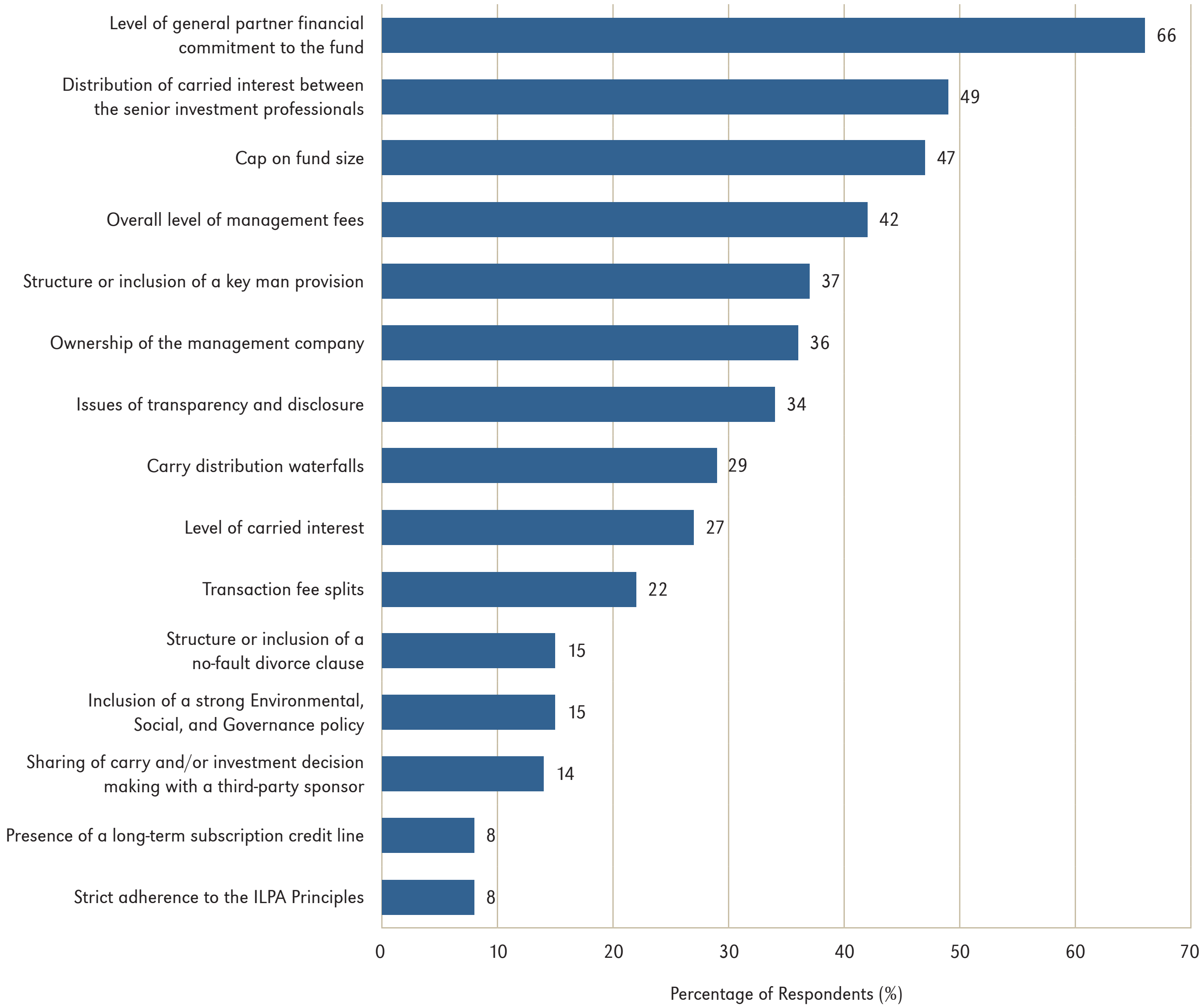
- This year, for the first time, we asked investors about their concern regarding long-term subscription credit lines. Though much discussed this year, it was not a major focus of respondents.

- Increasingly over the last five years a strong Environmental, Social and Governance ("ESG") policy has been pushed forward by certain investors. However, only 15% of respondents targeted it as a major issue.

  The investor comment below highlights a key point: in a market where access to "hot" funds is a major issue for investors, issues of terms and structure are not absolute: *For top general partners we are flexible, for all others, terms must be market.*

Chart XXVIII Issues Regarding Fund Structure

The issues I focus on most when investing or advising a client as far as terms or structure of a fund are (choose no more than four):



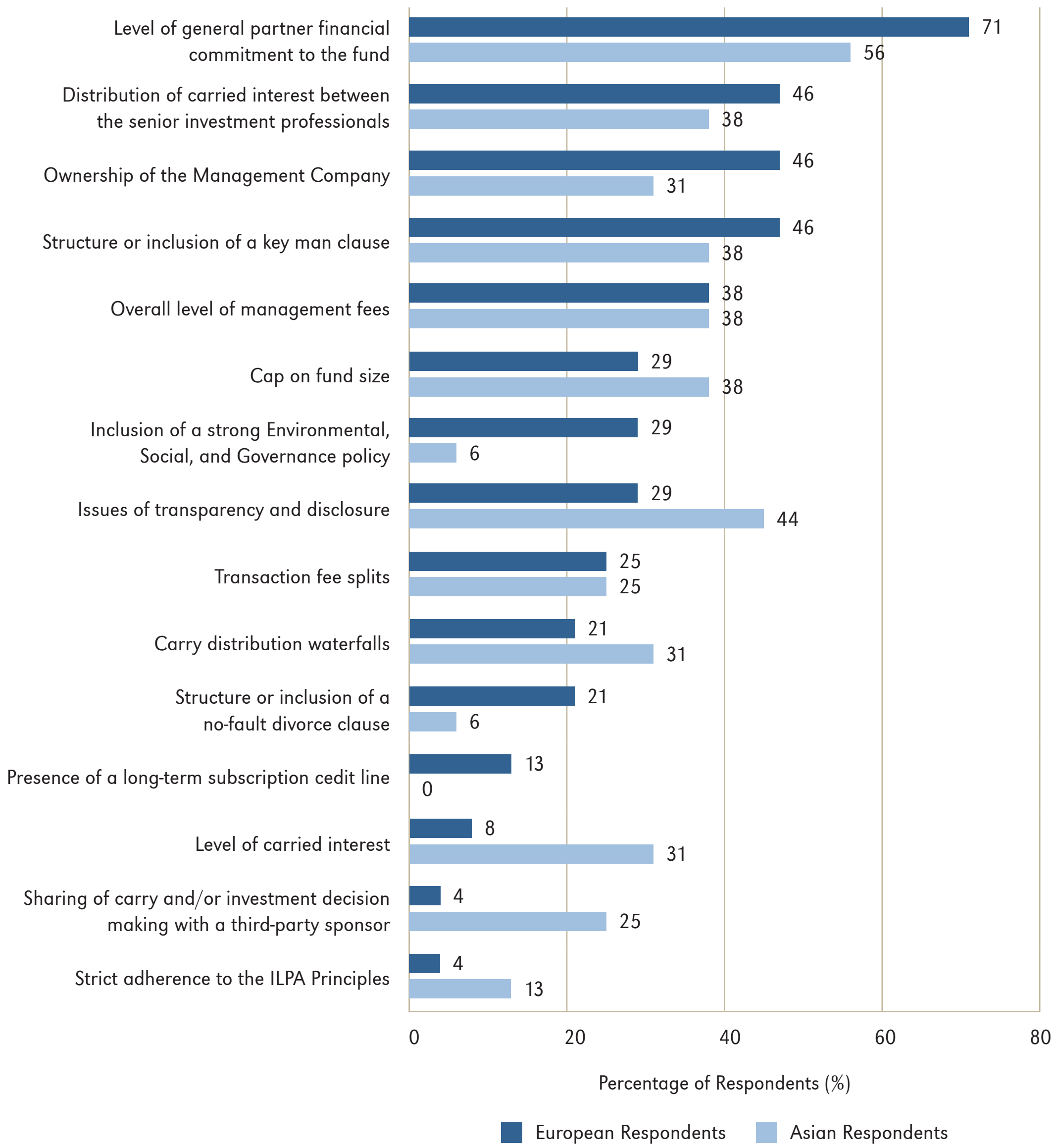
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Though there is some agreement on the most important issues, there are distinct differences among investors, especially by geography. Chart XXIX compares the responses of European and Asian investors.

- Notably, Asian respondents are much more focused on issues of transparency and disclosure, and the level of carried interest.
- European investors are much more interested in strong ESG policies, with 29% targeting it, while interest in Asia was minimal (6%) and North Americans falling in between.
- Europeans are more concerned with ownership of the management company.

Chart XXIX Issues Regarding Fund Structure; European Respondents vs. Asian Respondents

The issues I focus on most as far as terms or structure of a fund are (choose no more than four):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Benchmarking

- One of the important methods of due diligence and portfolio management for investors is benchmarking performance. However, there are a wide variety of databases and tools that investors use to benchmark (Chart XXX) and, as is obvious from the usage percentages below, many investors use more than one.

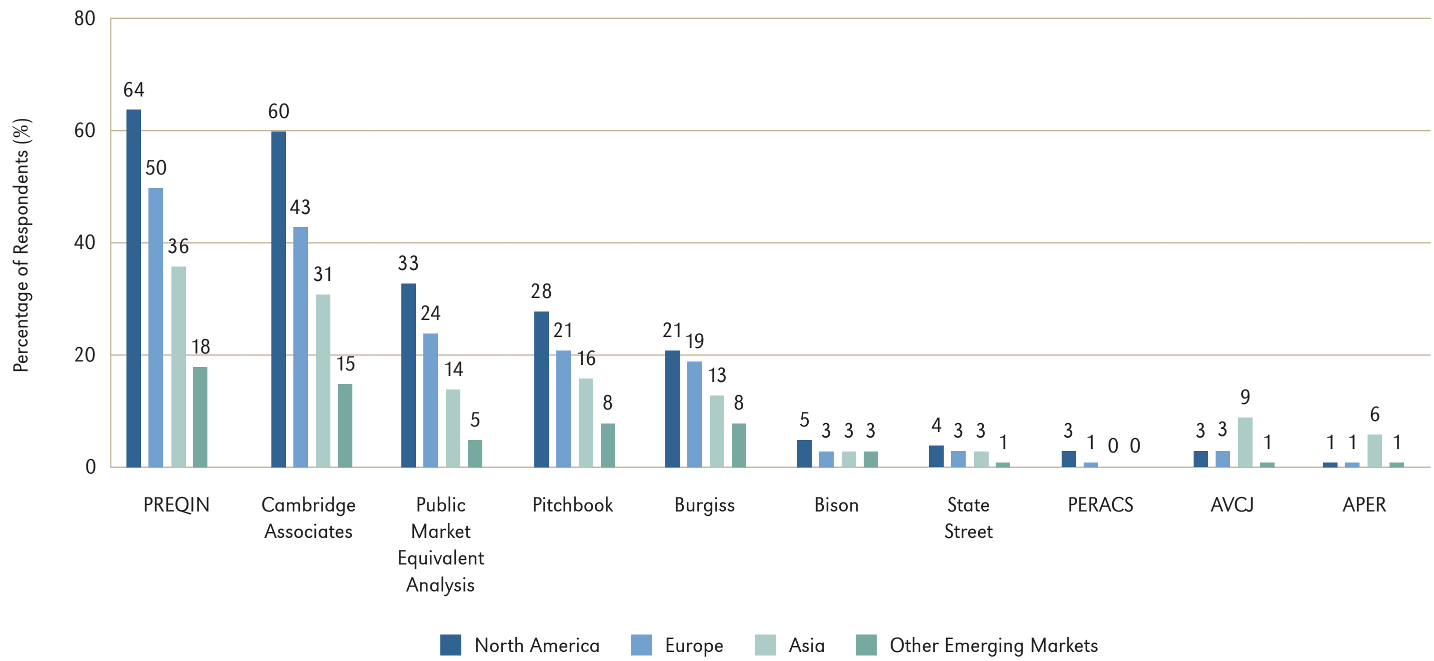
- The two leading databases are PREQIN and Cambridge, and they lead across all fund geographies. AVCJ and APER are most relevant to Asia.

- In North America and Europe, the third most used tool is Public Market Equivalent (PME) analysis. It should be noted, however, that there are at least five major PME models in use with a number of potential stock market indices that can be the basis for comparison.

- Besides the responses noted below, one investor stated that they used the ILPA indices while another used an Absolute Return target.

Chart XXX Benchmarking

As far as fund performance benchmarking, we use the following databases or tools in different fund geographies (please choose all that apply):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

[For Public Market Equivalent Analysis] there are at least five major PME models in use with a number of potential stock market indices that can be the basis of comparison

Investor Fears and Concerns

- As with last year, investors' greatest fear was that too much money was coming into all areas of private equity, followed very closely by the concern that the private equity market feels like it is at the top of the cycle (Table III and Chart XXX).
- Large investors are most concerned that we may be at the top of the cycle (70%).
- Though middle-market buyouts are the most sought-after sector globally, 36% of respondents felt purchase price multiples in the sector were too high.
- The two top fears in 2007, just before the GFC, were quite different than those cited today; then investors focused on management and transaction fees, and leverage usage.

Table III What Keeps You Up at Night?

Top five responses:

2007		2018	
Issue	**%**	**Issue**	**%**
Management fee levels and transaction fees on large funds are destroying alignment of interest between fund managers and investors	51%	Too much money is pursuing too few attractive opportunities across all areas of private equity	71%
The amount of leverage in the buyout market is unsustainable, and over the next two years credit problems will hurt performance of recent vintage funds	48%	The current private equity market feels like it is at the top of the cycle	55%
There is too much money available in the large buyout market and that will dramatically impact future returns	39%	Purchase price multiples in middle-market buyouts are too high and threaten future returns	36%
Private equity is most effective as a niche market and too much money is being raised in all sectors of private equity	35%	Purchase price multiples in large-market and mega buyouts are too high and threaten future returns	30%
Recapitalizations are boosting IRRs temporarily, but adding to fund risk by relevering companies	30%	Large firms in the market are becoming generalized asset managers and are moving away from key investment strengths	20%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 Survey and 2018 Survey

Chart XXXI Greatest Fears Regarding the Private Equity Market

My three greatest fears regarding the private equity market at the moment are:

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2018 Survey

Our View of the Future

A few key trends emerged from our analysis of the survey or from our ongoing conversations with investors:

- **The dramatic increase in private equity dry powder threatens future returns.** Private equity dry powder has built up rapidly over the last four years, especially for North American funds (Chart XXXII), though that growth has slowed so far in 2017. High levels of dry powder put more pressure on fund managers to put capital to work, a danger in a market where purchase price multiples are high. To put things into perspective, over the past four years, fund dry powder has expanded considerably above the 2007/2008 peak in North America and Europe.

- **The dry powder amounts in the chart below are understated; they are focused on closed-end funds and do not include private equity capital targeting co-investments, separate accounts, and direct investments.**

  - **Large separate accounts, often with wide investment mandates, are increasingly important to the largest investors.** The amounts of capital raised through these accounts are often more opaque then those raised for traditional commingled funds. Certain of the largest accounts have broad mandates that allow investment in a variety of strategies or geographies, even to sectors outside traditional private equity, making it even more difficult to track.

  - **Certain large, experienced investors — such as sovereign wealth funds, public pension plans, and family offices — have developed direct investment programs.** The intended amount of capital commitments they plan to make over a specified period of time is also difficult to track.

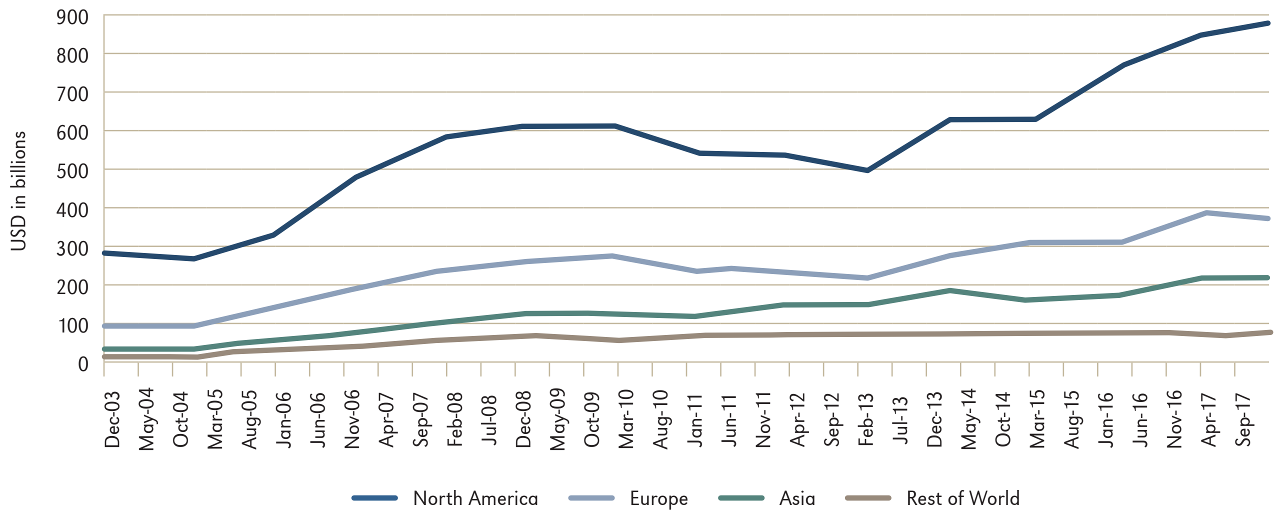
  - **Caveat on North America.** Strictly speaking, the North American dry powder numbers are overstated as they include a number of funds from large managers headquartered in North America that invest globally.

- **Increasing split in the approach to the market between large and small investors.** Large investors are increasingly turning to very large commitments to a smaller number of fund managers, not simply through fund commitments but also through co-investments, fund-linked separate accounts, and broad mandate separate accounts, all geared toward developing strategic relationships with the largest fund managers who can deploy capital in size.

  Many smaller, sophisticated investors are choosing to take a different approach to investing, focusing on "best of breed" managers in narrow strategies looking to generate alpha in inefficient sectors such as industry sector-focused buyout or growth capital funds, or middle-market distressed, turnaround and special situations vehicles. This approach often requires both looking at new managers and moving away from established relationships with managers who these limited partners perceive have grown too large relative to their original strategies. While this approach can generate outsized performance, it is not immune to the impact of a dramatic increase in dry powder as an increasing group of peers follows them and migrates to this approach.

- **Investors are worried about the market cycle, but there is no consensus what could trigger a market turn — or what its timing would be.** Investors are worried that increasing fundraising, dry powder, and purchase price multiples are all signaling that the market is "toppy." However, there is no consensus about what is the most likely

Chart XXXII Private Equity "Dry Powder" by Region Targeted



Source: PREQIN

trigger event that would flip the market into a downturn, especially since a trigger event could come from outside private equity, as it did in the GFC. Trying to time the market too aggressively could also impact their fund manager relationships and future returns.

- **Investors are also faced with a need to deploy capital and be in a position to pursue opportunities in a falling market.** Investors are trying to balance being cautious with a need to keep deploying capital in a market with few attractive alternatives. In the current low return environment, there are not many obvious opportunities more attractive than private equity and private debt. Investors who went through the GFC also realize that dry powder is necessary to take advantage of falling purchase price multiples when the market finally turns and the denominator effect kicks in and limits their options — as long as bandwidth of their fund managers with dry powder is not overwhelmed by legacy portfolio company issues in transactions that in hindsight seem too aggressively priced.

Summary

The memories of 2008 and 2009 are not that distant for experienced investors who lived through that turmoil. At the same time, any investor that had been badly burned previously and strongly curtailed private equity investments based on concerns about the market being toppy three years ago when the issue was first raised in our surveys would have missed out on three more years of opportunity. Investing in a long-term, illiquid market is often a prudent balancing act between greed and fear, focusing on generating strong long returns while also protecting your portfolio from the risks in a recession of fast moving market forces that can totally upset those plans.

As in 2006 and 2007, we live in interesting times.

Private Equity Institutional Investor Trends for 2018 Survey

Probitas Funds Group, LLC

425 California Street
Suite 2300
San Francisco, CA 94104
USA
Tel: +1 415 402 0700

Probitas Funds Group, LLC

1120 Ave. of the Americas
Suite 1802
New York, NY 10036
USA
Tel: +1 212 403 3662

PFG-UK Ltd.

1 Stanhope Gate, 4th Floor
London
W1K 1AN
UK
Tel: +44 20 3829 4330

Probitas Hong Kong Limited

Nexxus Building
Level 15
41 Connaught Road
Central, Hong Kong
Tel: +852 3757 9728