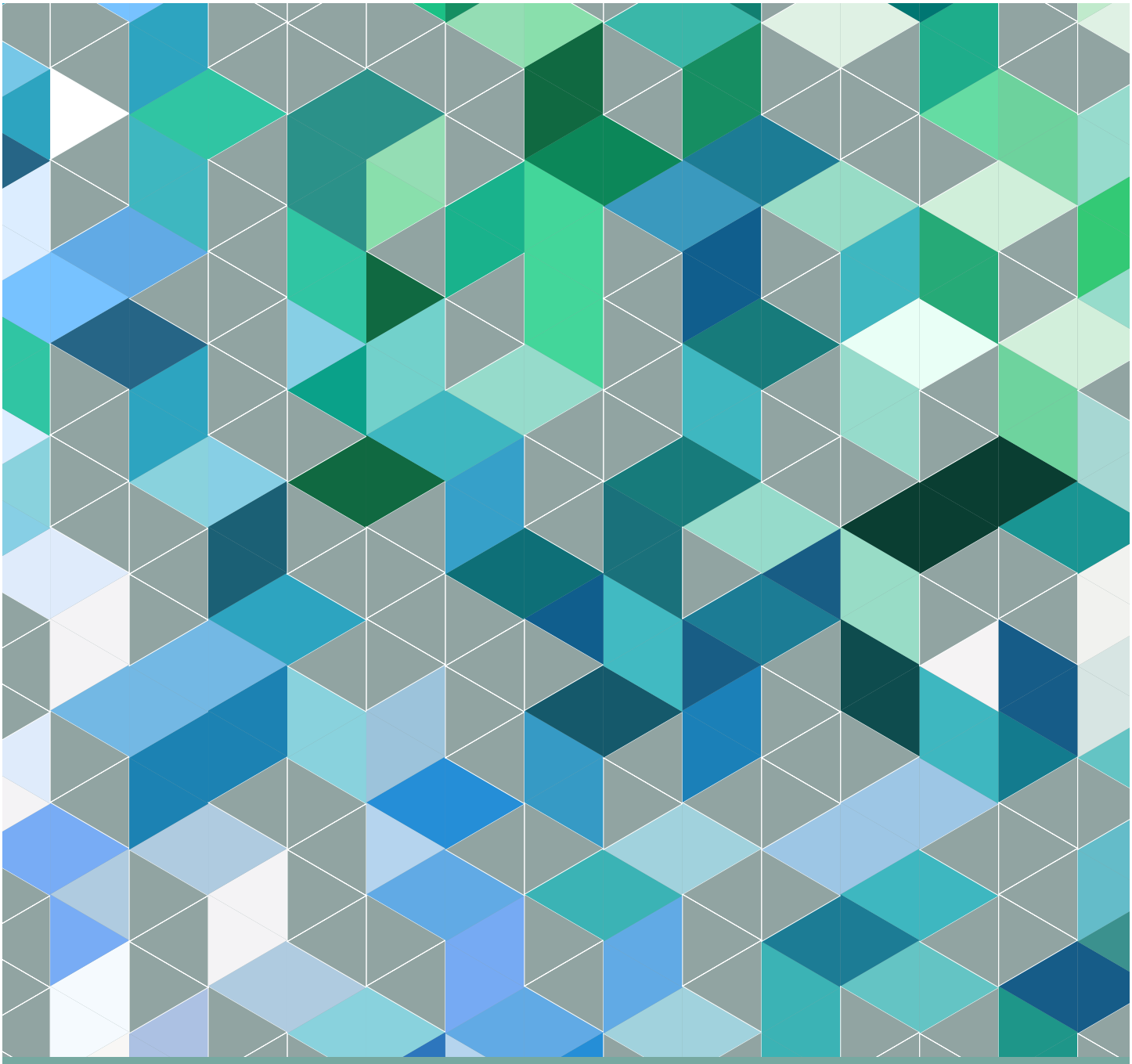


Private Equity Institutional Investor Trends for 2019 Survey Results

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

- As detailed in Chart I, global private equity fundraising achieved a new peak in 2017. Though not shown here, fundraising for the first nine months of 2018 has slowed notably, especially in North America. Fewer mega buyout funds have closed in 2018, and those that have closed are smaller than the huge Apollo and CVC funds that drove last year's totals.

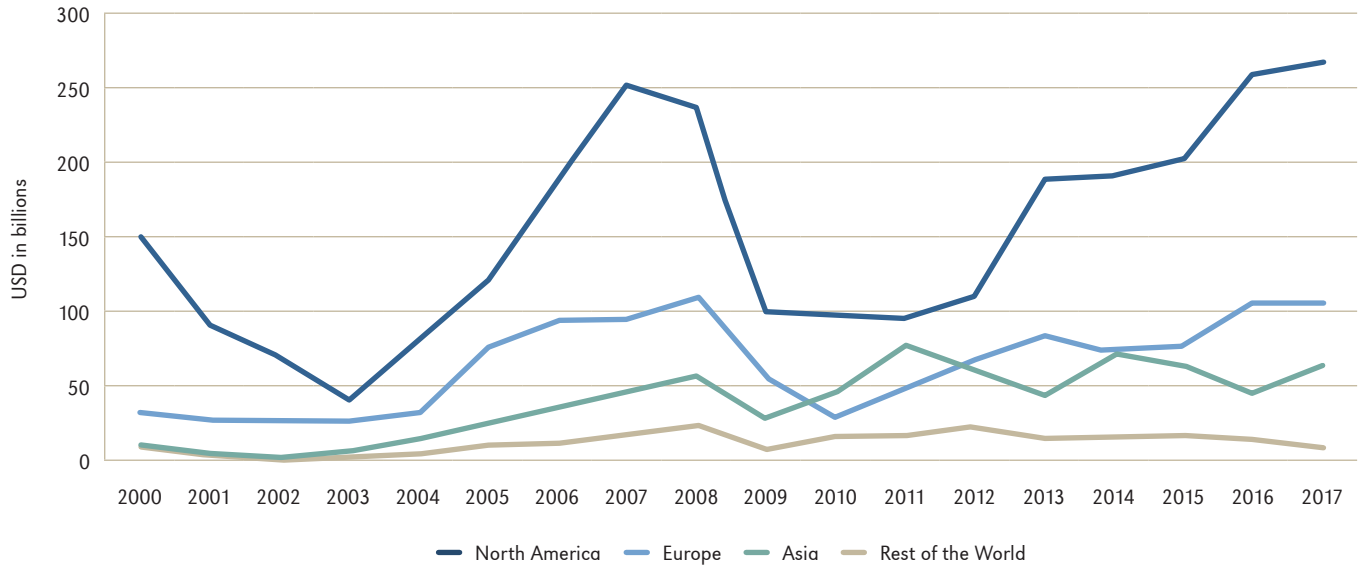
- Several underlying fundraising trends continue including:

  - North America is the largest, deepest private equity market for both raising and investing capital. However, it should be noted that the North American commitments in Chart I include amounts for a few large funds that are headquartered in the U.S. but invest globally.

  - The commitment amounts in the chart are for closed-end funds only and understate capital targeting private equity: they do not include co-investments or separate accounts as they are more difficult to track accurately.

  - Over the long-term, fundraising is volatile, shifting dramatically with market cycles. However, the cyclicality is not often global; local events can materially impact fundraising by geography. For example, Asian fundraising is significantly impacted year-by-year by actions taken by the Chinese government that affect funds denominated in Yuan, which have a substantial impact on overall Asian totals.

Chart I Commitments to Global Private Equity Partnerships



Source: PREQIN; Data as of December 31, 2017; does not include funds-of-funds

Private Equity Institutional Investor Survey

The survey was conducted in late September through early October 2018 and is meant to gauge investors' perspectives and opinions on the market going into 2019. Ninety 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

Key top-line findings from the survey and our discussions with investors include:

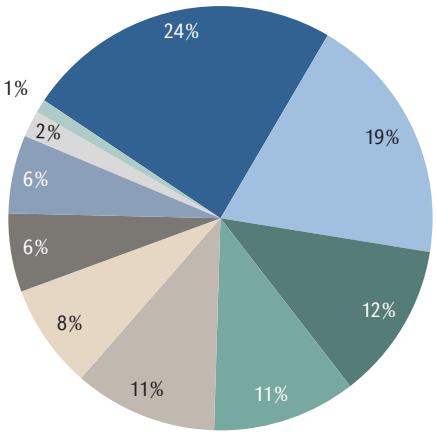
- ***Several major trends and issues have persisted over the last four years.***
  - **Interest in private equity remains strong and continues to expand, as evidenced by increased global fundraising. However, investors' fear that the market is approaching the top of the cycle continues to be a major issue.**
  - **Middle-market buyout funds in North America continue to be the strongest focus for investors globally, though there are some geographic differences among respondents.**
  - **Though interest in middle-market buyouts in North America and Europe remains strong, investors are increasingly concerned that purchase price multiples in the sector are too high.**
  - **Interest in industry-focused funds continues to grow as investors look for managers with proven and durable competitive advantages. Currently the strongest investment interest is in the healthcare and technology sectors**.
- ***The strong negative attitude by continental European investors towards investing in the UK has increased as the final resolution of Brexit approaches.*** Overall interest in UK-focused funds remains strong, but only because of the continued support from North American and Asian investors.
- ***Interest in emerging markets continues to fall.*** On the back of continued economic and political issues in key emerging market countries, more investors feel that the risk/return dynamic for private equity remains more favorable in developed markets.
- ***Interest in venture capital rebounded this year after last year's fall.*** Interest in U.S. venture capital strengthened, as did interest in European venture investing, though from lower levels.

Profile of Respondents

- Ninety institutional investors participated in this year's survey, with respondents from funds-of-funds, consultants, family offices, insurance companies, and public pension plans well represented (Chart II).
- Respondents to the survey mainly came from the developed markets which are the dominant sources of private equity capital targeting closed-end funds (Chart III).
- There was relatively little change from last year as far as where investors stood with their target allocations (Chart IV). A third of respondents cited less ability to back new relationships as they were at or near their target allocations and were most focused on re-ups. A quarter of the respondents were under their allocations and actively looking to add relationships. Another quarter were funds-of-funds or consultants who have a different allocation dynamic.

Chart II Respondents by Institution

I represent a:

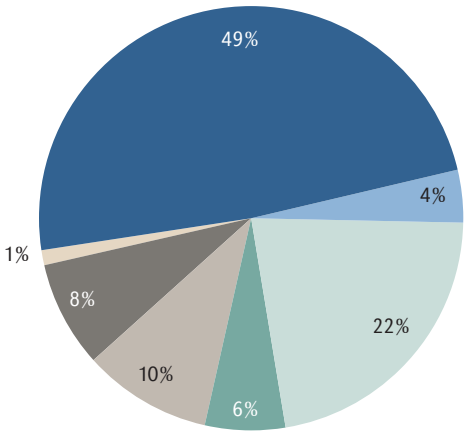


- Fund-of-Funds Manager
- Consultant/Advisor
- Family Office
- Insurance Company
- Public Pension
- Wealth Manager/Outsourced CIO
- Endowment/Foundation
- Corporate Pension/Industry Pension Plan
- Bank
- Government Entity

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Chart III Respondents by Firm Headquarters

My firm is headquartered in:

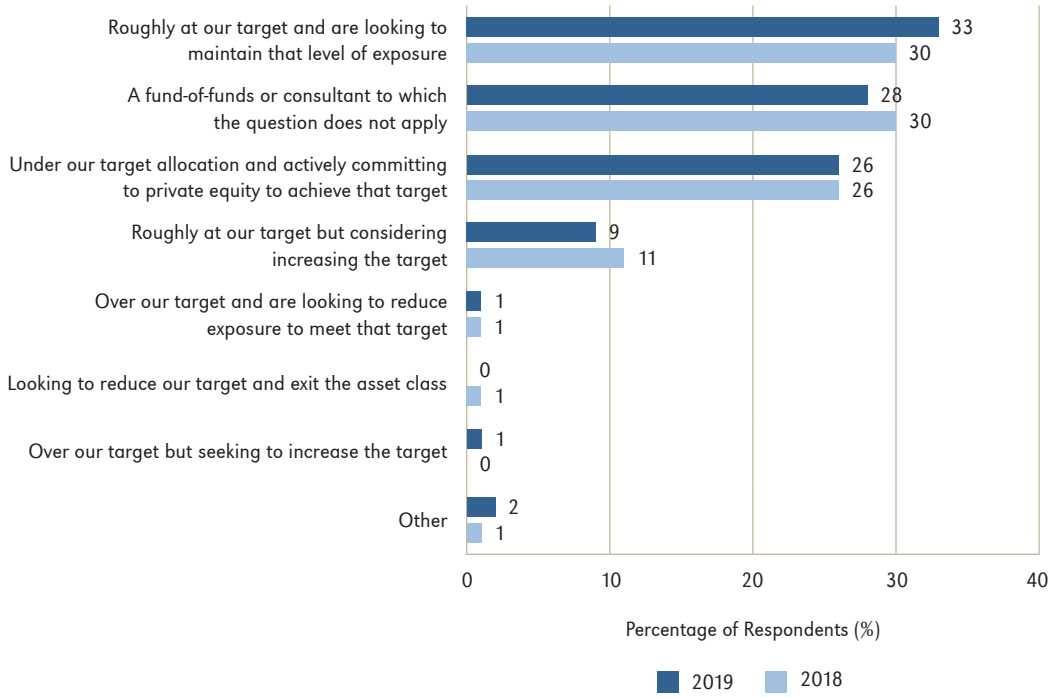


- United States
- Canada
- Western Europe ex-United Kingdom
- United Kingdom
- Japan
- Asia ex-Japan
- Australia

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

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 2019 Survey Results

- Two years ago, 52% of respondents to our survey stated that their primary strategy for targeting funds was "pursuing the best available managers and funds;" though that remains the predominant approach, fewer respondents feel that way — 38% this year — with no single approach dominating investors' strategies (Chart V).

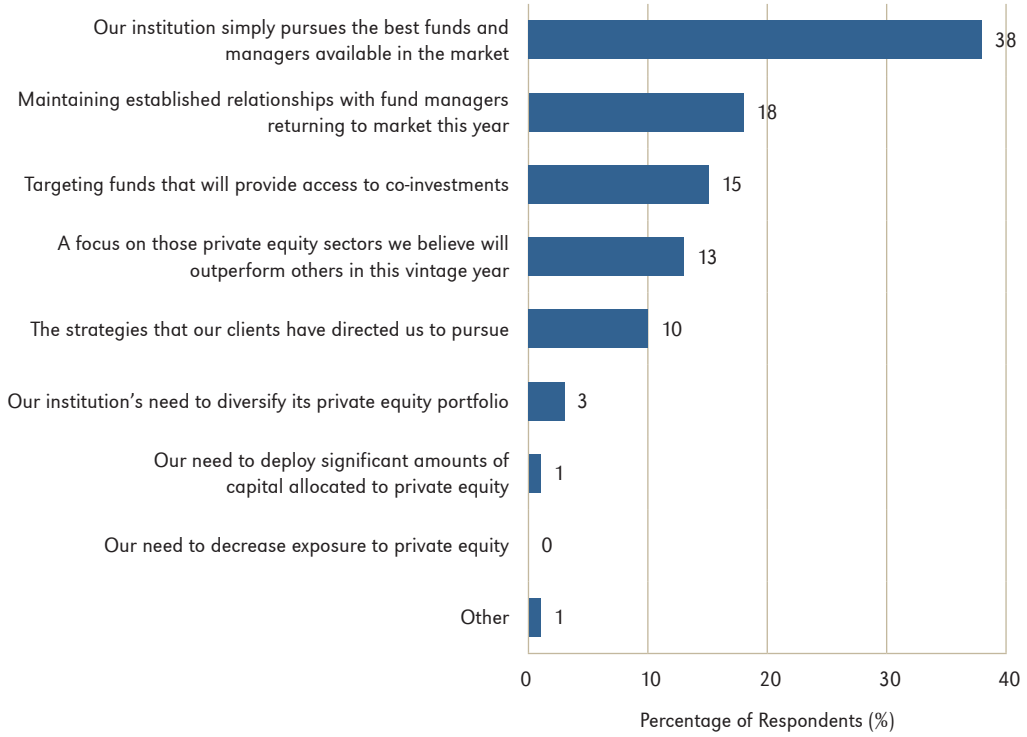
- Over the last three years, no investors indicated an intent to decrease their exposure to private equity.

- Both very large and small investors responded to the survey, with slightly fewer investors looking to commit $1 billion or more responding this year (Chart VI).

- There has been an increase over the last year in investors who are focused on current fund manager relationships with a limited look at new fund opportunities (Chart VII). At the same time, there was a drop in those investors who said that they were actively looking at new managers, reflecting the market challenges for managers seeking to build new investor relationships.

Chart V Drivers of Sector Investment

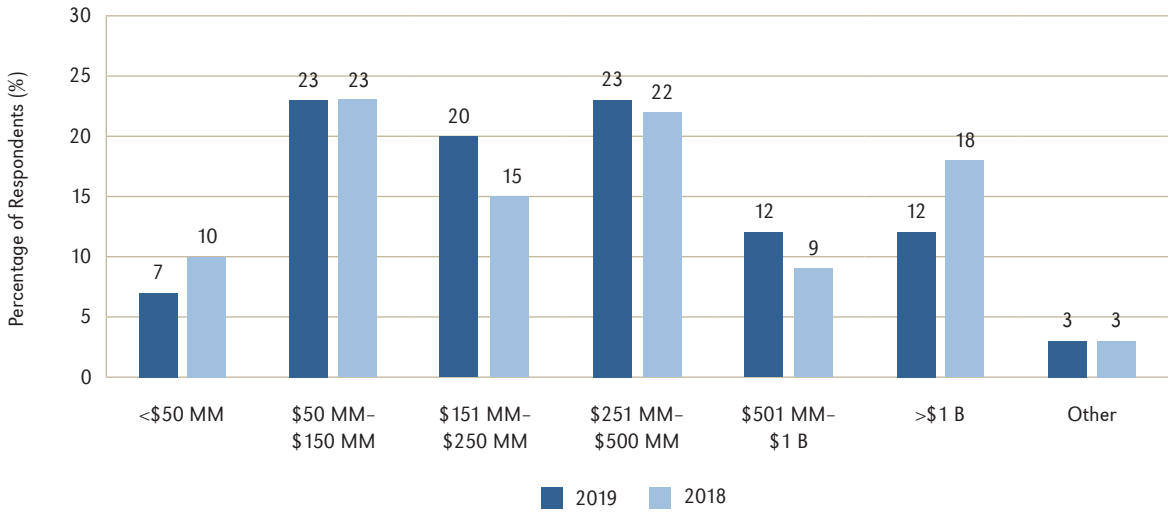
Our sector investment focus in 2019 will be driven by (choose no more than two):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Chart VI Private Equity Allocations

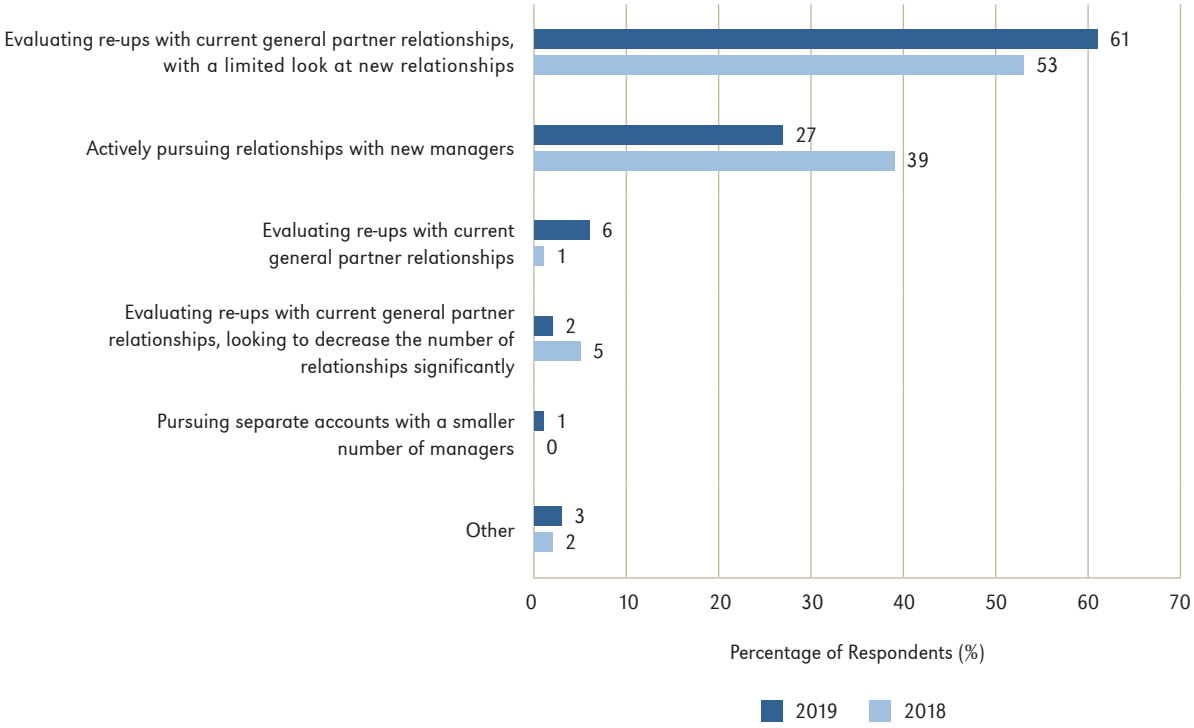
For 2019, we or the clients we advise are looking to commit across all areas of private equity (in USD):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results; Other responses were for respondents who had no target

Chart VII Manager Relationships

During 2019, we would expect our primary focus to be:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Sectors and Geographies of Interest

Chart VIII on the following page details the sectors of interest to respondents for 2019:

- U.S. middle-market buyouts, U.S. growth capital funds, and U.S. small-market buyouts hold the top three spots and are the only sectors attracting more than 50% of investor interest globally.

- Interest in special situations increased slightly (rising from 36% last year to 44% this year), while interest in U.S. venture capital also increased somewhat (from 31% to 37%). Conversely, interest in Pan-European funds fell notably (from 52% to 40%) while interest in European country-focused funds declined slightly (from 46% to 43%).

Table I compares differences among the top five areas of interest from before the Great Financial Crisis ("GFC") in 2007's survey and this year's results, to provide more perspective.

- The 2019 survey had more options than the 2007 survey (including a more detailed breakout of U.S. middle-market buyout funds), but U.S. middle-market buyout funds were clear preferences in both surveys.

- Though interest in U.S. venture capital has increased this year, it is still only ranked 7th, so it is not reflected in the table.

- On a relative basis, Asian funds — both Pan-Asian and country-focused funds — have declined in interest recently. While they both attracted the attention of 24% of the respondents, they were ranked only 10th compared to other strategies in 2019.

- While distressed debt has declined in interest over the last decade — only 19% of respondents selected it this year — an allied strategy, special situations, is now ranked 4th with 44% of respondents targeting it.

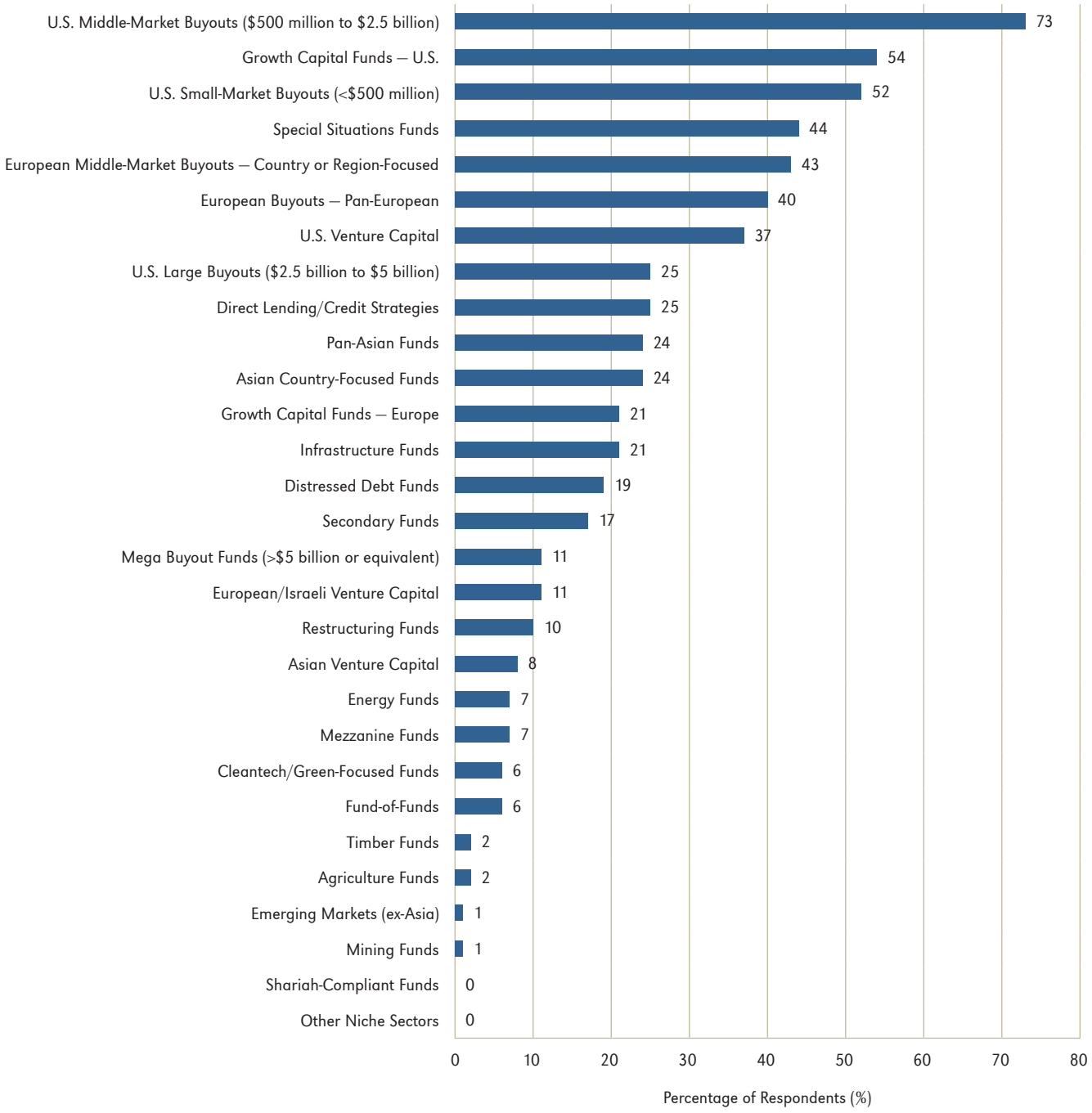
Table I Institutional Investors Focus of Attention Among Private Equity Sectors
Top Five Responses:

2007		2019	
Sector	**% Targeting**	**Sector**	**% Targeting**
U.S. Middle-Market Buyouts	49%	U.S. Middle-Market Buyouts ($500 million to $2.5 billion)	73%
European Middle-Market Buyouts	42%	U.S. Growth Capital Funds	54%
U.S. Venture Capital	34%	U.S. Small-Market Buyouts (<$500 million)	52%
Distressed Debt	30%	Special Situations Funds	44%
Asian Funds	25%	European Middle-Market Buyouts — Country or Region-Focused	43%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 and 2019 Survey Results

Chart VIII Private Equity Sectors of Interest

During 2019, 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 2019 Survey Results

Since North American investors made up over 50% of respondents to the survey and to avoid "hometown" bias in the rankings, Charts IX and X detail how European and Asian respondents perceive the market, while the views of North American respondents are also broken out separately in Chart XI.

As far as European respondents are concerned:

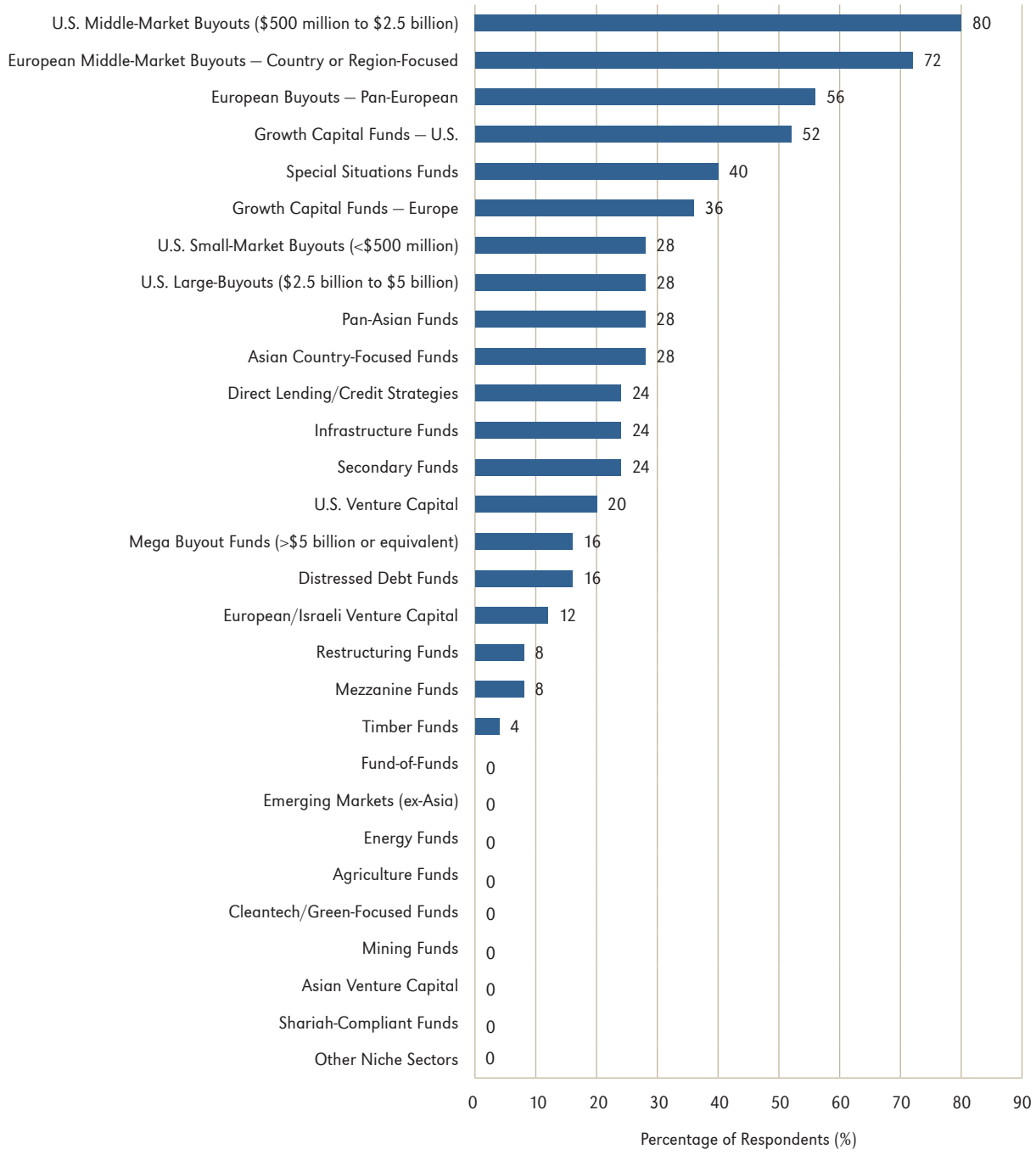
- The top-ranked sector of interest was U.S. middle-market buyouts (funds seeking $500 million to $2.5 billion), though European country-focused funds and Pan-European funds followed closely. This ranking is similar to 2018's results, though last year Pan-European funds were of slightly more interest.

- Europeans are much less interested in U.S. venture capital, in part because access to the top- performing managers in the sector is more difficult for them. They have relatively little interest in European venture capital and no reported interest in Asian venture capital.

- They have no interest in some niche strategies such as agriculture and mining funds.

Chart IX Private Equity Sectors of Interest; European Respondents

During 2019, 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 2019 Survey Results

- Responses from Asian investors, detailed in Chart X, were dominated by participants from Japan, who made up just over half of respondents this year.

- As with the investors in the other geographies, the leading sector of interest was U.S. middle-market buyouts — though unusually they were equally focused on U.S. venture capital. Asian respondents also had a much stronger interest in Asian venture capital.

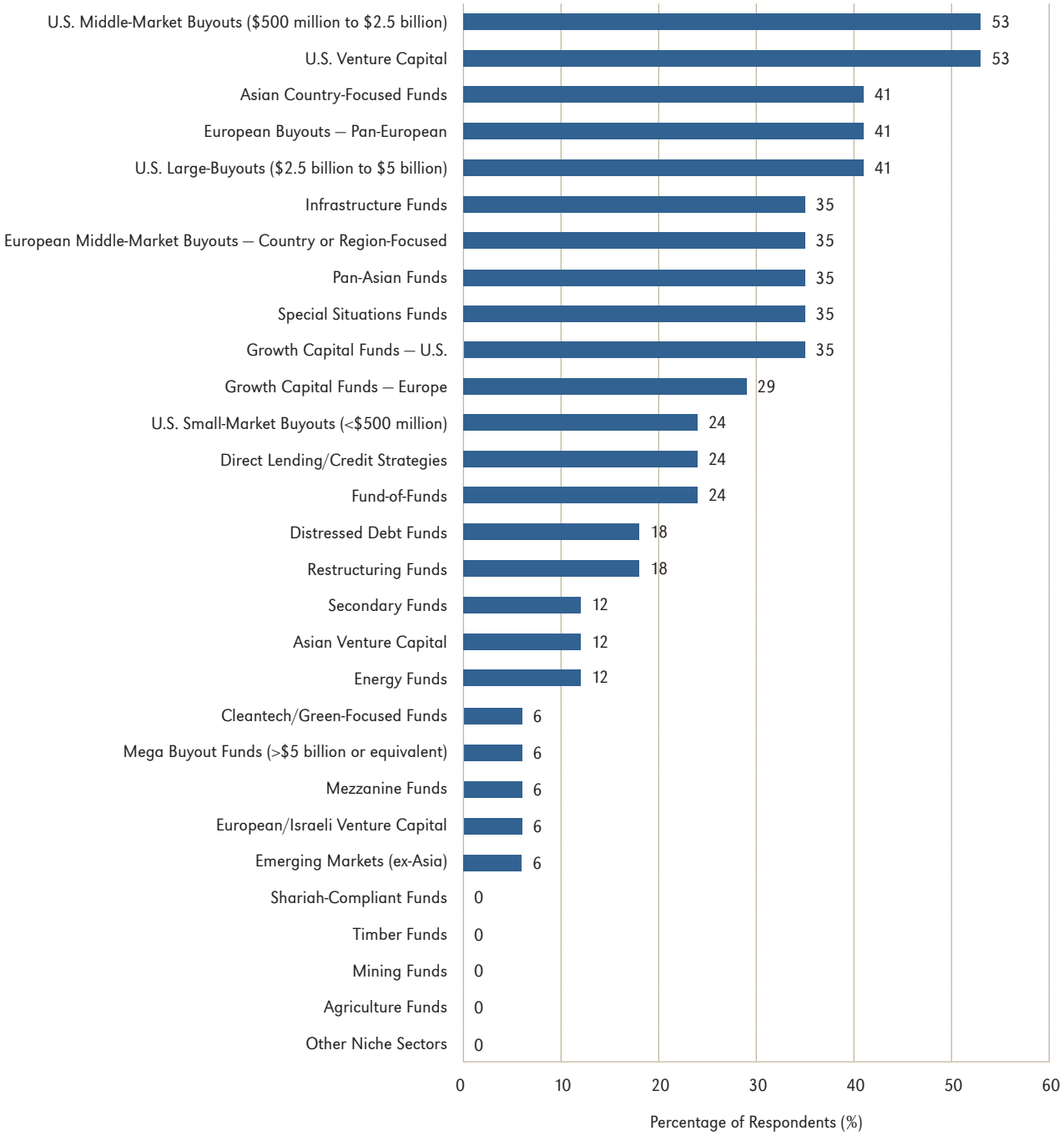
- There was also significant interest in Asian country-focused funds, with an increase from 31% last year to 41% this year.

- Asian respondents were the least interested in mega-buyout funds, with only 6% targeting them.

- Though most investors target infrastructure funds out of infrastructure or real assets allocations, some investors make these commitments out of private equity allocations. Our survey found the most significant interest in infrastructure amongst Asian investors.

Chart X Private Equity Sectors of Interest; Asian Respondents

During 2019, 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 2019 Survey Results

- Among North American respondents, U.S. middle-market buyouts, small-market buyouts, and growth capital funds dominated investors' interest; these were the only funds that attracted more than 50% of respondents' interest (Chart XI).

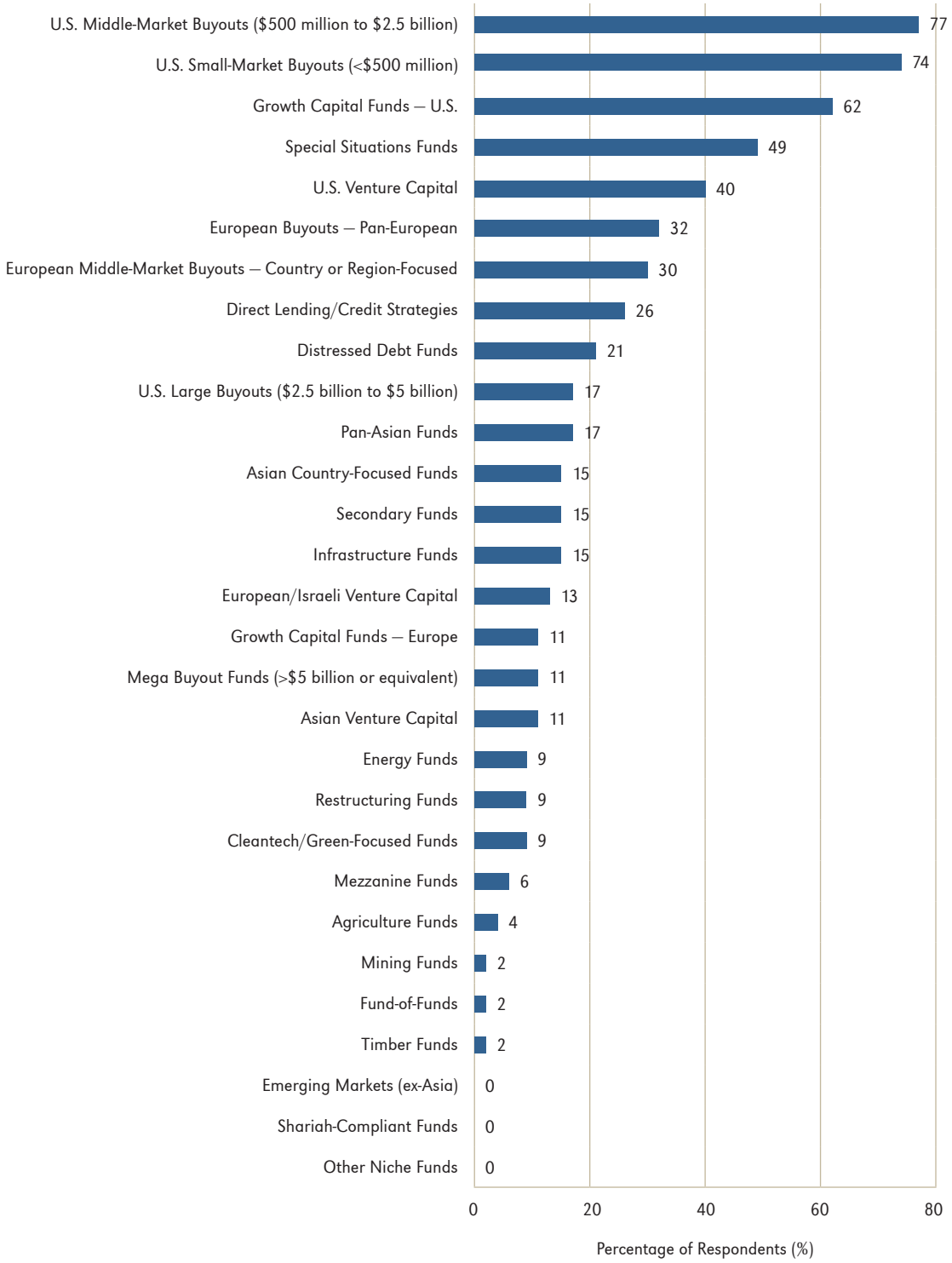
- Special situations funds ranked higher for North American respondents than those in the other geographies, as did distressed debt.

- Interest in U.S. venture capital ranked well among North Americans, though slightly behind that of Asian investors.

- North American investors were much more interested in European buyout funds than they were in Asian funds.

Chart XI Private Equity Sectors of Interest; North American Respondents

During 2019, my firm or my clients plan to focus most of our attention on investing in the following sectors (choose no more than seven):



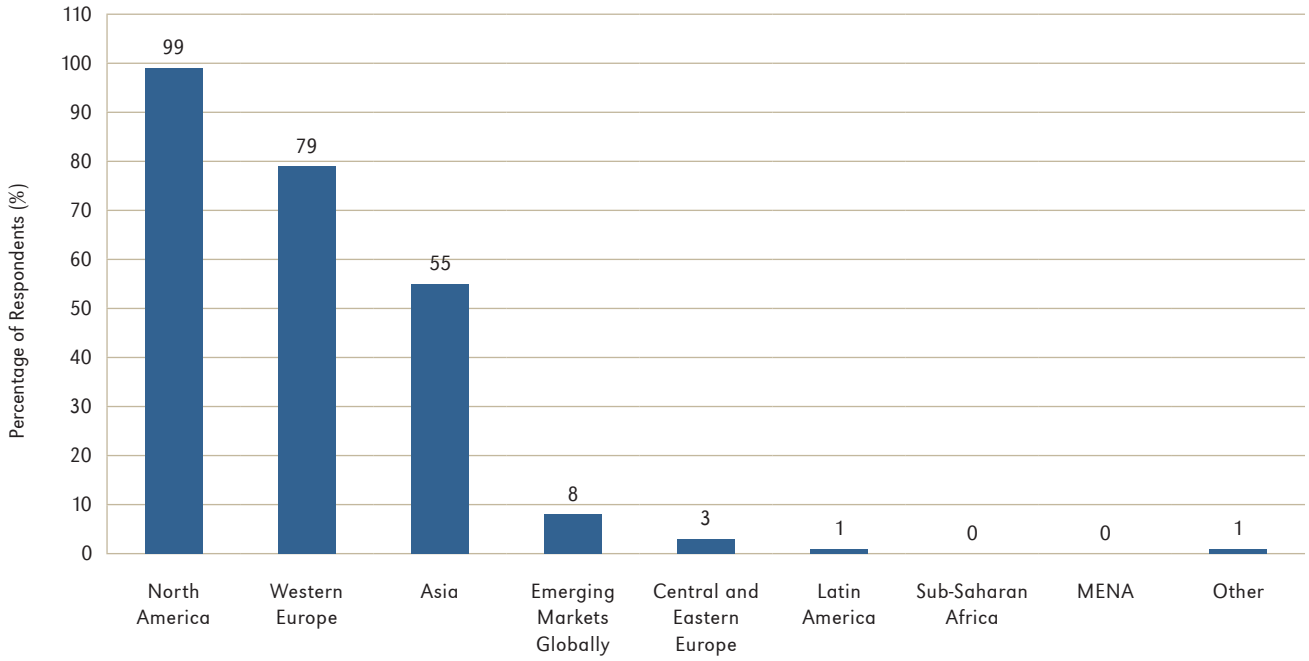
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

- Respondents are most interested in the developed private equity markets of North America, Western Europe, and Asia (Chart XII).

- Interest in emerging markets remained low this year and continued to fall over the last two years. Besides Asia — which contains a mix of developed and emerging markets — interest in emerging private equity markets remains scattered, with no other specific geography being a leading contender.

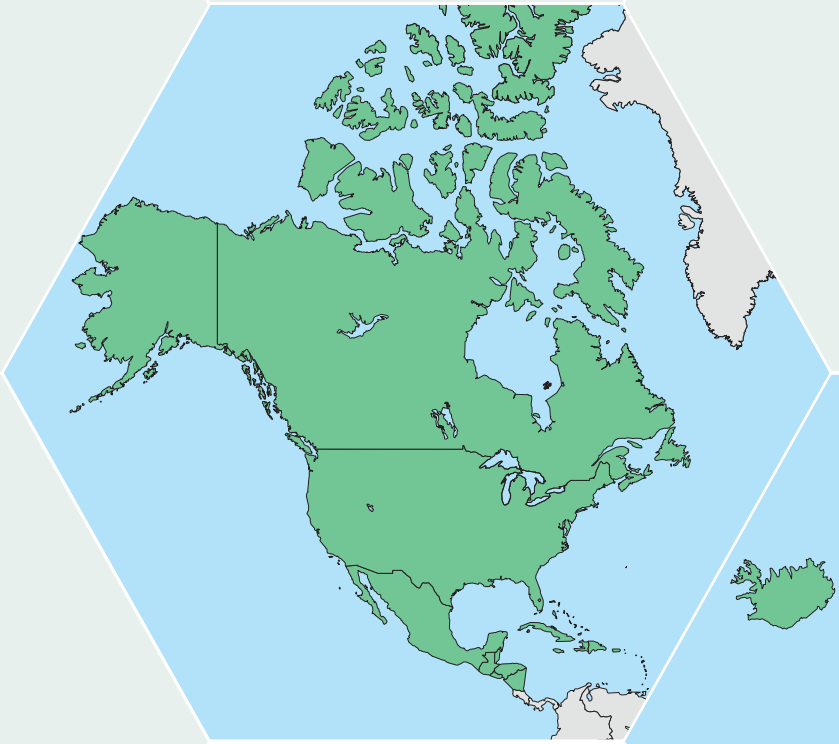
Chart XII Private Equity Geographical Focus

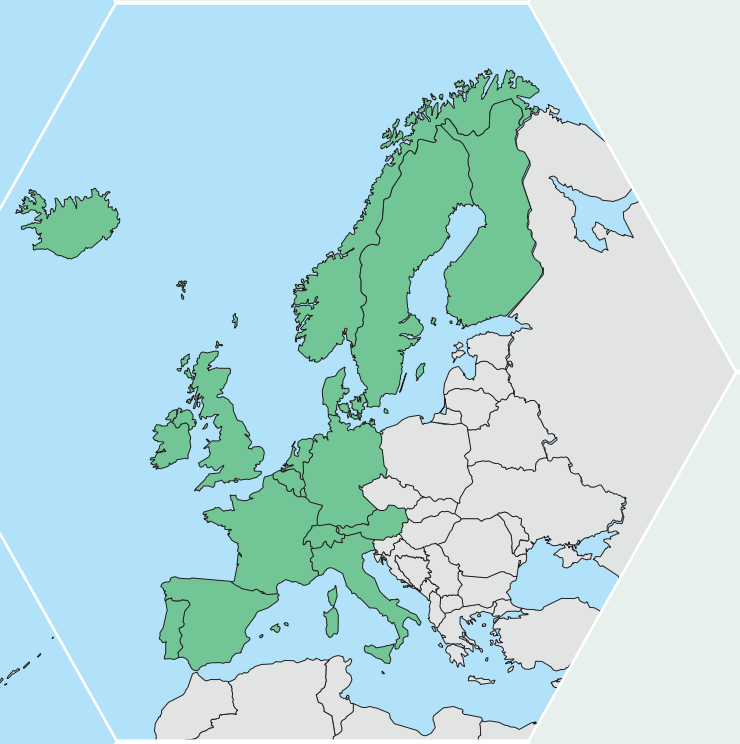
During 2019, my firm anticipates that the three primary areas of geographical focus for our programs will be:



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Respondents are most interested [in] North America, Western Europe, and Asia... interest in emerging markets remains scattered.





- In all our previous surveys, the UK, the Nordic Region, and Germany led investor interest in European funds, though their position within the top three changes year-by-year depending upon market forces. This year there was a sharp drop in interest in the UK and a surge in interest in Germany.

- There is a distinct split in investor interest in the UK, however. Only 22% of continental Europeans are targeting the UK, compared to 42% of North American respondents and 53% of Asian respondents; for continental Europeans, the UK ranked fifth instead of third, behind the Netherlands and France. In recent conversations with European continental investors, many of them expressed strong concerns over the uncertainties of exactly how Brexit will play out as far as the short-term impacts on the British economy and the value of the pound. A slightly different perspective was provided in a comment in the survey from a U.S. family office who is targeting the UK:

  - *"Brexit hangs heavy on European private equity and with that it presents opportunity in that region. We are actively exploring options with strong managers who are able to navigate that uncertainty and capitalize on opportunities that others might be too paralyzed to execute upon."*

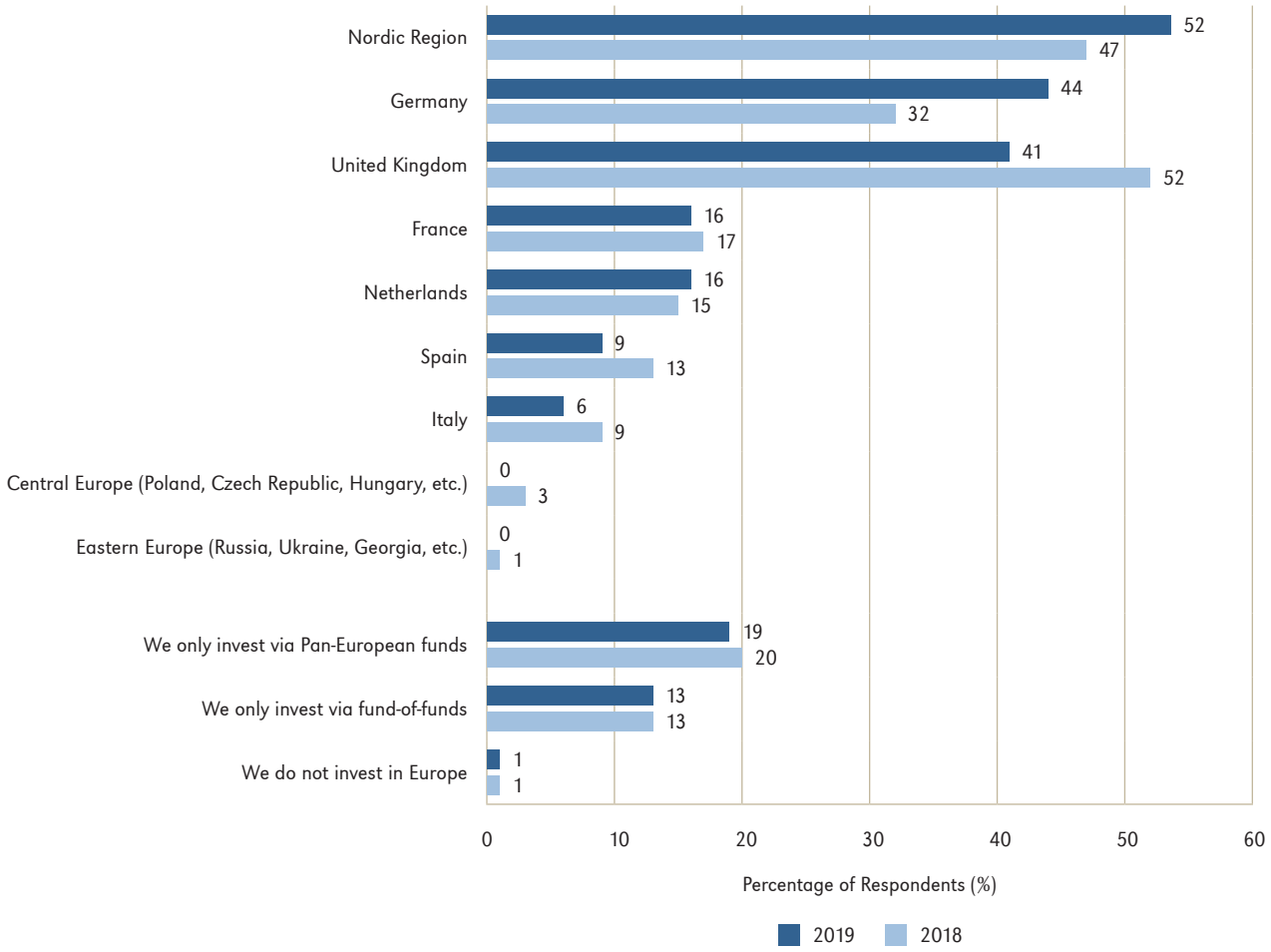
  A continental European corporate pension plan which focuses on Germany and Spain had a more favorable opinion about opportunities in continental Europe:

  - *"A stable market with still room for growth and strong returns possible for the foreseeable future."*

- This year interest in both Central and Eastern Europe continued to fall from its already low state, with no respondents selecting them as target markets.

Chart XIII Most Attractive European Markets

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

"Brexit hangs heavy on European private equity and with that it presents opportunity in that region. We are actively exploring options with strong managers who are able to navigate that uncertainty and capitalize on opportunities that others might be too paralyzed to execute upon."

Interest in Asia by geographic region is detailed in Chart XIV.

- Interest in China rebounded to 47% this year from 30% last year, driven in large part by a surge in interest from North American investors, from 32% last year to 53% this year. In our recent conversations, certain U.S. investors are concerned about how changes in The Committee on Foreign Investment in the United States ("CFIUS") will affect proposed Chinese investments and how a potential trade war between China and the U.S. will play out. However, those concerns do not yet seem to have had a significant negative impact on U.S. appetite for Chinese private equity in our survey.

- Interest in China was notably lower amongst Asian investors than it was for respondents outside of the region.

- Interest in Japan was driven in part by the large number of Japanese respondents targeting their home market.

Investor interest just before the GFC compared to this year's is detailed in Table II.

- Though there has been a lot of volatility in investor interest in Asia over the last 13 years, China has broken out from where it stood in 2007 to be the clear leading geography, especially among international investors.

- The percentage of respondents stating that they did not invest in Asia has remained relatively constant at about a quarter of the respondents.

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

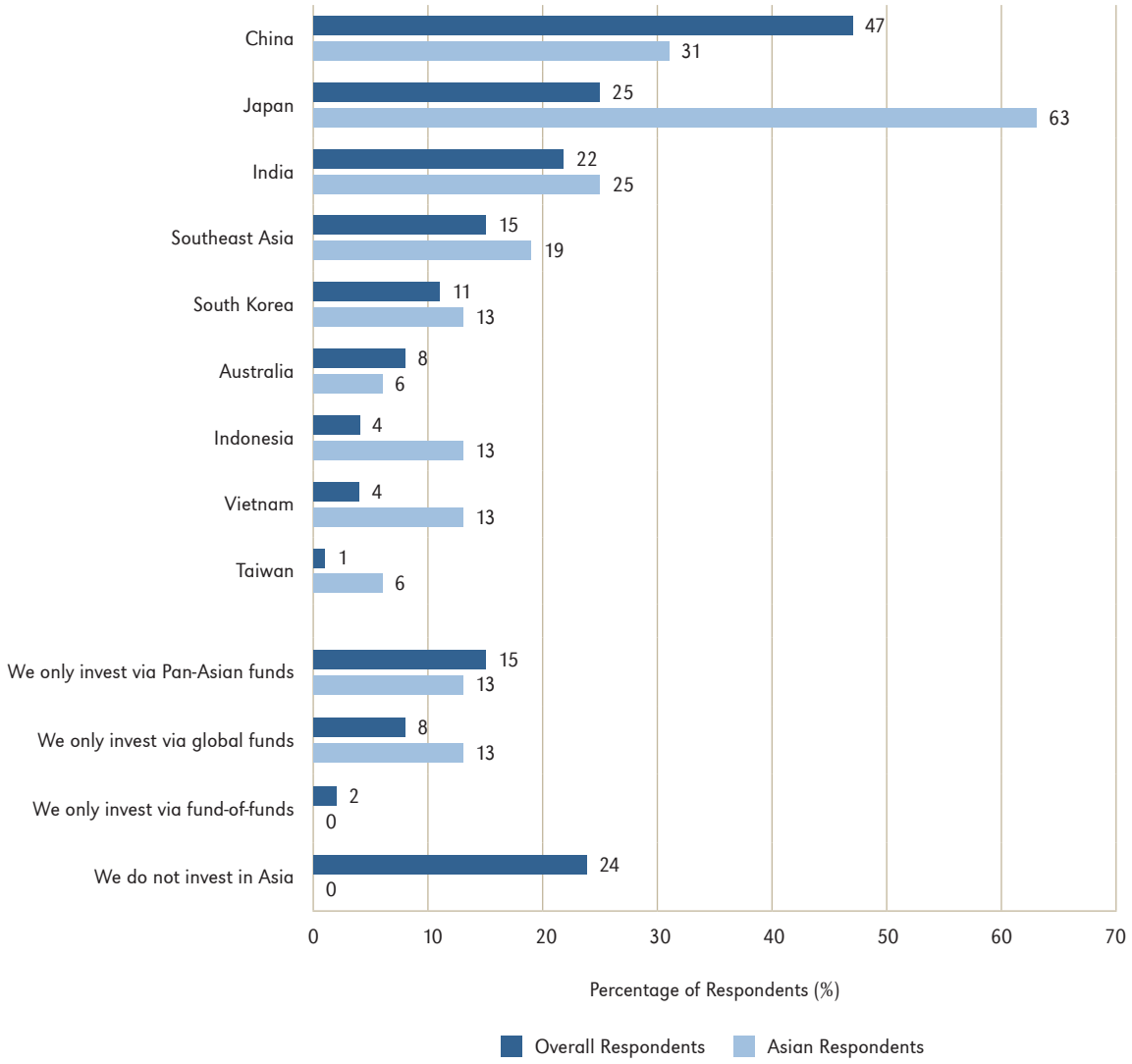
2007		2019	
Country/Region	**% Targeting**	**Country/Region**	**% Targeting**
China	28%	China	47%
India	28%	Japan	25%
Japan	25%	We do not invest in Asia	24%
We do not invest in Asia	25%	India	22%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 and 2019 Survey Results

Interest in China was notably lower amongst Asian investors than it was for respondents outside of the region.

Chart XIV Most Attractive Asian Markets

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Emerging Markets

Chart XV covers investor interest in emerging markets globally.

- The most notable change from 2018 (reflected in the previous chart covering Asia) is the surge in interest in China. This surge was driven by interest from large investors, those looking to invest $500 million or more in 2019, 57% of whom targeted China and the larger funds available in that market.

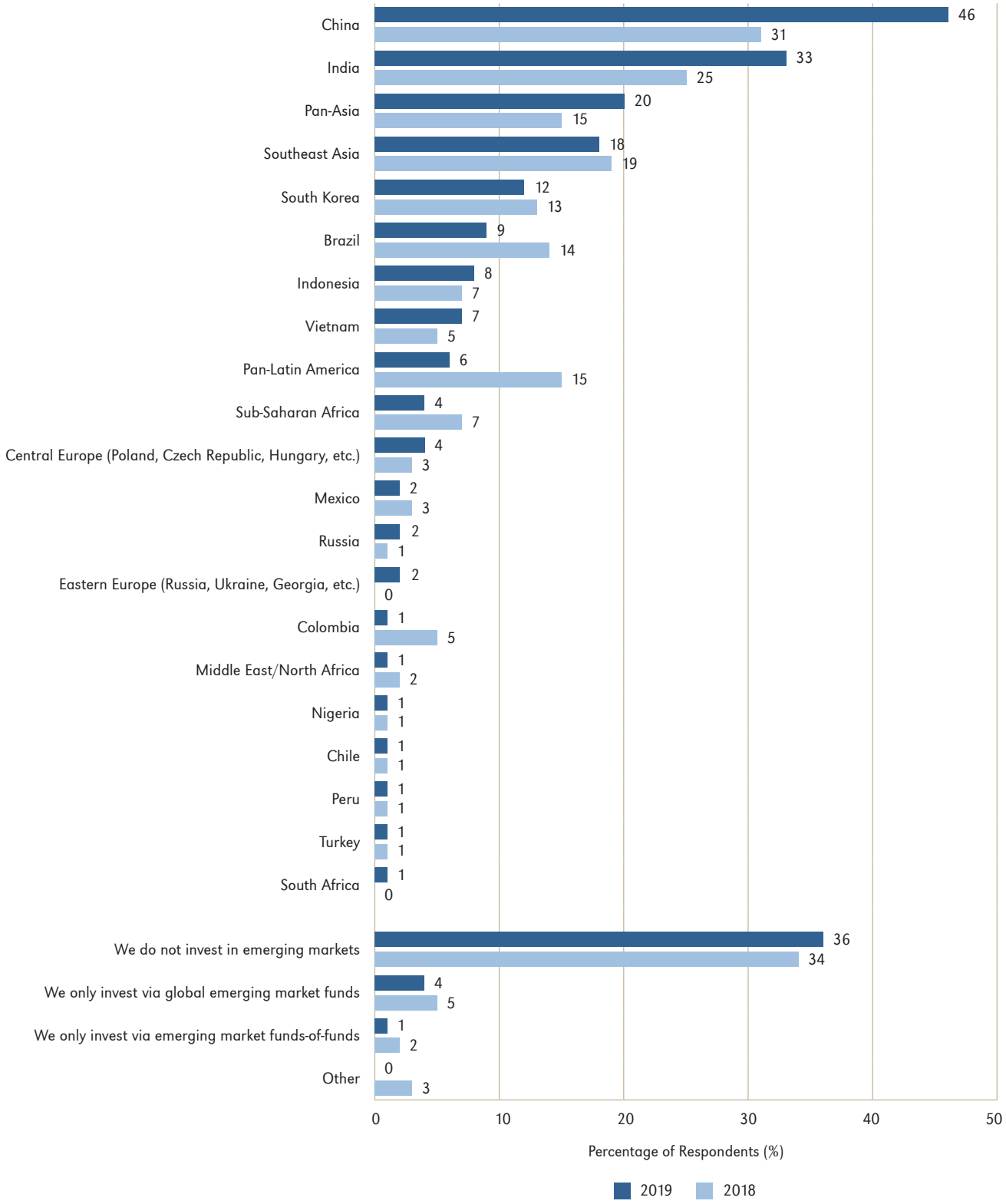
- Interest in both Indian and Pan-Asian funds increased notably this year, helping Asia to take the top five spots and dominate emerging markets interest.

- Latin America, on the other hand, saw a marked decline in interest across the board, with Brazilian and Pan-Latin American funds leading the retreat.

- Respondents not investing in emerging markets at all increased slightly to 36% this year. However, in 2016 only 16% of respondents did not invest there, so there has been a significant fall in interest in emerging markets over the last four years.

Chart XV Most Attractive Emerging Markets

Which emerging markets does your firm find most attractive (choose no more than four):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

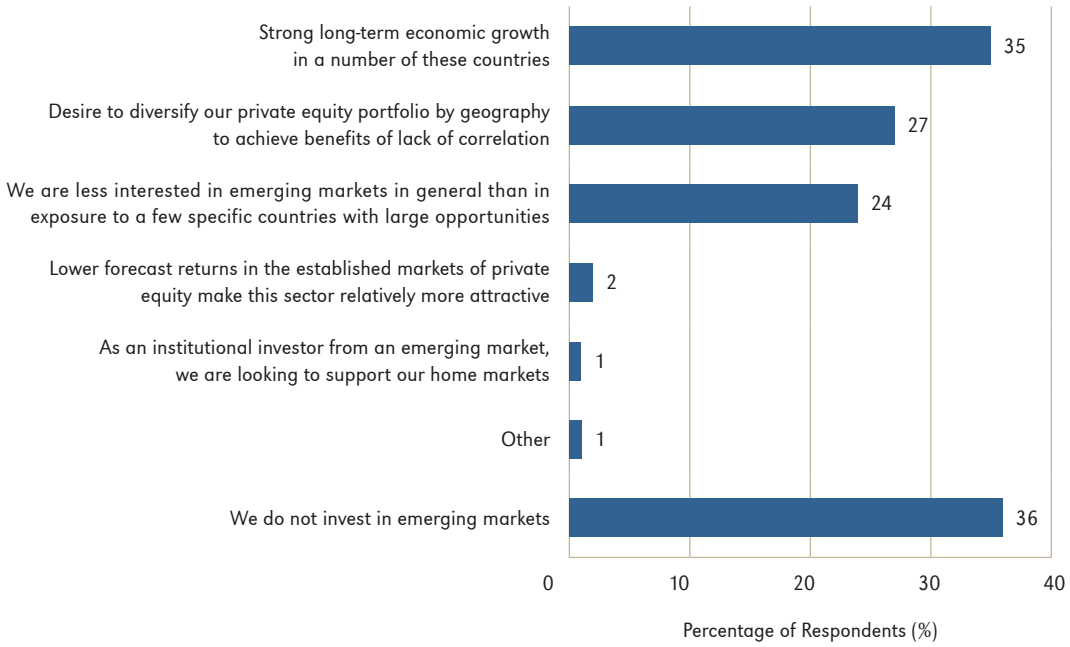
- Last year 44% of investors were interested in emerging markets, expecting to capitalize on strong long-term economic growth. Though that was the leading reason cited to invest in the emerging markets this year as well, only 35% of investors were focused on it (Chart XVI).

- Last year, 17% of respondents said they were targeting emerging markets as they felt returns in developed markets were under pressure; only 2% felt that way this year.

- Chart XVII outlines the reasons investors who are not interested in emerging markets feel that way. There were no dramatic changes in the rankings of the reasons cited this year, but every possible answer had a small increase in adherents this year.

Chart XVI Interest in Emerging Market Private Equity

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

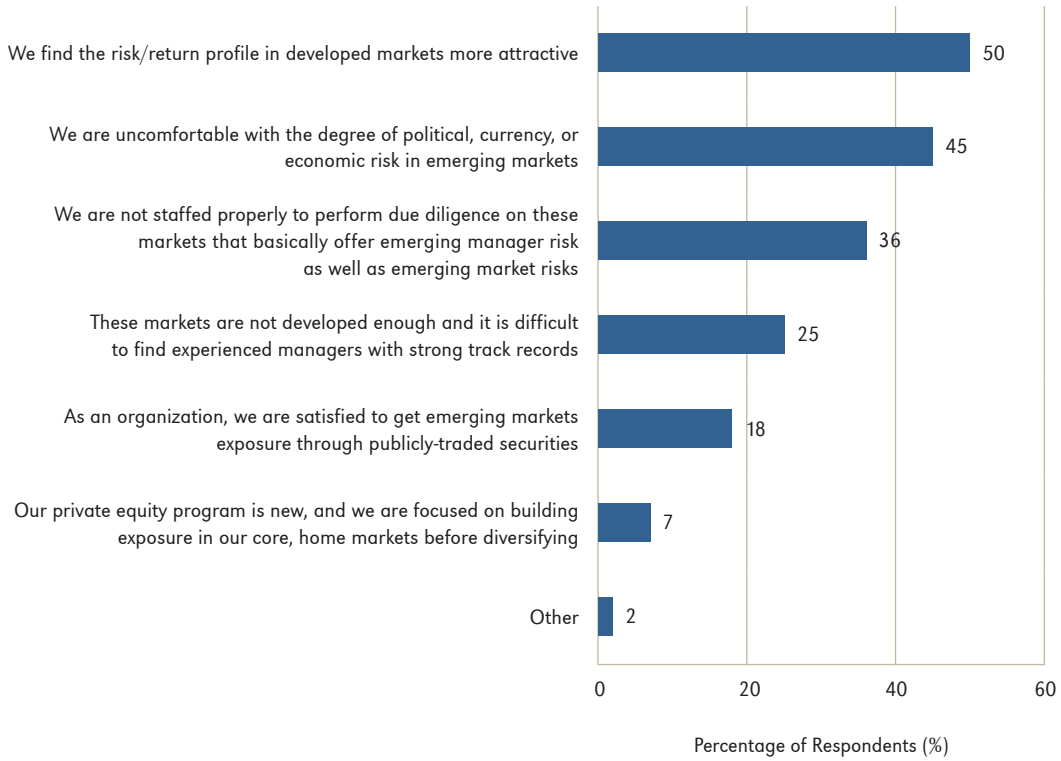


Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Last year, 17% of respondents said they were targeting emerging markets as they felt returns in developed markets were under pressure; only 2% felt that way this year.

Chart XVII Disinterest in Emerging Market Private Equity

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



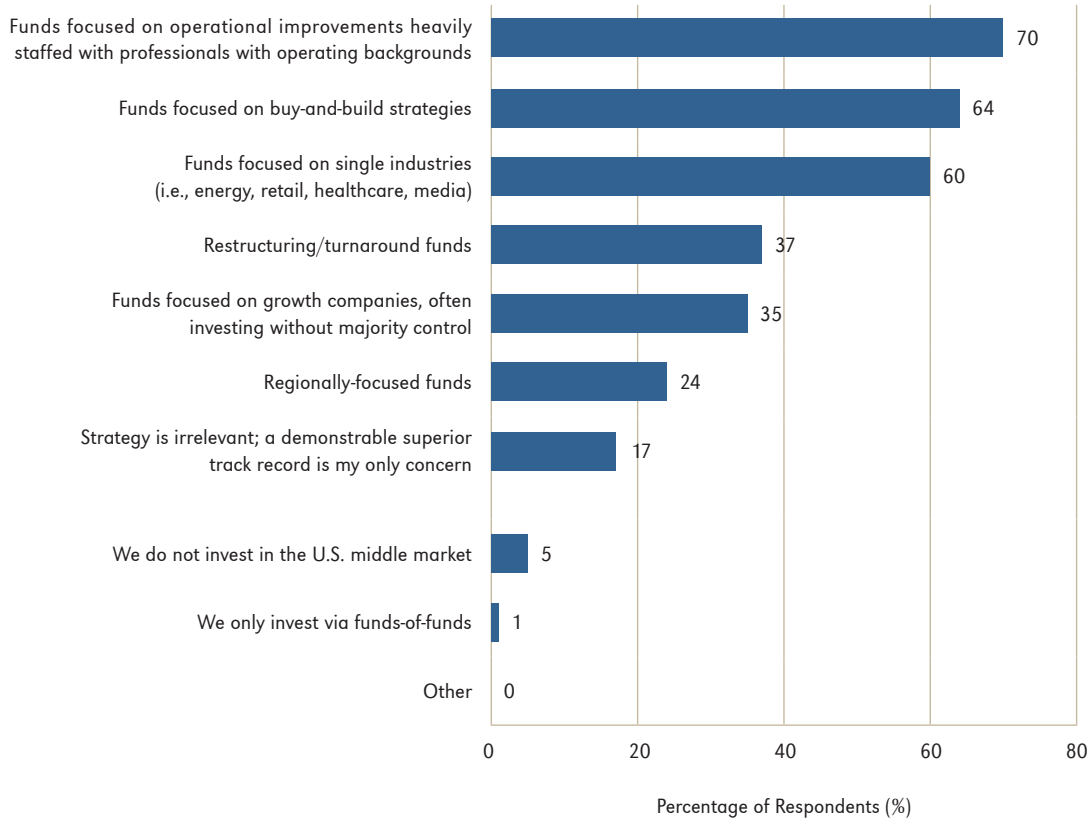
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

U.S. Middle-Market Funds

- As detailed earlier in the survey, U.S. middle-market buyouts are the sector most targeted by investors globally. However, within the U.S. middle-market investors' interest in specific strategies varies tremendously (Chart XVIII).
- Interest in operational strategies, buy-and-builds, and industry-focused funds continued to dominate the top three positions, with each strategy attracting a few more adherents compared to last year.
- The only focal point that declined notably this year was "a demonstrable superior track record." That priority attribute was only cited by 17% of respondents this year compared with 25% last year.

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

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



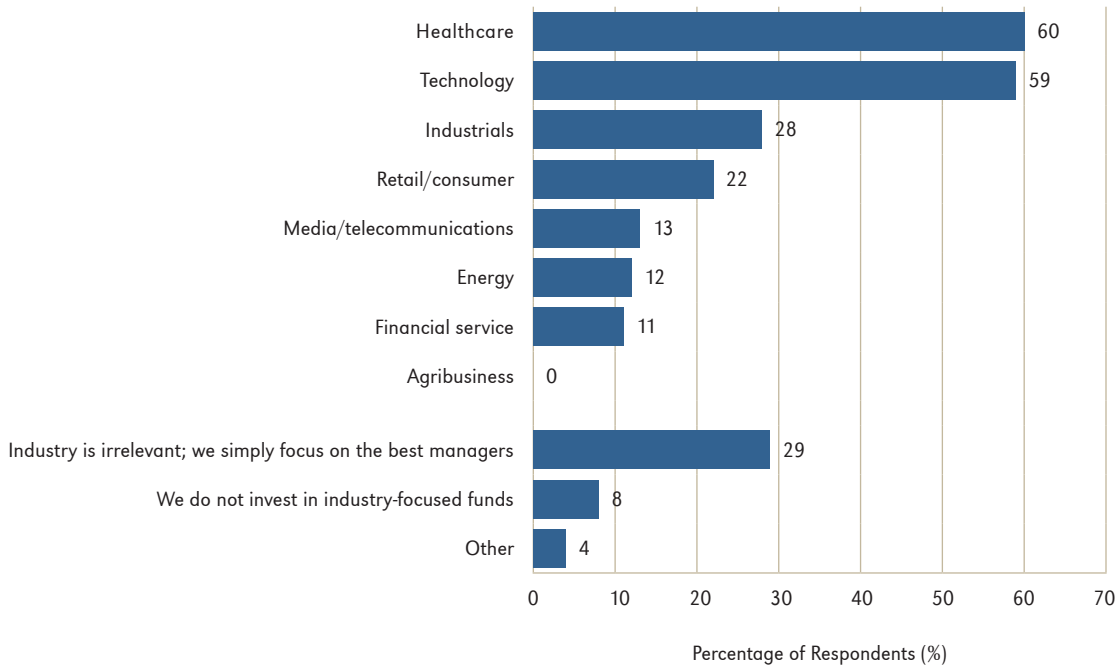
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

- Healthcare and technology-focused funds remain the dominant sectors of interest by an increased margin over other industries this year (Chart XIX). Agribusiness did not attract any respondents this year compared to 6% of investors last year.

- European investors are most focused on technology, with 61% targeting that industry compared to 44% focusing on healthcare.

Chart XIX Interest in Industry-Focused Funds

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

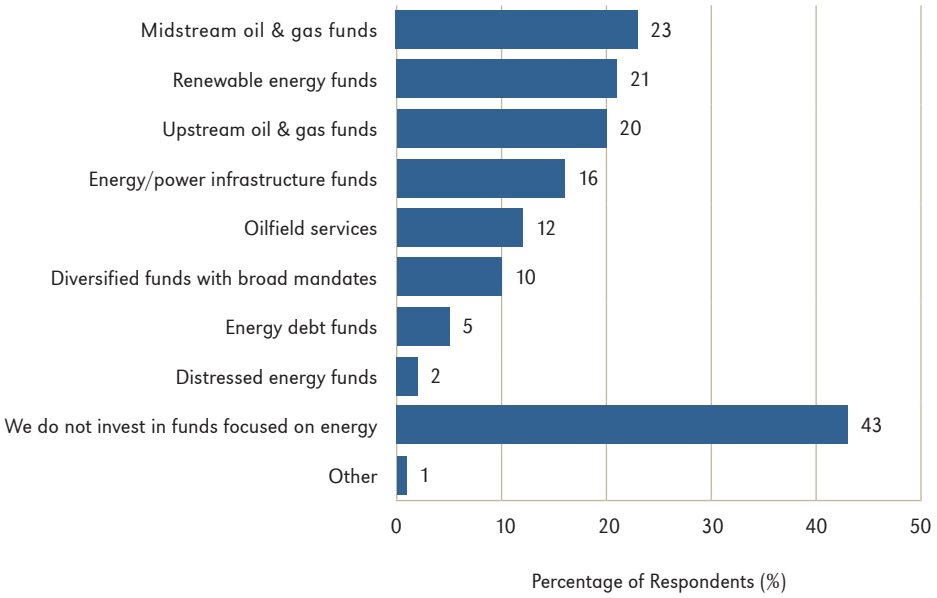
Interest in operational strategies, buy-and-builds, and industry-focused funds continued to dominate the top three positions, with each strategy attracting a few more adherents compared to last year.

- Investing in energy has attracted keen interest from North American investors over the last decade, though interest has declined over the previous four years as market prices for oil have been very volatile and an increased universe of investors seeks to reduce carbon exposure altogether. The energy sector is very broad and contains different sub-sectors, with various degrees of investor interest (Chart XX).

- The most significant difference compared to last year is renewable energy funds increasing in interest from 13% to 21%.

Chart XX Interest in Sectors within Energy

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Energy investing has attracted keen interest from North American investors over the last decade, though interest has declined over the previous four years.

Venture Capital

- Respondents are most interested in early-stage funds and funds targeting technology broadly (Chart XXI), while there is little interest in venture debt.

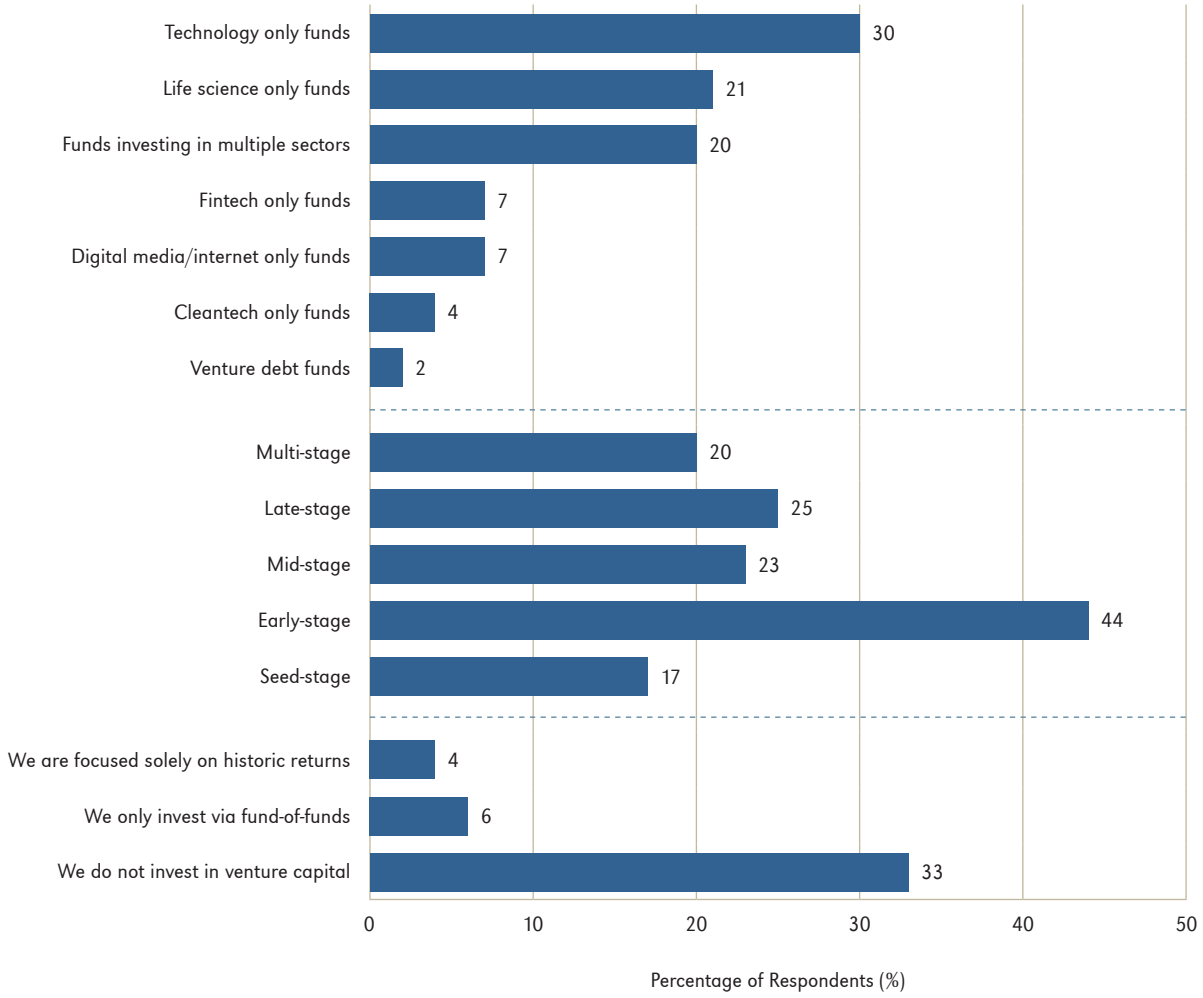
- Fintech-focused and digital media/internet funds with more narrow investment mandates than broader technology-only funds also attracted some degree of interest.

- There is a significant number of investors who do not invest in venture capital. This comment from an Asian endowment provides a rationale:

  - *"We think VC is an interesting opportunity but are faced with [the] same issues many LPs face — access and ability to gain meaningful exposure. If not in the top decile (not even quartile), then not really worth it. Our analysis shows over the last 20 years, even top quartile buyout funds have outperformed top quartile VC, and much less risk. Going to smaller emerging managers (e.g. 50-200m funds) may give an opportunity to get in early, but issue still remains around "taking a leap of faith" with them and getting a meaningful enough allocation to move the needle. FoF historically don't provide access and have very diversified holdings that are unlikely to capture the "3x+" type of alpha LPs would look for in a venture fund."*

Chart XXI Most Attractive Venture Capital Sectors

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

"We think VC is an interesting opportunity but are faced with [the] same issues many LPs face — access and ability to gain meaningful exposure."

Distressed Private Equity

- Distressed private equity includes several distinct strategies that are executed through different financial instruments (Chart XXII). Many funds are not "pure-plays" and pursue two or three strategies within the same fund. Certain large managers often raise different fund series that follow separate distressed strategies.

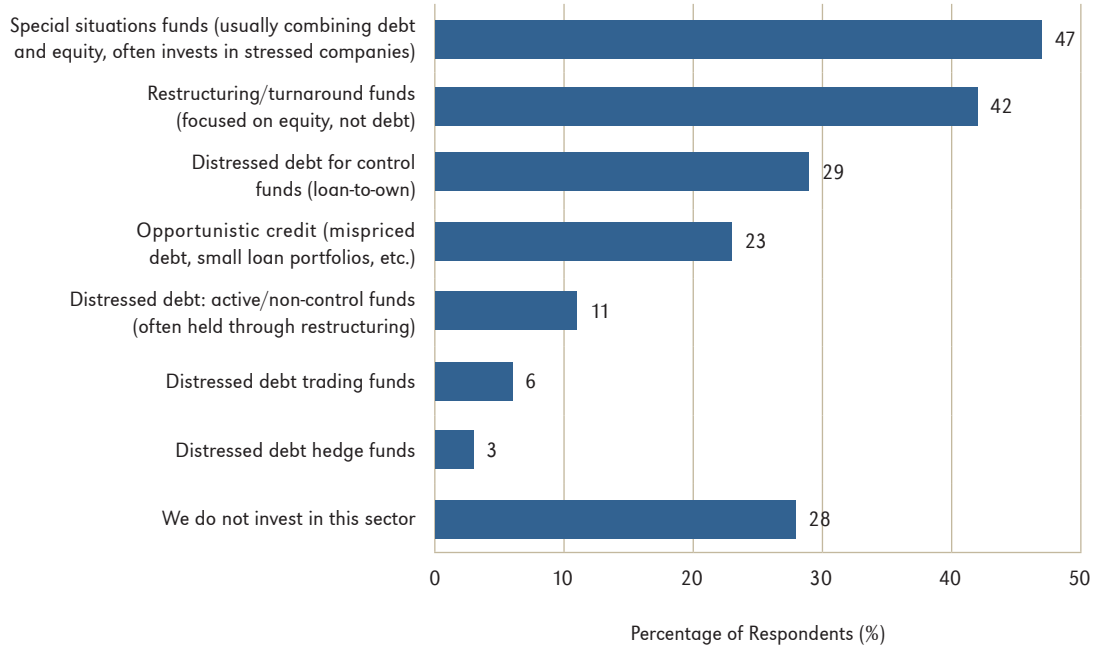
- In all our past surveys, respondents have focused on strategies that generate higher multiples of return instead of concentrating on IRR.

- This year, special situations funds gathered nearly 50% of respondents' interest, driven by the fact that they invest in stressed as well as distressed investments and thus have a broader opportunity set.

- A number of investors with whom we have spoken believe the cycle is not ripe enough to make major commitments to distressed, so they are waiting for the market to turn.

Chart XXII Distressed Investments

Within the distressed private equity sector, we are most interested in (choose no more than two):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Credit-Focused Funds

- Commitments to certain credit funds — those that tend to generate higher returns — are sometimes made through private equity allocations. For most respondents to the survey, mezzanine and opportunistic credit funds fall into that category, though these sectors also attract interest from private debt allocations (Chart XXIII). Funds focused on senior debt and diversified debt are also of interest, but these commitments are often made through private debt or fixed-income allocations.

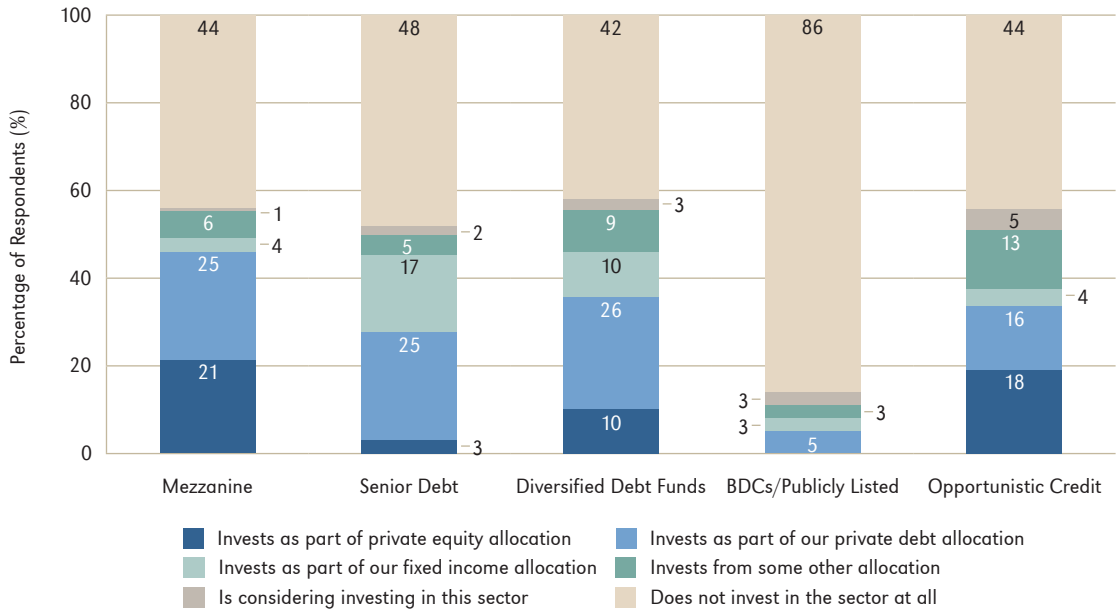
- Business Development Companies ("BDCs") and other publicly traded vehicles were of little interest to respondents in any type of allocation, with 86% stating that they do not invest in these vehicles at all.

- A Western European pension plan remarked that even with the tremendous growth in private credit over the last few years:

  - *"I would say this is an unproven market, difficult to assess the downside risk."*

Chart XXIII Credit

In the credit sector, my firm:



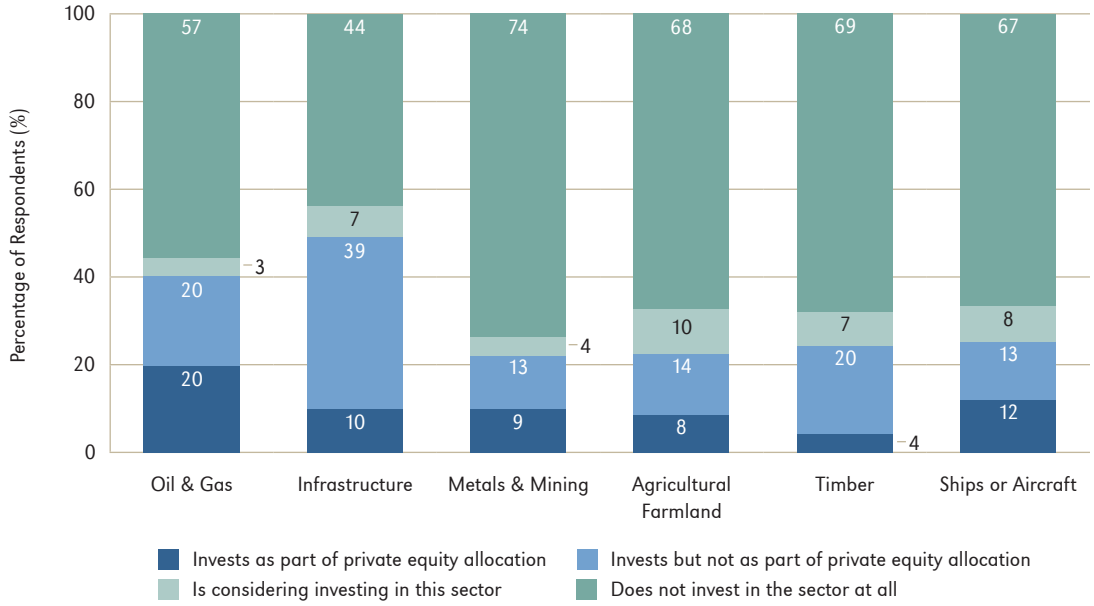
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results
Note: Some sectors total greater than 100% of respondents as a few investors had multiple responses

Real Asset Funds

- Over the last decade, investors with significant long-term liabilities have increased their focus on real assets, in part to secure assets of longer duration to match those liabilities but also to search for yield with downside protection. That attention has had an impact on the market, according to a comment from a Canadian public pension plan:
  - *"Most areas are expensive, because more institutional investors have been increasing allocations to these spaces in recent years, primarily in search of yield to replace low returns in fixed income. These spaces could get ugly, if rates rise sharply."*
- Current interest in real assets is covered in Chart XXIV.
  - The oil & gas sector (focused on upstream transactions in the real asset sector as opposed to midstream or services transactions) was of most interest from private equity allocations, driven by interest from North American investors, 27% of whom target it through private equity.
  - The largest sector of real asset interest was infrastructure, though most of those commitments come from specific infrastructure or real asset allocations.

Chart XXIV Real Assets

In the real asset sector, my firm:



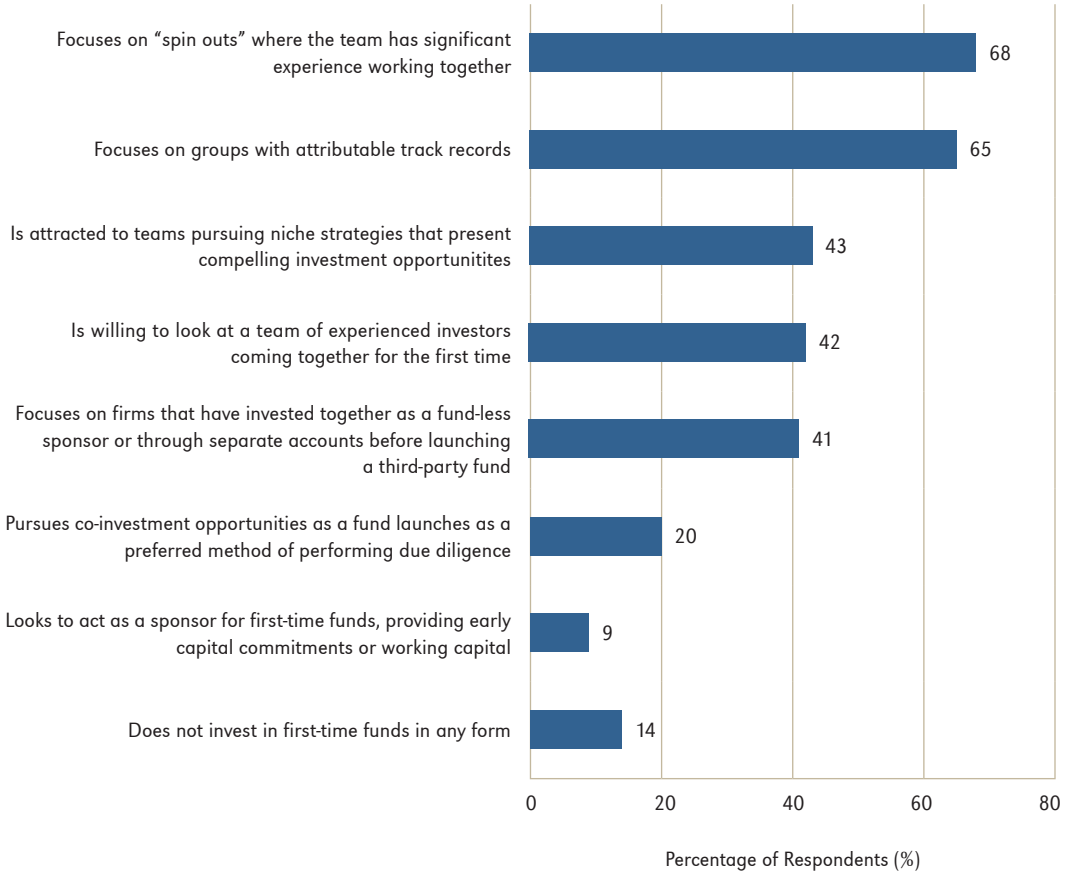
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results
Note: Some sectors total greater than 100% of respondents as a few investors had multiple responses

First-Time Funds

- Many investors are willing to invest in first-time funds, but they usually have a high bar on due diligence and target specific attributes (Chart XXV).
- The majority of investors interested in first-time funds de-risk their decision by focusing on "spin out" teams that have a history of working together and those groups that have legally attributable track records.
- Certain investors look for more than merely a chance for higher returns. One pension plan respondent commented:
  - *"We see these as a way to get a prime 'anchor' type position and close relationship with favorable economics, which is hard to get in established funds."*

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 2019 Survey Results

Secondary Market

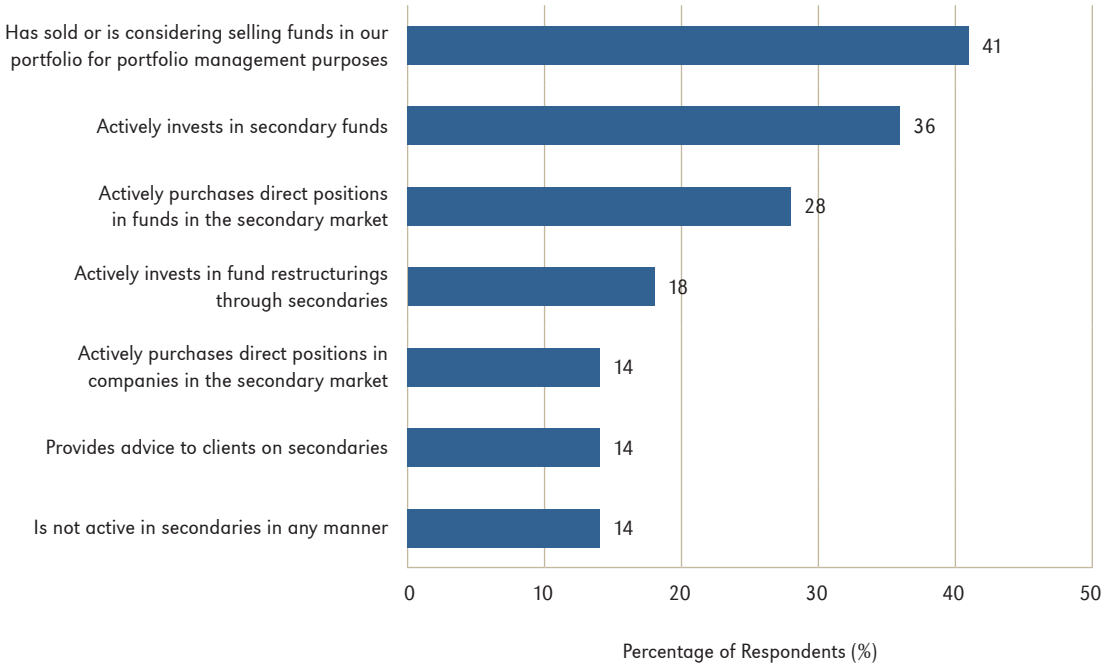
- For the first time, the largest response in the survey was that investors have sold or are considering selling positions for portfolio management reasons, with 41% selecting it compared to 29% last year (Chart XXVI). Large investors are even more interested in using secondaries as a portfolio management tool, with 50% of them selecting it.

- The other significant change in responses was that only 14% say they do not plan to be active in secondaries in any manner, compared to 26% last year.

- Fund restructurings or general partners-led transactions are becoming more important but can be more challenging to execute. However, potential conflicts of interest between fund managers and limited partners in these transactions have also attracted the attention of the U.S. Securities and Exchange Commission ("SEC"). Large investors are slightly more interested in investing in fund restructurings, with 22% of them selecting this option.

Chart XXVI Secondary Market Investments

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



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Co-Investments and Direct Investments

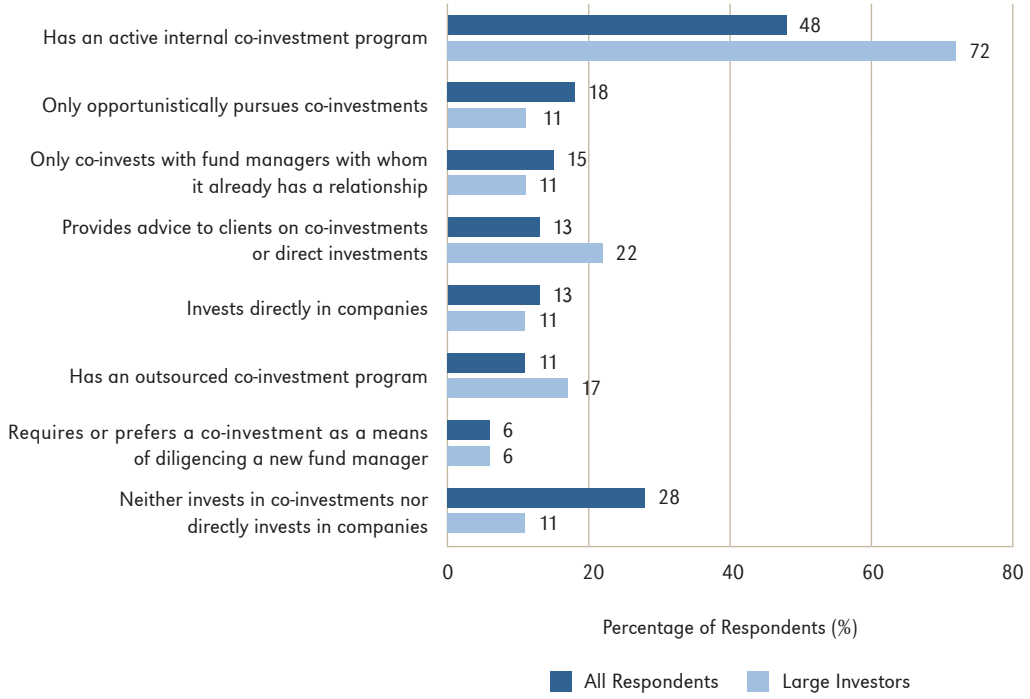
- Interest in co-investments has significantly increased over the last decade as investors look both to decrease net return dilution and exert more control over industry exposures. This is especially true of large investors who have more staff and other resources they can devote to co-investments (Chart XXVII).

- 89% of large investors have an active internal co-investment program or an outsourced program, a noticeable increase from 73% last year. Only 11% of large investors do not pursue co-investments at all.

- Few respondents of any size invest directly in companies; the exception is family offices, 60% of whom are active in direct investments.

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 2019 Survey Results
Note: "Large Investors" denotes those survey respondents who plan to commit $500 million or more to private equity in 2019

Fund Structures and Key Terms

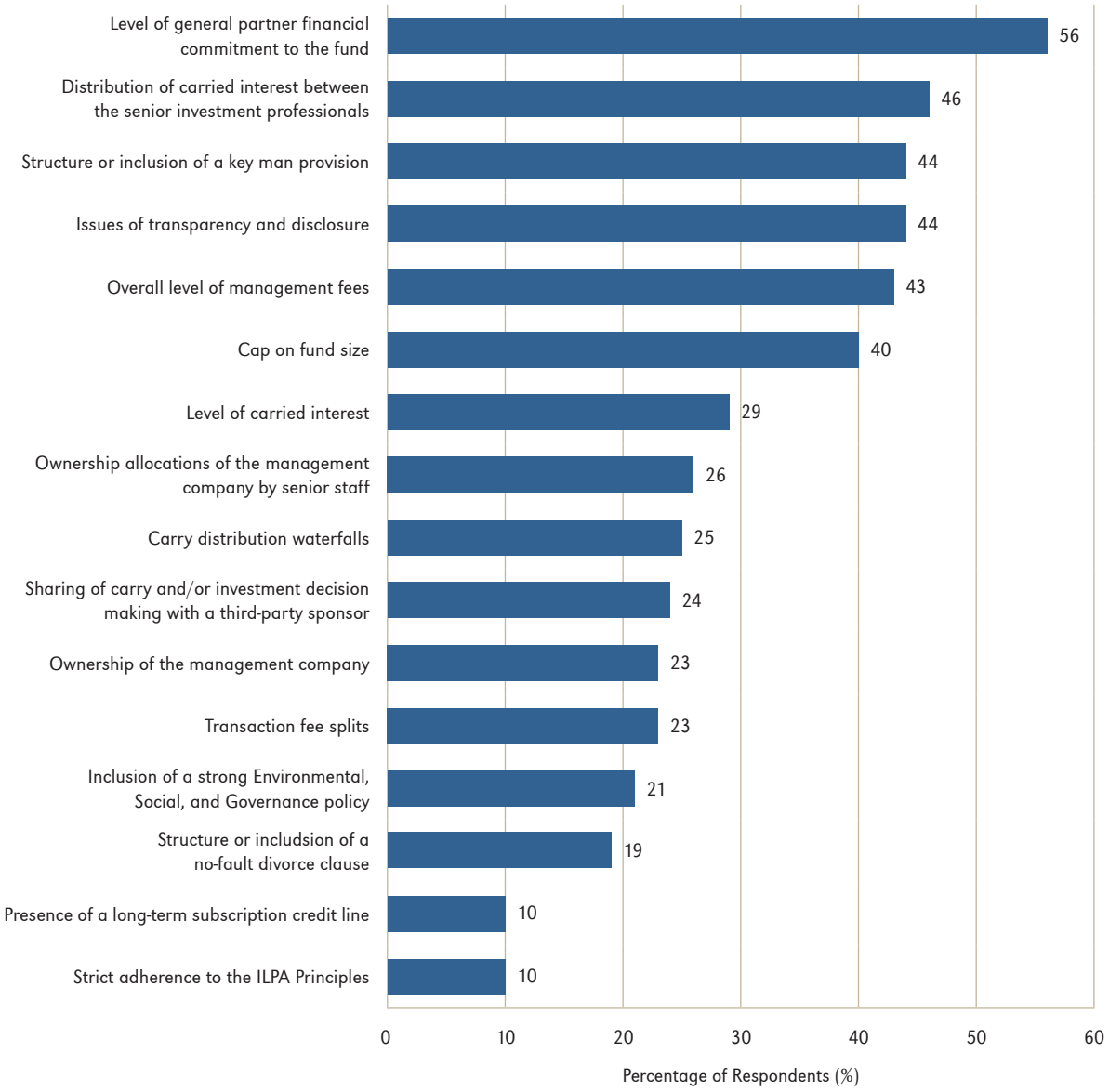
- The key term in negotiations remains the level of general partner financial commitment to the fund (Chart XXVIII), as it is a crucial factor establishing alignment of interest between investors and fund managers.

- The most significant change from last year was a notable increase in focus on transparency and disclosure, which moved from 34% last year to 44% this year.

- Several responses — the distribution of carry, the structure of a key man provision, issues of transparency, the level of management fees, and a cap on fund size — were tightly clustered as major areas of concern.

Chart XXVIII Issues Regarding Fund Structure

The issues we 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 2019 Survey Results

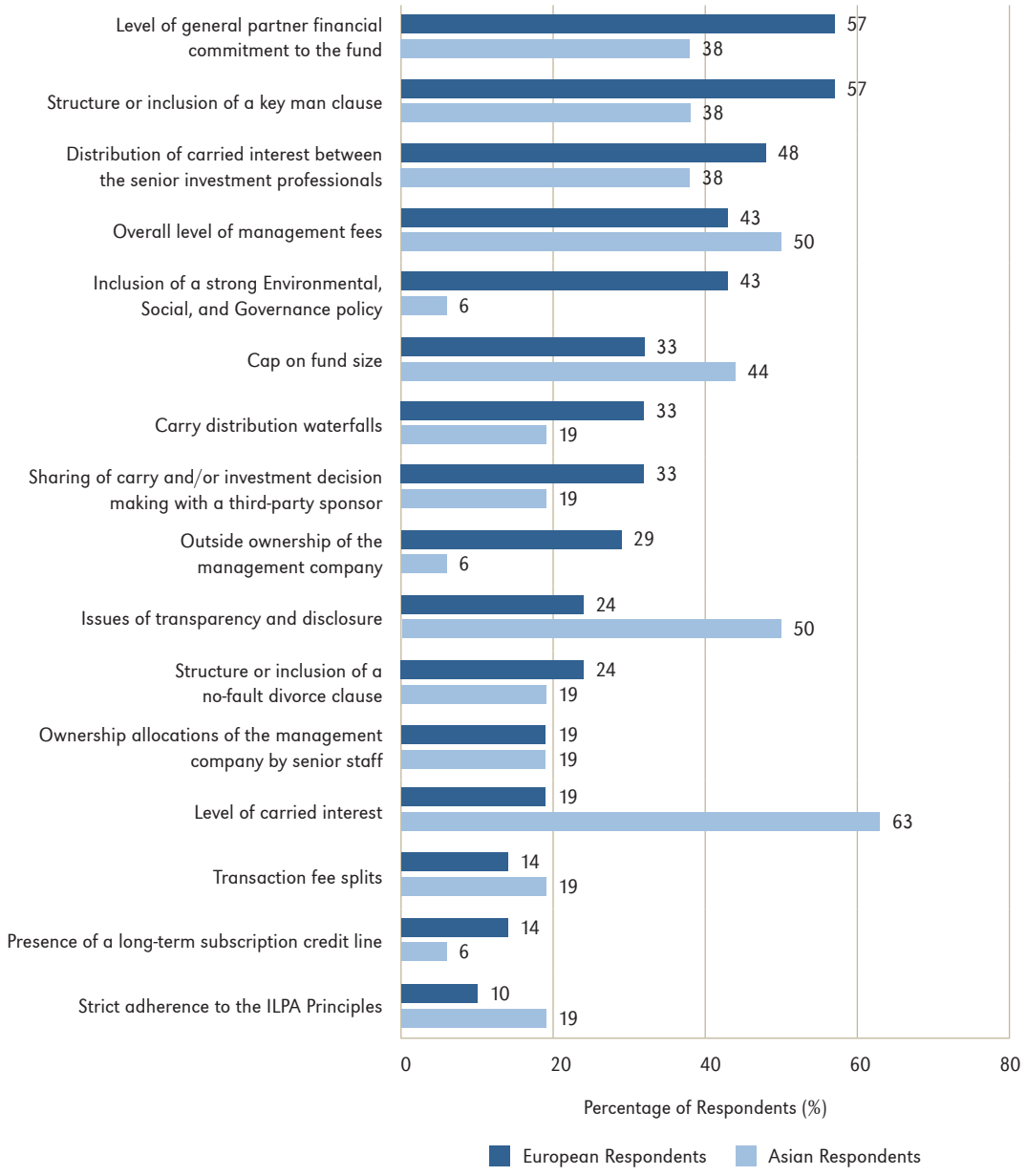
The most significant change from last year was a significant increase in focus on transparency and disclosure, which moved from 34% last year to 44% this year.

There are distinct differences of opinions as to what is essential among investors, with the responses of European and Asian investors being a case in point (Chart XXIX).

- As it was last year, Asian respondents are much more focused on issues of transparency and disclosure and the level of carried interest than are European respondents.
- Europeans, on the other hand, are much more focused on strong Environmental, Social and Governance ("ESG") policies, with 43% targeting them, while Asian investors were at the other end of the spectrum, with only 6% of them feeling they were a significant concern. North Americans fell in between at 21%.

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

The issues we 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 2019 Survey Results

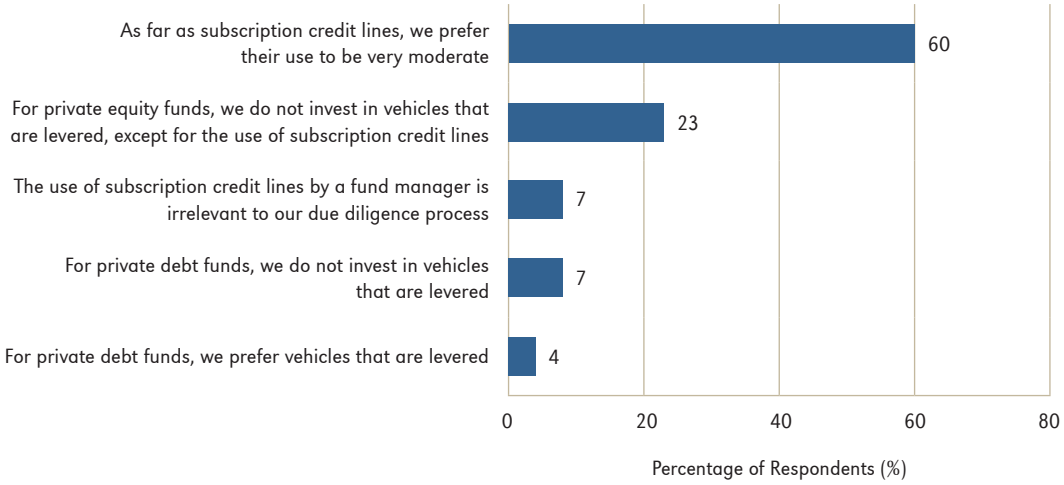
Fund Level Leverage

For the first time, we asked investors about their use of fund-level leverage.

- Investors felt most strongly about the use of subscription credit lines, with 60% of respondents stating that they preferred that the use of the lines be moderate and only 7% reporting that the use of subscription credit lines was irrelevant to the due diligence process. An Asian endowment commented:
  - *"Subscription lines are increasingly becoming more of a talking point among LPs and during our DD with managers."*
- As far as private debt funds — which more frequently use fund-level leverage than do private equity funds — investors did not feel as strongly about leverage one way or the other.

Chart XXX Fund-Level Leverage

As far as fund-level leverage is concerned (please answer all as appropriate):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Benchmarking

- Benchmarking performance against investment options is one of the important methods of due diligence and portfolio management. However, there is no agreement amongst investors on which benchmark is the market standard, and as is evident from the percentages in Chart XXXI, many investors use more than one.

- PREQIN and Cambridge are the two leading benchmarking databases, and they lead across most fund geographies.

- The third most used methodology is Public Market Equivalent (PME) analysis, though it is a framework of analysis and not a database per se. However, there are at least five major PME models that can be paired with a large number of potential stock market indices that can be the basis for comparison, and individual investors may use different indices to compare different fund strategies.

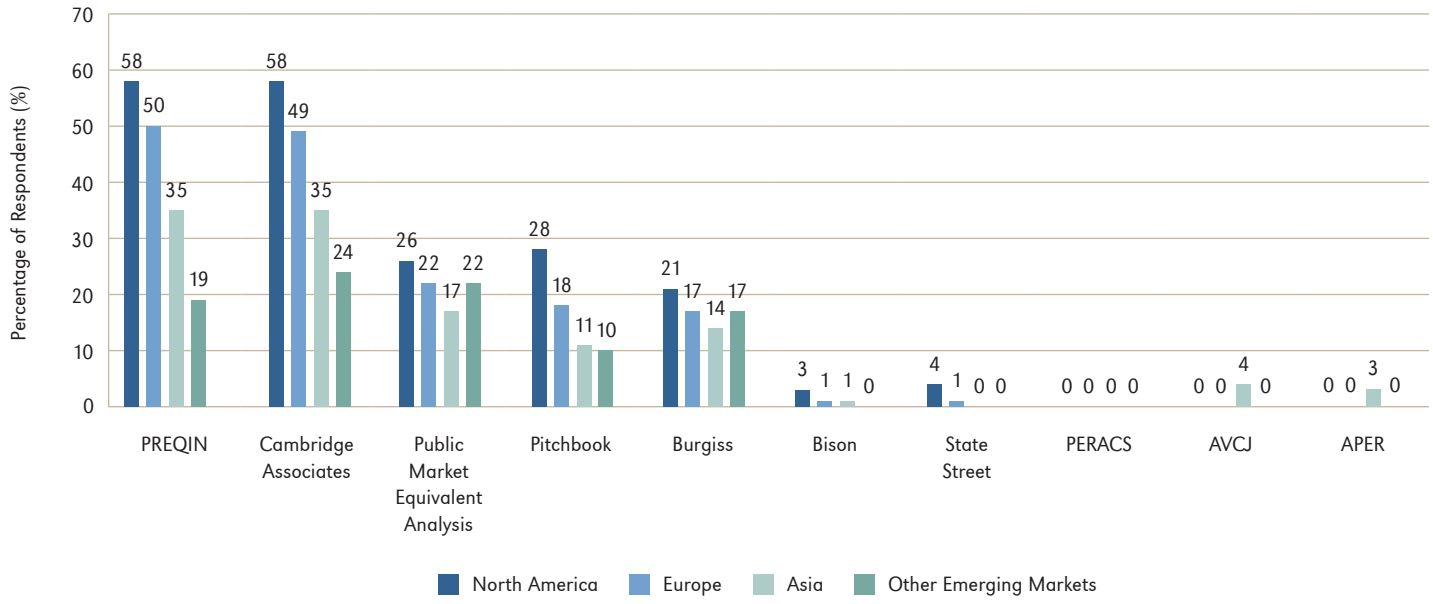
- The AVCJ and APER databases are non-standard; they are calculated based upon a portfolio of individual deal returns instead of fund-level returns, but they are somewhat relevant to Asian returns where fund level data is more difficult to come by.

- PERACS had a few adherents on last year's survey, but none chose it this year.

- Besides the responses noted below, two investors stated that they used Hamilton Lane benchmarks while another two used Pevara benchmarks.

Chart XXXI 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 2019 Survey Results

Investor Fears and Concerns

- Investors' greatest fear going into 2019 is that too much money is coming into all areas of private equity, a concern that ranked only fourth in 2007 when levels of leverage were also a significant concern (Table III and Chart XXXII). For 2019, fears that middle-market purchase prices are too high and that the private equity market feels like it is at the top of the cycle were the only other concerns that affected a majority of respondents.

- Though the top three concerns were similar for investors across all three geographies, there were some marked differences between different types of investors:

  - 42% of funds-of-funds are afraid that large funds are becoming generalized asset managers, moving away from their core private equity strengths, compared to 25% of overall respondents.

  - 33% of family offices felt that we are in or are facing a technology bubble, compared to 11% of total respondents.

  - 33% of insurance companies thought that they are under increased pressure in accessing co-investments compared to 8% of overall respondents.

- There was also an interesting fear noted by a Japanese bank:

  - *"How will our GPs deal with disruption at the portfolio companies due to technological advancement and other reasons."*

Investors' greatest fear going into 2019 is that too much money is coming into all areas of private equity, a concern that ranked only fourth in 2007 when levels of leverage were also a significant concern.

Table III What Keeps You Up at Night?
Top five responses:

2007		2019	
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	63%
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%	Purchase price multiples in middle-market buyouts are too high and threaten future returns	53%
There is too much money available in the large buyout market and that will dramatically impact future returns	39%	The current private equity market feels like it is at the top of the cycle	52%
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	25%

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2007 and 2019 Survey Results

Chart XXXII Greatest Fears Regarding the Private Equity Market

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

Source: Probitas Partners' Private Equity Institutional Investor Trends for 2019 Survey Results

Our View of the Future

Some key trends have emerged from our ongoing conversations with investors, backed up by the results of the survey:

- ***The significant increase in "dry powder" threatens future returns.*** Dry powder has built up rapidly since 2014, especially for funds headquartered in North America (Chart XXXIII), and has continued to grow throughout this year. Large amounts of dry powder in their funds put pressure on fund managers to put those commitments to work, a pressure that can be dangerous in a market where purchase price multiples are high. As a corollary, over the past four years, buyout purchase price multiples in North America and Europe have also risen significantly, especially at the large end of the buyout market, exceeding pre-GFC levels. It should also be noted that though the raw amount of dry powder has risen sharply, the total amount of private equity assets under management has also risen, with dry powder rising with that pace.

- ***Reported dry powder amounts are focused on undrawn commitments to closed-end funds; these totals understate capital targeting private equity as they do not include co-investments, separate accounts, and direct investments that are more difficult to track.***

  - ***Co-investment demands from investors — and the ability of investors to execute co-investments — has risen significantly since the GFC.*** Most investors active in co-investments do not have specific amounts dedicated or committed to co-investments over a particular period, but are more opportunistic.

  - ***Large separate accounts, often with broad investment mandates, are increasingly used by the largest investors to allocate larger commitments and obtain better general partner pricing.*** Capital deployed through these accounts are difficult to track accurately; some of the largest accounts have broad mandates that allow investment across a variety of private equity strategies or geographies, and even to sectors outside traditional private equity such as private debt or natural resources.

  - ***Also, certain experienced investors — such as sovereign wealth funds, public pension plans, and family offices — are investing directly in private equity transactions as well as through closed-end funds.*** The concept of dry powder is harder to apply to this activity, but these transactions do affect competition for deals and purchase price multiples.

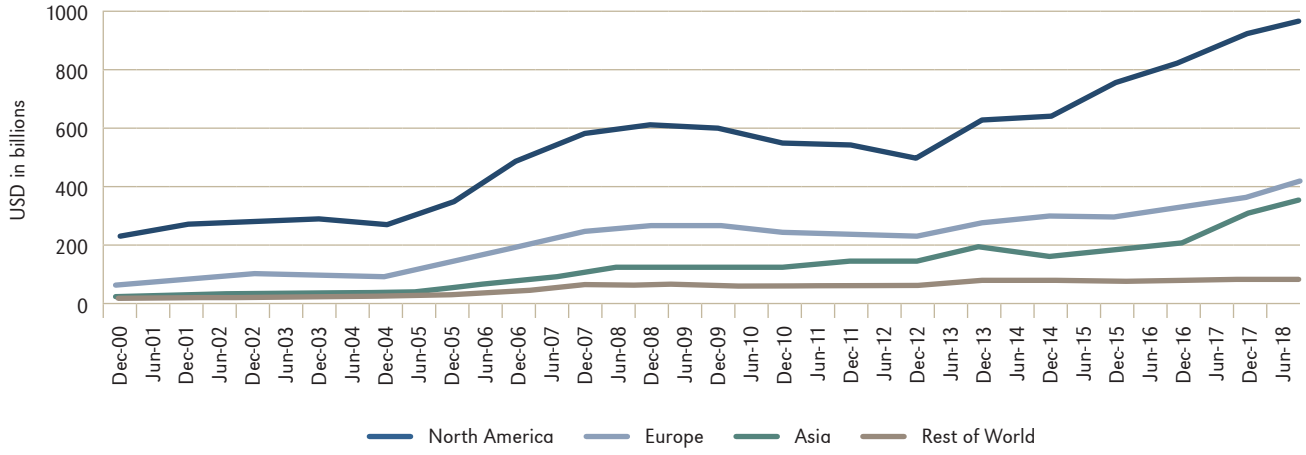
- ***The growing split in the approach to the market between large and small investors.*** Large investors — those looking to commit $500 million or more per year — are increasingly focusing on substantial commitments to a few fund managers, not just through fund commitments but also through co-investments, fund-linked separate accounts, and broad mandate separate accounts. These commitments are geared not only toward deploying capital but also toward developing strategic relationships with these large managers.

  Some smaller, sophisticated investors are taking a different tack, targeting "best of breed" managers in narrow strategies, focused on generating alpha in inefficient market sectors or using emerging managers with a perceived "edge." This approach results in these investors moving away from established relationships that these investors perceive have grown too large relative to their original strategies.

As a natural result of these very different strategies, there is a split in these investors' portfolios. However, at the large end of the middle-market, there is some degree of overlap. Though our survey does not show this as a significant area of concern, in a few conversations we have had with mid-size and small investors an issue has popped up: the large investors who dominate Limited Partner Advisory Committees have more in common with the fund managers they have made large strategic investments with than they have with smaller limited partners.

- ***Many investors continue to worry that we are near or at the top of the market cycle — but there is no agreement on what will trigger a market turn or when the actual turn will occur.*** Certain investors are looking to slow their investment pace — this is challenging to accomplish as fund managers are looking to increase their fundraising pace — but investors are also very aware that they need to maintain key fund manager relationships and have dry powder with experienced managers who can take advantage of lower purchase price multiples when the market does turn.

Chart XXXII Private Equity "Dry Powder" by Region Targeted



Source: PREQIN, October 2018

Summary

Investors are moving through a complex and changing market and are trying to balance their fears and hopes. Many of them are keenly aware that though history does not exactly repeat itself, it often rhymes. No one with whom we have spoken expects a market meltdown the likes of the GFC; however, it does not require an event of that magnitude to have a negative impact on a portfolio.

Private Equity Institutional Investor Trends for 2019 Survey Results

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