Preqin Research Report

Investors' Plans for Future Private Equity Fund Investments (1)

The impact of the global financial downturn on the private equity industry was far reaching. Levels of fundraising for new vehicles fell as many investors were either unable or unwilling to make new investments in private equity. The denominator effect left significant numbers of LPs over-allocated to the asset class and a lack of distributions from portfolio holdings exacerbated this situation. Preqin's December 2009 survey of 106 institutional investors found that a considerable 40% had not made a commitment to a private equity fund during 2009.

In the second half of 2009, LPs saw their situations gradually improve as rising public market valuations and adjusted private equity portfolio valuations led to a reduction in the impact of the denominator effect. Deal volumes also started to pick up and it was anticipated that fundraising would begin to show an improvement. However, the increased level of LP caution when approaching the asset class has persisted. The $50 billion raised by funds that reached a final close in Q1 2010 showed only a slight increase on the $48 billion raised in the previous quarter. Fundraising levels are still low and improvement in private equity fundraising is taking longer than expected.

So when is this situation set to change? Certainly, investors have remained far more cautious in their investments in private equity funds since the financial downturn, with many opting to conduct much more stringent due diligence processes. Fund terms and conditions have also drawn an increasing degree of attention from LPs and Preqin's December 2009 survey found that 57% were dissatisfied with the alignment of interests between GPs and LPs, with many citing management fees and the carry structure as areas requiring improvement.

Other investors are simply unable to make fresh commitments owing to a lack of available capital. Fig. 1 shows the aggregate capital called by private equity funds globally each year from 2004 to 2009 and compares it to the aggregate capital distributed. Capital calls and distributions were relatively balanced from 2004-6; however, from 2007 onwards, capital calls have significantly outweighed distributions, leaving investors with more capital invested in the asset class than they had anticipated. Consequently, many do not have capital available to make fresh commitments to funds.

For some investors, their current cash flow situation and the volume of undrawn commitments they are subject to are likely to prevent further commitments being made in 2010. For example, Stena Metall, a Swedish corporate investor, does not anticipate making any new commitments this year as it is waiting for two largely undrawn commitments to buyout funds to be called up. Los Angeles City Employees' Retirement System (LACERS) has also seen the rate at which it makes new commitments decrease owing to low levels of distributions. The pension fund has not yet determined the extent to which it will be active over the next 12 months as it needs to see an increase in the rate of distributions, which it saw decline in 2009, in order to continue approving new commitments to the asset class.

Fig. 1: Capital Contributions and Distributions for the Global Private Equity Industry (All Fund Types)

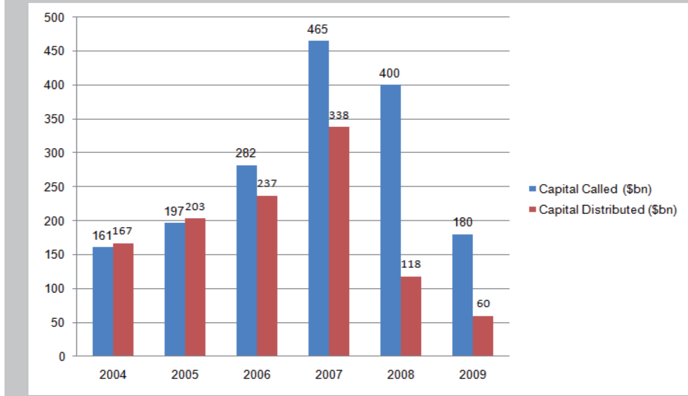
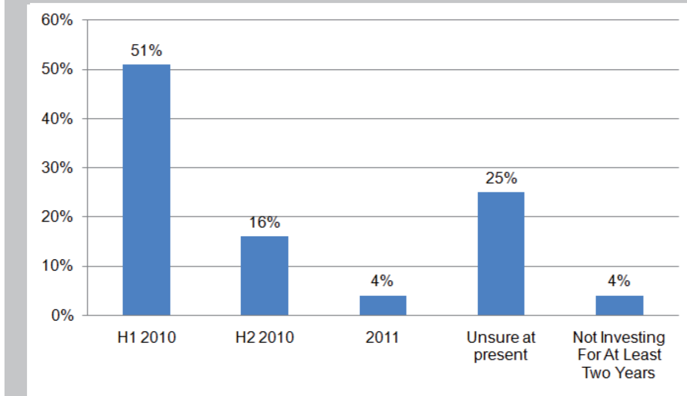


Fig. 2: Time Frame for Investors Next Intended Commitment to Private Equity as of December 2009



A number of prominent institutional investors in private equity, including Pennsylvania Public School Employees' Retirement System (PSERS) and Yale University Endowment, have

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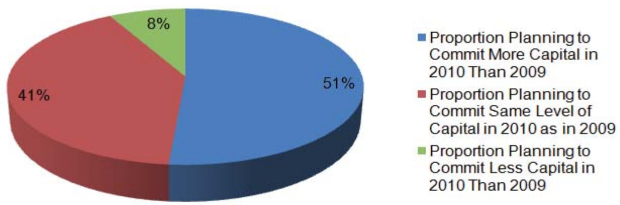
opted in the past year to increase their target allocations to private equity. Although both view private equity as a long-term component of their investment portfolios, the decision to increase their target allocations can also be attributed to an over-commitment to the asset class. PSERS voted in March 2010 to raise its target allocation by three percentage points to 21% of total assets, a decision made following a recommendation issued by both its CIO and its general consultant, Wilshire Associates, in response to the expected volume of contributions to and distributions from its existing private equity portfolio. Yale's decision in June 2009, disclosed in March 2010, to increase its target allocation from 21% to 26% of total assets was also prompted by an expectation of an increase in its exposure to private equity. Its allocation to the asset class had hit 24.3% of total assets at that time.

Despite the obstacles some LPs are facing when considering further private equity investments, actual investor sentiment is, in general, still positive towards private equity. Furthermore, as shown in Fig. 2, Preqin's December 2009 survey found that just over half of investors (51%) are planning to commit to new private equity funds in H1 2010. 25% have yet to decide when they will make their next commitments, typically a result of unknown levels of distributions and drawdowns in the year ahead.

The amount of capital LPs have set aside for new commitments in 2010 also exceeds that set aside in 2009 for the majority of LPs surveyed, as shown in Fig. 3. 51% intend to commit a greater amount of capital to new offerings in 2010 than in 2009, and just 8% expect the amount of capital used for new commitments to drop.

Preqin is continually in contact with investors across the globe regarding their future plans for private equity investment, and what is clear from our conversations is that there are still significant numbers of institutions with capital available to commit to the right fund offerings. Some examples include Massachusetts Pension Reserves Investment Management Board (MassPRIM), which is looking to commit $1 billion to private equity vehicles during 2010; Liberty Mutual Insurance, which is looking to commit $300-500 million to between eight and 12 funds in the next 12 months; and Korea Investment Corporation, which is intending to double its allocation to

Fig. 3: Investor intentions: 2010 vs 2009



alternatives, including private equity, and is particularly interested in distressed private equity and secondaries at present.

We are still seeing institutions decide to commence investment in private equity for the first time, bringing a fresh supply of capital to the asset class. The £4 billion Pension Protection Fund confirmed in March 2010 that it was intending to start investing in private equity as part of its 20% allocation to alternatives and had selected secondaries funds as the method of gaining its initial exposure.

So what level of activity can be expected from LPs over the rest of 2010? It is clear that the increased degree of caution with which investors have approached the asset class in recent months is set to remain in 2010 and some LPs will be prevented from making new commitments by a lack of available capital or as a result of over-commitment to the asset class. Slow distributions from portfolio holdings have also meant that investors are not required to commit to new vehicles at the same rate as in previous years in order to maintain their allocations.

Despite all these factors, in general, attitudes are reasonably positive and there are strong signs that increasing numbers of LPs will return to the market over the course of 2010. Certain areas of the market are attracting particular LP interest at present. Small to mid-market buyout, distressed private equity and secondaries funds are all drawing significant levels of investor attention. Two-thirds (67%) of respondents to our survey intended to make new commitments to private equity funds during 2010 and a further 25% were still considering the time frame of their next commitments. As a result, we anticipate fundraising to continue to pick up over the course of the year. However, profitable exits from portfolio holdings will need to improve, leading to an increase in distributions and investor confidence, in order for fundraising levels to improve significantly. Investors will remain cautious in their investments and GPs will need to pay close attention to the concerns of investors and consider their expectations when drafting fund terms and conditions in order to improve their chances of successfully securing commitments in the next few months.