Alternative Investments Outlook 2013: Limited Partner Survey

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Foreword

Welcome to Alternative Investments Outlook 2013, presented by Duff & Phelps in collaboration with mergermarket. Based on interviews with 100 limited partner (LP) investors operating across North America and Western Europe, this report provides forward-looking insight into private equity from those who know it best.

According to the LPs interviewed, private equity has successfully rebounded from the crisis, and is positioned for a strong 2013. Nearly half of respondents say that their PE investments have surpassed their expectations and, of those who plan to adjust their allocation to private equity within the next year, the overwhelming majority (95%) expect to increase the amount apportioned to the asset class.

Many LP respondents are optimistic about the climate in Europe. Although Northern Europe is most frequently mentioned by respondents as fitting with their investment strategies, over half of interviewees see Southern Europe, including Portugal, Spain and Italy, as offering up attractive opportunities.

A key trend to emerge from the survey is an increased interest in the market for secondary PE commitments. The market is tipped to become busier, with nearly three-quarters of respondents expecting LP investors to acquire more secondary commitments. Another notable result is that LPs are increasingly looking to side-step GPs (general partners) to provide direct lending to companies. This is attributed partly to the opportunity afforded by the lack of bank lending and, among those who foresee more direct lending, 73% see this as a new and growing area for LPs.

The survey suggests that the dynamic between GPs and LPs has evolved in other respects, including an increased level of interaction, with nearly all respondents (98%) reporting that they are now communicating more frequently with their GPs. There is also increased demand for timely valuation information, with 63% of respondents citing the timeliness of reporting as the most common problem with valuation information.

Transparency and an accompanying focus on detail is another key theme, with three in four respondents stating that they have asked GPs for greater transparency in the last 24 months. When choosing a fund manager, 70% of those surveyed indicated that transparency was the most important factor, ahead of even the fund manager's strategy and track record of performance.

This report helps to shed light on the private equity outlook in the coming year. We hope you find the following pages informative and useful and, as always, welcome your feedback.

Executive Summary

Investment Strategies

- Two-thirds of respondents plan to **reconsider their allocation to PE** in the next 12 months, of which 95% say they will **increase their allocation to PE**.

- With private equity firms stepping in to fill the funding gap left by banks, more than two in three respondents say **growth capital funds are among the most attractive**, followed by nearly half who point to LBO and sector or region-focused funds.

- Around half of respondents say **private equity is beating expectations**, while almost two-thirds of respondents say PE investments are **performing better than other investments** in their portfolio.

- Respondents expect returns on 2012 investment vintages to **fall below levels achieved historically** but 2013's vintage to perform better, with one in three of those polled saying they will be targeting net returns of 15% or more.

- LPs will increasingly **bypass GPs and provide direct lending**, according to 63% of respondents. This is a structural shift in approach, with three-quarters of respondents seeing this as a **new and growing area**.

- A large majority (72%) of those surveyed expect LP investors to **acquire more private equity commitments in the secondary market**, allowing LPs to improve their exposure to a variety of assets at a discount to face value.

- Nearly two-thirds of respondents say that **private equity portfolio assets are one of the most attractive opportunities** for GP investors. This is reflected in mergermarket data, with secondary buyouts accounting for a record proportion of European PE acquisitions in Q4 2012.

- With many corporates looking to deleverage, **corporate disposals are also highly rated,** with 60% of respondents placing them among the most attractive opportunities.

Western Europe Outook

- European LPs are **more optimistic about assets in Southern Europe**, with a large majority (72%) stating that they would be likely to invest in funds with exposure to the region compared to only 40% of North American investors who say the same.

- European LPs are also **more attracted to Eastern Europe**, with half of European LPs saying that they are likely to invest in the region compared to just 28% of North American LPs.

- Within Western Europe, the **Germanic countries are seen as the most attractive** and Iberia as the least attractive.

- The economic environment, political uncertainty and vendor price expectations are the **biggest concerns for LPs** investing in Western Europe.

- Nearly all respondents say the **Eurozone crisis has been a major influence** on their investment decisions, prompting a change in geographic allocation and making them more selective.

- The majority (63%) of respondents think that the **Eurozone crisis will escalate** leading to a deepening of recession conditions before any recovery, but that this will not lead to countries defaulting.

- **Emerging markets are more attractive** than Western Europe, say nearly all respondents, but a large majority (81%) believe that Western Europe **offers substantial distressed opportunities**.

- More than three-quarters (78%) of North American LPs think **Western Europe is currently too risky to invest in**, but only 34% of European LPs think that the risks are too high.

GP-LP Relations

- The vast majority (91%) of respondents report that over the past 12 months they have been **more vocal about fund investment strategies**.

- Almost half (48%) of the LPs report having had **more difficult conversations with GPs** about fund performance.

- Seventy percent of LP respondents say **transparency is a key concern** when allocating capital, with 34% saying it is the most important factor. Three-quarters (76%) of respondents have asked GPs for more transparency.

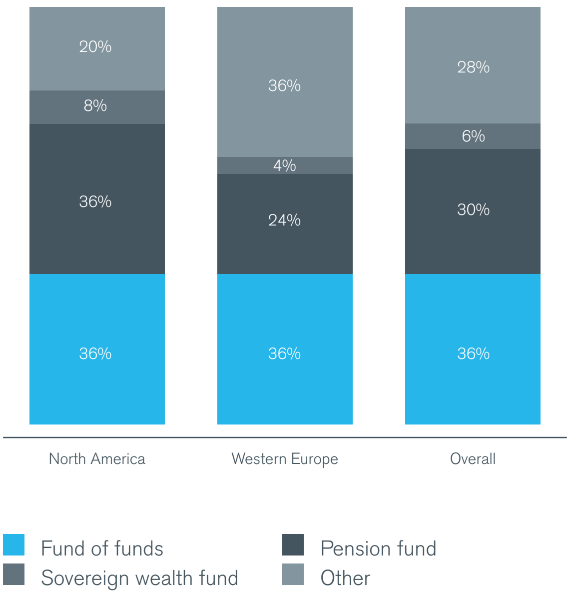
- LPs more likely than not to **investigate factors influencing investment performance**, with nearly two-thirds saying they delve into such details when considering allocating to a fund.

- Nearly two-thirds of respondents say that **timeliness and lack of details are common problems** with valuation information.

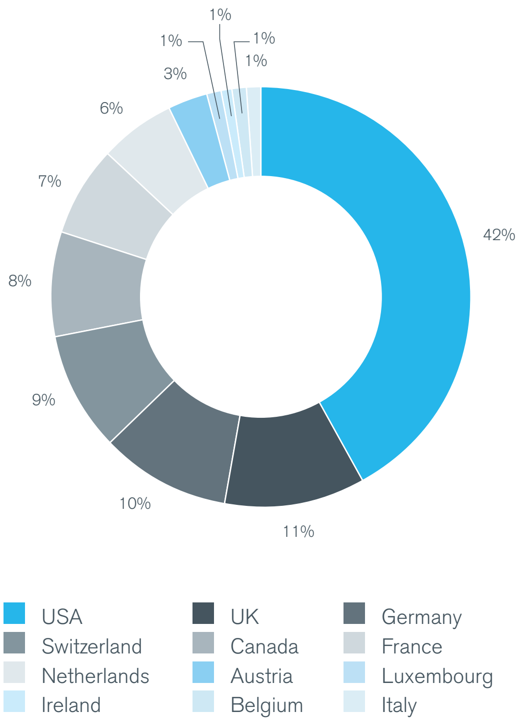
Market Research: Methodology

In the fourth quarter of 2012, mergermarket interviewed 100 limited partner investors regarding their views on the private equity investment environment in Western Europe and their outlook for the future. All interviews were conducted by telephone and are reported anonymously with the results presented in aggregate.

Which of the following best describes your entity?

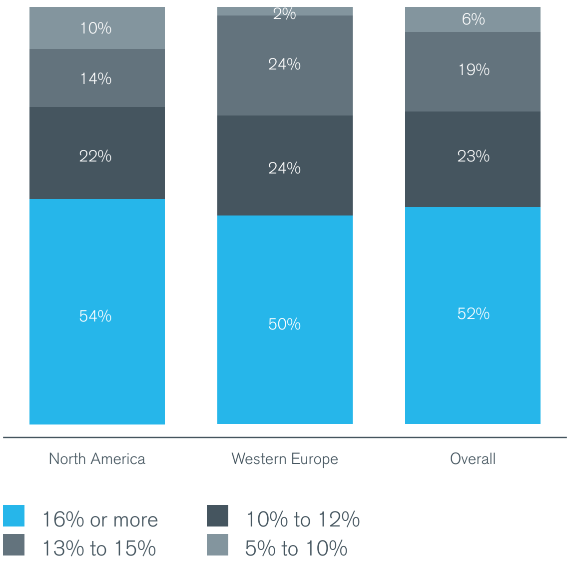


In which country are the headquarters of your company located?



The largest portion of survey respondents (36%) are fund of funds investors, followed by pension funds (30%), sovereign wealth funds (6%) and other fund investors (28%), which includes family offices, insurance funds and other asset managers. One-half of respondents are based in North America, while the other half is based in Western Europe. More than half of survey participants (52%) have allocated 16% or more of their portfolio to private equity.

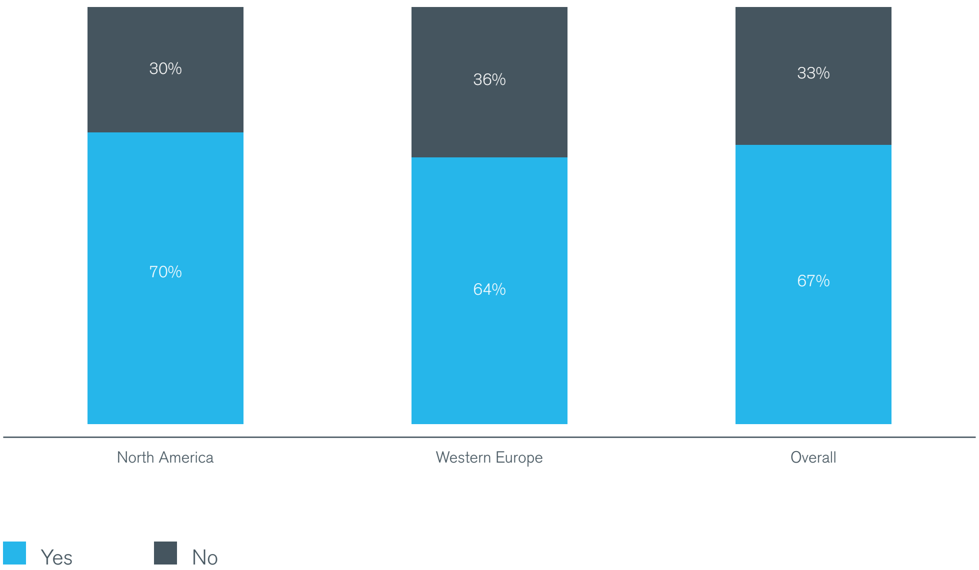
What percentage of your portfolio is currently allocated to private equity?



Market Research: Investment Strategies

Majority of respondents set to change allocation to private equity

Do you plan to adjust or reconsider your allocation to private equity in the next 12 months?



Two-thirds of respondents (67%) say they will adjust their allocation to private equity within the coming year. The overwhelming majority will increase (76%) or significantly increase (19%) the amount of capital apportioned to the asset class. Across the whole of the respondent pool, 64% of LPs plan to increase their funding allocated to private equity.

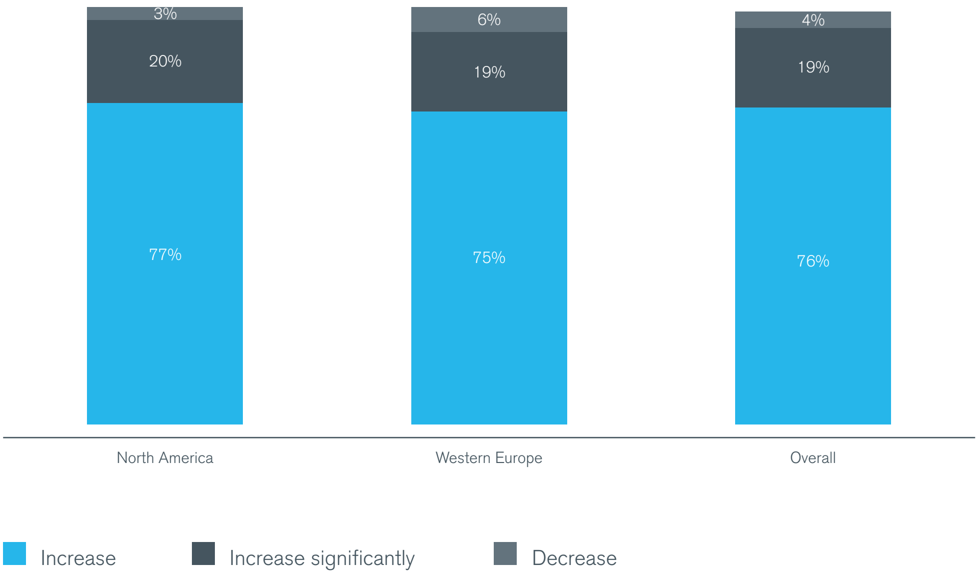
One US pension fund investor comments, "After a decline in PE investments, now there is a gradual increase in activity. I expect a private equity investment boom is on the cards and we will also certainly increase our private equity allocation if the situation becomes more favourable in the next 12 months. We have already identified many funds in the US and Europe for new investments."

Similarly, a Swiss respondent from an insurance fund comments, "Given the improving situation in funding markets and the state of dry powder among private equity players, I think private equity activity will increase over the next 12 months and we will also increase our allocation to private equity. We've been preparing a list of potential private equity managers, pinpointing companies that are cheap and would benefit us."

Among the 33% of respondents who do not plan on increasing exposures to PE, the Head of Investments for a Canadian institutional investor takes a more bearish view of the asset class, explaining, "Private equity is an illiquid type of investment whose value has been diminished due

Nine in ten will increase their allocation to the asset class

If yes, which of the following is most likely?

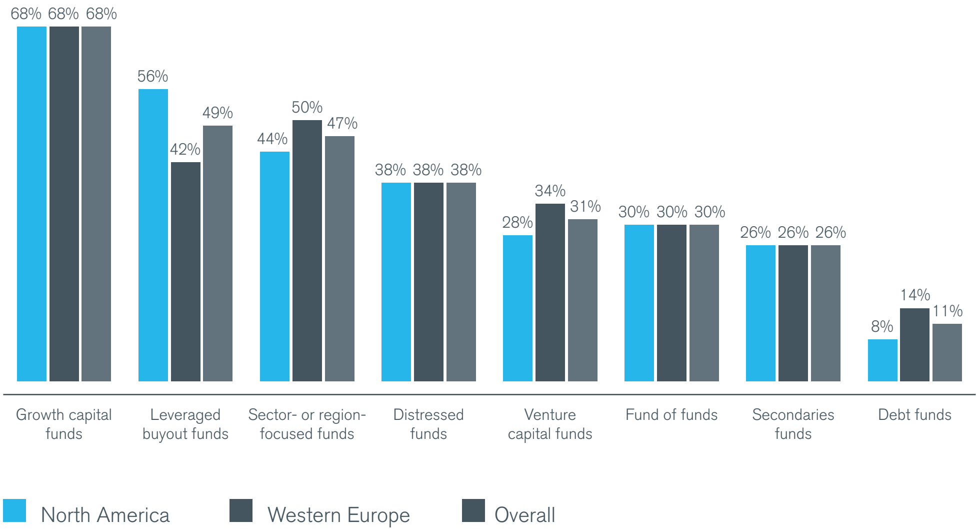


to poor market conditions. These investments carry high risk and may not provide good returns. Also, because of the economic woes, private equity investments cannot be exited at a reasonable price in the event of an immediate need for cash."

The bearish view is reflected in the overall fundraising environment. Figures from data provider Preqin show the number of firms seeking funding in Q3 2012 reached 1,918, an increase of 11% year on year. The amount being sought is up 13% to US$796bn. However, an increase in competition is leading to a tough environment, with Preqin data indicating that 25% of Europe-focused buyout funds failed to meet their funding targets in 2012.

Growth capital funds most attractive

What type(s) of private equity funds do you expect to be most attractive in the next 12 months?



Growth capital funds are seen as the most attractive place to invest over the next 12 months, say more than two in three respondents (68%). With private equity firms stepping in to fill the funding gap left by banks, there is a growing need by companies to access alternative financing. "There is no issue with the availability of targets and, as PE funds are already holding cash, they can step in when companies are not able to raise finance," comments a London-based LP.

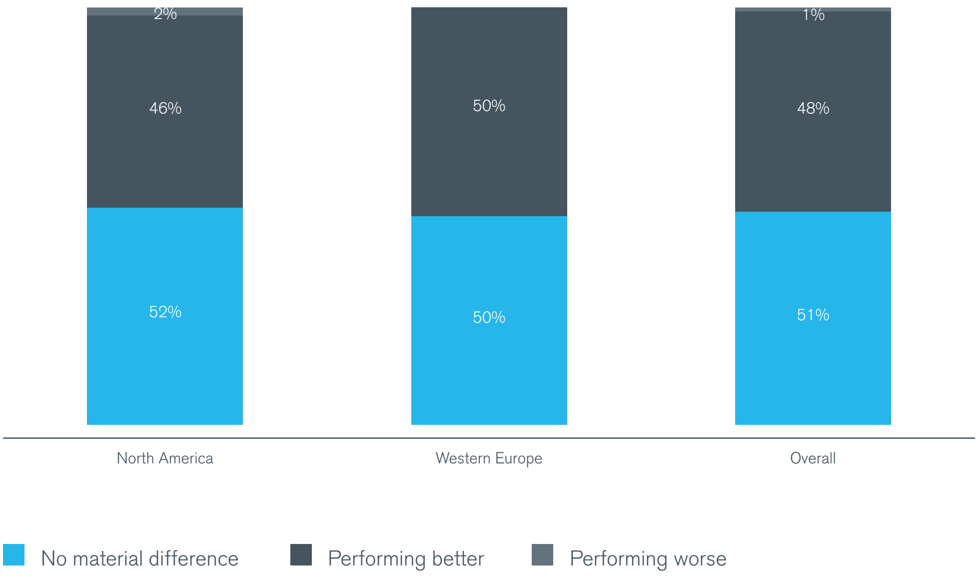
Moreover, growth funds can be lucrative investments as one US investor comments, "Growth funds and sector-focused funds are able to provide superior returns to investors." He takes a dimmer view toward leveraged buyout funds (LBOs), however. "At the moment, LBOs are less popular because of the global credit crunch, which has largely restricted the amount of debt offered for such deals [meaning that] LBOs have an inherent risk the deal will not be successful."

In spite of the difficult credit markets, nearly half (49%) of respondents disagree about the attractiveness of LBO funds. "The availability of cheap debt in Europe will give more room for leveraged buyouts, and with PE investors now particularly targeting the small- and mid-cap market they have many good opportunities," says a Managing Partner from a US fund of funds firm that specifically targets growth fund investing.

Almost as many respondents (47%) expect sector- and region-focused funds will draw significant levels of investor interest in the coming year. An investment manager from a UK-based pension fund elaborates, "General Partners are grappling with numerous challenges as they try to invest capital in the current market, and given the macroeconomic environment only those PE funds that are sector-focused are able to bring value to their investments."

Almost half of respondents say private equity is beating expectations

How are your private equity investments performing relative to your expectations for this asset class?

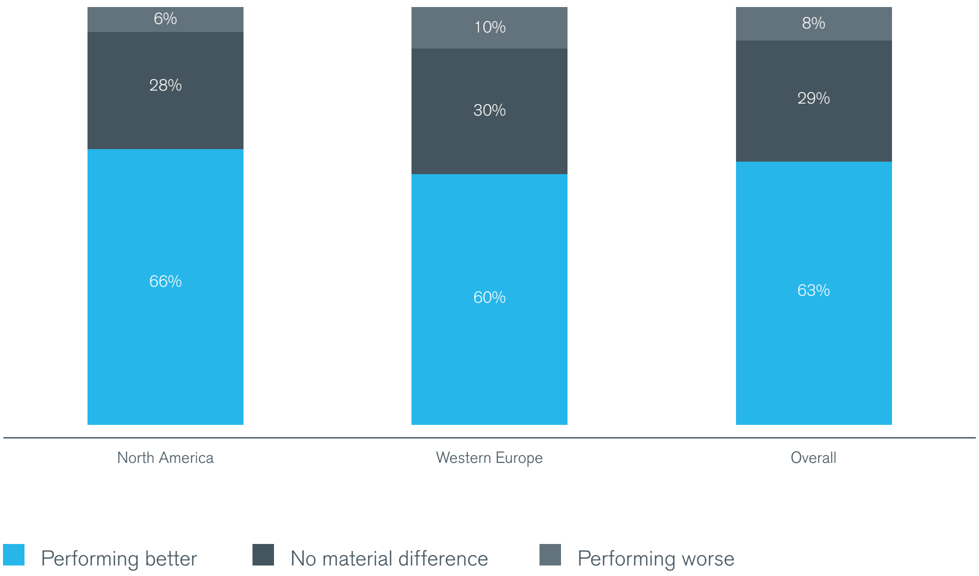


The survey pool is split between those who say there is no material difference (51%) between their expectations and the performance of the asset class, and those who say it is outperforming their expectations (48%). "The returns are in line with our expectations. The performance of private equity has revived and improved. We are happy with the current performance of our investments," comments the Managing Partner at a Paris-based fund of funds investment firm.

"We have invested in some world-class private equity funds, and certainly pay high fees for it, but in return we have been getting the high returns that we actually hoped to achieve," explains a CIO from a US state pension fund. "Now we are planning even bigger investments in private equity, particularly in growth funds."

Private equity outperforming other investments

How are your private equity investments performing relative to other investments in your portfolio?

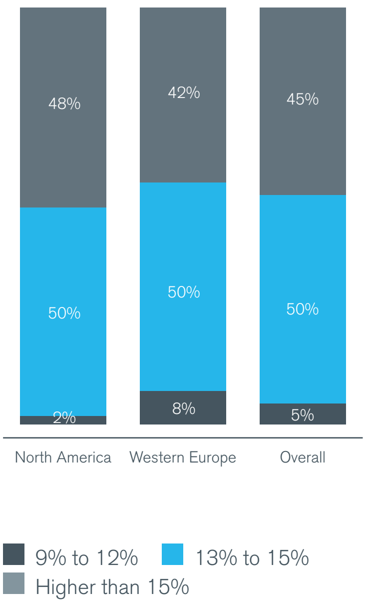


Viewed against the performance of other investments, nearly two-thirds of the survey pool (63%) remains remarkably upbeat about the performance of their private equity investments, while just over a quarter (29%) say there is no material difference.

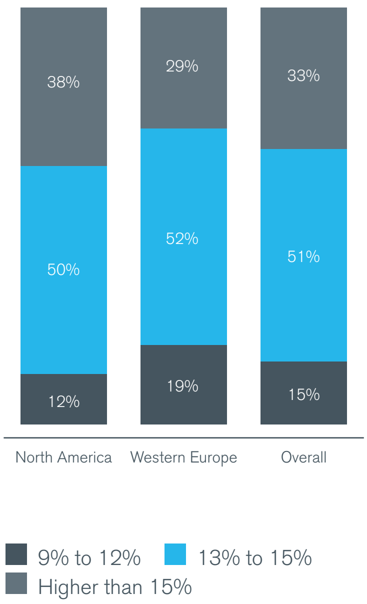
"I would say private equity investments are much better when compared to other investments like real estate and capital markets," says a Paris-based Managing Partner at a fund of funds investment firm. "In private equity, there is direct control of the investments [and investors] can improve the value of the portfolio companies by providing support for strategic acquisitions and corporate development for better returns."

Limited partners target higher returns for 2013 vintage

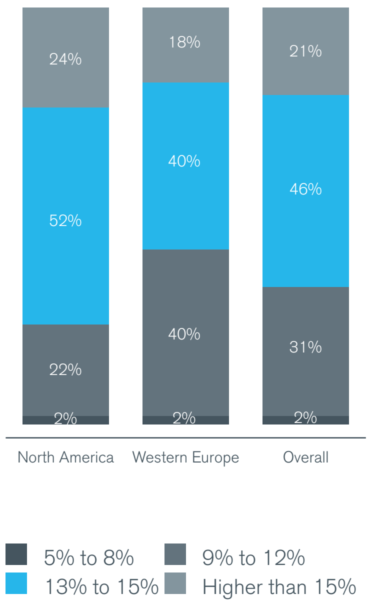
What net rates of return have you typically realised on historic investments in private equity?



And what net returns are you targeting for your private equity investments of the 2012 vintage?



And what net returns are you targeting for your private equity investments of the 2013 vintage?



Exactly half of the LP investors say they have realised net returns of 13-15% on their investments in private equity historically, while 45% report that their investments returned more than 15%.

Despite the current depressed state of asset prices, LP investors anticipate that private equity funds that began in 2012 will deliver lower returns than seen historically, with 46% of respondents anticipating returns of 13-15%. Only 21% expect returns of more than 15%.

A Director of Investments at a US fund of funds explains this cautious view, "Because of the economic slowdown the rate of return has generally come down. We need to be cautious and cannot go on increasing our risk appetite in order to gain higher returns."

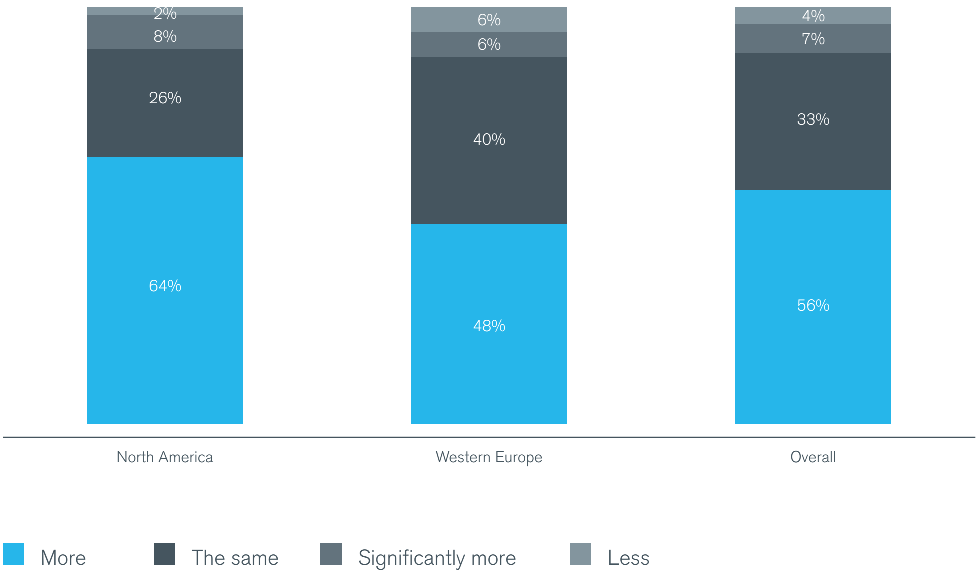
For funds that will begin making investments in 2013 the outlook is more optimistic with half of those surveyed expecting to realise returns of 13-15% and around a third of respondents targeting returns of more than 15%.

"I have high hopes for 2013," explains a Managing Partner at a US fund of funds "We're expecting the situation to turn around in 2013 and for private equity to return to the top level."

"The economic slowdown has created a new layer of opportunities in private equity," adds a Head of Investments at a Dutch pension fund. "Weak market conditions have already depressed valuations, helping our partners to acquire assets at much lower prices."

More direct lending

Please indicate whether you expect limited partners to do more/less/the same amount of direct lending in place of banks in the next 12 months:



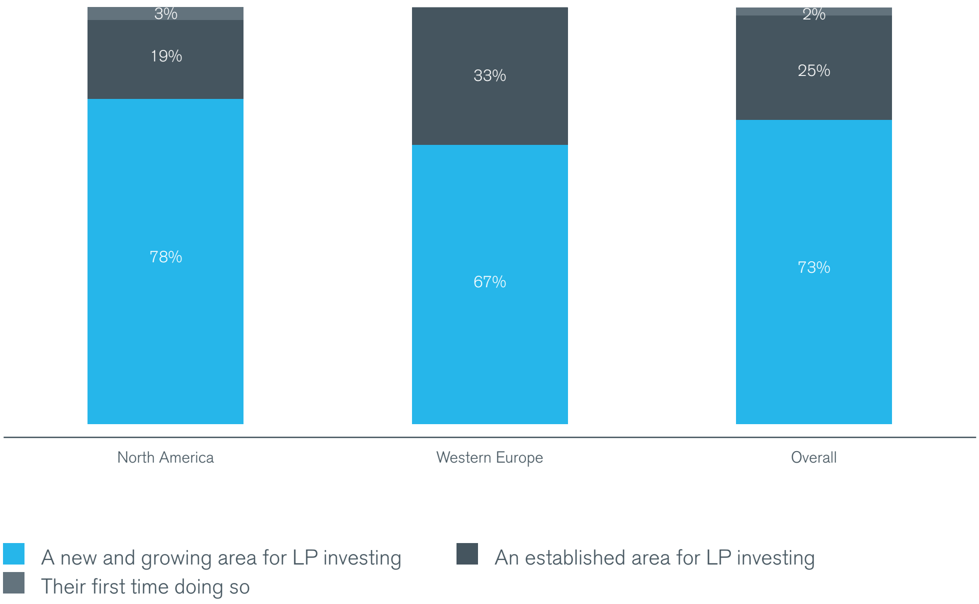
LPs will increasingly bypass GPs to provide direct lending according to 63% of those surveyed, including 7% of those who thought that the increase would be significant. A third of respondents expect the amount of direct lending to be the same while only 4% expect a decrease.

“The combination of economic weakness and fragile financing markets has created demand among many companies for new sources of external financing and LPs are quick to grab this opportunity,” says a European pension fund manager.

Nearly three-quarters (73%) of respondents see direct lending as a new and growing area for LP investing, indicating that the move represents a structural shift in approach within the industry.

A growing area

If you expect to see more limited partners providing direct lending in place of banks, do you expect this will be:

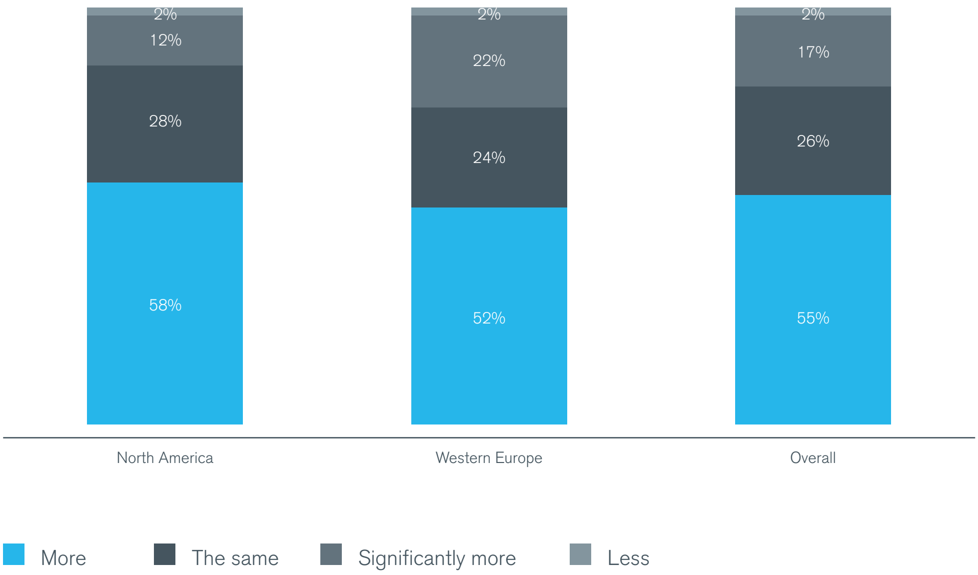


"Debt is not accessible in Europe and this is the right opportunity for the limited partners to go for direct investments and build relationships with the companies by providing them capital," suggests a Managing Partner at a US fund of funds.

"There are no limitations for LPs now," adds a Managing Director at a US fund of funds. "They have already tried and tested direct lending and LPs have realised the potential in making direct investments. This is not a new area and in the future LPs will give tough competition to GPs."

Portfolio secondary market to see bump

Please indicate whether you expect limited partners to do more/less/the same amount of acquiring European private equity commitments in the secondary market in the next 12 months:



A large majority (72%) of those surveyed expect LP investors to acquire more European private equity commitments in the secondary market, including 17% who expect the amount to be significantly more. Some 26% expect purchases in the secondary market to be the same, while only 2% expect a decrease.

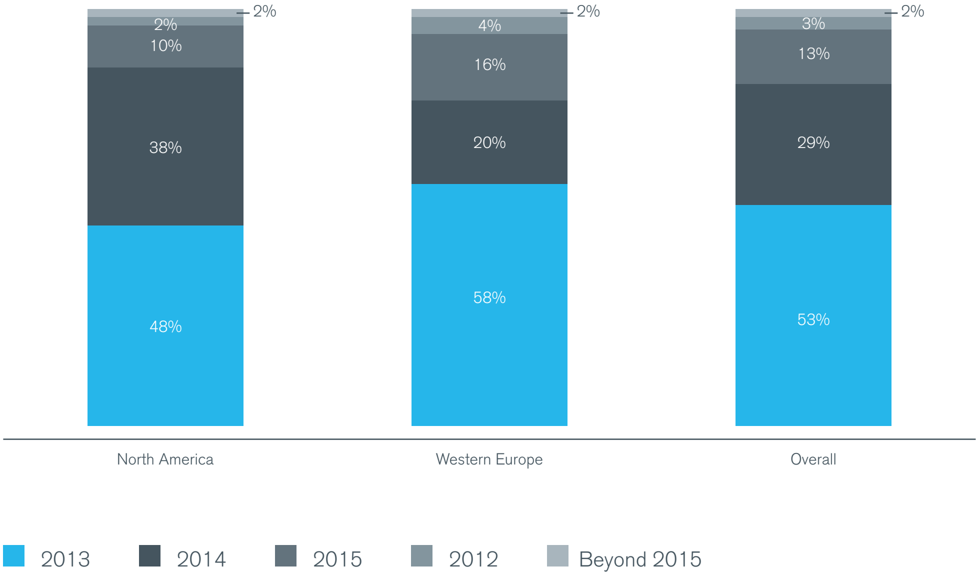
A Managing Partner at a US fund of funds elaborates, “LPs are more active in the secondary market now. Many now have dedicated teams to study and acquire portfolios in the secondary market and manage them for higher returns.”

The benefits are clear according to a CIO at a US pension fund. “By acquiring private equity commitments, LPs are able to deepen their exposure to a variety of private equity assets at a reduced cost. However, moves into this area require additional skills. It’s true that LPs lack the right knowledge and don’t know what they are getting themselves into and thus they are using advisors and adding managers for acquiring and managing private equity assets.”

A second US pension fund CIO explains the growth in this area: “Many existing private equity funds are looking to sell their interests through the secondary market for a variety of reasons, including elimination of balance sheet liabilities and to raise cash for other purposes such as acquiring new portfolios. This has created a buyer’s market and LPs with access to capital have the opportunity to buy assets in the secondary market at a discount from face value.”

2013 will provide best conditions for acquiring secondary commitments

When do you expect market conditions to be ideal for limited partners to acquire secondary commitments?



A majority (53%) of respondents believe that the optimum conditions to acquire secondary commitments will occur in 2013. A significant minority (29%) think that the ideal conditions will not occur until 2014, while 13% expect 2015 to be the best year for secondary market purchases.

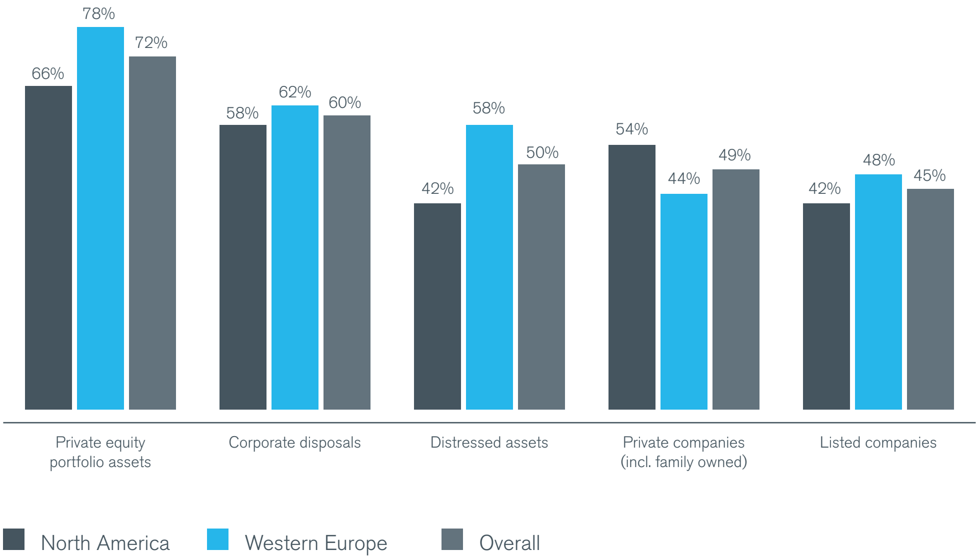
"For the conditions to become ideal, it will certainly take two more years," suggests a Managing Partner at a French fund of funds investment firm. "In 2013 and 2014, the markets are expected to be uncertain because of the Eurozone crises. Debt is up for maturity and there is no clarity from where the money is going to come from. Valuations are fluctuating and LPs will not get the confidence they need until the market stabilises."

A Luxembourg-based Head of Equity Investments at a fund of funds has a different opinion. "2013 will be a year for reconstruction and LPs will have significant buying opportunities at low cost. LPs will have the opportunity to acquire quality assets at attractive prices because of a growing pool of sellers in the secondary market."

A CIO at a US institutional investor elaborates, "No doubt there is an increased interest by the limited partners to acquire assets in the secondary market, but because of current volatile markets LPs are waiting for the situation to get better. However, now the market has started improving and we expect stability in 2014 and limited partners will then start freely accessing secondary markets again."

Private equity targets most attractive

What types of assets do you think will present the most attractive opportunities to private equity investors over the next 12 months



Nearly two-thirds of respondents say that private equity portfolio assets will be among the most attractive opportunity for PE investors over the next 12 months. This is reflected in mergermarket data, with the proportion of PE acquisitions represented by secondary buyouts reaching record levels in the second half of 2012 as a proportion of total deal flow.

If the trend towards SBOs continues, LPs may raise more questions about whether this is a sign of deal flow weakness and points to an inability to find other, less-conspicuous targets that have greater scope for operational change and higher returns. Considerations about whether SBOs are being used to sustain deal flow at the expense of LP returns has to be balanced against the fact that assets will naturally be targeted at different stages of their maturity by funds executing different strategies.

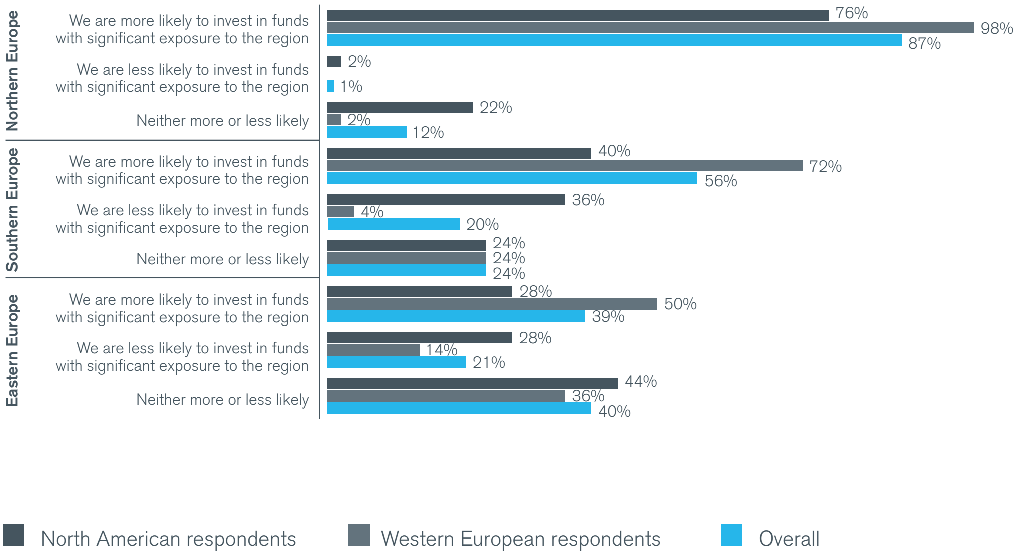
With many corporates looking to deleverage and selling off attractive assets, corporate disposals are also rated highly, with 60% of respondents putting them among the most attractive opportunities. Distressed assets and private companies are seen as less attractive, with around 50% of those surveyed rating them as among the most attractive areas for investment.

Listed companies were rated the least attractive opportunity and a CIO at a US institutional investor fund explains the lack of enthusiasm, saying, “Listed companies still have high valuations. If a listed company and a private company are both equally stressed and have the same opportunities, then why pay more for listed companies when the risk and expected rate of return is the same.”

Market Research: Western Europe Outlook

North American LPs more bearish towards Eastern and Southern Europe

Where does Europe fit into your current private equity investment strategy?



European LPs are more optimistic about assets in Southern Europe with a large majority (72%) stating that they would be likely to invest in funds with exposure to the region, compared to only 40% of North American investors.

"Countries like Greece, Spain and Italy are very unsafe for private equity investments and we are not considering any investment," explains a Vice President at a US pension fund.

However, there are some North American investors who see opportunities, "We have a core interest in distressed assets and both Northern and Southern Europe have ample distressed opportunities which we can exploit," comments a CIO at a US institutional investor fund. "Countries like Portugal, Spain and Italy have very good distressed assets at very low valuations that can give us high returns."

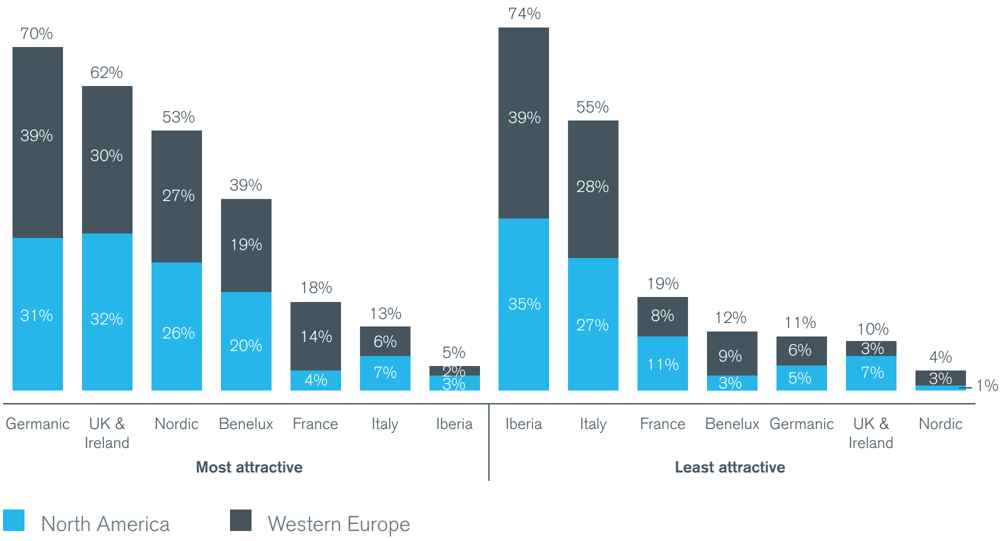
European investors are also more attracted to Eastern Europe, with half of European LPs saying that they were likely to invest in funds exposed to the region, compared to just 28% of North American LPs.

The Head of Investments at a Dutch pension fund elaborates, "Our primary focus would be the Netherlands and Belgium, but we are also very interested in Eastern Europe, where the economy is growing at an impressive rate. We are trying to be more diverse when selecting countries."

Both sets of investors are the most positive towards Northern Europe but North American investors are less confident than their European counterparts. A CIO at a US pension fund explains "We are not a significant investor in distressed debt, but currently only distressed assets are attractive as we cannot find many growth or venture capital opportunities in Northern or Southern Europe."

Germanic region most attractive, Iberia least attractive

In Western Europe, which regions or countries do you view as most attractive?



Within Europe, investments in the Germanic region are cited as among the most attractive by 70% of respondents, while 62% state the UK & Ireland offers attractive opportunities.

"The UK and Germany will lead the private equity investment activity in Western Europe," suggests a CIO at a US pension fund. "There are signs the market in Germany has bottomed out and will be in excellent shape for private equity investments in the next six months."

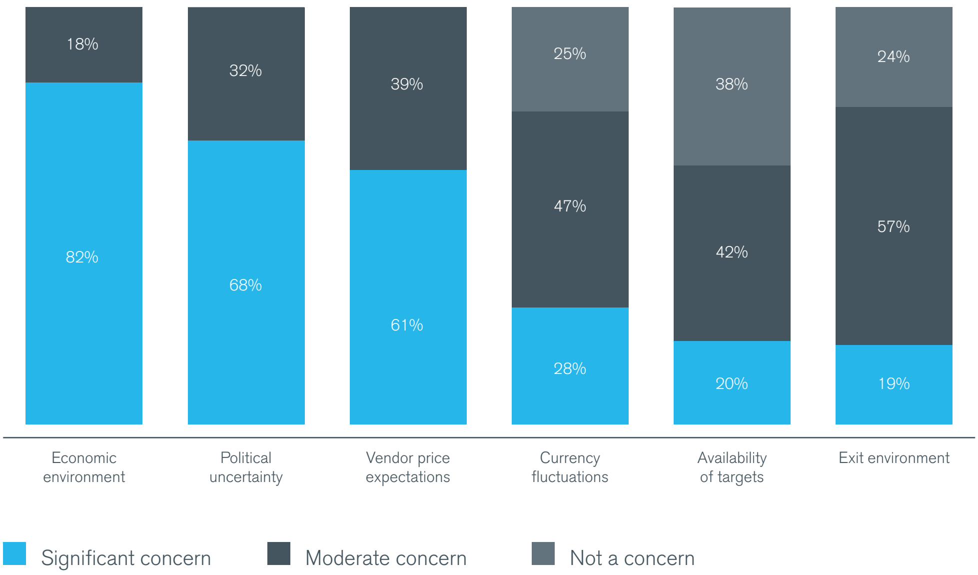
Iberia is by the far the least attractive region, according to those surveyed, with nearly three-quarters (74%) of respondents rating it as one of the least attractive regions. Italy is also viewed unfavourably, with 55% seeing it as unattractive, while France is viewed poorly by 19%.

"Germany, Switzerland and the Nordic countries have recovered and they have started growing, whereas Italy, Spain and Portugal are all still suffering from debt crises and there is widespread unemployment," comments a US Managing Partner at a US fund of funds.

"Conditions vary greatly between Northern and Southern Europe," adds a Partner at a UK fund of funds. "Economic vitality in Germany and Switzerland has been improving and thus funds exposed to these economies have good potential."

Economic environment top concern for LPs

What are your biggest concerns for private equity firms investing in Western Europe over the next 12 months?



The economic environment and political uncertainty are the biggest concerns for LP investors on both sides of the Atlantic. Some 86% of North American LPs cite the economic environment as a significant concern, while 78% of European LPs say the same.

“The political and economic environment in Western Europe is very uncertain,” comments a Managing Partner at a US fund of funds. “The Greek crisis is yet to be over and there are other major economies like Spain and Italy that are at risk of default. Western Europe is politically fragmented and there are no solid decisions being taken to improve the debt situation and bring the economy towards recovery.”

The political environment is also having an impact on the regulatory environment explains the Head of Investments at a Dutch pension fund, “There is significant uncertainty over the regulatory regime and change regarding tax.”

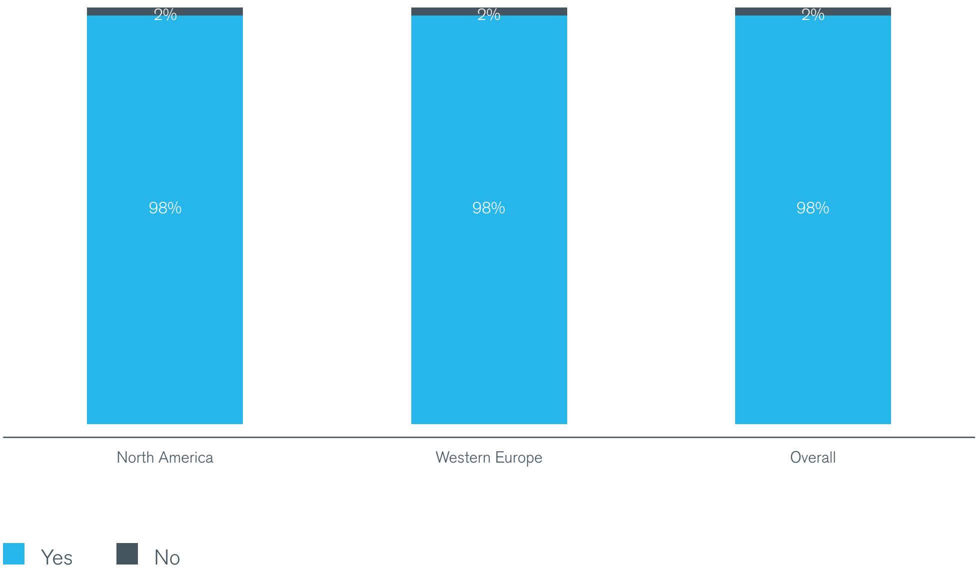
“There is still a gap between vendor and buyer price expectations which is affecting private equity deal making,” he adds. Indeed, vendor price expectations are also an important consideration for both sets of investors, with 64% of North American respondents saying that it was a significant concern and 58% of Europeans citing it as a significant concern.

Currency fluctuations, the availability of targets and the exit environment were viewed as less important factors for LP investors from both regions.

“Target availability is not a big issue in Western Europe,” suggests a Managing Director at a Swiss fund of funds. “There are many investment opportunities in all type of funds including growth funds and venture funds. However, in countries which are attractive for investment, the valuations are very high.”

Eurozone crisis affecting strategy

Has the Eurozone crisis been a major factor in deciding your private equity investment strategy over the past 12 months?



Nearly all respondents (98%) state that the Eurozone crisis has been a major influence on their investment decisions over the past 12 months.

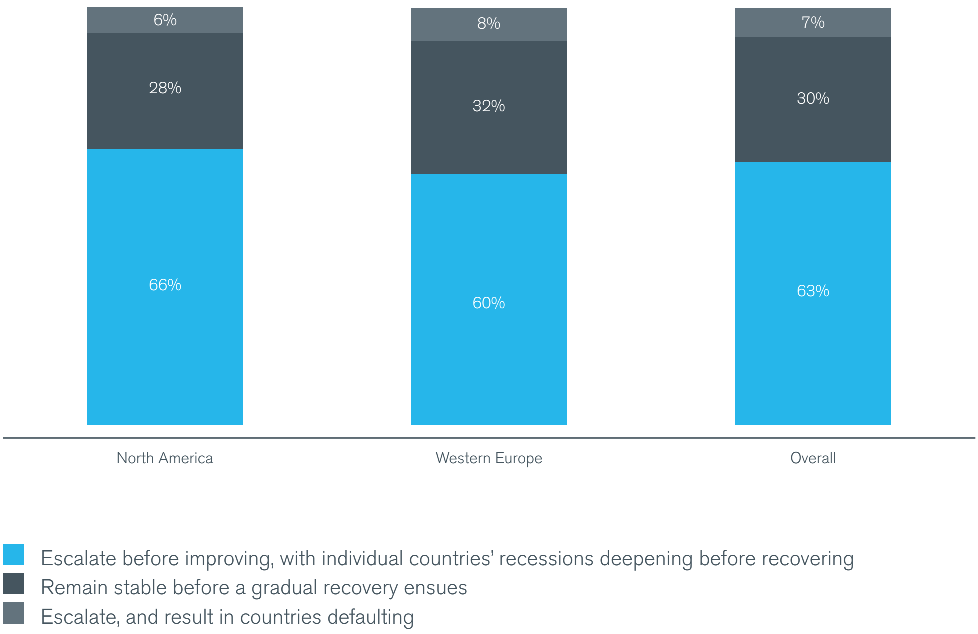
“The Eurozone crises cannot be neglected when investing in private equity in Europe or in any other region,” suggests a Managing Partner at a US fund of funds. “We have shifted our focus from some key markets to new markets and also postponed our investments in some new countries.”

The Head of Investments at a Luxembourg-based fund of funds explains how they have adapted to the environment, “It was important for us to anticipate the impact of any Eurozone event such as the exit of Greece from the monetary union and thus we made investments accordingly and had also planned the steps we would need to take in response to any such development.”

“Unlike other times, we have become very choosy and specific in what we invest into,” adds a CIO at a US institutional investor fund. “We have also undertaken the painful process of deleveraging, which has affected our returns.”

Deeper recession expected, but defaults not foreseen

Do you expect the Eurozone crisis to:



The majority (63%) of respondents think that the Eurozone crisis will escalate, leading to a deepening of recessionary conditions before any recovery, but that this worsening environment will not lead to countries defaulting.

"The situation will get worse because governments are not undertaking any substantial measures and there is no recovery happening," suggests a Managing Partner at a US fund of funds. "However, as the situation gets worse and when the EU realises that there is a real danger of the Eurozone breaking up they will take the required measures."

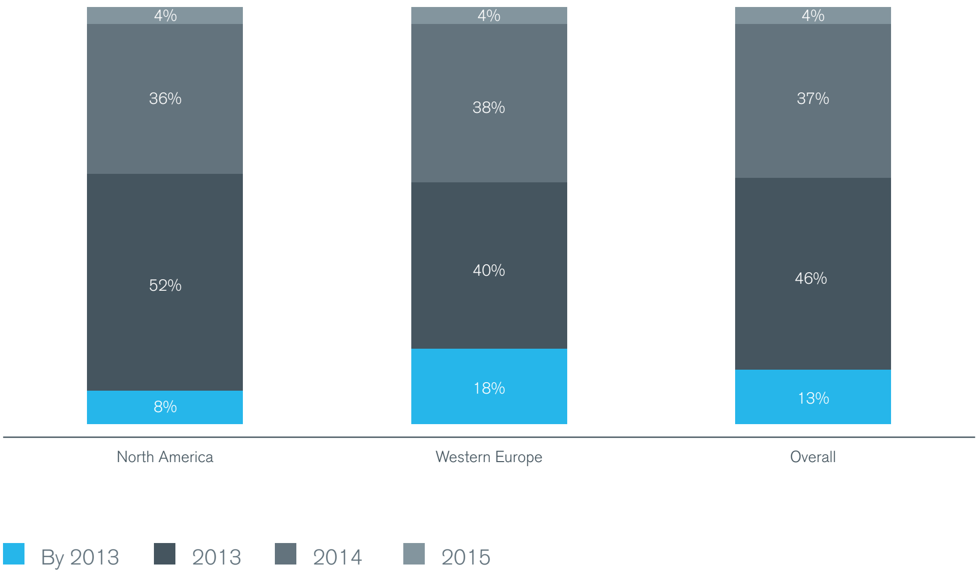
Thirty percent of respondents, including a Managing Partner at a US fund of funds, expect conditions to remain relatively stable prior to a gradual recovery, "I have a fair hope that the situation is getting stable and soon Europe will start recovering. The European Union has come together and is now taking the right measures to keep the Euro safe and bring developments to ease the pressure. Fear of default and breakup of the Eurozone has gone and investors are now returning."

Only 7% anticipate an escalation of the crisis that will see individual countries defaulting on their sovereign debt. This includes the President of a French asset manager, "A Greek exit is not the ideal solution to end the uncertainty, but if no immediate measures are taken then certainly default by Greece is very much possible."

Just under half (46%) of respondents expect that a significant change in the underlying economic environment will occur in 2013, while 37% expect it will take until 2014.

Changes to occur in 2013 or 2014

When do you expect these shifts/developments to occur?



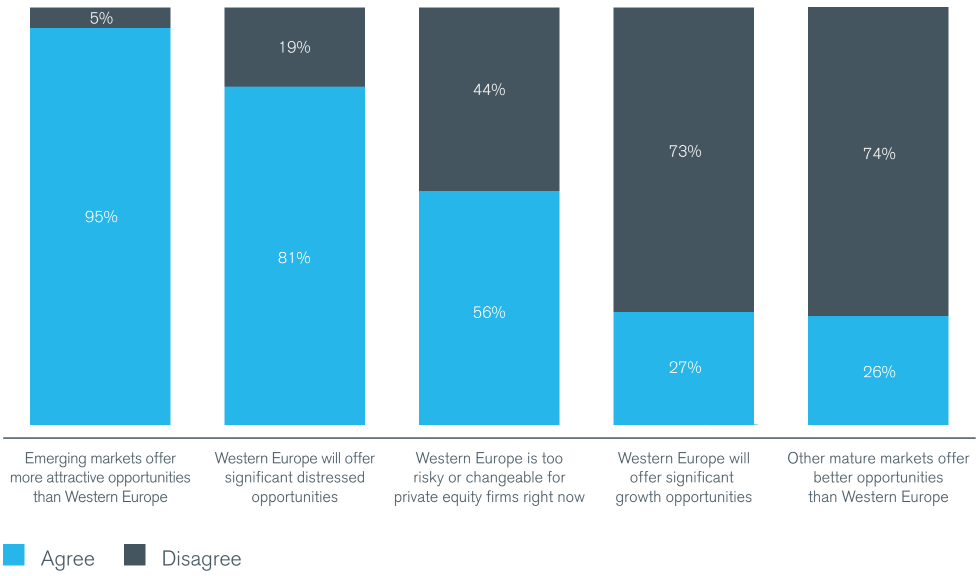
There is a range of views as to how the economic environment will develop. "The Eurozone crisis has already stabilised and we will see marked progress in 2013," suggests a Head of Equity Investments at a Luxembourg-based fund of funds. "Although the market is still very sensitive, there is a greater level of control and the economy is slowly improving."

A CIO at a US pension fund is less bullish, saying, "A huge amount of sovereign debt is maturing in 2013…the crisis situation in Greece and Spain will intensify and more bailouts will be needed to overcome the debt crisis."

This view is shared by the Managing Director of a Canadian asset manager, who says, "Some countries like Greece, Italy and Spain are in very bad shape and conditions in these countries will get worse in 2013 as another heap of debt unfolds. However, certainly these countries will not default and instead bailouts in Europe will continue until the conditions stabilise and a recovery starts."

North American LPs see Europe as too risky

Please state whether you agree or disagree with each of the following statements:



Nearly all (95%) respondents believe emerging markets offer more attractive opportunities than Western Europe, although a large majority (81%) also believe Western Europe currently offers substantial distressed opportunities. "Emerging markets are in healthy condition and continue to introduce reform measures, which are making them even more attractive," comments a Managing Partner at a Swiss fund of funds.

"Western Europe is in its fourth year of recession without any improvement. It is not easy to ignore this fact when investing," says a Director of Investments at a Dutch pension fund. "Investors are trying to find and invest in alternative opportunities available in emerging markets such as China and India."

There is a disagreement between North American and European LPs on whether Western Europe is currently too risky for PE firms with 78% of North American LPs viewing conditions as too precarious, compared to 34% in Europe.

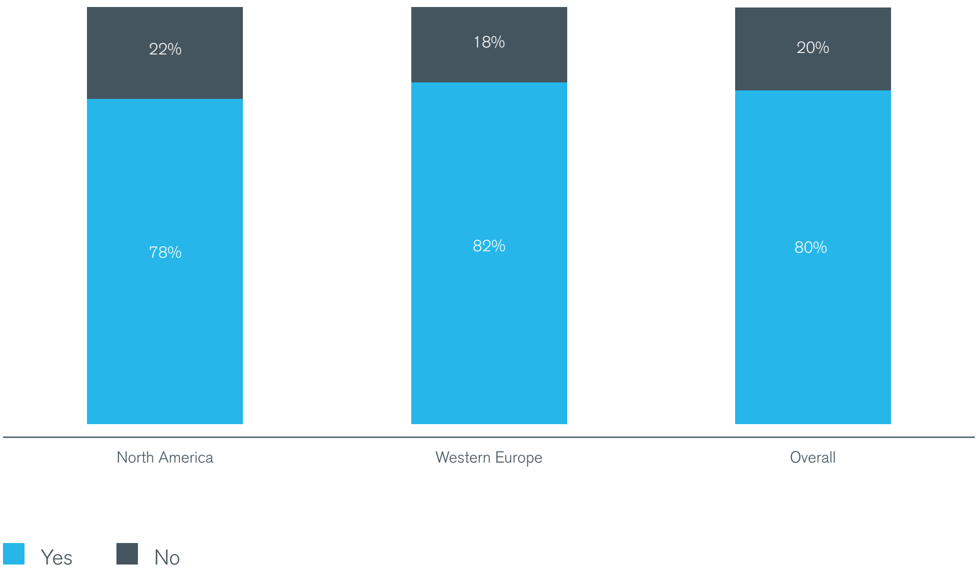
Similarly, only 10% of North American investors expect Europe to offer significant growth opportunities, compared with 27% of European LPs. Over two-thirds (36%) of North American respondents think that mature markets outside of Europe offer up greater opportunities while only 16% of European LPs agree with this view.

"Western Europe is always in the grip of uncertainty either because of the political outlook or debt crises," suggests a CIO at a US pension fund. "Even the distressed opportunities are not worth investing in for now. Most investors are shifting their focus to emerging markets or to other countries such as the US, Australia and Japan."

Market Research: GP-LP Relations

Relationships with GPs changing amidst the past year's slump

Has your relationship with private equity funds (GPs) changed in the past 12 months?

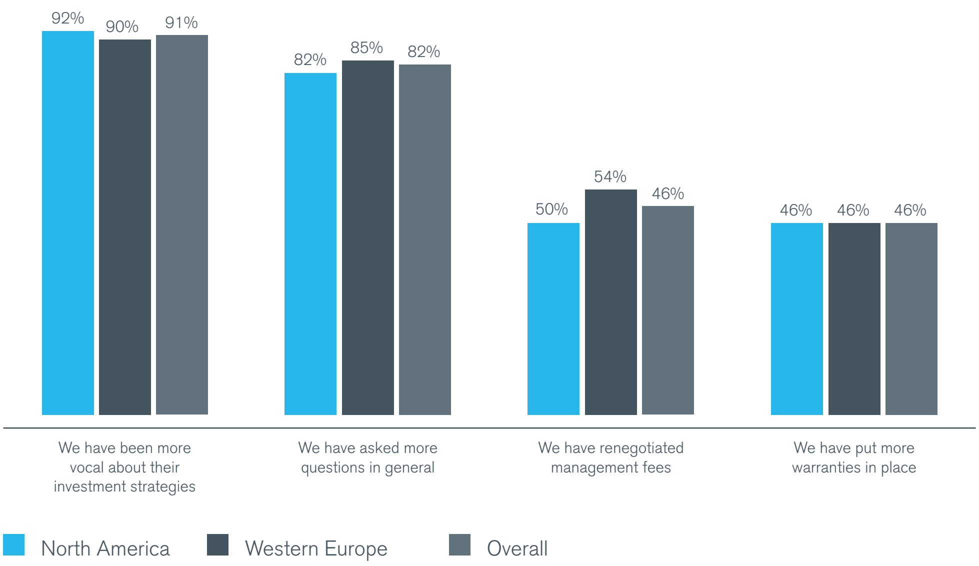


Four in five respondents say the past year has seen a change in their relationships with general partners.

The wide majority (91%) have been more vocal about fund investment strategies, while more than four in five (82%) are asking more questions in general. "We do not restrict our general partners or interfere in their investment strategies," says a CIO at a US state-backed sovereign wealth fund. "We just want to know how they are investing our money and what we can expect out of it. We are doing what we are required to do."

LPs keeping watchful eye on private equity fund activities

If yes, how so?

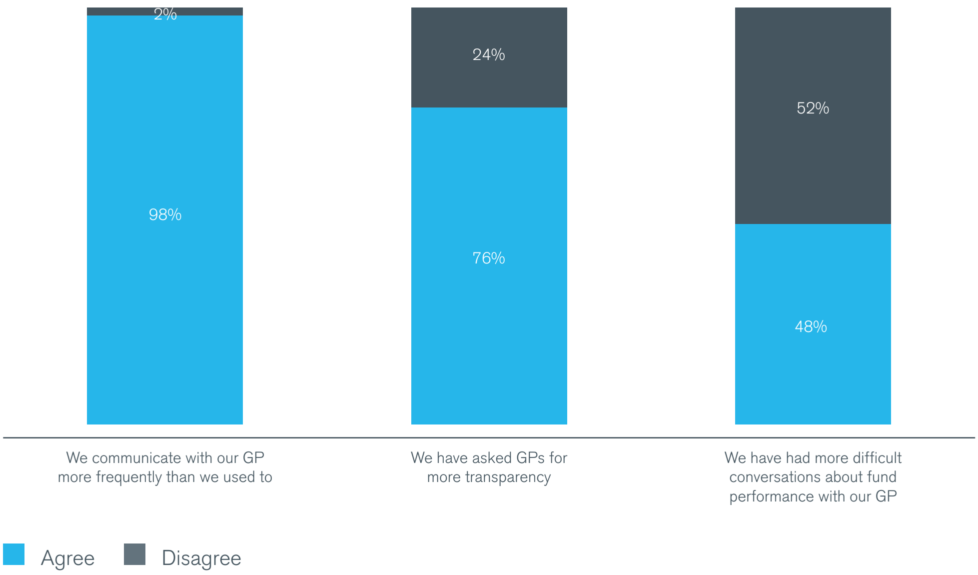


Limited partners are not simply taking a greater interest in the investment strategy of the funds, with many pushing to renegotiate fees (50%) and put more warranties in place (46%).

"We have opposed our GPs management fees structure and the confidentiality provisions as their transparency level regarding our investments was not satisfactory. We managed to revise the contract to change the transparency level, but did not get a major change to management fees," says a second CIO at a US institutional investor fund.

Communication more frequent as LPs push for transparency and nearly half report having more difficult conversations about performance

Please state whether you agree or disagree with each of the following statements about how your GP-LP relationship has changed over the past 24 months:



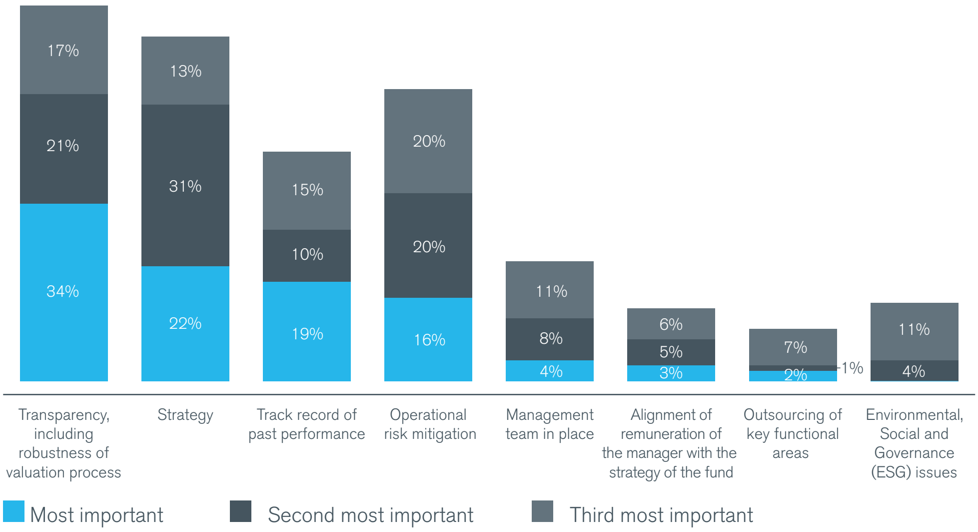
Communication with GPs has increased over the past 24 months according to almost the entire survey pool (98%), with many LPs requesting more transparency (76%). Almost half (48%) report having had more difficult conversations about fund performance.

"Although the GPs report valuations to us regularly, we have started to monitor fund activities on an ongoing basis through regular communication. We are focused on working with our GPs very closely, not because we do not believe in them but because in the current market it is required," explains the CIO from a US state employee pension fund.

A Dutch pension fund manager echoes his North American counterpart, saying, "It's because of the market situation that we need to keep a regular check on the GPs' performance and their investment strategies. There is lot of uncertainty and we want our GPs to be more transparent regarding their plans for investing in the uncertain markets."

Transparency a key concern when allocating capital

When making an allocation to a fund manager, please select the top three factors in order of importance to you:



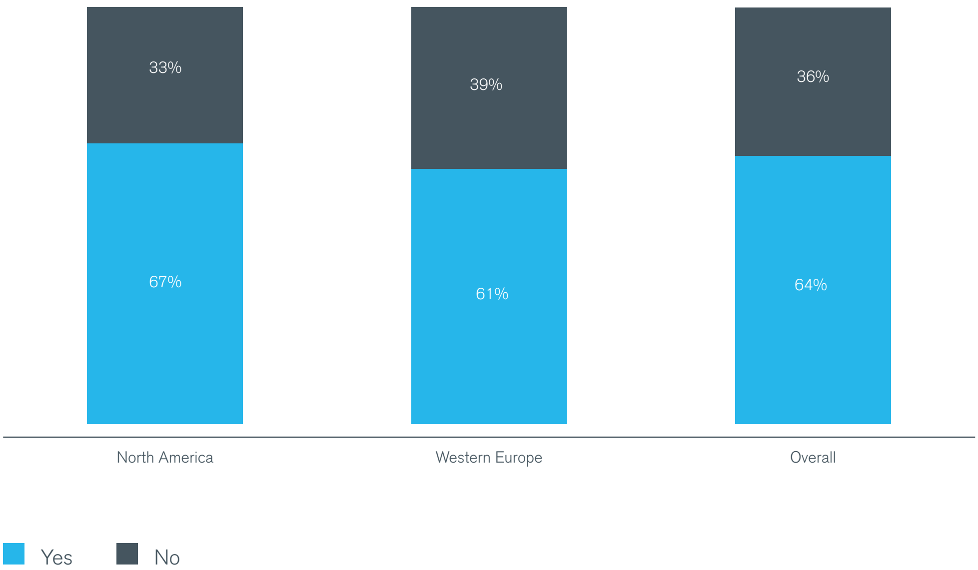
"Transparency is key factor as it keeps the entire investment process robust," says a CIO from a Dutch pension fund. Thirty-four percent of respondents agree that it is the most important factor when allocating capital to a fund – in total over 70% of those polled cite it as one of the top three investment factors.

Over one-fifth of respondents (22%) say strategy is the top factor, while 19% say the track record of past performance by the private equity firms is the most important.

Elsewhere, environmental, social and governance (ESG) issues are viewed as comparatively less important – cited by only 15% of respondents as a top factor. Yet this remains an important area for LPs to explore before committing capital, as the abovementioned Dutch investor explains, "Often LPs have limited influence with regard to managing ESG risks and opportunities when committing capital to any private equity fund, which greatly increases the risk of the investment. But, it is still important to address the ESG issues before agreeing to commit or investing in a fund."

LPs more likely than not to investigate factors influencing investment performance

If past track record is important to you, do you investigate what factors contributed to how the GP made money on past investments?

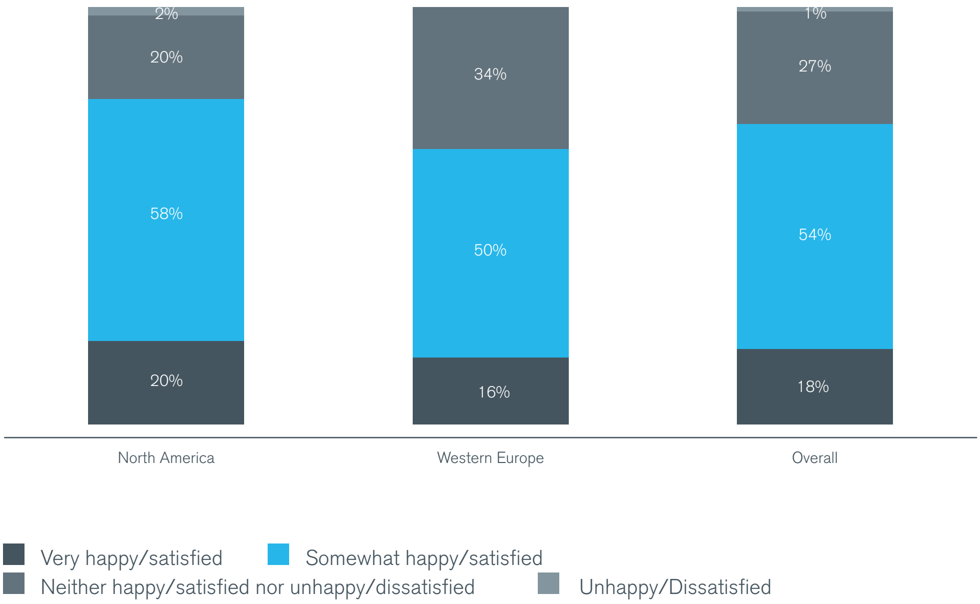


Sixty-four percent of respondents say they do investigate the past performance to unearth the factors supporting a fund's past profit making.

While it is somewhat surprising that the figure is not higher, one US investor who does not investigate these factors puts it into perspective thus, "Past investments are not of a big concern to us. Four years back ,the markets were very different – investments then and now cannot be compared. Instead, we are more interested in knowing how our general partners have planned for now. Looking at past performance can give us confidence on our fund managers, but we are concerned about our GPs' current ability to mitigate market risks and make profits."

LPs are generally happy with current communication on fund performance

How happy/satisfied are you with the interim performance and valuation information on portfolio companies provided by GPs?

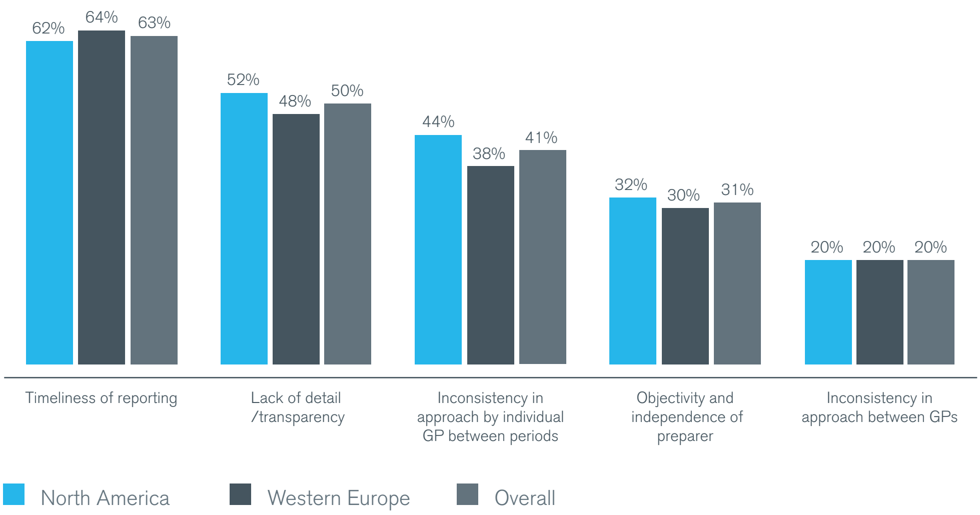


More than half of LPs (54%) say they are generally satisfied with the interim performance and valuation information they receive from GPs on portfolio companies. Only a miniscule 1% of the respondent pool indicates any unhappiness with the reporting on the status of portfolio investments.

"Valuations information is crucial for deciding on exiting the investment, but often PE funds provide inconsistent information and do not share it in a timely manner. This affects our strategy and sometimes it causes us to miss our commitments," says a pension fund manager based in New York.

Timeliness and lack of details are common problems with valuation information

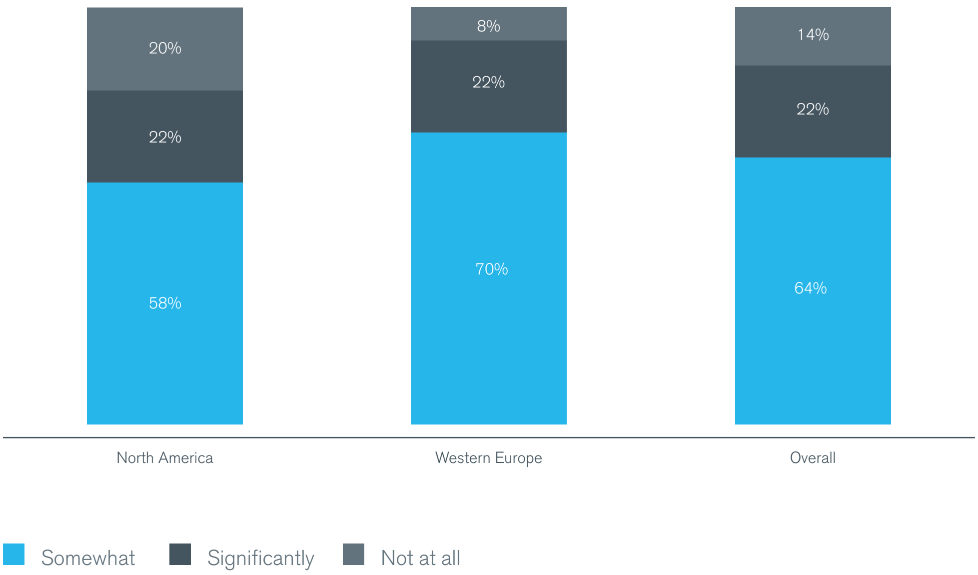
With respect to valuation information, what are the most common problems with the information you receive?



Indeed, timeliness of reporting is cited by 63% of survey participants as one of the most common problems with respect to valuation information, while lack of detail and transparency is identified by 50%.

Negative media attention has changed LP approach to private equity investing

Has negative media attention on the private equity industry changed your firm's approach to private equity investing?



A combined 86% of respondents say their approach to private equity investing has been affected by negative media attention toward the asset class either somewhat (64%) or significantly (22%). In the post-crisis period, increased scrutiny toward alternative investments and the finance industry has brought private equity unwanted attention.

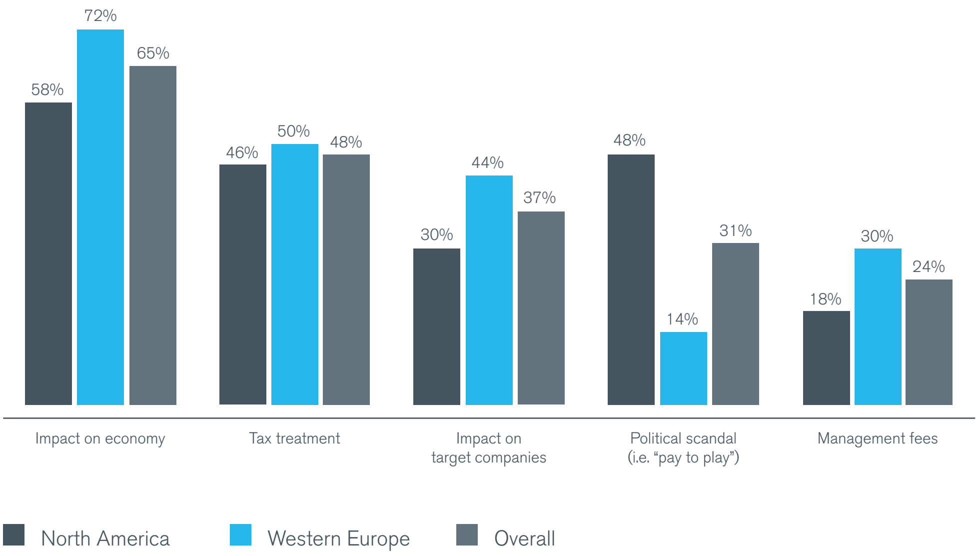
Mitt Romney's candidacy for the US presidency also cast a spotlight on the industry. Nonetheless, respondents from the US were less likely than their European counterparts to say the negative media attention had not affected their approach to investing in the asset class at all – a fifth of North American respondents indicate this compared to 8% from Western Europe.

The impact on the economy was the top cited issue that respondents found most troubling (65%), followed by tax treatment (48%) and impact on target companies (37%). There was a notable difference between regional LPs on this latter issue, with 44% of Western Europeans citing this as troubling compared with 30% of their transatlantic counterparts.

"Tax structures for the private equity industry have become a major issue in political circles and with the US election the issue has intensified. Private equity is an integral part of the economy and tax issues will

Impact on economy biggest concern arising from negative media attention

In light of negative media attention, which of the following issues have you found most troubling



likely affect private equity – it will certainly affect our equation with our private equity partners," says a US institutional investor fund investor.

Another area of discontent for Western European respondents is management fees, with fully 30% saying that it is a troubling issue. "Management fees have increased significantly in the past few years which has received negative media attention, because PE firms have not been able to give back returns but still they are charging heavy fees. I somewhat understand that PE firms need to raise management fees in order to pay for high quality investment managers, but if the situation remains the same, then it will be difficult to handle," elaborates one New York-based pension fund investor.

Private Equity in Review

Sponsor to sponsor buyouts sustain fund activity

A major trend within the European private equity space in recent months has seen an increase in the proportion of deals represented by sponsor to sponsor buyouts. Sponsor to sponsor buyouts have represented 20% and 31% of all PE deals from volume and value perspectives since 2005. However, in Q3 2012 these figures hit 25% and 60% and so far in Q4 have accounted for 30% of all deals by volume – the highest figure since the start of 2005.

In part, this can be attributed to timing. Many sellers are moving to offload assets purchased during the boom years. Similarly, buyers are looking to spend dry power raised in 2007 and 2008 in the face of a looming five-year investment period deadline. Indeed, deals of this type look likely to peak in 2013 as the five-year deadline for funds raised before the crisis is reached.

On the sell-side, a sponsor to sponsor buyout does not necessarily offer the highest exit multiple, but corporate buyers for all but the highest quality of European PE assets remain thin on the ground. In the IPO market, meanwhile, exit activity has been largely subdued, a combination that has made private equity buyers one of the most attractive routes to exit.

How much further optimisation is possible for a firm already backed by private equity? This is a question that stirs debate among investors, but there are a couple of factors that support sponsor to sponsor buyouts. First, the industry's growth means there is a diversity of PE funds investing in companies at different stages of their lifecycle and applying different strategies and skills.

Second, firms already under PE ownership are likely to have a strong management in place and the financial records will have been heavily scrutinised by lenders, making them lower risk and easier to raise finance against – both attractive features for GPs given the current market conditions. Recent deals of this type include AXA Private Equity's €800m purchase of Germany's Fives Group from Charterhouse Capital Partners, and HgCapital's €592m sale of Mercury Pharma to Cinven Ltd.

Sponsor to sponsor buyouts are helping to prop up the level of activity within the European PE sector, but the overall trend has been one of decline since Q2 2011. Renewed concerns about the state of the Eurozone, coupled with uncertainty surrounding the US fiscal cliff are to blame. Any improved clarity in these areas should help support dealmaking in 2013. The number of buyouts should also be supported by renewed enthusiasm from LPs, with 95% of those surveyed saying that they will increase investment into PE next year, pointing to recognition that PE investment, particularly when coupled with expertise acquired through sector specialisation, can be a good way to avoid the continued volatility in other parts of the market.

The downward trend in overall activity this year is more pronounced for fresh buyouts than it is for portfolio company exits. Indeed, the €33.5bn aggregate deal value for European exits recorded in Q2 2012 was the second highest since the onset of the crisis (surpassed only by Q2 2011). Exits have been supported by a number of large deals to corporate buyers including Walgreen's €5.3bn acquisition of Alliance Boots, CVC Capital's €2.7bn sale of StarBev to Molson Coors and Watson Pharmaceuticals' €4.4bn purchase of Actavis from Novator. These deals demonstrate that cash-rich corporates will bring money to the table for the right asset.

Casting a look to buyouts, the picture looks more languid. The average size of PE buyouts is still well below its pre-crisis high at €205m compared to €327m in 2006. This is partly because of the lull in very large deals due to the continued difficulties raising financing for large leveraged buyouts. While the proportion of deals above €500m has risen steadily since 2009, buyouts above €1bn are still rare. In 2012, there have been two notable exceptions with Tagus Holdings' €4.2bn acquisition of transportation company Brisa-Auto Estradas de Portugal and Terra Firma's €4bn purchase of UK property firm Annington Homes perhaps signalling renewed appetite for larger deals among lenders as long as the target company has a strong operating history and impeccable financial records.

Q&A

David Larsen (San Francisco)
David is a Managing Director in the Alternative Asset Advisory practice of Duff & Phelps. He specialises in valuation and accounting issues faced by alternative asset managers and investors. He is a member of the International Private Equity and Venture Capital Valuation Board (IPEV) and a member of the board of the Private Equity Industry Guidelines Group (PEIGG).

Mathias Schumacher (London)
Mathias is a Managing Director in the Valuation practice of Duff & Phelps and specialises in business valuations for private equity and corporate clients, as well as transaction consulting and purchase price allocations.

MM: With the majority of LPs surveyed planning to increase their private equity allocations, is there a growing recognition that private equity is a good way to avoid the high levels of volatility currently seen in other investment classes?

MS: Volatility exists at different points in time for every asset class. The increased allocation to private equity by LPs is more likely to be related to the need to increase overall returns and especially risk-adjusted returns. While private equity investments may be deemed more risky than other investment classes, returns have continued to be strong.

MM: Has the global financial crisis changed the power-balance between LPs and GPs?

MS: The current fundraising environment is difficult for GPs. As such, LPs can be selective and are receiving some concessions from GPs with regard to fees and carried interest.

MM: Transparency and the robustness of the valuation process are seen by LPs as the most critical factors when allocating capital, so what are the most important steps GPs can take to improve in these areas?

DL: LPs are feeling increased regulatory pressure themselves to ensure that they have a robust process for monitoring and valuing their fund interests. As such, LPs are requesting increased transparency from their GPs. Some steps that GPs can take to demonstrate that they have a robust and transparent valuation process are to adopt the industry leading IPEV Valuation Guidelines and, as appropriate, utilise an experienced qualified third party valuation expert to validate their fair value conclusions. GPs who report using the newly developed IPEV Investor Reporting Guidelines will meet most, if not all, LP information needs.

MM: Timeliness and a lack of detail are seen as common problems with valuation information, so what would you say differentiates the best and worst performers in this respect?

DL: LPs' own reporting timeframes are being compressed, and as a result LPs need valuation information from GPs as quickly as possible. For many GPs this requires a paradigm shift in their own valuation process and way of thinking. Many of the very large GPs have adjusted their internal process such that they can produce fair value estimates very quickly after quarter end and it is possible for all GPs to accelerate their reporting. Currently the level of detail provided by GPs is inconsistent and again, following the IPEV Investor Reporting Guidelines provides a great baseline as to the extent of information needed by LPs.

"Many of the very large GPs have adjusted their internal process such that they can produce fair value estimates very quickly after quarter end and it is possible for all GPs to accelerate their reporting."

MM: What else can GPs do to aid fundraising at a time when investors remain relatively cautious but the number of private equity firms competing for investment is rising?

DL: While a robust and transparent valuation and reporting process is now essential, the ultimate capital allocation decision is based on historical performance and the belief that it can be repeated in the future. Therefore GPs increasingly need to demonstrate how they add value. For example, value attribution can be empirically assessed to show the extent investment returns stem from operational improvements, structuring, financing, etc as opposed to simply "riding an economically beneficial wave." GPs also need to demonstrate the ability to identify primary investment opportunities, where true Alpha can be generated.

"GPs who report using the newly developed IPEV Investor Reporting Guidelines will meet most, if not all, LP information needs."

MM: Do you think that there will be more questions raised about how much value is created through sponsor to sponsor buyouts if these types of deals continue to dominate deal flow in 2013?

MS: We are seeing secondary and tertiary sponsor to sponsor acquisitions becoming more common and LPs are rightly asking questions about the economic merits of these deals. This is particularly true when the LP is invested in both funds and is incurring expenses on both sides of the transaction.

At the same time, though, it highlights the limited opportunities to deploy capital and with the large amount of dry powder left in many funds it will remain a common occurrence. Given the volatile IPO market, an exit to another financial buyer is often seen as a more predictable and likely to complete outcome.

MM: With LPs increasingly pursuing acquisitions of secondary market commitments, what are some of the pitfalls to avoid when valuing assets in a market which remains relatively illiquid?

DL: A number of secondary investors have raised and are raising funds to focus on the secondary marketplace. To a great extent, secondary investment performance is driven by supply, which in turn is driven by macro factors impacting existing LPs. Given relatively weak global economic conditions, the supply of LP positions may remain strong, with some LPs needing to rebalance portfolios and eliminate the need for funding future capital commitments. Such supply provides an opportunity for secondary investors.

Thorough analysis at the underlying investment level is key. Taking a macro approach to valuing a basket of secondary fund interests may be efficient, but this approach increases the risk of not achieving targeted returns.

MM: North American LPs are currently much less positive towards investing in Europe than their European counterparts. Why do you think this is and what needs to change for opinions to improve?

MS: Generally it is a reaction to regular press reports that highlight economic difficulties in Europe generally, and within specific European countries.

The macroeconomic environment is clearly a key factor in achieving targeted returns. However, astute investors can and do find selected companies where returns can be achieved irrespective of the geography or macro environment.

About Duff & Phelps

As a leading global financial advisory and investment banking firm, Duff & Phelps balances analytical skills, deep market insight and independence to help clients make sound decisions. The firm provides expertise in the areas of valuation, transactions, financial restructuring, alternative assets, disputes and taxation, with more than 1,000 employees serving clients from offices in North America, Europe and Asia.

The Duff & Phelps Portfolio Valuation team specialises in assisting private equity firms, hedge funds, business development companies and corporations as well as limited partners, institutional investors and endowments with the valuation of alternative investments, specifically securities and positions for which there are no "active market" quotations. Duff & Phelps' professionals provide practical guidance on emerging fair value issues initiated by the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB) and governmental bodies as well as industry standards, such as those provided by the American Institute of Certified Public Accountants (AICPA), the Private Equity Industry Guidelines Group (PEIGG) and the International Private Equity Valuation (IPEV) board. Duff & Phelps also advises on valuation policy best practices and provides investors with an independent third party assessment of their fund manager's operating policies and procedures.

For more information, visit www.duffandphelps.com

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