PEI Alternative Insight
PRIVATE EQUITY INTERNATIONAL

Vote of confidence

Private equity's continuing appeal for family offices and foundations

A Research Report

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Vote of confidence

Private equity's continuing appeal for family offices and foundations

Commentary from Montana Capital Partners

Montana Capital Partners (mcp) and Private Equity International (PEI) are proud to present the results of the fifth Annual Family Office and Foundation Private Equity Survey.

Family offices and foundations are a widely unreported segment of the investor community. This is due to their relative opacity compared to larger, more institutional investors. Nevertheless, they are playing an increasingly active role in private equity. It is now a stable investor group and a major provider of new capital to private equity funds. The often entrepreneurial DNA of family offices and foundations means they have a natural affinity to the asset class.

This survey provides an overview of the strategies and opinions of this active and sophisticated investor group. In contrast to more institutional investors, family offices are often more flexible and return-driven. Their investment behaviour is also less affected by regulations and market trends.

Through mcp's long-standing work with family offices and foundations, mcp's and PEI's combined extensive network and experience in research, we were able to speak with a significant number of investors to garner their views on the private equity market.

Headline results from this year's survey are:

- Family offices and foundations have the most positive view of private equity since this survey started back in 2013: 92 percent of respondents have kept their allocation to the asset class constant or have increased it over the past year. Over the coming 12-month period, 57 percent intend to keep their allocations constant and 38 percent plan to increase it from current levels.
- Private equity continues to play a large role in the portfolios of family offices and foundations: 30 percent of respondents allocate more than 20 percent to the asset class, and 85 percent allocate more than 10 percent (up from 61 percent in last year's survey).
- Mid-market buyouts is the most favoured strategy. While it has always been popular, the share of respondents selecting it as their top choice has increased from 58 percent in 2016 to 70 percent in this year's survey. Real estate and infrastructure have suffered a decline in popularity this year, but secondaries is more sought after than ever with 48 percent of respondents selecting it; the highest proportion since this survey began.
- Large fund portfolio acquisitions are again the most unpopular secondaries strategy. For the first time, secondary directs has surpassed small secondaries as the preferred secondaries strategy. It will be interesting to see whether this trend continues in the coming years.

- Amid a continued abundance of cheap capital and the prospect of increasing interest rates, a record number of respondents indicate that GPs buying into companies at too high valuations is their top concern.
- A small proportion of respondents – 28 percent compared to 51 percent in 2016 – are expecting a major correction in public markets within the next 12 months. This growing optimism somewhat contradicts respondents' concerns about high valuations.

Family offices and foundations continue to be among the most active investor groups in private equity and among the first investors in newer, though now established, strategies such as direct/co-investments, small/complex secondaries and smaller buyouts.

mcp has an investor base of well-known and reputable global family offices and foundations, as well as institutional investors like pensions funds and insurance companies. We provide attractive investment funds for these investors and create innovative solutions that allow them to actively manage their private equity portfolios by selling fund interests, direct company participations or funds of funds.

mcp focuses on deals sourced in direct contact with sellers in order to create customised solutions that benefit both investors and sellers. Such solutions include structures like deferred payments, earn-outs, preferred equity, and securitisation-elements, or the creation of new funds through, for example, the acquisition of direct investments and the spin-out of teams. mcp often works directly with GPs to provide liquidity solutions for investors.

We hope that the 2017 Family Office and Foundation Private Equity Report offers you plenty of valuable insights. Should you have any questions or comments, please do not hesitate to let us know.

Kind regards,

Christian Diller and Marco Wulff
Montana Capital Partners

Accessing the asset class

In a time of geopolitical uncertainty and continued low interest rates, family offices and foundations remain a key proponent of the private equity market. Our latest annual research study explores the allocations, appetites and concerns of this relatively tight-knit community, and reveals that the majority plan to either increase or maintain their exposure to the asset class over the next 12 months.

Institutions that allocate more than 10 percent of their portfolio to private equity account for 80 percent of survey respondents this year (see Figure 1), compared to 63 percent in 2016.

We asked respondents how this allocation had changed over the past 12 months. Figure 2 shows that almost half have increased their exposure. The biggest change since last year's study is the increase in the number of institutions maintaining their exposure – to 44 percent from 37 percent.

Similarly, 57 percent of respondents (compared to 51 percent in 2016) are planning to maintain their allocation to private equity in the coming 12 months (see Figure 3). This is the largest proportion of respondents that have no plans to change their allocation since our 2014 survey report.

Figure 1

What is your current allocation to private equity?

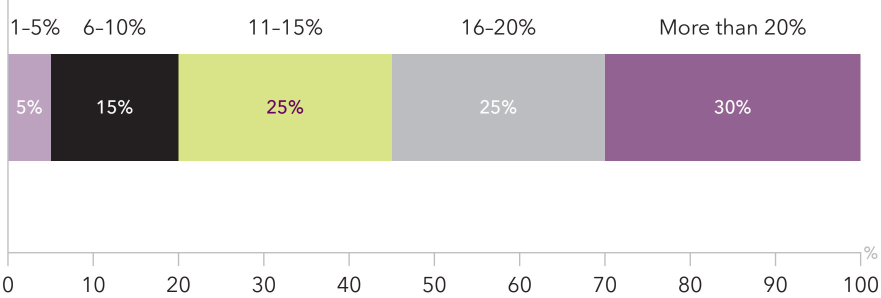


Figure 2

How has your allocation to private equity changed in the past 12 months?

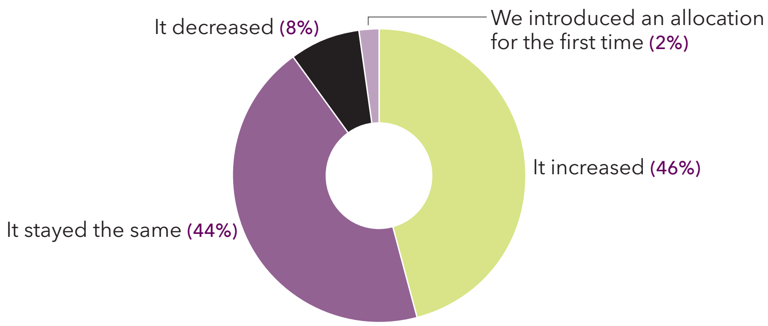
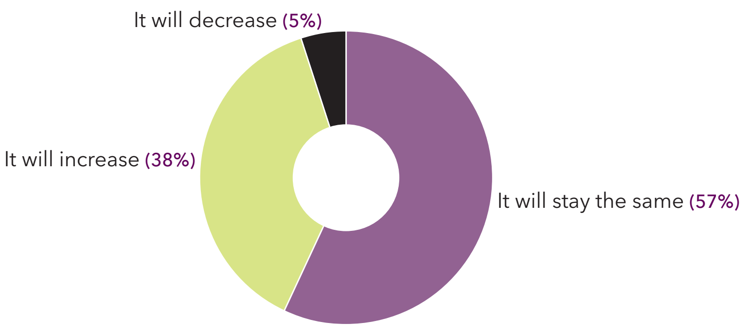


Figure 3

How do you expect your allocation to private equity to change in the coming 12 months?



While some family offices and foundations are exercising caution, a significant proportion are planning to place more capital in private equity. Thirty-eight percent of respondents are confident that a growing market and anticipated stable returns justify increased exposure to the industry.

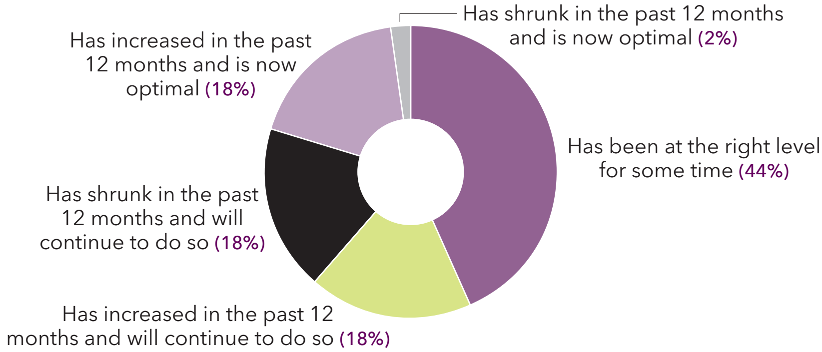
These results make sense in light of current market trends. According to PEI data, 2017 looks set to be the largest fundraising year since the financial crisis.

Figure 4 gives an insight into the number of managers that respondents invest with. Forty-four percent are of the opinion that the number of managers has been at the right level for some time, 18 percent are planning to increase the number of managers they invest with over the next 12 months, and 18 percent are planning to decrease the number.

Overall, 63 percent believe that the number of managers they invest with is now at an optimal level.

Figure 4

Has the number of managers you invest with increased, decreased, or stayed the same?



Investment preferences

In this section, we look at the strategic and geographic preferences of family offices and foundations, and analyse whether these preferences have changed over time.

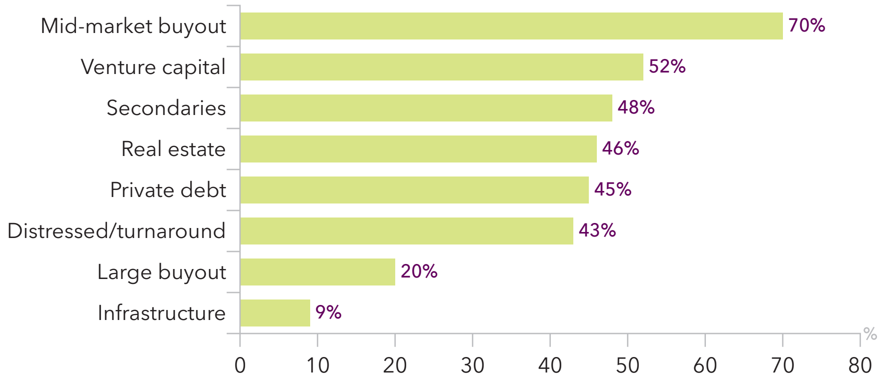
The long-term strategic preferences of respondents is revealed in Figure 5: 70 percent preferring mid-market buyout investment strategies. Although this figure has risen from 58 percent in 2016, the strategy has remained popular among family offices and foundations since we began our analysis of this investor group.

A marked change in the results this year is the falling popularity of real estate and infrastructure. In 2016, real estate was the preferred strategy for 62 percent of respondents, compared to 46 percent this year. Infrastructure has dropped from 20 percent to 9 percent.

Secondaries is now preferred by 48 percent of those surveyed, which is the largest-ever proportion to choose this category.

Figure 5

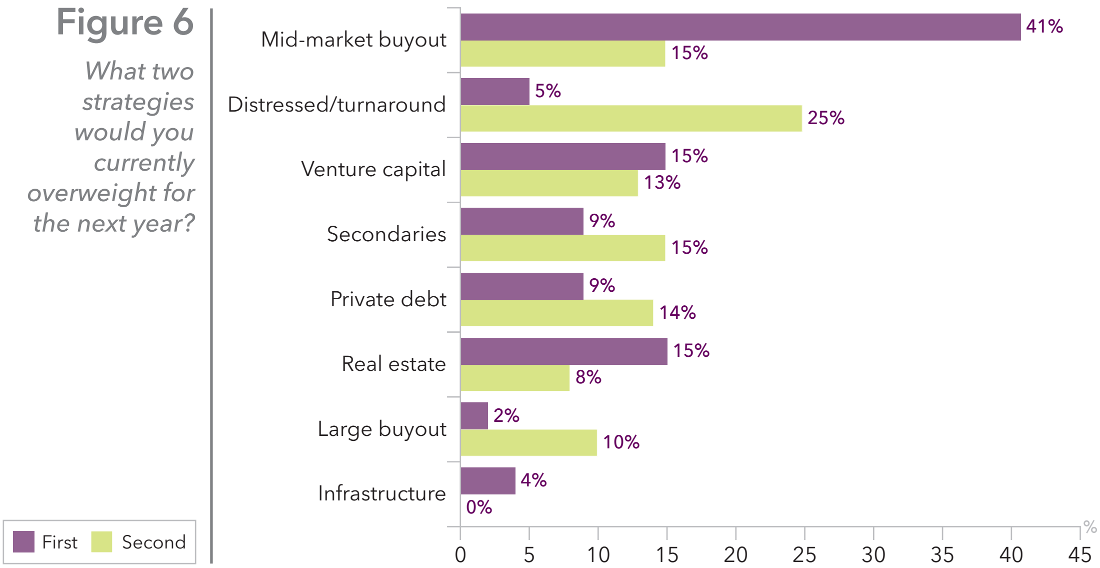
What are your long-term strategic preferences?
(select all that apply)



Real estate and infrastructure have also fallen down the ranks of strategies that would be over-weighted next year (see Figure 6), while secondaries has been chosen as a first and second choice by 24 percent of respondents compared to 16 percent last year.

Figure 6

What two strategies would you currently overweight for the next year?



Distressed/turnaround ranks highly among strategies that would be over-weighted for the next year, despite being ranked third lowest for long-term strategic preferences (see Figure 5). The proportion of family offices and foundations planning to take advantage of the cheap price of distressed assets in the near-term has risen from a 21 percent response in 2016 to 30 percent in 2017.

North America has risen above Western Europe as a preferred region for 82 percent of those surveyed (see Figure 7).

At the same time, around three-quarters of respondents plan to over-weight Western Europe in their strategy for next year compared to the 58 percent that would over-weight North America (see Figure 8). This is a significant increase in preference for Europe, which was selected by only 57 percent of respondents in the 2016 survey.

Figure 7

What are your geographic preferences? (select all that apply)

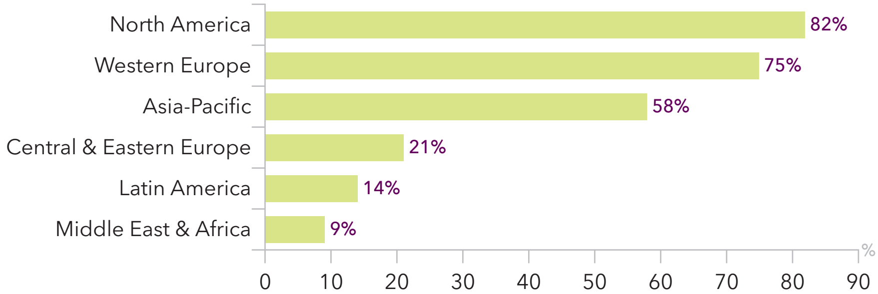
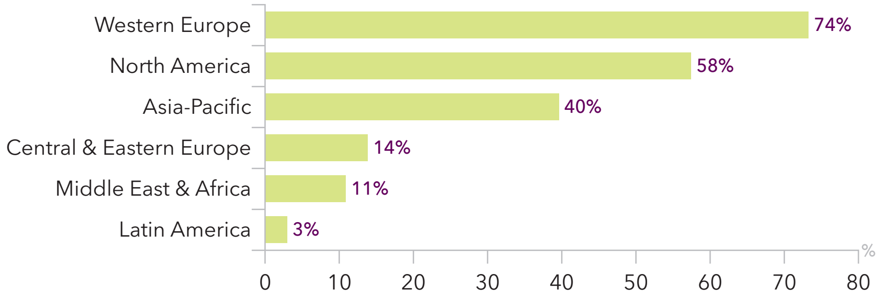


Figure 8

Which two geographic regions would you currently overweight in your strategy for the next year?



Secondaries

Originally seen as an important tool for portfolio diversification, secondaries are today a standard component of the private equity market. Around three-quarters of the family offices and foundations surveyed are involved in the secondaries market in some way, and more than half invest into secondaries funds (see Figure 9). In our previous two research studies, just half of the respondents were involved in this market.

For 22 percent of respondents, secondaries constitute more than 10 percent of their private equity portfolios (see Figure 10).

Figure 9

How would you describe your relationship with secondaries?

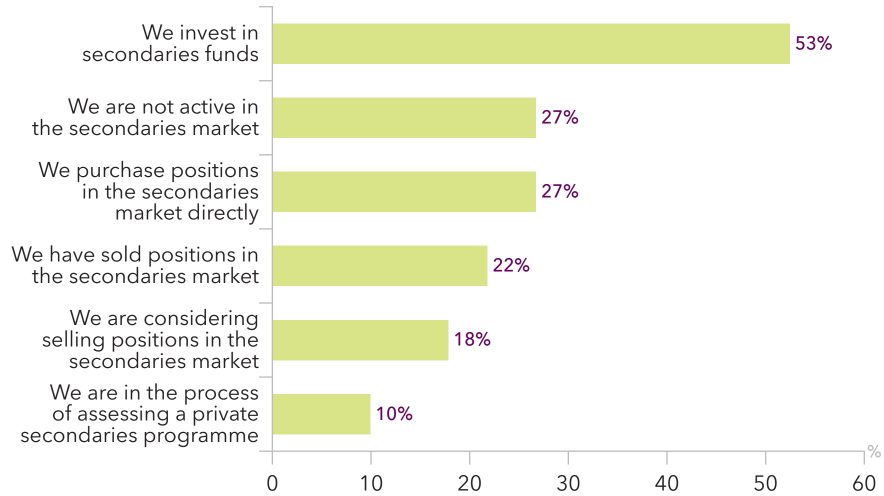
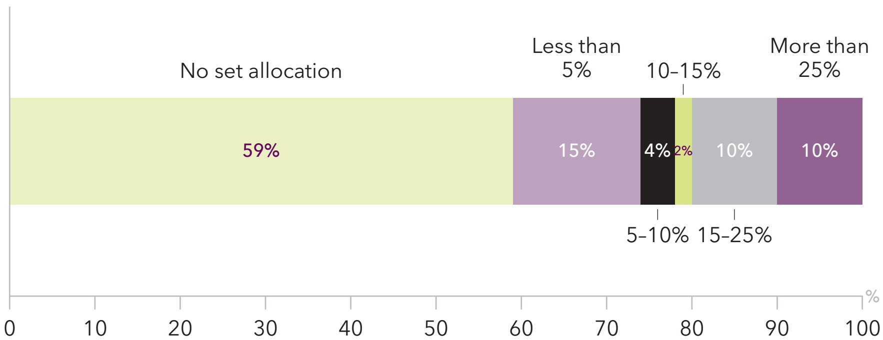


Figure 10

What proportion of your private equity allocation is dedicated to secondaries?

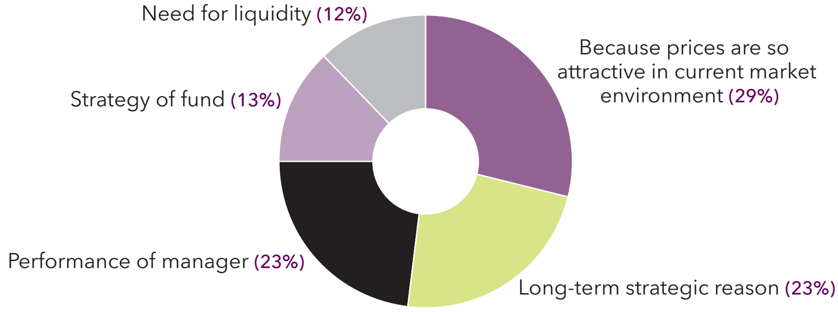


In Figure 11, we see that attractive prices in the current market environment – the most likely reason for undertaking active portfolio management – has gained in importance as a reason for selling. Long-term strategic reasons and the performance of underlying managers rank equal second.

The importance of liquidity has decreased: selected by 12 percent of respondents this year compared to 17 percent in 2016.

Figure 11

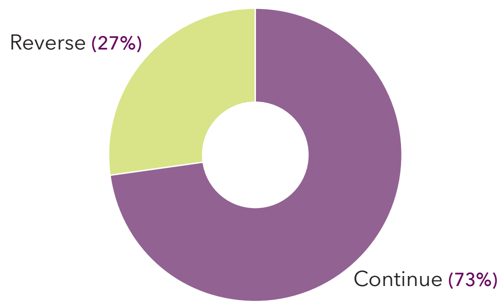
What would be your most likely reason for conducting active portfolio management via secondaries?



The question of whether secondaries will continue to grow in number over the next 12 months has maintained a relatively consistent response since our research study began. The overwhelming response again this year is that respondents expect the market to expand further (see Figure 12).

Figure 12

In terms of deal volume, secondaries are at a historical peak. Will this trend continue or reverse in the next 12 months?

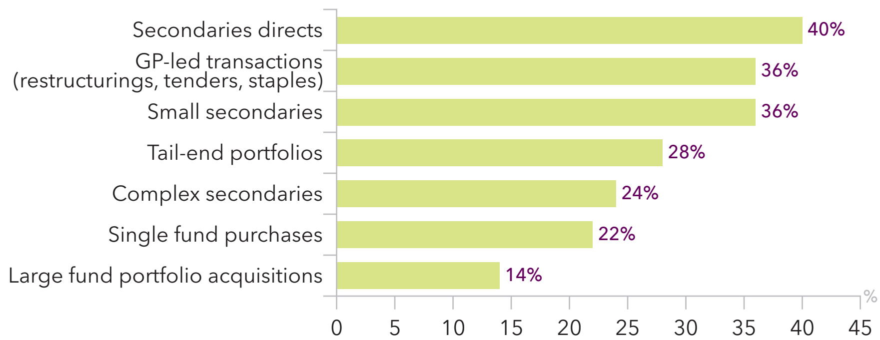


Secondary directs are the preferred strategy for the first time since we began surveying family offices and foundations: 40 percent of respondents intend to prioritise this strategy over the next 12 months (see Figure 13).

While GP-led transactions and small secondaries continue to rank highly among respondents, large fund portfolio acquisitions are again the most unpopular secondaries strategy.

Figure 13

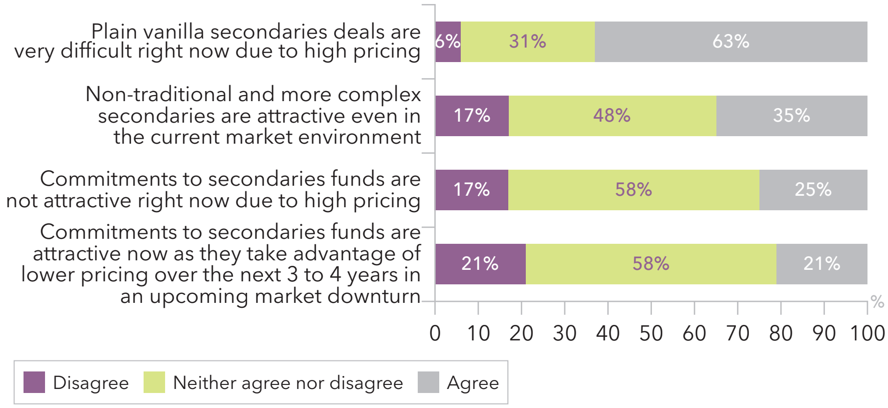
As an allocator of capital to secondaries strategies over the next 12 months, which two would you prioritise?



We wanted to know how attractive certain secondaries strategies are in the current market. Almost two-thirds of respondents (63 percent) believe that plain vanilla secondaries deals are very difficult due to high pricing, while only 17 percent disagree that non-traditional and more complex secondaries remain attractive in the current market environment (see Figure 14).

Figure 14

To what extent do you agree with the following statements about secondaries strategies?



Market trends

According to PEI data, between Q1 and Q3 2017, $386.1 billion was raised from the final close of 524 private equity funds. With this amount already comprising 87 percent of the total capital raised in the previous year, 2017 looks set to be the largest fundraising year since the financial crisis.

As the private equity industry continues to thrive, we asked family offices and foundations for their views on the market, to understand how current trends are affecting their portfolios.

The proportion of respondents that believe private equity is now a mature industry has risen from 55 percent in 2016 to 64 percent this year (see Figure 15).

Figure 15

Do you consider private equity to be a mature industry?

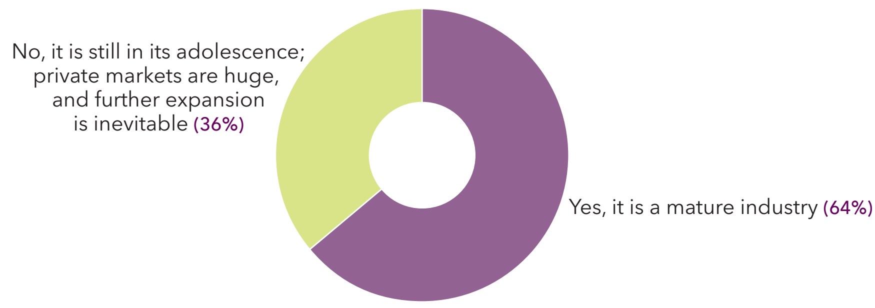
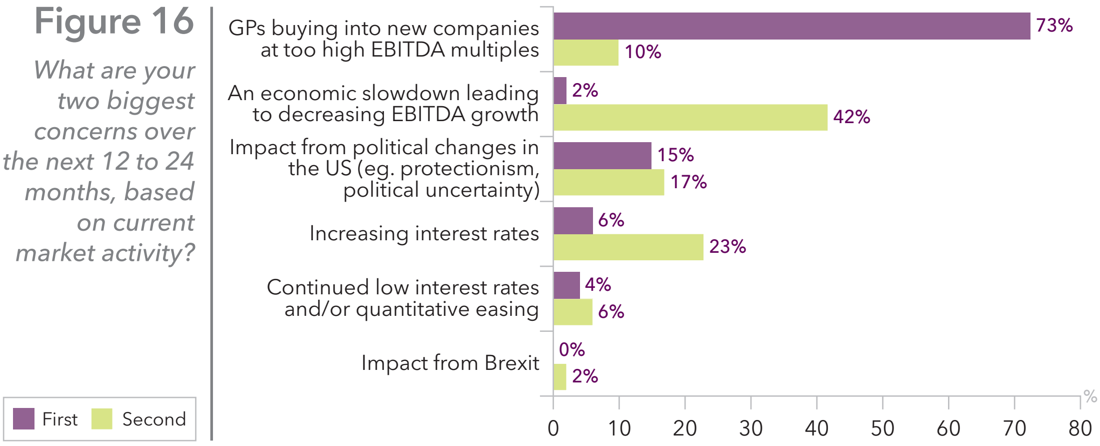


Figure 16 presents the biggest areas of concern for family offices and foundations over the next 12 to 24 months. Almost three-quarters of respondents cite GPs buying into new companies at too high EBITDA multiples as their main concern. Despite this answer ranking as the highest concern overall in 2016, the proportion of respondents choosing this as their first concern in our previous study was just 35 percent.

Further developments include a sharp decline in the proportion of respondents concerned about Brexit, from 20 percent overall to 2 percent.

Figure 16

What are your two biggest concerns over the next 12 to 24 months, based on current market activity?



Over the last 12 months, portfolio allocations to co-investments and direct investments have increased by 41 percent and 39 percent respectively (see Figure 17). At the same time, 37 percent of respondents decreased their exposure to funds of funds. Notably, the segment with the greatest level of stability is secondaries funds.

Figure 17

Have you changed your portfolio allocation to any of the following investment approaches over the last 12 months?

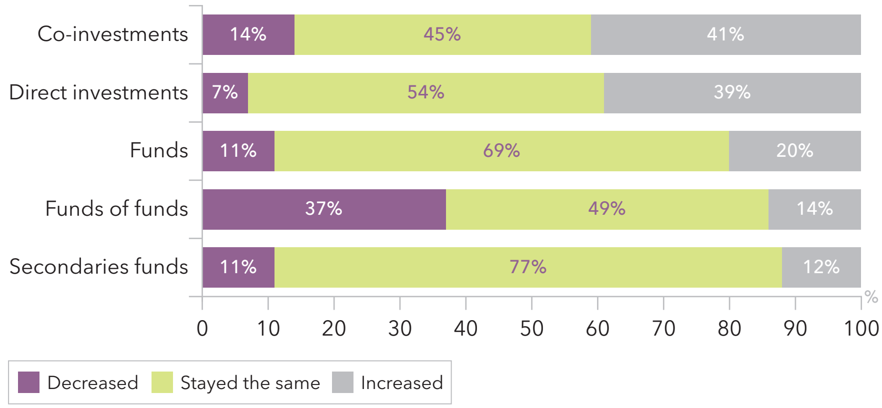
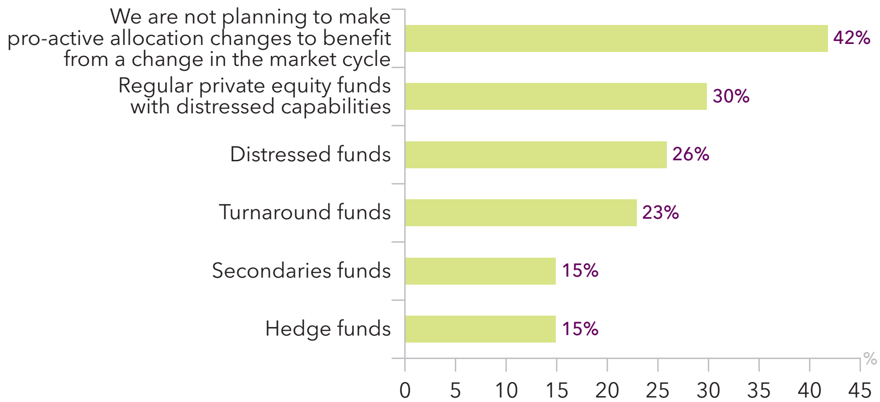


Figure 18 shows that 58 percent of respondents are actively investigating strategies that will allow them to benefit from changes in the market cycle. For these respondents, both regular private equity funds with distressed capabilities and distressed funds are the most popular strategies. This suggests that many investors believe there is an end to the current market cycle is on the horizon.

Figure 18

Are you actively investigating any of the following strategies in order to benefit from a change in the market cycle?



We asked investor groups what their return expectations are for private equity. Answers vary for primary funds, secondaries funds and direct/co-investments (see Figure 19). For primary funds, around half of all respondents expect returns of 15 percent or more. For secondaries funds, only slightly more than a third of respondents expect similar results. A higher proportion of respondents expect returns 20 percent or more. In contrast, direct and co-investments are expected to generate the highest returns, with more than half of respondents expecting returns of 20 percent or more.

The wider dispersion of expected returns for secondaries funds compared to primary funds (that is, a higher proportion of respondents who expect 20 percent or higher returns, but also a higher proportion who expect less than 10 percent) can be explained by looking at the data shown in Figures 13 and 14. Accordingly, the relatively lower expected outcomes for secondaries funds can be attributed to large portfolio acquisitions or plain-vanilla secondaries with leverage that often occurs at the larger end of the market, exhibiting a lower return potential but also lower risk. In contrast, non-traditional and more complex secondaries, and those involving secondary directs and small secondaries, for example, appear to be associated with an outsized return potential of 20 percent or higher.

Around two-thirds of respondents that have invested directly in the past say they have not been burnt by doing so (see Figure 20). Forty-six percent indicate that returns were as expected, about one-third say returns were higher than expected, and about one-fifth achieved significantly lower than expected returns.

Figure 19

What is your current expectation for private equity returns (net to investors) when you invest in primary funds, secondaries and directs/ co-investments?

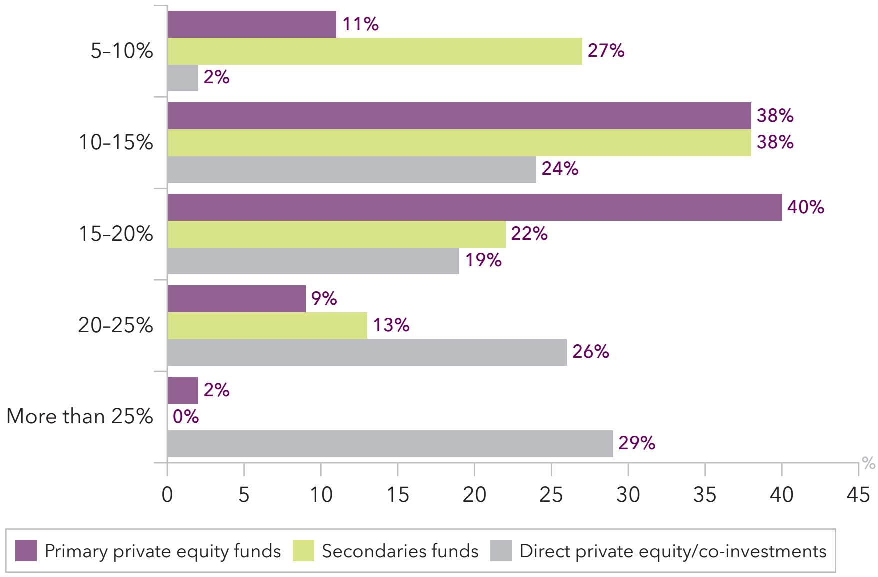
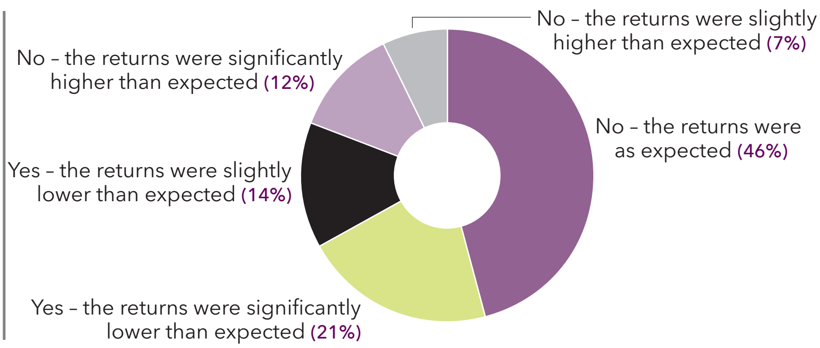


Figure 20

Have you been burnt by investing directly in the past?



Political change

There have been some big political changes in the US and Europe, most notably Donald Trump's election to the US Presidency and the UK's decision to leave the European Union. In this section, we ask how family offices and foundations expect their private equity portfolios to be affected and what measures they are considering in response to the changing political and economic landscape in the West.

Questions remain as to the path that Brexit will take and how this will affect both the UK and Europe, so we asked respondents how they expect Brexit to impact their portfolio performance in both the short and long term (see Figure 21).

No respondents believe that Brexit will have a positive impact on private equity portfolio performance in the short-term compared to 12 percent in 2016. However, more than half are of the opinion that Brexit will have no impact in the short term and two-thirds believe it will have no impact in the long term.

According to an Asia-based family office advisor:

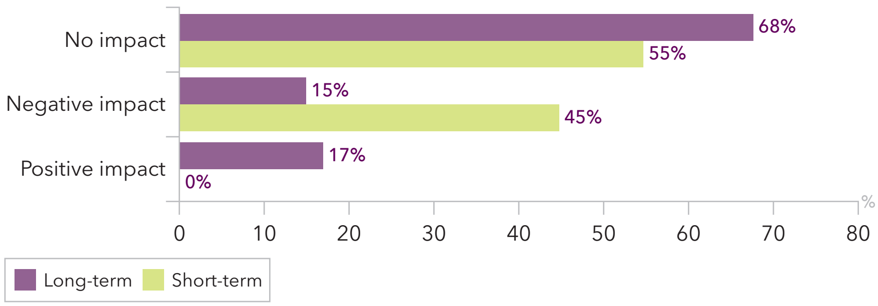
> "I don't think Brexit will have a major impact unless you are a private equity firm that invests into specific businesses in the UK."

One family office based in the UK notes:

> "We have definitely seen a faction of our clients, particularly those that are not based in continental Europe, that see the fall in sterling as being a buying option."

Figure 21

What impact do you expect Brexit to have on your portfolio performance?

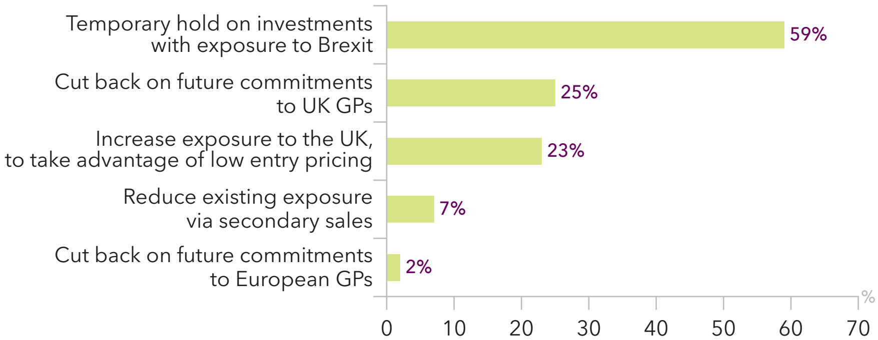


A temporary hold on investments with exposure to Brexit continues to be the top response considered by more than half of those surveyed (see Figure 22). Fewer respondents are planning to increase their exposure to the UK – 23 percent in 2017 compared to 38 percent in 2016.

Figure 22

What measures are you considering as a response to Brexit?

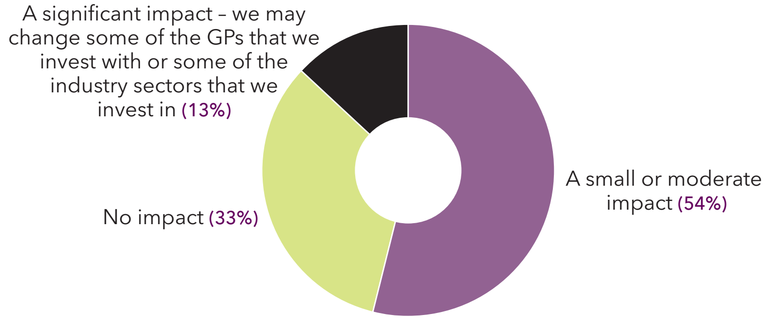
(select all that apply)



The LP community is also concerned about changes to protectionist policies, particularly in the US. Two-thirds of family office and foundation respondents expect this to have an impact on their portfolio planning for private equity (see Figure 23).

Figure 23

What impact will protectionist policies (especially in the US) have on your portfolio planning for private equity?



Change in central bank policy: cheap capital coming to an end?

As investors begin to prepare for the end of the current market cycle, changes in central bank policy are an increasing concern among the family office and foundation investor community.

Central banks in the EU and the US raising interest rates are now the top two concerns for respondents (see Figure 24). Concerns among survey respondents about the US raising interest rates has increased from 46 percent in 2016 to 69 percent this year.

Despite this, more than half of respondents are also concerned about interest rates in the US and the EU continuing to stay low. This suggests that a change in either direction will bring challenges for investors.

When asked about his concerns over central banks in the EU raising interest rates, Benedict Rodenstock of Astutia explains:

> "I am currently seeing quite a lot of money in the market and a few years ago there was little capital. I wonder whether this will still be the case if interest rates go up, and whether investors will look for other opportunities again."

A partner at a UK-based multi-family office is:

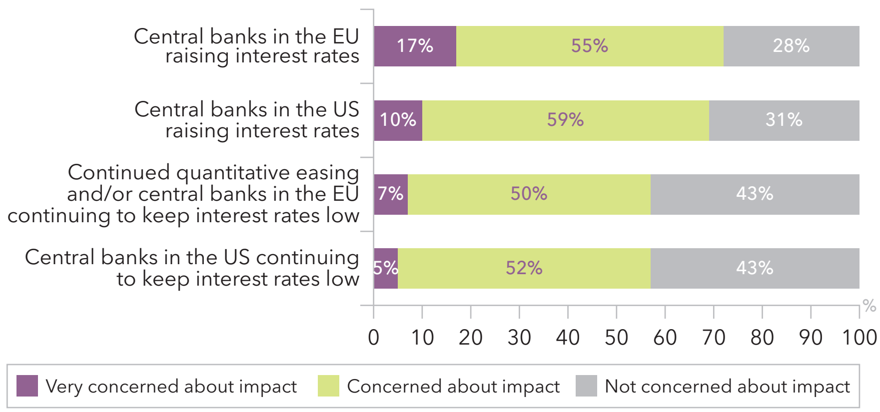
> "not hugely concerned in the short-term, but more medium- and long-term potentially."

He says:

> "within private equity we are de-emphasising managers with strategies that have a reliance on leverage. Anyone that is highly leveraged we are tending to shy away from."

Figure 24

When thinking about the impact of the interest rate environment on portfolio returns, what are you most concerned about?



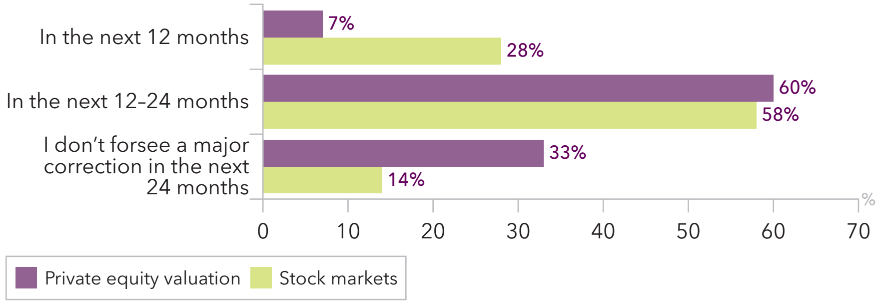
We asked respondents when they expect the next major correction will take place, for both stock markets and private equity.

Figure 25 shows that only 28 percent believe that there will be a major correction in the public markets within the next 12 months. This is a significant decrease from the 2016 survey when 51 percent thought the next major stock market correction would take place within 12 months a year ago – a scenario that failed to materialise.

The majority of respondents believe that the next major correction will take place in 12 to 24 months for both markets. For private equity, this result matches up to the 63 percent who held this opinion in 2016.

Figure 25

When will the next major correction take place?



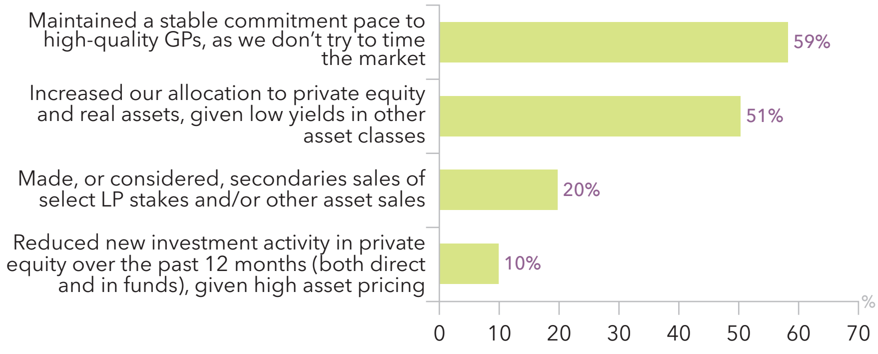
We also asked family offices and foundations how they have approached investing in the current environment. More than half have maintained a stable commitment to high quality GPs (see Figure 26). This is an increase from 2016 when 44 percent of respondents answered in this way. It also supports the results shown in Figure 3.

The proportion of respondents that have reduced new investment activity has also fallen from 20 percent in 2016 to 10 percent this year.

Figure 26

What has been your investment approach in the current market environment?

(select all that apply)



Participants

In this section, we provide background information about the investors surveyed for this research study in September 2017, including: institution type, location, age of institution and assets under management (AUM) range.

More than half of this year's respondents were single family offices (see Figure 27), which is a similar proportion to previous years. The 2 percent that did not fall into these categories include a family with a corporate pool of capital.

This year's research study received the largest response from European family offices and foundations. North America, Asia-Pacific and MEA are also represented (see Figure 28).

Figure 27

What is your institution type?

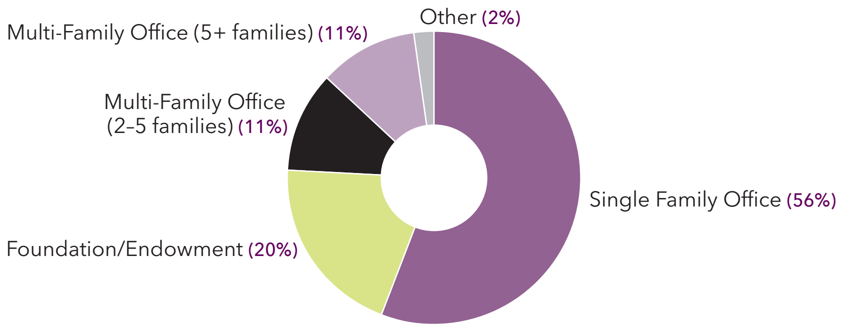
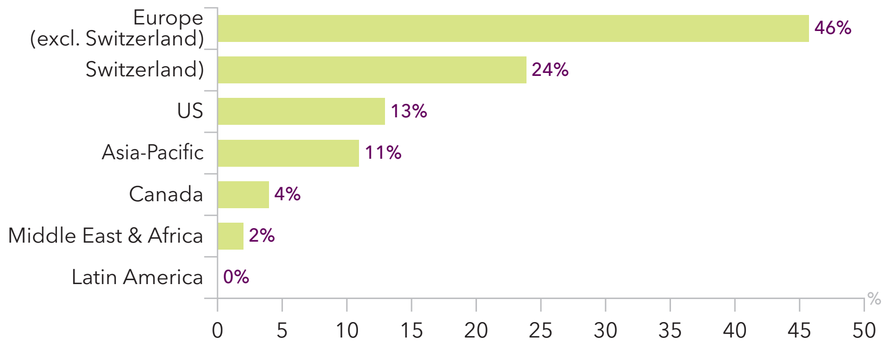


Figure 28

Where is your institution located?



More than half of this year's respondents are established investors that have been operating for more than 20 years (see Figures 29 and 30). This is an increase on the 34 percent in the 2016 report. The share of respondents with assets under management in excess of $6 billion has also increased from 7 percent to 17 percent.

Figure 29

How long have you been operating?

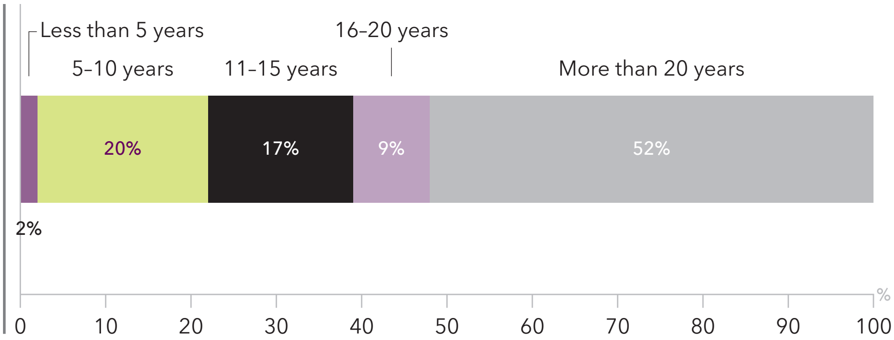


Figure 30

Please indicate your AUM (USD million)

About PEI Research & Analytics

PEI's Research & Analytics team monitors the activities and opinions of over 12,000 alternative asset investors and fund managers worldwide. We profile institutions in each of our online products – Private Equity International, PERE, Infrastructure Investor, and Private Debt Investor.

In addition, our team tracks every market development and delivers research papers that stimulate engagement and debate. We use our expertise, scale, reputation and contacts to deliver informative and engaging research in collaboration with our clients. We work with general partners, limited partners, service providers and associations to help build profiles within their chosen markets.

We have customers in over 100 countries who are serviced by over 150 personnel from three regional offices in London, Hong Kong, and New York.

Methodology

PEI's Research & Analytics team obtained the thoughts and opinions of select groups of family office and foundation investors in September 2017 by email survey. A smaller group of investors were then interviewed by telephone to give colour to the results we gathered.

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About Montana Capital Partners

Montana Capital Partners (mcp) is a Swiss-based asset manager focused on attractive niches of the private equity secondary market globally. The firm has raised three funds so far, each closed at the hard cap, and currently has more than EUR 600 million in assets under management. The team provides liquidity solutions from straight sales to more innovative structures such as non-traditional secondaries (co-investments and fund-of-funds) and structured transactions. In addition to its secondary activities, mcp offers high quality advisory services for investments and risk management.

mcp's latest fund, which had a first and final closing at EUR 400 million in 2015, focuses on attractive niches of the secondary market such as smaller and more complex transactions, which are usually sourced directly from the seller. The established investment strategy has proven to be successful over the past three funds and provides strong benefits to investors.

mcp's close relationship with sellers allows for customized solutions that take into account the specific requirements of sellers, towards creating mutually beneficial outcomes. To support investors in reshaping their portfolios, mcp's solutions help address regulatory and strategic considerations, reduce specific risk factors, and optimize the cash flow profile of underlying portfolios. Transaction types include single fund positions, small portfolios, fund-of-funds, co-investments, fund liquidity solutions, and more complex structured transactions.

In addition, mcp provides innovative solutions in primary investments and risk management advisory. Through our investment management services, we assist investors in finding attractive primary investment opportunities and support them in implementing high-quality risk management systems.

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