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mcp
Annual Investor Survey 2018

How family offices and institutional investors are capitalizing on a thriving private equity market

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Summary

Montana Capital Partners is proud to present the results of its sixth mcp Annual Investor Survey, in which for the first time we extended our survey beyond family offices and foundations to also include the views of other investor types including institutional investors such as asset managers, banks, insurance companies, pension funds, and sovereign wealth funds.

In a time of elevated asset prices and slowly rising interest rates, our research report explores the allocations, appetites, and concerns of investors in private equity and compares the latest results of our survey across investor types, while highlighting notable changes compared to past results.

Some of the most noteworthy findings from this year's survey are:

- Private equity continues to play a very important role for investors: 86% of family offices and foundations report an allocation to private equity of more than 10% of their portfolio, and 35% of more than 20%; 58% of institutional investors report an allocation to private equity of 1-5% of their oftentimes very sizeable portfolios, while 15% have more than 20%
- Mid-market buyout continues to be the preferred investment strategy, with 94% of family offices and foundations, and 92% of institutional investors selecting it as a preference
- Long-term strategic repositioning currently is the most important reason for undertaking active portfolio management via secondaries among respondents across investor types
- Complex secondaries and small secondaries are the two most preferred secondaries strategies over the next 12 months across investor types. Family offices and foundations are more inclined towards secondary directs than institutional investors are, while the opposite is the case for GP-led secondary deals
- Investors indicated that their top concern is GPs buying into companies at too high valuations, while also worrying about the impact of the U.S. Federal Reserve raising interest rates
- Despite having concerns about high valuations, investors are relatively optimistic. At the time of the survey, only 26% of all investors expected a major correction in public markets within the next 12 months, and only 20% of family offices and foundations (compared to 28% in 2017, and 51% in 2016)

mcp has an investor base of well-known and reputable global family offices and foundations, as well as institutional investors such as pensions funds, insurance companies, and sovereign wealth funds. We create innovative solutions for secondary sellers that enable them to actively manage their private equity portfolios by selling both fund and fund of funds interests as well as direct company stakes.

mcp focuses on transactions sourced in direct contact with sellers to create customized solutions that mutually benefit both investors and sellers. Such solutions include structures like deferred payments, earn-outs, preferred equity, and securitization-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 their investors.

We hope that the mcp Annual Investor Survey 2018 offers you many valuable insights. Should you have any questions or comments, please do not hesitate to let us know.

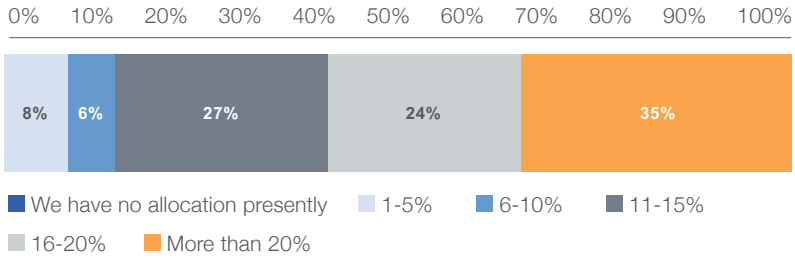
Assessing the asset class

Attracted by the return potential of private equity, a large portion of investors that participated in our survey reported a very meaningful exposure to the asset class, and at the same time plan to either maintain or further increase their exposure.

Family offices and foundations demonstrate a particularly high conviction in the merits of private equity: 86% have an allocation of more than 10% of their portfolio to the asset class, and 35% have an allocation of more than 20% (see Figure 1A).

Figure 1A

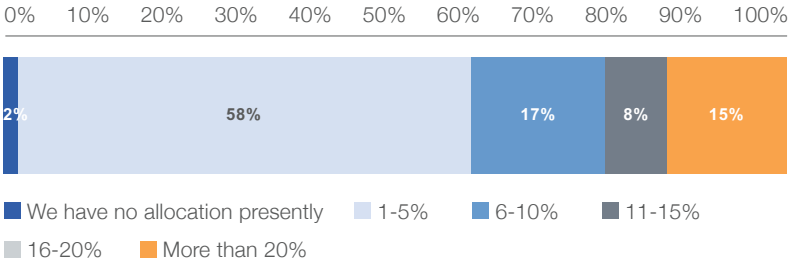
Family offices/ foundations: what is your current allocation to private equity?



Among respondents from institutional investors including asset managers, banks, insurance companies, pension funds, and sovereign wealth funds, a majority of 58% report an allocation to private equity of 1-5% of their overall portfolios, while only 15% have more than 20% (see Figure 1B). This however oftentimes represents very meaningful investment amounts, given the typically rather large size of institutional investment portfolios.

Figure 1B

Institutional investors: what is your current allocation to private equity?



We asked respondents how their allocations have changed over the past 12 months. Figure 2 shows that almost half of respondents across all investor types increased their exposure to private equity, while a similar percentage maintained their existing allocation.

Similarly, in the coming 12 months, almost two-thirds of respondents are planning to maintain their allocation to private equity and one-third are planning to further increase it (see Figure 3). This pattern appears similar across investor types. At the same time, the largest proportion of family offices and foundations have no plans to change their allocation.

Figure 2

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

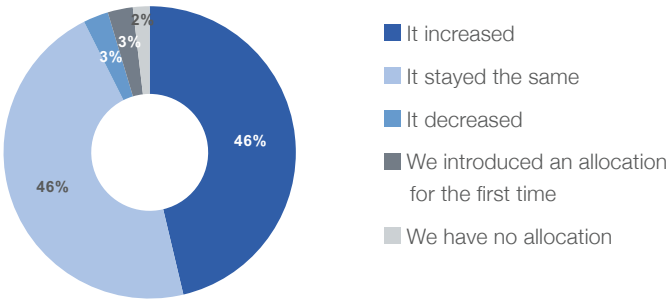


Figure 3

How do you expect it to change in the coming 12 months?

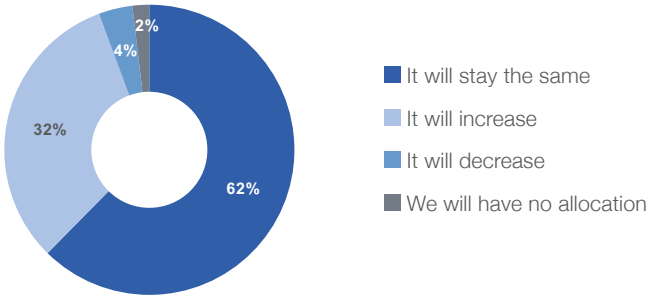
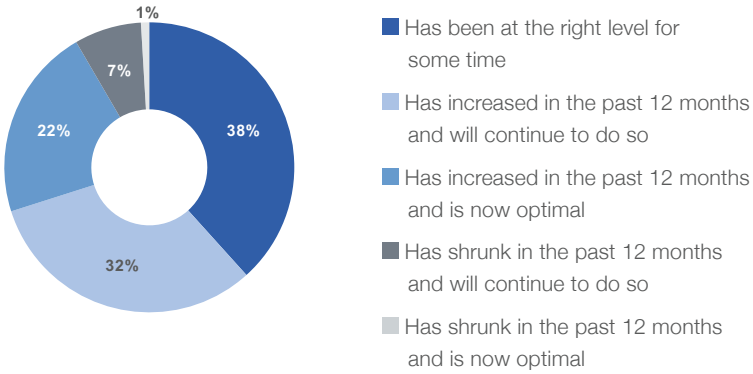


Figure 4 provides an insight into the overall number of managers that investors invest with. 38% of respondents believe that their number of managers has been at the right level for some time, while 32% are planning to increase the number of managers they invest with over the next 12 months. Merely 7% are planning to decrease the number. Overall, more than 60% believe that the number of managers they invest with is currently at an optimal level.

Figure 4

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



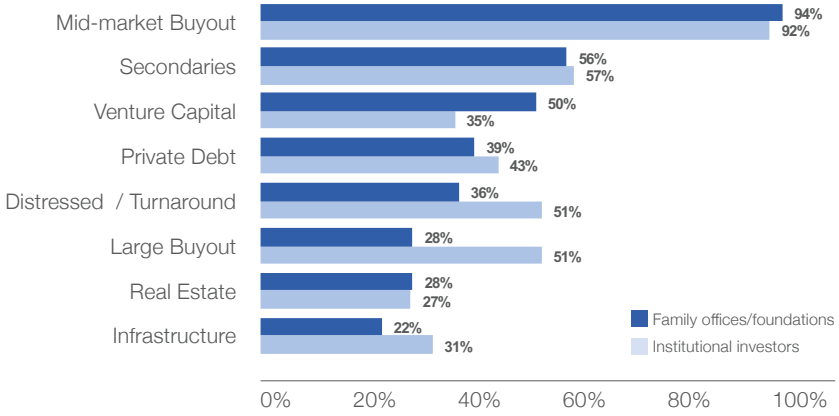
Investment preferences

This section evaluates the current long-term strategic and geographic preferences of investors. As shown in Figure 5, mid-market buyout continues to be the preferred investment strategy by far, with 94% of family offices and foundations and 92% of institutional investors selecting it as a preference. Notably, for family offices and foundations, this figure has increased significantly from 58% in 2016 and 70% in 2017. On the other hand, real estate and infrastructure are the least preferred investment strategies.

A marked change in the results of family offices and foundations this year is the increasing popularity of secondaries and decreasing popularity of real estate. Secondaries increased from the third most preferred strategy in 2017 with 48%, to the second most preferred this year with 56%, while real estate decreased from 46% to 28% during the same period.

Figure 5

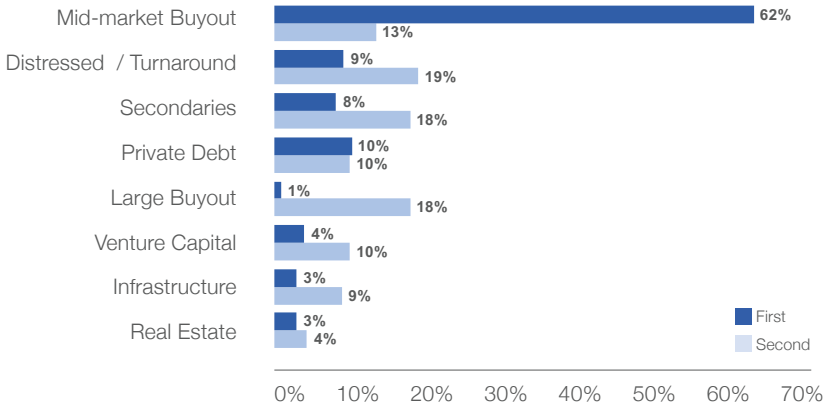
What are your long-term strategic preferences?



Mid-market buyout also ranks first among strategies that would be over-weighted for the next year by all survey participants (see Figure 6), while secondaries ranks third, selected by 26%. Distressed/turnaround ranks similarly high in this list, selected by investors planning to over-weight their exposure to GPs that can take advantage of a downturn.

Figure 6

What two strategies would you currently over-weight for the next year?



Western Europe is the most preferred geography among respondents across all investor types (see Figure 7), slightly ahead of North America. For family offices and foundations, Western Europe has surpassed North America, becoming the preferred region with 89% of responses, compared to 75% in 2017.

Around three-quarters of investors plan to overweight Western Europe and North America in their strategy for the next year, and at the same time one-third selected Asia (see Figure 8).

Figure 7

What are your geographic preferences?

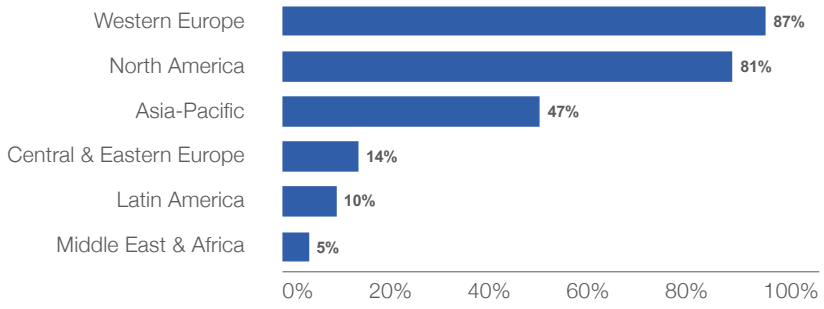
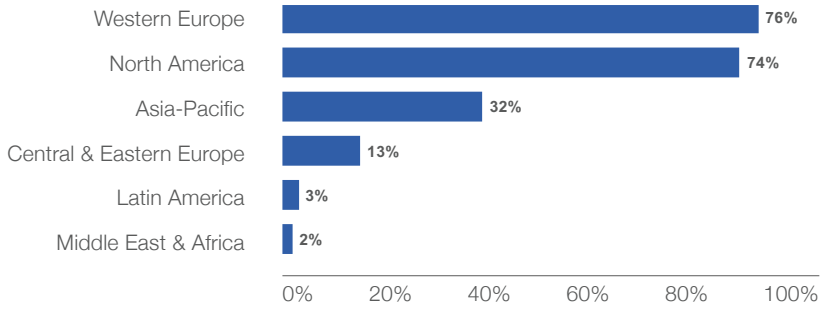


Figure 8

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

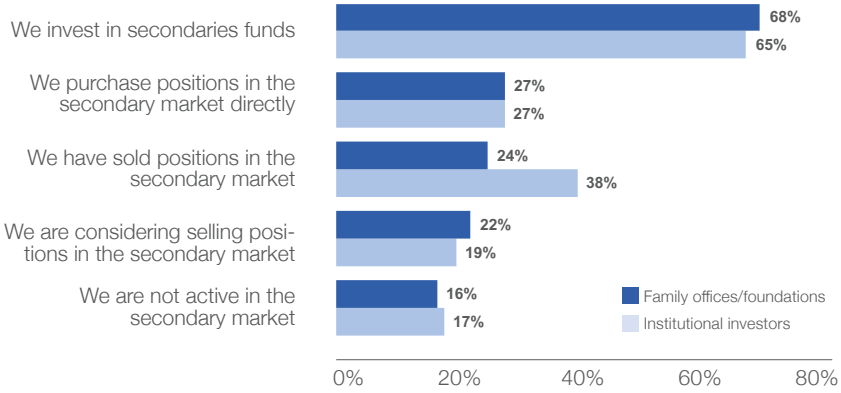


Secondaries

The results of this year's survey demonstrate that secondaries have become an integral part of the private equity market. Around two-thirds of the investors surveyed are invested in secondaries funds with a similar proportion across investor types (see Figure 9). 27% of investors indicated they purchase positions in the secondary market directly. Interestingly, a rather high portion of institutional investors (38%) report that they have sold positions in the secondary market, while only 24% of respondents among family offices and foundations have done so, mirroring a perception in the market that secondary sales have become a standard portfolio management tool particularly among institutional investors.

Figure 9

How would you describe your relationship with secondaries?



Almost six out of ten institutional investors and five out of ten family offices and foundations report having a set allocation to secondaries, with the remainder having no set allocation. Among family offices and foundations, more than three out of ten report having a set allocation for secondaries of 10% or more of their overall private equity exposure (see Figures 10A and 10B).

Figure 10A

Family offices/ foundations: what proportion of your private equity allocation is dedicated to secondaries strategies?

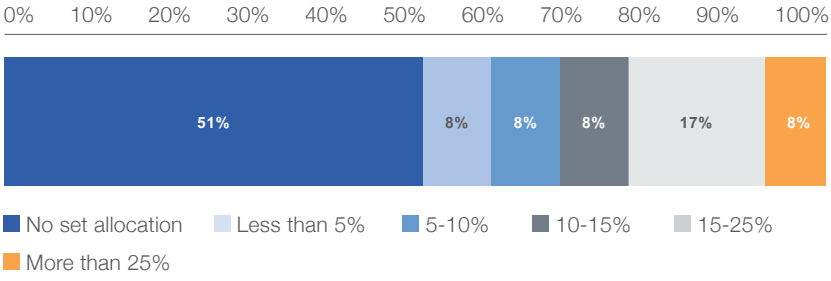
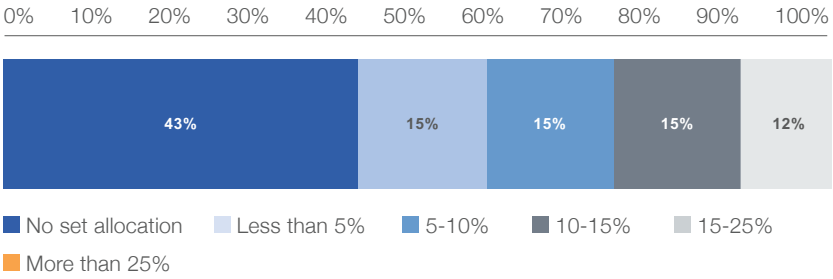


Figure 10B

Institutional investors: what proportion of your private equity allocation is dedicated to secondaries strategies?



As shown in Figure 11, long-term strategic repositioning currently is by far the most important reason for undertaking active portfolio management via secondaries among respondents across all investor types. For institutional investors, this trend is the most pronounced, with 50% selecting long-term strategic reasons as their primary concern, followed by 20% selecting attractive prices – two reasons that oftentimes go hand-in-hand, as attractive pricing with low or no discounts tends to make discussions around strategic sales easier. However, even for family offices and foundations, strategic repositioning has increased from 23% in 2017 to 39% in 2018.

Also notable, manager performance appears to be more important for family offices and foundations, ranking second with 22%, while only 10% of respondents among institutional investors selected it as their primary reason for a secondary sale.

The importance of mere liquidity has decreased considerably; only 8% of family offices and foundations selected it this year as their most likely reason to sell, compared to 12% in 2017 and 17% in 2016.

An investor at a single-family office in the DACH region commented on the connection between long-term strategic reasons to sell and attractive pricing:

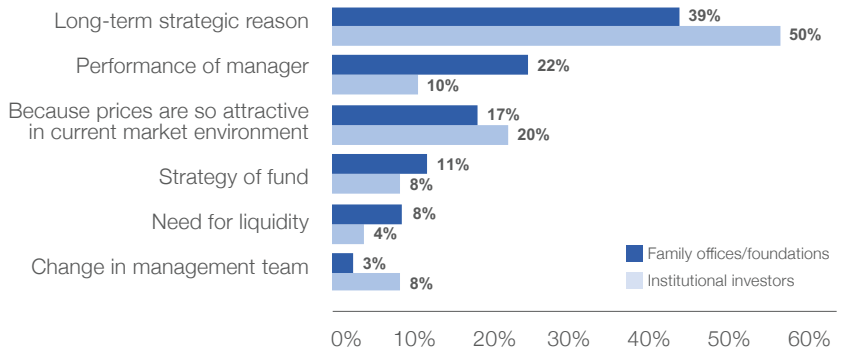
"There is significant momentum to do transactions right now due to attractive pricing in the market; this certainly makes it easier to secure buy-in internally to consider a sale. However, it appears that we are almost beyond the peak in terms of pricing, and discounts seem to be increasing again."

On family offices and foundations penalizing poor manager performance more than institutional investors, the same investor added:

"That is contrary to what we would have predicted, as family offices are usually assumed to be the stickier LPs."

Figure 11

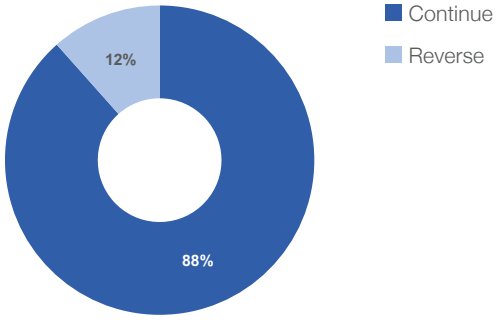
What would be your most likely reason for doing active portfolio management via secondaries?



Despite a record high deal volume and high fundraising figures, with approximately USD 32 billion invested in H1 2018 and with an expected USD 77 billion of capital to be raised in H2 2018 and H1 2019 for secondaries funds according to Evercore, an overwhelming 88% of 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?



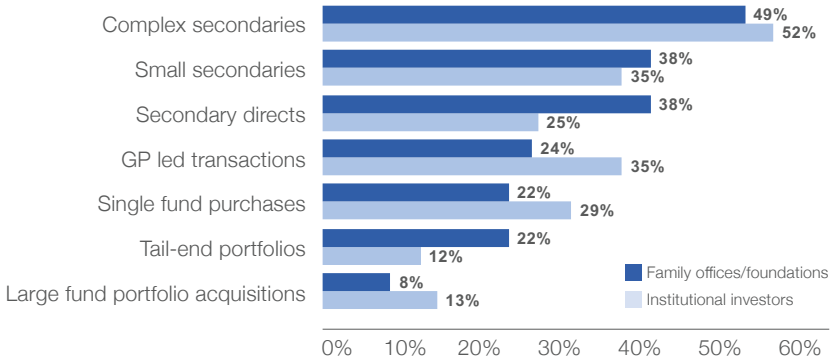
Complex secondaries and small secondaries were found to be the two most preferred strategies for the next 12 months across investor types (see Figure 13).

An interesting divergence in opinion was revealed around secondary directs and GP-led transactions: while family offices and foundations favor secondary directs (defined in the survey as single asset secondaries or "strips of directs") significantly more than institutional investors do, the opposite is true for GP-led transactions (including restructurings, continuation funds, tenders), which are more liked by institutional investors.

This seems plausible if considering that family offices are oftentimes reported to have an affinity towards single businesses and direct investments, having built in many cases their own wealth around the ownership of one or more businesses. At the same time, institutional investors with their usually larger number of managers in their investment portfolios may be more familiar with some of the managers pursuing GP-led transactions and therefore more open to the notion that these types of deals can create meaningful value and attractive returns. In addition, more capital can usually be deployed in GP-led transactions and diversification is higher, making it easier for institutional investors to invest.

Figure 13

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

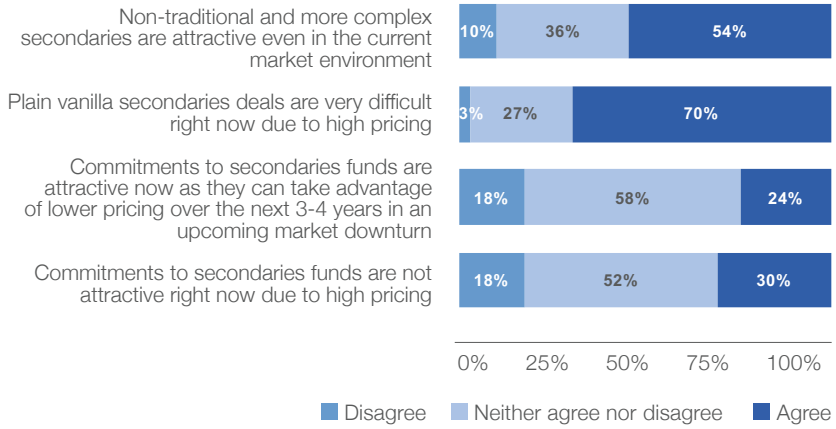


Large fund portfolio acquisitions remain the least preferred secondaries strategy, with only 8% of family offices and foundations and only 13% of institutional investors selecting it.

Prompted by questions around the attractiveness of certain specific secondaries strategies, more than half of all survey participants agree that non-traditional and more complex secondaries remain attractive even in the current market environment, while more than two-thirds believe that plain vanilla secondaries deals are very difficult due to high pricing (see Figure 14).

Figure 14

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



When asked about his/her opinion on secondaries strategies, an investor at a Northern European single-family office commented:

"The smaller and more complex end of the secondaries market is the only way to make money in the current market environment."

Another investor from the DACH region commented:

"We noticed that GP-led transactions are en vogue right now and have become more prevalent; particularly the involvement of some brand-name GPs has gotten us interested, and we are therefore considering whether we should get exposure to this market segment."

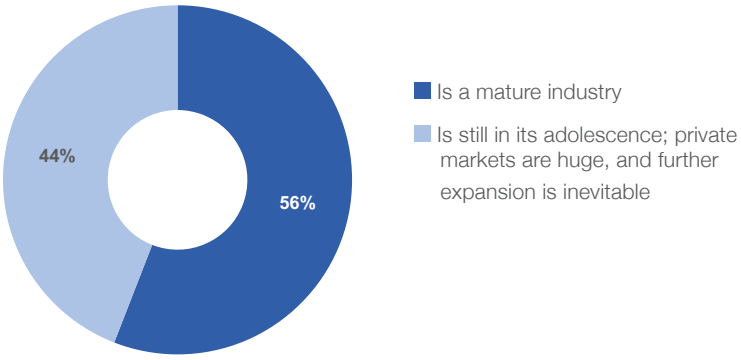
Market trends

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

More than half of all survey participants believe private equity is now a mature industry (see Figure 15).

Figure 15

Do you consider private equity to be a mature industry?



Figures 16A and 16B present the biggest areas of concern for private equity investors over the next 12 to 24 months. Almost three-quarters of both investor types cite GPs buying into new companies at too high EBITDA multiples as their main concern. This response ranked the highest in every year since we first asked this question in 2015. The proportion of family offices and foundations that chose it as their concern was almost the same as last year but increased from 2016 when it was just 35%.

An economic slowdown was the highest ranking second concern across all investor types. With 41%, family offices and foundations report a similar level of concern as last year, while a higher percentage of institutional investors recognize this as a concern (57%).

Interestingly, an investment professional at a UK-based single-family office mentioned the new trend of investing in GP stakes as their current top concern and elaborated:

"If not properly done/structured, [GP stake investments] distort the alignment of interests, as the incentive for the GP may switch from performance to asset gathering." Also, "balance sheet funding of GP commitments may represent less of an alignment compared to GP commitments funded directly in cash by the partners."

Figure 16A

Family offices/ foundations: what are your two biggest concerns over the next 12 to 24 months, based on current market activity?

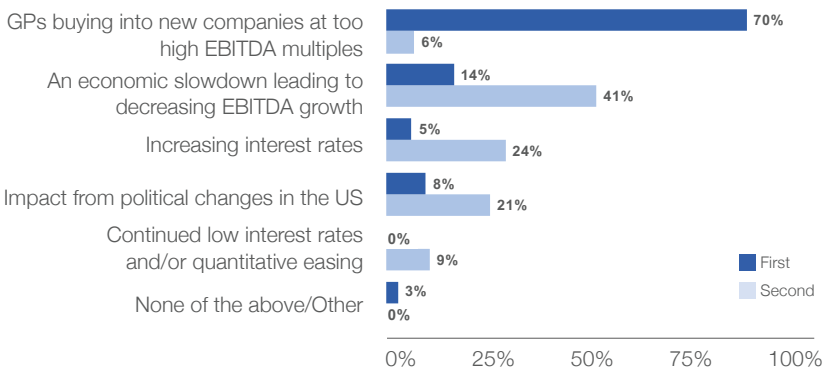
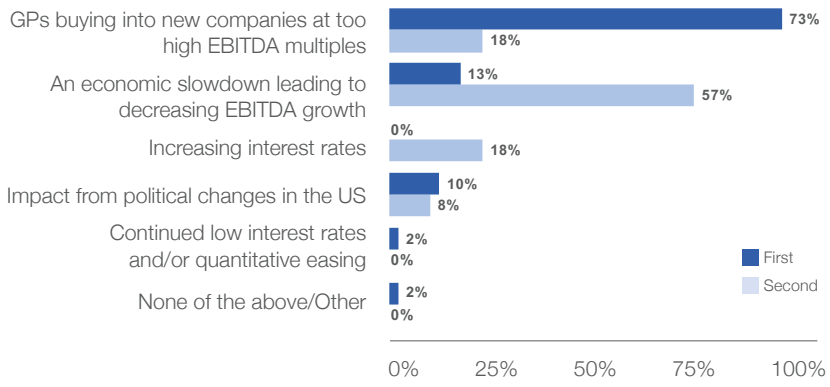


Figure 16B

Institutional investors: what are your two biggest concerns over the next 12 to 24 months, based on current market activity?



Over the last 12 months, 22% and 34% of investors have increased portfolio allocations to co-investments and direct investments, respectively (see Figure 17). At the same time, 26% of all respondents decreased their exposure to funds of funds. The segment with the overall highest level of stability is secondaries funds, with 76% leaving their allocations unchanged.

The most notable difference across investor types is that a larger proportion of institutional investors (83%) than family offices and foundations (55%) expect to maintain the same allocation to direct investments.

Figure 17

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

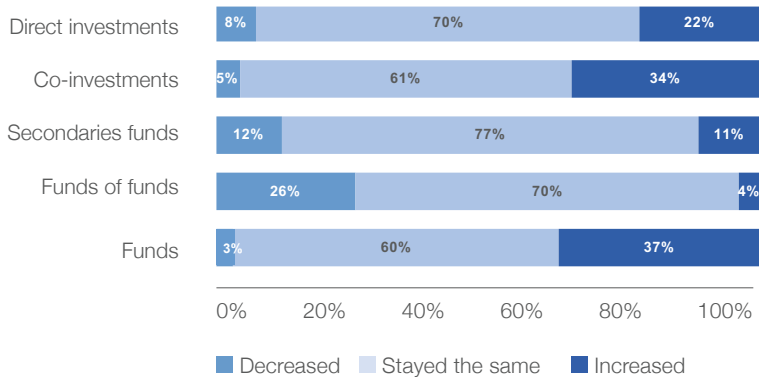


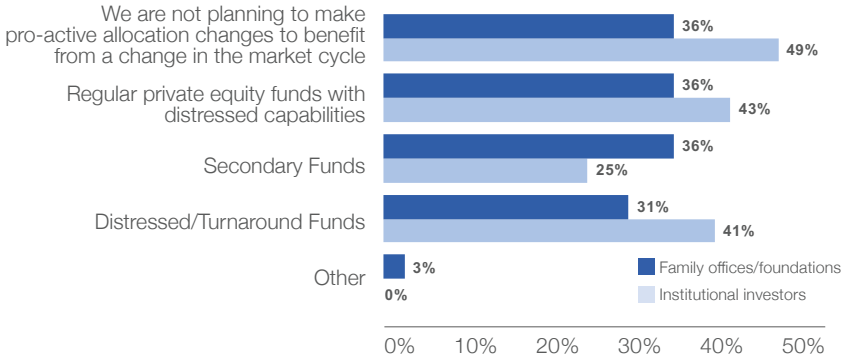
Figure 18 shows that almost two-thirds of family offices and foundations and more than half of institutional investors are planning to make pro-active allocation changes that will allow them to benefit from a change in the market cycle. This is in line with the anecdotal notion that family offices focus more on timing the market than institutional investors do.

While allocating to regular private equity funds with distressed capabilities is the most popular approach overall, a higher portion of family offices and foundations plan to shift more towards secondaries funds to take advantage of a change in the market cycle (currently 36%, versus merely 15% in 2017) compared to institutional investors. The opposite is the case for distressed and turnaround funds, which institutional investors favor more than family offices and foundations do.

These results suggest that many investors believe that an end to the current market cycle is on the horizon.

Figure 18

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



An investment professional at a UK-based single-family office pointed out the difficulties with trying to time the market ahead of a downturn:

"Sitting on cash is a perfectly fine strategy […]; but missing five years of good returns just to avoid one bad year is not necessarily the best strategy."

The same investor added:

"We expect a downturn in the 12- to 24-month timeframe; we therefore currently favor GPs who can play both cycles and are able to do healthy deals and distressed deals."

Another family office investor explained:

"I am convinced that there are some private equity investors who will be able to make money in a downturn, including distressed investors and secondaries firms - but there is a lot of capital sitting on the sidelines, and it is not merely about buying low, but having an angle and a differentiated strategy will still be key."

We asked investors what their return expectations are for private equity. Answers varied across family offices and foundations and institutional investors for primary funds, secondaries funds and direct/co-investments (see Figure 19).

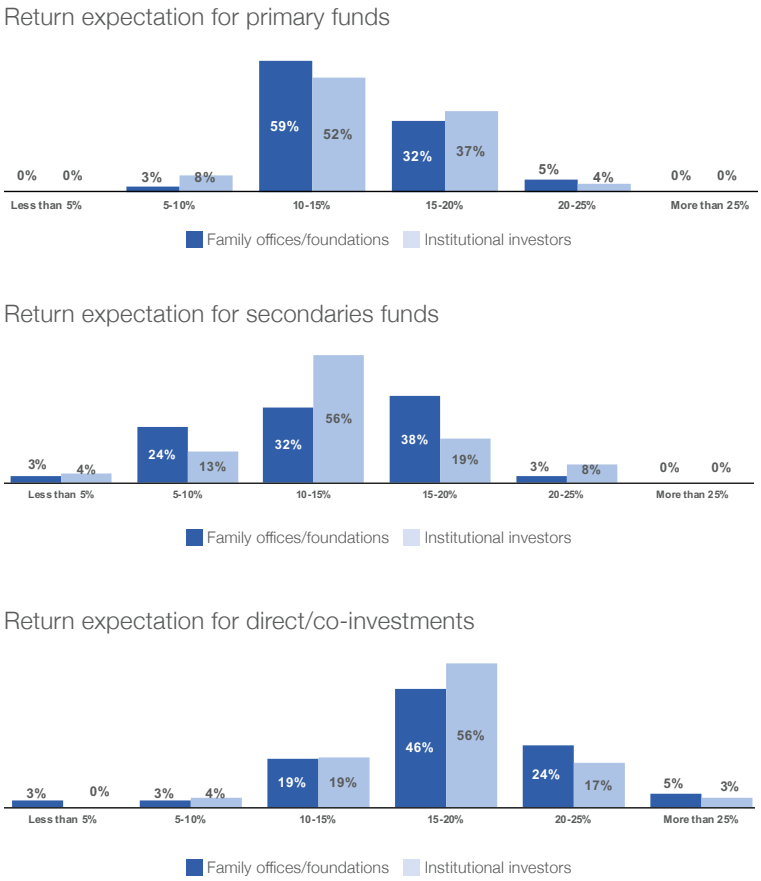
For regular primary private equity funds, more than nine out of ten respondents across both investor types expect to achieve net returns of more than 10%, and around four out of ten expect more than 15%.

For secondaries funds, the views of the two investor groups differed slightly: three quarters of family offices and foundations expect to achieve net returns of more than 10% and four out of ten expect more than 15%, whereas eight out of ten institutional investors expect net returns on secondaries funds of more than 10% and three out of ten expect to achieve more than 15%.

Direct and co-investments are expected to generate the highest returns, with around three-quarters of both investor types expecting returns of 15% or more.

Figure 19

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



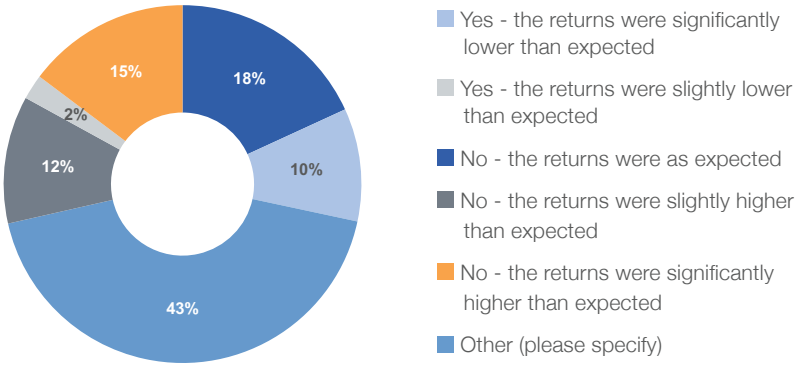
An experienced investor at a single-family office clarified, after indicating 10% to 15% net returns for primary private equity funds, and 5% to 10% for secondary funds:

"We see a significantly lower risk level in secondaries funds compared to regular primary private equity funds, since the portfolio is already visible and oftentimes more diversified, and we therefore conceptually also assign a lower expected return; if however a secondary fund manages to reach a similar return level as regular private equity funds, then this is clearly a superior risk-return profile."

More than half of all respondents who have invested directly in the past say they have not been burned by doing so (see Figure 20). 43% indicate that returns were as expected, 14% say returns were higher than expected, and 28% achieved lower than expected returns. The remaining respondents did not invest directly.

Figure 20

Have you been burnt by investing directly in the past?



ESG has become an important topic in the private equity industry. Investors increasingly recognize that integrating environmental, social, and governance considerations into their investment decision making offers the potential to create additional value at a portfolio company level while at the same time benefiting society as a whole.

As shown in Figure 21B, two-thirds of institutional investors make sure that a GP has an ESG policy in place, and 17% of institutional investors went as far as to say that this was essential in their decision to invest in a fund. However, 57% of all family offices and foundations indicate that it would not preclude them from investing if a GP did not have an ESG policy (Figure 21A).

Figure 21A

Family offices/ foundations: to what extent does a GP's ESG policy impact your decision to invest in a fund?

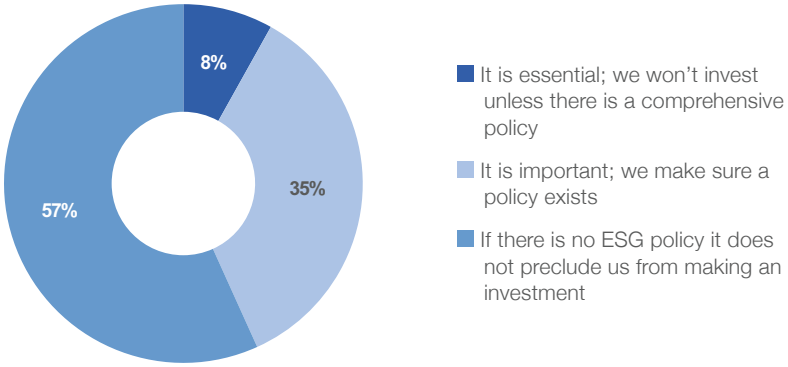
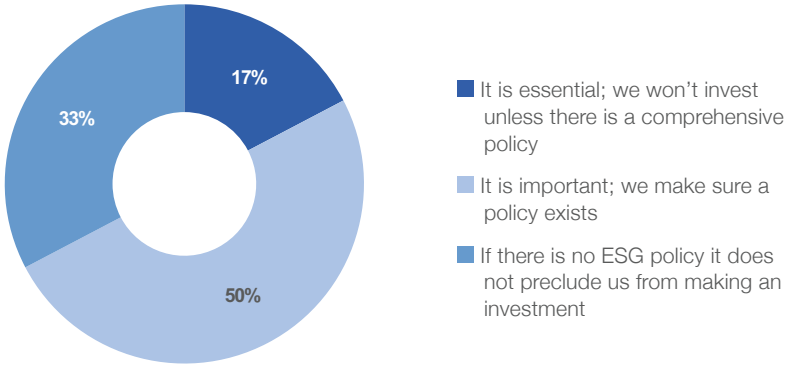


Figure 21B

Institutional investors: to what extent does a GP's ESG policy impact your decision to invest in a fund?



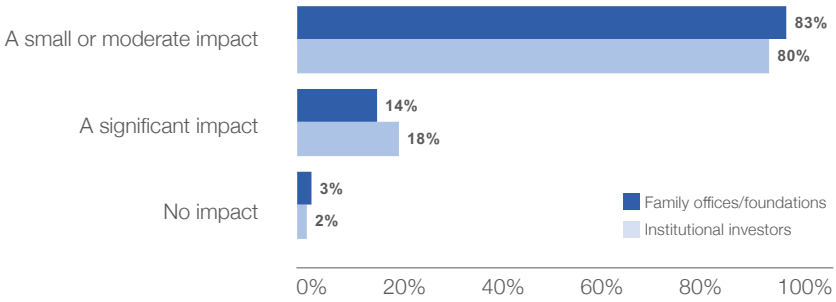
Political changes

Amongst the political changes observed around the globe in recent years, the rise in protectionist policies, such as tariffs imposed by the U.S. or China, has become an increasingly relevant topic.

We asked survey participants what impact they expect protectionist policies to have on private equity (see Figure 22). Interestingly, a clear majority of more than four out of five respondents believe that such developments will have only a small or moderate impact on the industry.

Figure 22

What impact will protectionist policies (e.g. tariffs imposed by the U.S. or China) have on private equity?



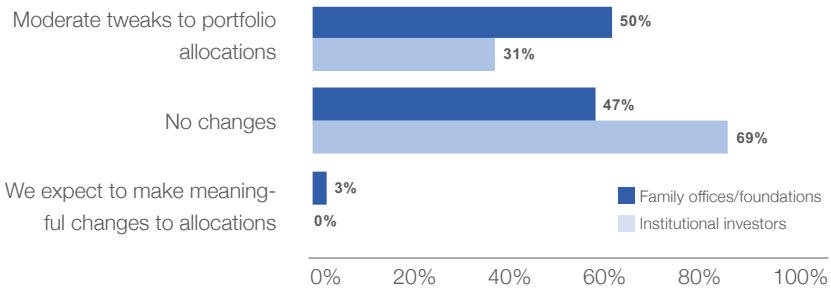
One investor, who expects a significant impact from protectionist policies on private equity, commented:

"We are addressing this by being even more careful in our general investment decision making, not just in private equity, but across all asset classes."

Asked how this will affect portfolio planning going forward, family offices and foundations appeared more likely to take action than institutional investors. While half of the respondents among family offices and foundations expect to make moderate tweaks to portfolio allocations as a result of protectionist policies, less than a third of institutional investors indicated they would do so. Hardly any respondents across both investor types indicated however that they expect to make meaningful changes to their portfolio allocations (see Figure 23).

Figure 23

How will it affect your portfolio planning?



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

With the U.S. Federal Reserve raising interest rates eight times during the past two years, some investors are preparing for an end of the current market cycle.

With central bank policy as a key factor, we asked respondents how concerned they are about the impact of either continued low or increasing interest rates in the U.S. and Europe, respectively.

Not surprisingly, a majority of survey respondents indicated that among the four choices presented, "Central banks in the U.S. raising interest rates" is their top concern, followed by around a quarter of respondents who indicated "Central banks in the EU raising interest rates" (see Figure 24). Interestingly, still 8% of respondents indicated that "Central banks in the U.S. continuing to keep interest rates low" was their top concern. Results across family offices and foundations and institutional investors were similar on this topic.

A senior investment professional at a Swiss-based pension fund commented:

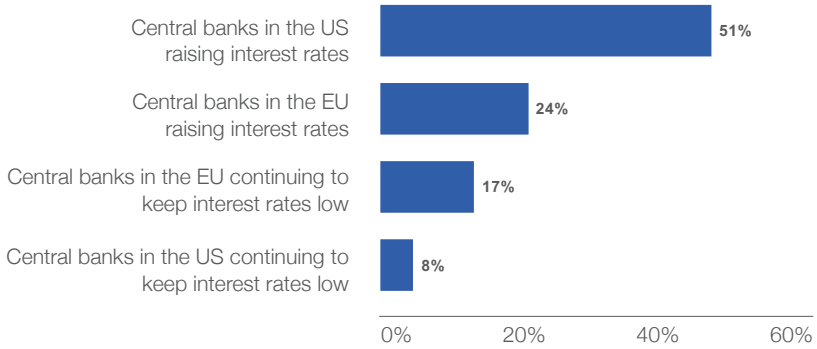
"Some of our U.S. GPs report that wage increases are starting to be very noticeable; this increases inflation and also creates pressure on highly levered companies."

The same pension fund investor added:

"Our fear is that if interest rates go up, a lot of investors that are long on e.g. bonds will lose a lot of value, but at the same time it will also have an impact on private equity valuations."

Figure 24

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



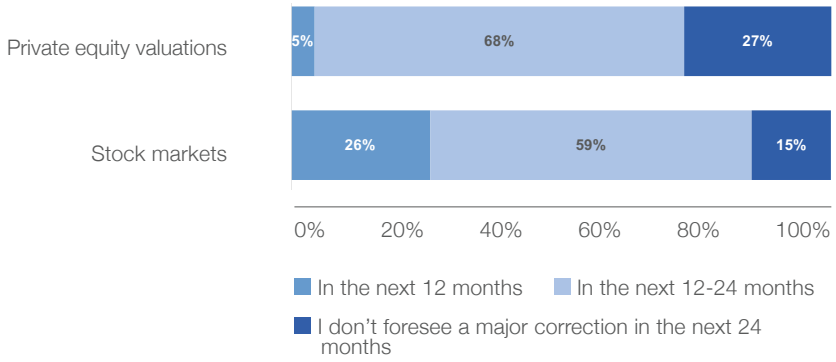
We asked survey participants when they expect the next major correction will take place, for both stock markets and private equity.

Figure 25 shows that the large majority of all respondents believe that the next major correction will take place in 12 to 24 months for both stock markets and private equity valuations, with family offices and foundations, and institutional investors sharing similar views.

26% of all investors believe that there will be a major correction in the public markets within the next 12 months. Here, family offices and foundations are slightly more optimistic than institutional investors, with only 20% expecting such a scenario within the next 12 months. This response is also more optimistic than in the 2017 survey when 28% of family offices and foundations thought the next major stock market correction would take place within 12 months, and much more optimistic than the 51% in the 2016 survey.

Figure 25

When will the next major correction take place?

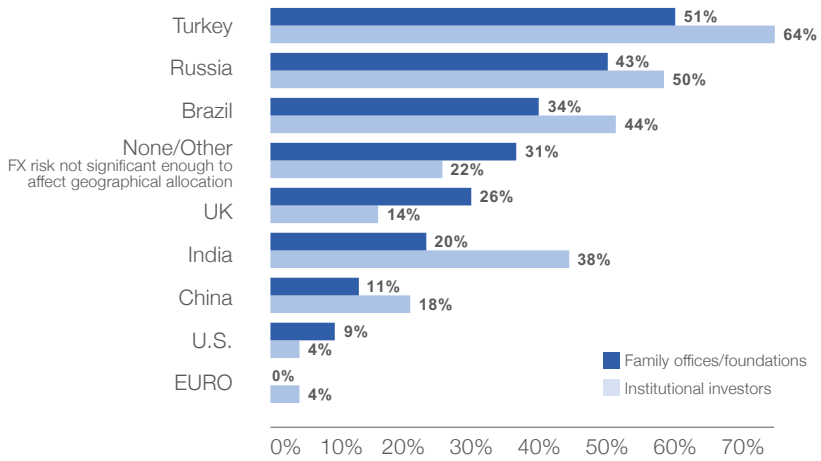


Finally, we asked investors how they approach investing in the current foreign exchange rate environment. Around half of family offices and foundations and almost two-thirds of institutional investors are most likely to underweight Turkey due to exchange rate risk (see Figure 26). Russia and Brazil complete the top three geographies which are most likely to be underweighted by both investor types, while very few respondents are concerned about the U.S. and the eurozone.

Interestingly, opinions diverged for the UK, which family offices and foundations (26%) are more likely to underweight due to FX risk, as well as India, which institutional investors (38%) are much more likely to underweight.

Figure 26

Which geographies are you most likely to underweight due to exchange rate risk?



Participants

Participation in this year's mcp Annual Investor Survey was very high, with 108 responses collected between August and September 2018 from a wide range of sophisticated investors. Additional one-on-one interviews took place in October 2018 including a select few investors who indicted their availability for follow-on questions.

The largest portion of respondents were single family offices with 30%, followed by insurance companies with 21%, and pension funds with 15% (see Figure 27). Other notable groups were asset managers, foundations and endowments, sovereign wealth funds, and multi-family-offices.

In terms of geography, the survey received the largest response from European private equity investors. North America and Asia-Pacific were also represented (see Figure 28).

Figure 27

What is your institution type?

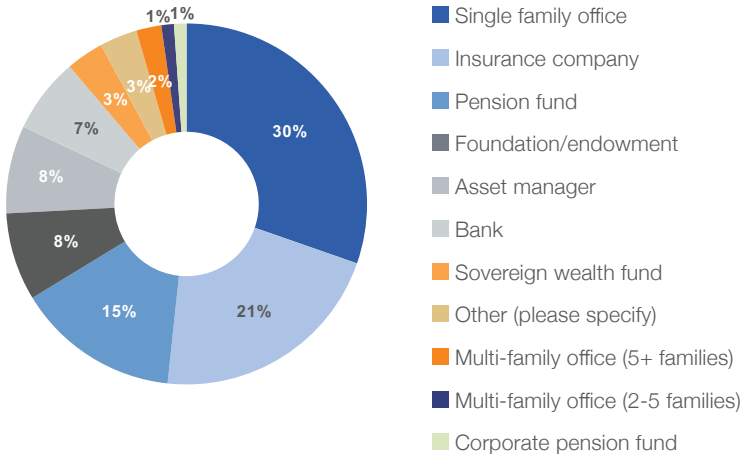
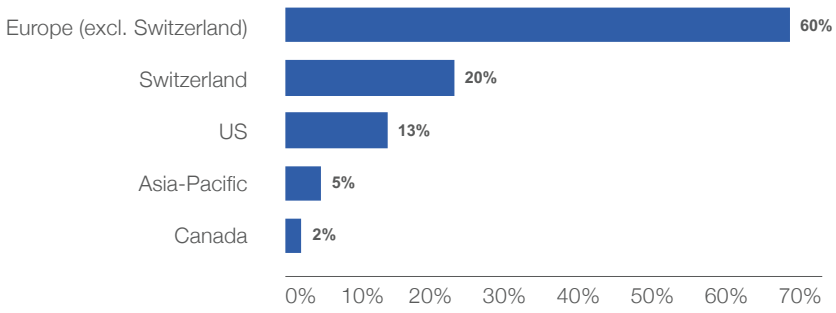


Figure 28

Where is your institution located?



60% of this year's respondents are established investors that have been operating for more than 15 years (see Figure 29). The share of respondents with assets under management in excess of USD 6 billion has sharply increased from 17% to 46% as the survey was extended beyond family offices and foundations to a broader range of investors (see Figure 30).

Figure 29

How long have you been operating?

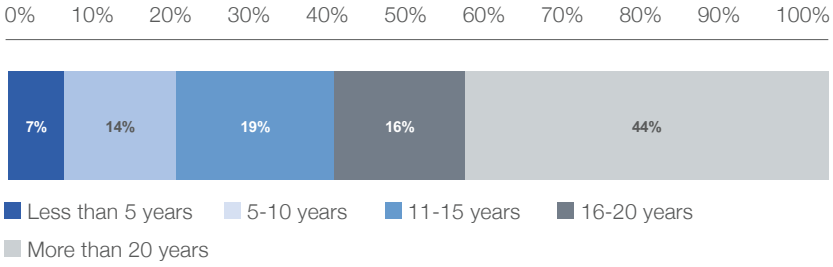
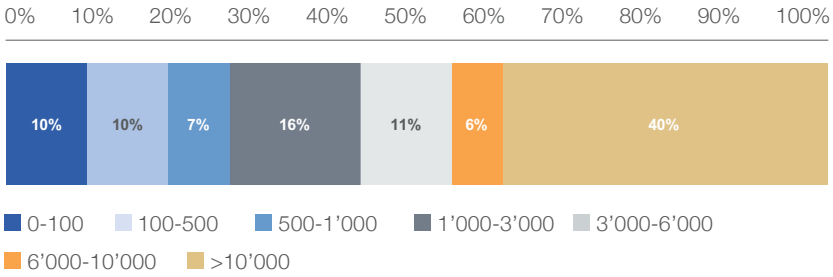


Figure 30

Please indicated your AUM (USD million)



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 four funds so far, each closed at the hard cap, and currently has EUR 1.5 billion 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 closing at the hard cap of EUR 800 million in 2018, focuses on attractive niches of the secondary market such as smaller and more complex transactions, which are usually sourced directly from sellers.

mcp's close relationship with sellers allows for customized solutions that take into account the specific requirements of sellers, in order to create 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.

Contact information

For further information or should you have any questions please do not hesitate to contact us.

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