Schroder Adveq

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We look at why private equity should remain high on institutional investors' agendas in 2018.

December 2017

- **We maintain a positive outlook for new capital commitments to private equity in 2018**
- **A vast universe of thousands of funds - often specialized - offers a broad choice to investors**
- **Large buyouts and "unicorns" are currently the segments most exposed to valuation risk**
- **The best risk/return opportunities are in segments with high barriers to entry.**

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Asset raising expected to continue at a strong pace

Private equity[1] has played an increasingly important role in portfolio allocations for many institutional investors. We expect that this trend will continue in 2018, leading to another record year for private equity fund raising.

Recent surveys[2] show that 95% of respondents are either satisfied or highly satisfied with the performance of their private equity investments. According to the same surveys, private equity investors typically expect long-term private equity outperformance over listed equities of 2-4%, and in some cases even more.

Investors are attracted to this asset class for a number of reasons. Investors expect certain private equity strategies to have lower volatility than listed equities. Private equity is also expected to have a low correlation with traditional asset classes and thus to deliver positive diversification effects. Finally, private equity allows investors access to sectors or industries that cannot be accessed through other asset classes.

A few mega funds and thousands of specialized funds

The private equity fund manager universe has grown to more than 4,000 firms[3], consisting of buyout, venture capital, growth capital and turnaround focused fund managers (see graph on the next page). We expect it to continue to expand in 2018. We expect continued growth in fund sizes which, as in the past, is likely to be concentrated in about 15-20 "mega" fund managers. In 2017 two fund raising records were broken. The $100 billion Softbank Vision Fund became the largest private equity fund ever raised and the $24.6 billion Apollo Fund IX became the largest ever buyout fund. We believe that it is likely that we will see more fund raising records being broken in 2018.

The segments most exposed to valuation risk

The rising interest in private equity is encouraging, but this "frothy" environment also creates challenges. Some parts of the market - especially the segments where the "mega" fund managers are most active - have a lot of committed but undrawn capital, or "dry powder".

This has already led to historically high valuation levels in those segments where general partners are competing for the same transactions, especially when it comes to large buyouts. There is a similar situation for pre-IPO technology companies - so-called "unicorns"[4] - where significant amounts of capital have been deployed by non-traditional private equity investors. Debt financing for buyout investments at the large end of the market is also currently widely available, which further contributes to high valuation levels.

We believe that investors should exercise caution with regard to the risks that arise from elevated valuations and debt levels in these segments. Furthermore, as more and more investors embrace private equity and other illiquid investments, there is also a question as to whether the illiquidity premium that investors have historically expected to realise from their illiquid investments may diminish over time.

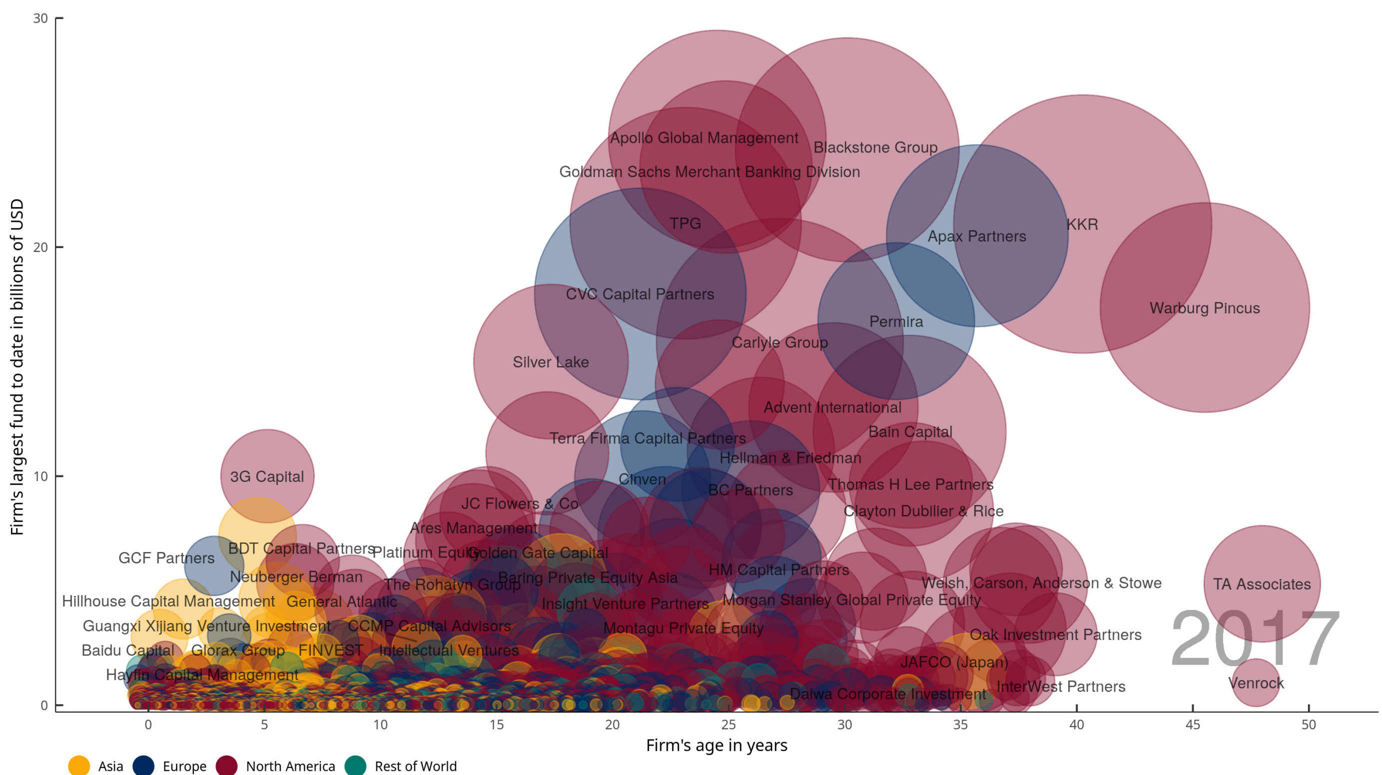
"In private equity, a "complexity premium" is nowadays much more important than an illiquidity premium."

1 Private equity is defined as investment in privately held companies that are actively managed by professional fund managers (typically referred to as "general partners")

2 Source: Preqin institutional investor survey, 2017

3 In addition, there are another 12,000 fund managers in China that are only accessible to Chinese investors

4 Defined as privately-held venture backed companies with more than $1 billion enterprise valuation



Look for high barriers to entry

It is our view that, in private equity, a "complexity premium" is nowadays much more important than an illiquidity premium. That is to say, investors are typically being rewarded for doing things that are difficult or complex rather than just illiquid. This is certainly the case where there can be significant challenges and barriers to sourcing, accessing, developing and exiting investments successfully.

We generally see smaller capital inflows, less competition for deals, more attractive valuations and more valuation upside potential in those segments of the private equity markets that are more difficult to access. We believe that in 2018, the most attractive market segments will include (on a global basis):

1. Small and mid-sized transformational buyouts and investments
2. Growth oriented investments in young and fast-growing privately held technology and life sciences companies

The former includes buyout investments in small and mid-sized companies in Europe and the US where we believe there is potential for either organic growth or market consolidation through add-on acquisitions. The latter includes early stage venture capital investments and early growth capital investments in the US, Europe and Asia. In these markets, the focus is on strongly-growing companies that develop or apply innovative technology or that are based on disruptive business models.

Accessing these companies either directly (through direct investments or direct co-investments) or through highly specialised general partners (through primary or secondary transactions) is not easy, making these segments especially attractive for investors that can successfully allocate capital.

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Positive outlook for new capital commitments made to private equity in 2018

Despite the valuation challenges noted, we remain positive for the performance outlook for new private equity investments made in 2018. As discussed, some segments of the private equity market are less exposed to elevated capital inflows and valuation risks than others. Further, the private equity model has some built-in resilience, conferred by the structure of deploying committed capital over a multi-year investment horizon. Deploying capital gradually not only provides for time diversification, but also creates opportunities for investors to benefit from potential market corrections for new investments, or add-on acquisitions for existing portfolio companies.

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