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Private Assets: Cause for Both Celebration and Caution

Investor demand is set to keep rising, but so too is competition

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Summary

- Around one-quarter of the large institutional investors surveyed by Cerulli plan to increase their allocations to mid-market buyout funds, growth funds, and distressed debt during 2020. Nearly half of smaller investors—those with assets of less than €15 billion (US$17 billion)—plan to boost their allocation to mid-market buyout funds and distressed debt strategies.

- Wide private equity funds performance dispersion will continue to increase the pressure on managers that deliver below-median internal rates of return (IRR) to reduce management fees, with contract clauses that favor limited partners (LPs). Favorable LP contract clauses will include capping administrative expenses and charging management fees on invested capital. However, we believe that the most sought-after managers, those delivering top-quartile returns, will continue to dictate fund terms.

- Our survey of European institutional investors found that 50% would prefer to pay management fees only on invested capital. However, LPs should carefully evaluate the alignment of interest with respect to each general partner's (GP) size when negotiating management fee structures. Furthermore, although negotiating carry fees is rare, LPs should pay increasing attention to contract terms outlining the use of subscription lines. Requiring managers to recalculate performance adjusting for the use of subscription lines can help overcome any issues regarding performance manipulation and carry fee calculations.

- Private banks' average recommended strategic allocation to private equity is 10.9%, yet more than 30% of family offices typically allocate more than 15% to the asset class. High-net-worth (HNW) and ultra-HNW individuals typically have slightly lower allocations to private equity than family offices. Cerulli believes GPs that can offer deal overflow, knowledge sharing, and increasingly environmental, social, and governance (ESG) capabilities can improve their competitiveness with family offices.

- Managers are placing more emphasis on attracting retail clients further down the wealth curve, but questions remain regarding the most suitable fund structure. The European long-term investment fund (ELTIF) structure has been slow to garner interest, but the recent rise in notable fund launches focused on private markets indicates that managers are increasingly seeing the structure as a way to package illiquid strategies for retail investors.

- Only 22% of the private banks we surveyed plan to use mainly new GP relationships when allocating to private equity. Almost half of respondents plan to rely on both existing and new GP relationships over the next 12 months.

- Investors are growing increasingly anxious of the extended business cycle. Although we expect late-cycle strategies to see demand from both retail and institutional clients, manager selection is becoming more vital. This is especially true in private debt, where the number of managers that have performance track records encompassing entire business cycles is limited.

- 79% of the European institutional investors Cerulli surveyed believe that in two years' time it will be "very important" to integrate responsible investments (RI) into private equity. Cerulli believes the growing interest in and adoption of RI, together with a greater focus on generating value creation through operational improvements, will help GPs in their fundraising endeavors, meet return targets, and help improve the public perception of the asset class.

European managers of private equity and debt saw their assets under management (AUM) reach significant highs last year. In June 2019, private equity AUM stood at €717 billion (US$815 billion) and private debt reached €162 billion according to Preqin. Fundraising momentum has passed its peak for private equity, but European private debt managers had a record-breaking year in 2019. While the market environment remains favorable, managers are accumulating assets for the expected downturn.

The average fund size for a European private equity manager increased from €228 million in 2010 to €821 million in 2018. Over the same period, the average number of months to final close for European managers dropped from 17 months to 15 months. In addition, on average, funds final closed at 107% of their target in 2018.

The increasing size of private equity funds is leading GPs to increase either the number of deals per fund or the size of deals. This can lead GPs to exhibit diminishing deal selectivity and creates a risk of expertise drift. LPs need to monitor GPs' deal teams relative to fund size. These concerns will be compounded by the growing dry powder and rising deal volume in the industry. Potential metrics can include the number of unrealized companies per investment team member and the growth in the investment team relative to that of the fund. Particularly, LPs should pay attention to managers that increase the size of successive funds at a faster rate than AUM for the asset class.

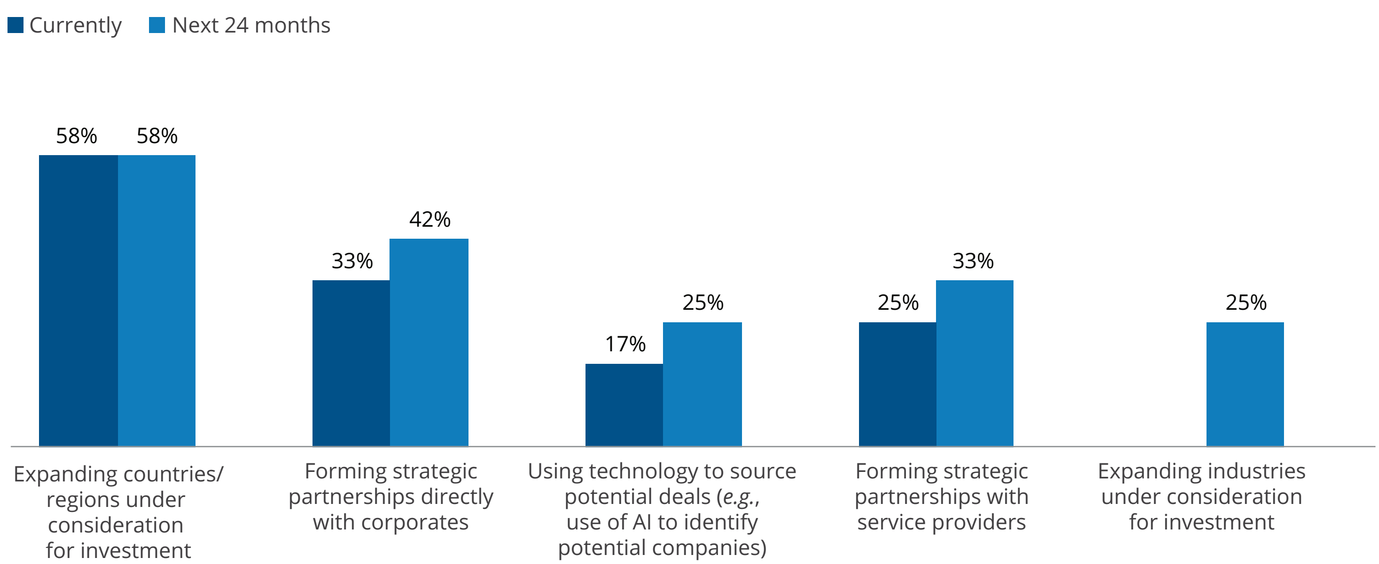
Cerulli expects the market environment to become more challenging for private equity managers, especially those that fail to deliver above-median returns. Although they have so far benefited from stable pricing power and favorable contract terms, we expect intensifying competition, a downturn in the business cycle, and greater focus on industry practices to increase the pressure on managers.

Intensifying competition and increasing dry powder in the industry mean that GPs need to diversify their deal-sourcing capabilities. For 58% of the managers surveyed by Cerulli, expanding the regions under consideration is the preferred way to expand deal flow and improve capital deployment. Additionally, managers should explore technology, especially machine learning, to source deals, improve due-diligence, and support operational improvements for portfolio companies.

General Partners: Approaches Currently Used for Capital Deployment and Deal Sourcing and Planned Changes Over the Next 24 Months, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Analyst Note: One manager stated that it will introduce internal deal origination over the next 24 months.



Increasingly, managers are using technology to improve their due diligence of companies and foster better decision-making; GPs that are lagging are devoting more resources to exploring ways to expand their technological capabilities. Cerulli encourages GPs that often participate in competitive bidding auctions to find technology that can help to ascertain their bidding limits and improve the depth of their due diligence within shorter periods. As yet, few such GPs use technology for deal sourcing. Technology has the capacity to flag potential investments, both for managers and investors, although the final stages of any investment will still require intense human resources.

Institutional investors demand for private investments

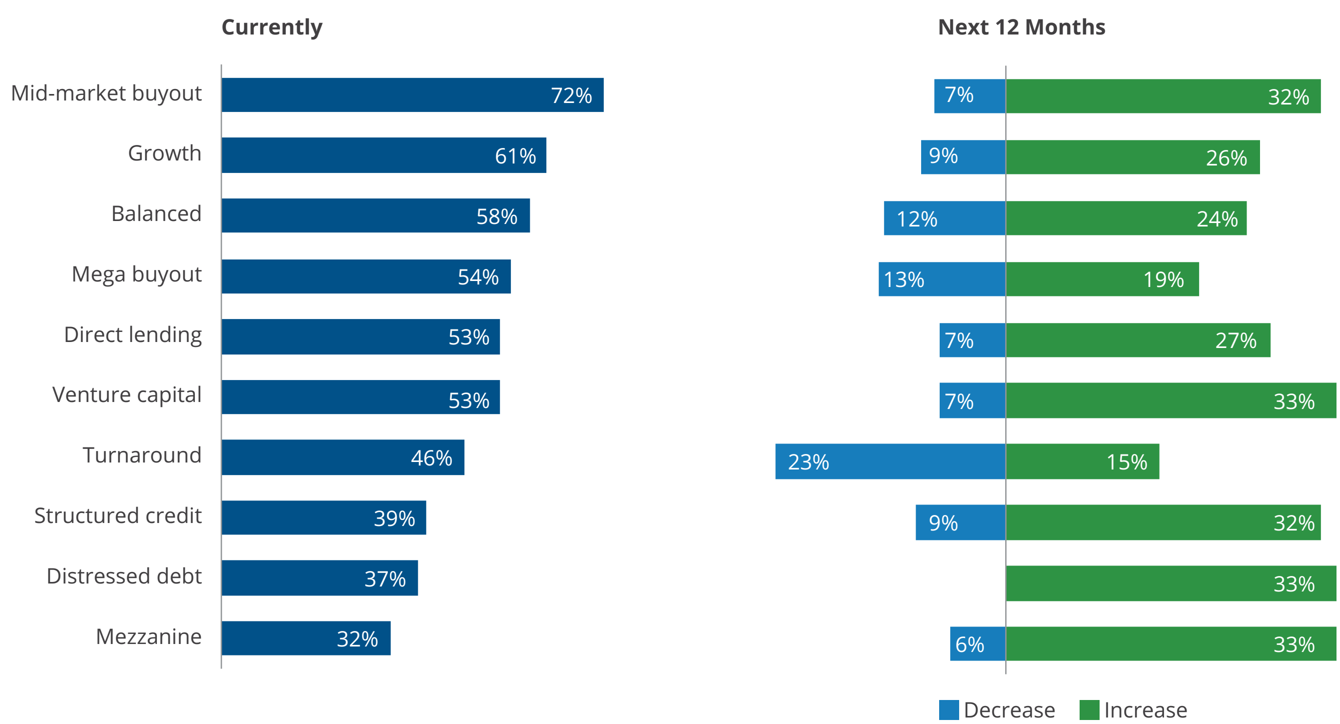
Pensions remain the main source of capital for private equity, having contributed 31% of fundraising for European private equity managers in 2018. For instance, Dutch pensions have increased their allocation to private equity to 4% in recent years and 20% of German pension funds expect to increase their allocation to private equity over the next 24 months. Pensions are also expected to drive demand for higher risk/return private debt strategies, with those pensions that started to invest in private debt earlier in the decade exploring debt strategies lower down the capital structure. Insurance companies contributed 11% of total fundraising for European private equity managers in 2018, compared to 8% in 2017. Cerulli expects the European Commission's 2019 decision to reduce the capital charge for long-term financing investments, both equity and debt, to 22% to spur further demand for private investments from insurance companies.

Cerulli's survey of European institutional investors found that 72% of respondents already allocate to mid-market buyout funds. Around one-quarter of the large institutions we surveyed plan to increase their allocations to mid-market buyout funds, growth funds, and distressed debt during 2020 and half said that they plan to boost their allocations to mezzanine debt in the coming 12 months. Nearly half of investors with assets of less than €15 billion said that they plan to increase their allocations to mid-market buyout funds and distressed debt strategies

Institutional Asset Owners: Private Equity and Debt Strategies Currently Invested in and Planned Changes Over the Next 12 Months, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Analyst Note: Reflects only the views of asset owners that currently invest in private equity and debt.



over the next year. Institutional investors are increasingly favoring small to mid-sized buyout funds, although they continue to maintain their allocation to large buyout funds. Large buyout funds generally rely on the availability of cheap capital and it is more difficult to make operational improvements for a large firm. Around 30% of the smaller investors we surveyed are still considering opportunities in the mega buyout market, whereas only 10% of large investors are considering such investments.

Manager selection is more important than ever in the GP-driven marketplace, where LPs often have to accept GPs' terms. One Nordic investor told Cerulli that poor performance or style drift—which can cause a strategy to become too correlated with the remaining portfolio—can be the key factors in the decision to terminate a relationship with a GP. Sophisticated institutional investors generally want to avoid overcommitment to one sector. Although, for instance, technology is booming, investors do not want to have too much exposure to the industry. They would rather invest across three or four sectors instead.

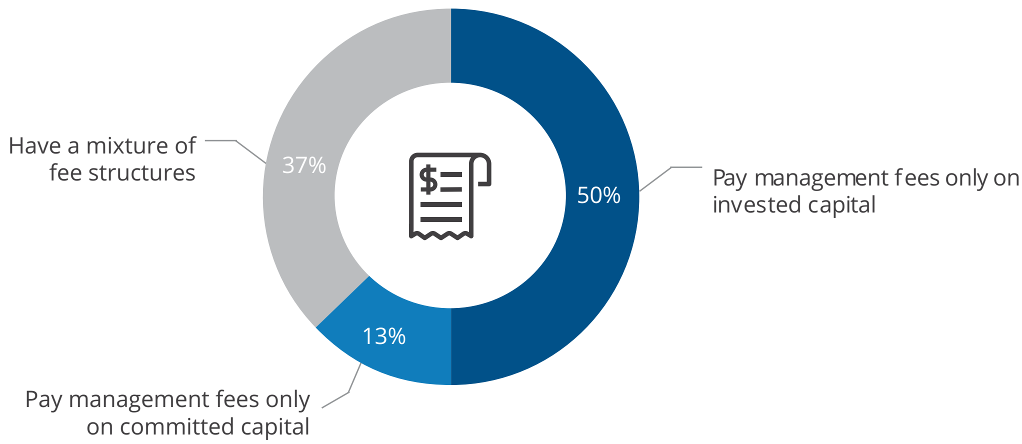
Fee pressure and the alignment of interest between LPs and GPs

Private markets' strong performance over the past 10 years has helped to solidify the 2/20 fee structure, because investors have often been more focused on gaining access to the asset class than on negotiating terms. Now, however, the crowded marketplace and decreasing risk-adjusted returns are putting pressure on private equity's 2/20 fee model, with investors questioning why they should pay the same fees for returns that have declined. Cerulli believes that top-quartile GPs will continue to set terms, but those in the lower quartiles will be forced to accept terms that are more investor-friendly.

Some 22% of the institutional investors Cerulli surveyed always extract discounts from private equity managers, whereas only around one-third of respondents never achieve discounts for real estate investments. Approximately 50% of the investors achieve only a small discount—between 1% and 10%—for private debt. Institutional investors do try to negotiate, but they do not have much power because they fear being cut or excluded from popular funds.

Institutional Asset Owners: Preferred Fee Structures When Investing in Private Equity, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands



Benefits of fee arrangements

Committed capital ⟷ **Invested capital**

Committed capital

- Can avoid incentivizing managers to deploy capital too quickly, which may adversely affect investment returns
- Can help sustain smaller managers with enticing investment propositions

Invested capital

- Reduces fees for the LP and potentially improves net returns
- Can encourage GPs to raise funds that are within their core expertise in terms of size and focus to maintain capital deployment speed
- Discourages GPs from becoming asset gatherers

Fees and the alignment of interests are improving in the hedge fund industry, but fee structures in the private equity sector have not shifted to favor the interests of LPs. The reduction in hurdles rates and the introduction of super carry are examples of this.

With buyout funds raising capital quicker than ever before, some of the largest buyout manager firms are increasing their performance fees to 30%, significantly more than the industry norm. However, Cerulli believes that only top-tier funds with stellar results will succeed in charging such fees. For instance, KPS raised US$15 billion for two of its funds in just two weeks. The two funds have 30% carried interest and a 1.25% management fee. Bain offers investors an option to pay a 1% management fee and 30% carried interest and EQT has also reduced its management fee in exchange for increased carried interest.

As some managers move beyond 20% carry, others are offering LPs the choice of either a lower management fee with higher carry or a standard management fee with standard carry. However, increasing competition between GPs and pushback from investors will limit the number of private equity managers that are able to charge super carry. As a result, Cerulli expects new types of fee structures to emerge in the coming years to sustain fundraising activities. For instance, some of the largest European institutional investors have expressed an interest in linking carry to ESG, but the lack of data means it can be difficult to link sustainability goals to carried interest. Nordic institutional investors are among the most vocal when it comes to setting ESG targets for private equity managers and monitoring their progress towards these goals. Currently, the preferred approaches for European institutional asset owners to monitor RI for private equity managers include reviewing and evaluating ESG objectives linked to strategy, investment restrictions, and ESG incidents.

Specialist private equity firms typically charge management fees on committed capital, whereas large asset management firms that have added private equity expertise to their product ranges tend to charge management fees on invested rather than committed capital. Cerulli's survey of European institutional investors found that 50% of respondents would prefer to pay management fees on invested capital only; 13% said that they prefer to pay management fees on committed capital. As contract terms become increasingly favorable to GPs, Cerulli does not expect top private equity firms to change their management fee structure to charge fees on invested capital.

Hurdle rates and the use of credit subscription lines

GPs are particularly focused on hurdle rates as they anticipate a downturn, which could lead to them holding assets for longer to generate greater value, in turn negatively affecting internal rate returns (IRR). As a result, some private equity firms are reducing or dropping hurdle rates. For instance, CVC Capital reduced its hurdle rate to 6% for its CVC Capital Partners Fund VII, which raised US$18 billion of assets in 2018.

One Nordic institutional investor told Cerulli, "Hurdle rates are being lowered—or in some cases taken out entirely. I do not sympathize. This is also especially problematic in structures with deal-by-deal carry. It really creates a misalignment."

The fall in hurdle rates is an example of GPs rather than LPs driving the market. Large buyout managers with a good track record and the ability to raise capital quickly are most likely to remove or reduce hurdle rates. Top-quartile GPs are in a strong position and can demand structures favorable to them. LPs have less power to push back, given that the market is supply-demand driven. However, investors continue to appreciate having a hurdle rate.

Over the past two years, the mechanics of IRR calculations and the appropriateness of using IRRs to assess GPs' performance has increasingly been called into question. The rise of super carry and the increasing use of subscription lines of credit have contributed to these discussions. Subscription lines of credit can be used to manipulate and substantially improve a fund's IRR. The use of credit lines delays capital calls and thus shortens the GP's hold period for investors' money. This helps to achieve the hurdle rate required for the carried interest to apply without actually increasing returns for investors.

When subscription lines are used for a short period of time (less than six months), investors typically have no issues. They are more concerned when GPs use subscription lines for an extended period. As one European institutional investor told Cerulli, "The effect of such use should be taken out of the hurdle rate calculation." However, this position has faced some resistance from GPs.

To assess the performance of private equity funds, institutional investors increasingly ask GPs to provide adjusted performance without the effect of subscription lines. In addition, managers should not be surprised if LPs request access to full cash-flow data to recalculate IRRs based on their internal assumptions.

In 2017, the Institutional Limited Partners Association (ILPA), a trade group for private equity investors, published its first guidance on subscription credit lines with the aim of improving managers' disclosure of such facilities. ILPA released recommendations on how to better benchmark manager performance and factor credit lines into managers' hurdle rates. Its guidelines also recommend that GPs disclose their net IRR with and without the use of subscription credit facilities.

Cerulli's conversations with LPs suggest that investors tend to implement ILPA's recommendations on subscription credit lines when dealing with private equity managers. However, even if the level of disclosure and the understanding of subscription credit lines start to improve, the usefulness of IRRs remains questionable. Cerulli believes that the removal of hurdle rates and the growing use of subscription credit lines has increased the need to reassess performance calculation methodologies and improve the alignment of interests between LPs and GPs.

Private banks' allocations to private investments

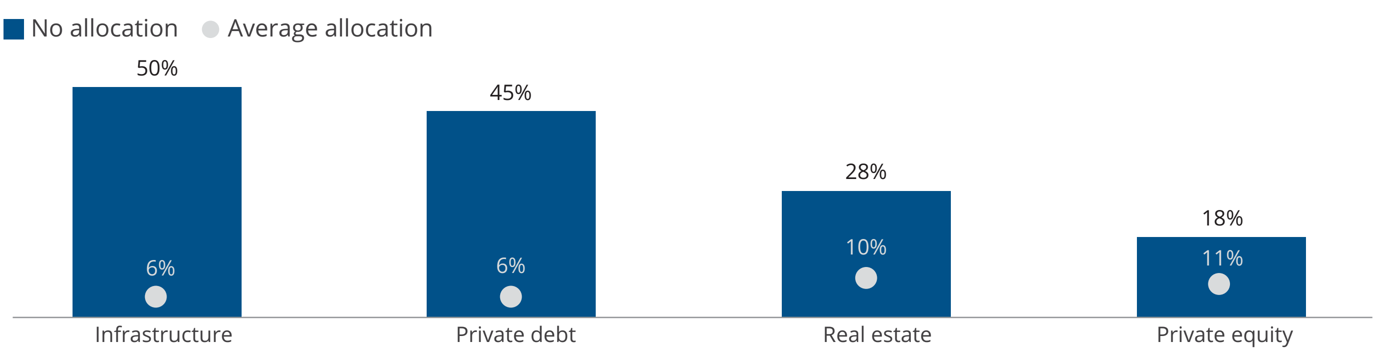
Although private banks' recommended allocations to private equity are already high, they are expected to continue increasing them over the next 12 months. In total, 45% of the private banks Cerulli surveyed plan to increase their allocation to private equity: almost 38% will increase their strategic allocation slightly and 8% will increase it significantly. The average recommended strategic allocation to private equity stood at 10.9% in 2019, but more than 30% of family offices typically allocate more than 15% to this asset class. High-net-worth (HNW) and ultra-HNW individuals typically have slightly lower allocations to private equity than family offices.

Private Banks: Recommended Strategic Allocation to Private Assets and Anticipated Changes Over the Next 12 Months, 2019

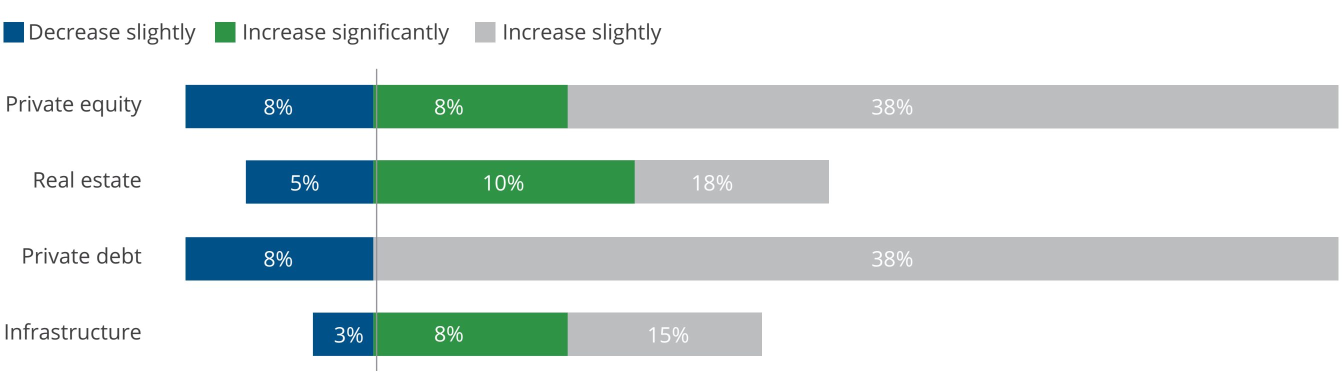
Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Analyst Note: Reflects views for a client with a balanced portfolio with moderate risk tolerance. "Decrease significantly" was not selected.

Recommended Strategic Allocation



Anticipated Changes In the Next 12 Months



Cerulli expects to see the greatest demand for turnaround, growth, and buyout strategies. Nearly half of the private banks we surveyed plan to use external asset managers to source previously highlighted strategies; only around 17% of respondents have the expertise necessary to run these strategies in-house. On the private debt side, few private banks plan to decrease their investments in mezzanine debt, distressed debt, and structured credit. In addition, smaller private banks plan to increase their allocation to turnaround, growth, and balanced strategies and a higher proportion of large private banks plan to increase their allocation to venture capital or structured credit the most in the next 12 months.

Private banks' recommended strategic allocation to infrastructure currently is the lowest of all alternative asset classes. However, this is likely to change over the coming 12 to 24 months: 50% of the private banks surveyed plan to increase their allocation to core and opportunistic infrastructure.

Private banks' use of existing GP relationships

Private banks increasingly want to have well-diversified portfolios that invest across different strategies, vintages, and geographies. Banks more often than institutional investors prefer to work with top-tier private equity firms as they believe that the big-name players have the expertise and established networks needed to have access to the most attractive deal flow. For instance, Pictet Wealth Management has indicated its preference for large private asset managers such as Blackstone and KKR due to their access to high-quality deals.

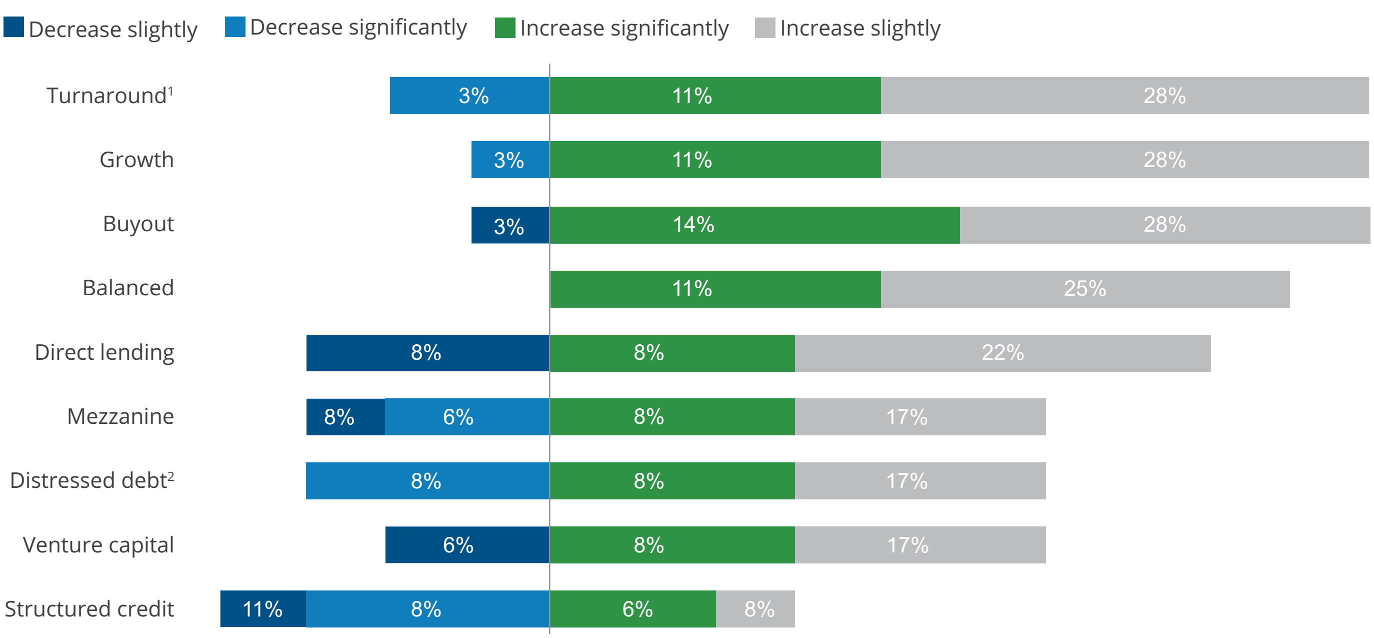
Only 22% of the private banks Cerulli surveyed plan to use mainly new GP relationships when allocating to private equity over the next 12 months. Almost half of private banks plan to rely on both existing and new GP relationships and around 30% will either entirely or mostly allocate to their existing managers. For instance, Credit Suisse's private banking and wealth management function only considers first-time investments with spin-off teams, although it will also co-invest alongside GPs as well as through separate accounts. KBC Private Banking, meanwhile, targets a diversified range of private equity strategies with established managers, with a preference for Europe-based firms.

Cerulli believes that significant opportunities exist for large private equity firms, especially those that can propose vehicles suitable for retail investors and deliver the required liquidity to investors.

Private Banks: Expected Changes in Allocation to Private Equity and Private Debt Strategies Over the Next 12 Months, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Analyst Note: [1]3% selected decrease slightly and decrease significantly. [2]8% selected decrease slightly and decrease significantly.



Private investment structures for retail investors

Cerulli's survey found that 43% of private bank respondents use fund-of-funds private equity vehicles for advisory mandates; direct investments, master feeder funds, and funds of funds are the three most popular vehicles for discretionary mandates. In addition, family offices are more likely than HNW individuals to choose direct private equity deals over fund-of-funds vehicles.

Although managers and GPs are keen to develop innovative fund vehicles for retail investors, it is difficult to tell which type of vehicle will see the most success among retail investors and private banks. Schroder GAIA II Specialist Private Equity Fund, an open-end vehicle that invest in primaries, secondaries, and co-investments and is managed by Schroder Adveq, is one of the most promising funds launched in 2019 for less wealthy investors. The fund offers monthly subscriptions and quarterly redemptions; the minimum investment is US$50,000. Investors have access to small and mid-sized buyouts in Europe and the US.

Additionally, smaller firms and technology platforms are also emerging to meet the growing demand for private investments. For instance, technology platform Moonfare allows investors to invest in top-tier private equity funds run by firms such as KKR and Carlyle, with a minimum investment of €100,000. Publicly available information suggests that the platform charges a 1% one-off fee and a management fee of 0.5% on top of the fees set by each fund.

The ELTIF structure has seen an increase in interest lately, with several notable fund launches. The structure allows retail investors with portfolios of as much as €500,000 to invest up to 10% of their portfolio in ELTIFs. Despite the sluggish start—only a handful of ELTIFs have been launched since their introduction in 2015—Cerulli's conversations with managers across Europe indicate significant interest in developing ELTIF vehicles in 2020, as managers aim to increase retail investors' share of AUM. Cerulli believes that as many as eight ELTIF funds could be launched this year, mainly by large traditional asset managers that already have private investment offerings for institutional clients but are keen to expand and develop innovative vehicles for retail investors.

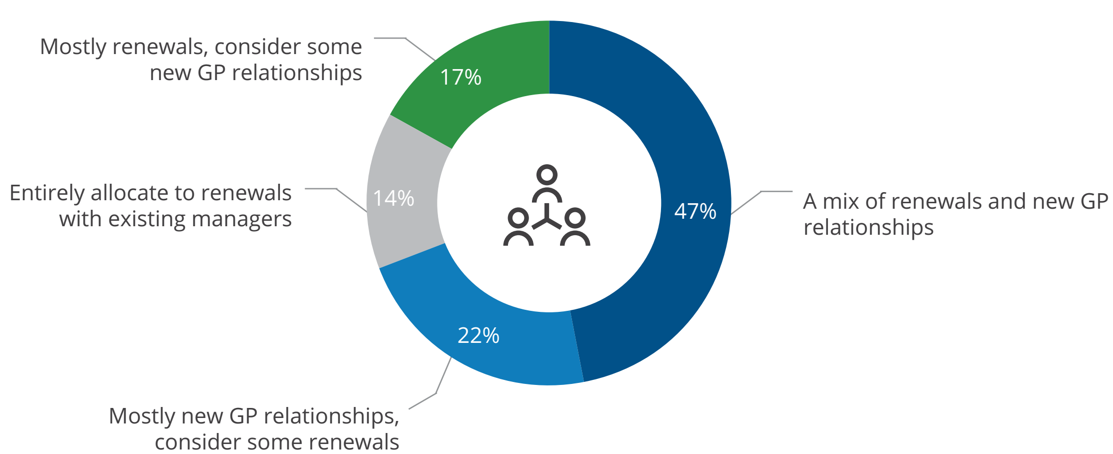
Managers that are considering launching ELTIF vehicles need to have strong sales support or build partnerships with local private banks across Europe, otherwise they may find it challenging to distribute their new products. For instance, Muzinich has partnered with an unnamed private bank to sell its ELTIF product to HNW individuals in Germany, Italy, and Spain. Similarly, BlackRock has partnered with BNP Paribas Wealth Management and Banque Havilland to distribute its ELTIF product.

Importance of responsible investment in private investments

Many institutional investors are finding private investments a particularly good way to make an impact with their capital. GPs tend to use the UN's Sustainable Development Goals (SDGs) as a starting point, although LPs increasingly want tangible information on how

Private Banks: Allocation of Capital to Private Equity Over the Next 12 Months by Type of Manager Relationship, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands



GPs aim to achieve their SDG targets. GPs should work to demonstrate which SDGs an investee company contributes to and to what extent. They should also focus on engagement activities to unlock the value for investors.

Cerulli's conversations with GPs indicate that most mandates now integrate ESG requirements and that exclusion is no longer enough. For example, investors increasingly ask GPs for 2°C degree scenario analysis. Many GPs have two different ESG integration methodologies: one for funds and another for direct investments. However, more standardization is expected in the coming years. Two years ago, each LP had its own reporting framework, but the situation has improved recently, with more groups trying to bring consistency to the reporting frameworks LPs use. For example, France Invest, the French Association of Investors for Growth, aims to issue recommendations for a reporting framework. GPs would appreciate more such initiatives across Europe.

European institutional investors are increasingly interested in impact funds, but not all GPs have such funds. Instead, some try to measure impact metrics and assess where a portfolio company makes the strongest impact. The key challenge fund-of-funds managers face is the lack of meaningful information for all portfolio companies in a given fund—and one fund of funds could include 500 portfolio companies. In addition, portfolio companies often lack knowledge and expertise in this area, so GPs need to focus on increasing management teams' awareness of carbon, employment management, and other issues. As one French private equity firm told Cerulli, "We do not only invest in sustainable companies, but try to teach portfolio companies the benefits of sustainability—to provide knowledge and tools."

Although 72% of asset owners monitor ESG incidents, managers can find it difficult to identify ESG warning signs in their portfolio companies. Whistleblowing systems for portfolio companies can yield results, but managers should seek to adopt technology to parse various sources of information—including social media, news websites, and online reviews—to identify ESG issues from internal and external stakeholders.

The ability of GPs to dictate RI terms for their portfolio companies will depend on their level of ownership and contract terms. Minority co-investors will rely on lead investors to set the agenda and the level of priority portfolio companies give to ESG. As the popularity of co-investment funds increases, LPs should be aware of the limitations such arrangements impose on their ability to pursue their RI agendas. Cerulli believes that performing ESG due diligence on the lead partner is vital when assessing co-investment opportunities to ensure alignment.

Applying RI criteria to private debt is more complicated than doing so in private equity, yet there is growing momentum for integrating ESG in the asset class. Cerulli's research shows that 73% of European institutional

European Long-Term Investment Funds: Notable Launches, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Launched or Planned	Year	Asset Manager	Product Name	Strategy
Launched	2016	BNP Paribas Asset Management	BNP Paribas European SME Debt Fund	Credit
Launched	2018	BlackRock	BlackRock Private Equity Opportunities ELTIF	Private equity
Launched	2019	Muzinich & Co	Muzinich Firstlight Middle Market ELTIF	Multi-credit
Launched	2019	Eurizon Asset Management	Eurizon Italian Fund (ELTIF)	SME financing
Planned	2020	Kairos	KAIS Renaissance ELTIF	SME financing

investors and 33% of European private banks believe that integrating RI in private debt will be very important in two years' time.

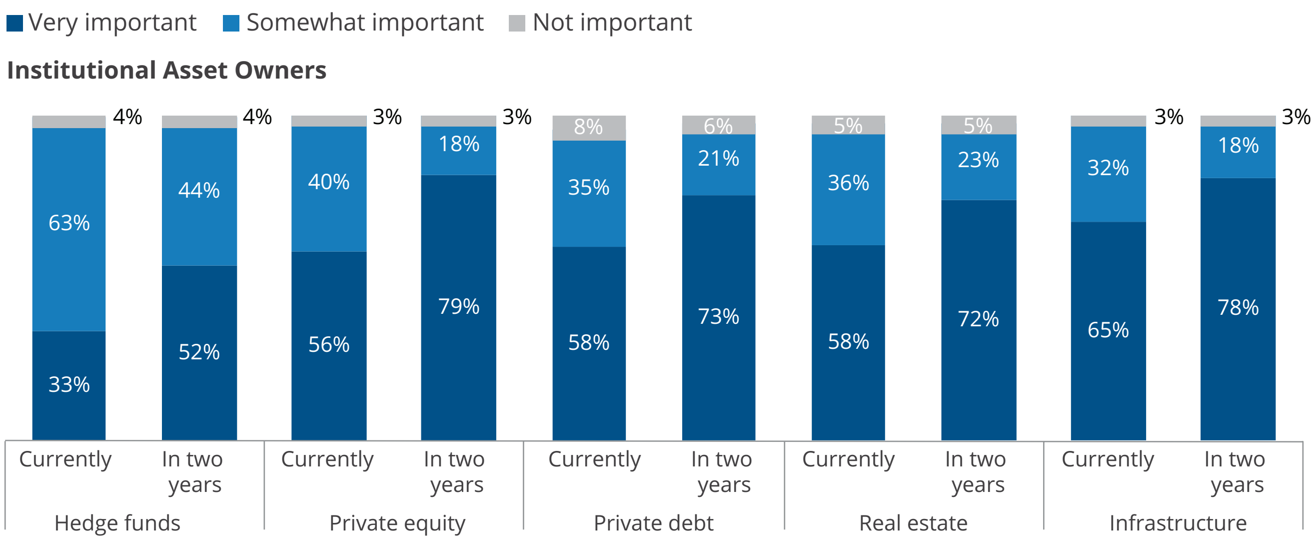
Private debt managers can usually impose RI factors on borrowing companies only through covenants or by not investing in companies that do not meet their ESG criteria. Nearly one in five (18%) private debt managers complain of a lack of attractive investment opportunities when ESG factors are assessed.

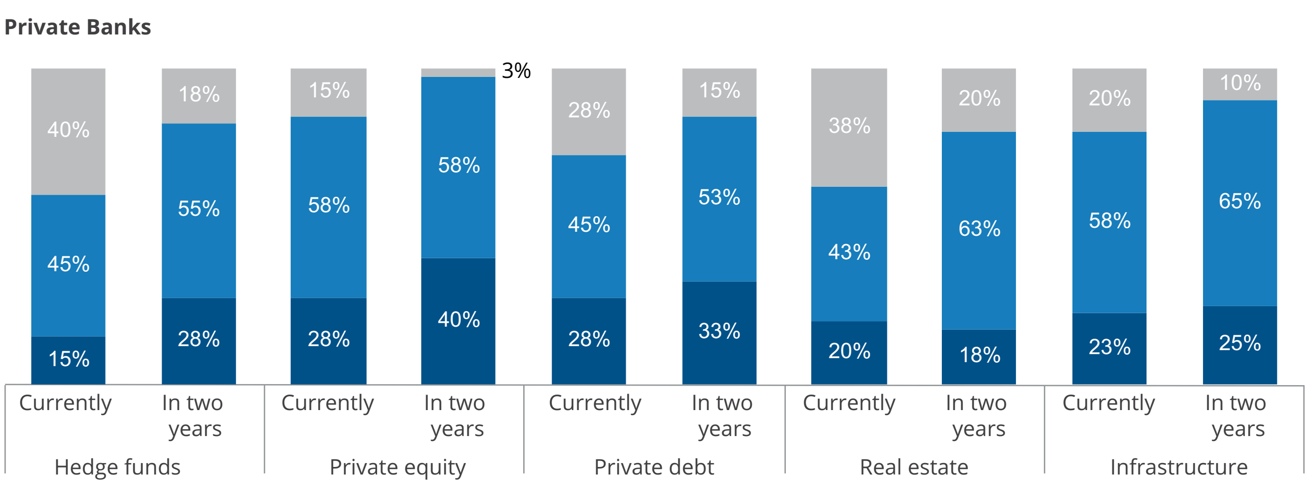
ESG factors are becoming an increasingly material part of assessing credit risk, with managers placing greater weight on evaluating ESG metrics during their investment analysis. Applying an exclusion list can be a starting point, but Cerulli believes that managers should explore other approaches, including pricing incentives for borrowers related to ESG criteria. It will remain vital for managers to provide transparency on their RI approach.

The Importance of Integrating Responsible Investments into Alternative Asset Classes Currently and in Two Years' Time, 2019

Source: Cerulli Associates, The Cerulli Report—European Alternative Investments 2020: Matching Different Demands

Analyst Note: May not sum to 100% due to rounding.





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