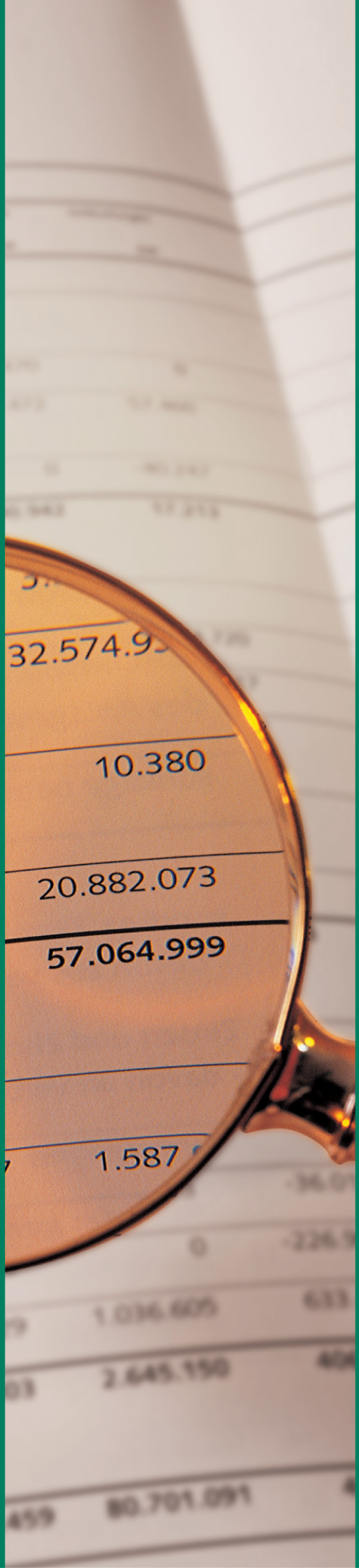

Institutional Investors and their Activities with regard to the Alternative Asset Class Private Equity.

An Empirical European Survey.

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1. Preface

Developing new investment strategies (*strategic asset allocation*)

Institutional investors around the globe are continuously on the lookout for high-yield investment opportunities to boost their capital income. During their search, investor interest remains focused on conventional forms of investments like bonds, stocks, and money market products. As the stock market turned bearish in the spring of 2000 and continued its slump well into 2003, accompanied by a prolonged phase of low interest rates, asset managers in banks, pension funds, insurance companies, foundations, and family offices have intensified their search for alternative asset classes. After having experienced three bearish years on the investment market, all institutions are now striving to develop new investment strategies intended to counter declining returns. As a logical consequence, strategic asset allocation gained in significance, an approach that takes criteria like capital investment targets, investment horizons, and risk affinity into consideration.

Using private equity for portfolio diversification

Even though conventional investment forms continue to account for the highest allocation of funds, the intent is to broaden the spectrum of investment opportunities within the scope of asset allocation to enhance opportunities to diversify into alternative investment segments. Within this context, private equity gains importance as a significant alternative asset class. The intent is not unilateral alignment to private equity – private equity serves exclusively to enhance the portfolio mix, but to an ever-increasing degree.

Still, there are those who continue to claim that this investment segment is complicated and lacks transparency. Thus, one prerequisite for investing successfully in the private equity segment is a certain level of experience.

Returns potential and risk diversification at the forefront

When investors contemplate taking the step into the private equity asset class, expected returns and risk structures are initially at the forefront. Many asset managers in leading institutions would like to become more active in private equity, attracted by returns potential and risk differentiation opportunities – others, however, remain constricted in their investment behavior by a lack of transparency, corporate guidelines, or liquidity requirements.

Information deficit

This empirical study is intended to contribute to reducing information deficits among many potential investors.

What objectives do investors aim to achieve with their investment activities; how do they select their target funds from the broad spectrum of investment companies on the market? Which criteria do they apply when selecting funds and what does the selection process entail? What level of returns do investors hope their private equity investments will generate; which regions, industries, and financing phases will their future investments target? What makes private equity so attractive compared with fixed-interest investments? Is there a trend toward outsourcing private equity activities to fund of funds specialists? Our study addresses these and further questions.

Generating transparency

This report profiles investor groups and their objectives, documents the results of our empirical analyses, lends transparency to this investment sector, and offers an outlook on future developments within the private equity market. In addition, we compare the developments revealed by this study with the results from our previous study published in 2002 (Expertise – Risk – Success: Investing in Private Equity Funds – Market on the Move).

Our thank goes to our interview partners ...

We would like to take this opportunity to thank our interview partners across Europe, some of whom have taken part in our studies a second time. Their invaluable contributions were a key factor in the success of this study.

... and to our sponsors

We would also like to thank our three sponsors (Adveq Management AG, ERGO Equity Partner AG, and LGT Capital Partners), who boosted analysis quality even more, in particular as a result of their specialized support. They have stood by us as valuable sparring partners throughout the entire process – from preparing the questionnaire and selecting interview partners all the way to conducting plausibility checks of the empirical analysis and the final report without influencing results or jeopardizing the neutrality of survey-based statements.

Almost 200 institutions surveyed across Europe

Market gaining maturity

Generally speaking, our current study of almost 200 European institutions revealed a substantially higher awareness for private equity than was apparent in our 2002 study. Many institutions also seemed to have built up their knowledge regarding organizational aspects of private equity over the past two years. Investors will increasingly turn to the private equity asset class. As we see it, the market for private equity is gaining maturity.

Uwe Fleischhauer
Götz Hoyer
Detlef Mackewicz
Munich, May 2004

2. Conducting the study

Continuation of our 2002 study

This study is closely based on the structure and approach used in its predecessor study from 2002. The predominantly closed-end questions used in the survey also ensured good comparability between these two empirical analyses. Nevertheless, the current study was designed as a stand-alone project with high informational value. By analyzing and interpreting the results from **almost 200 interviews** against the backdrop of the turbulent developments over the past two years, we are confident that this study will provide readers with insights just as useful and valuable as those from our 2002 study.

Empirical analysis from October to December 2003

The interviews were conducted from **October to December 2003**. The majority were telephone interviews. To supplement these, we held face-to-face interviews in order to discuss aspects beyond the scope of the questionnaire and gain additional insights into the institutional investor's mindset.

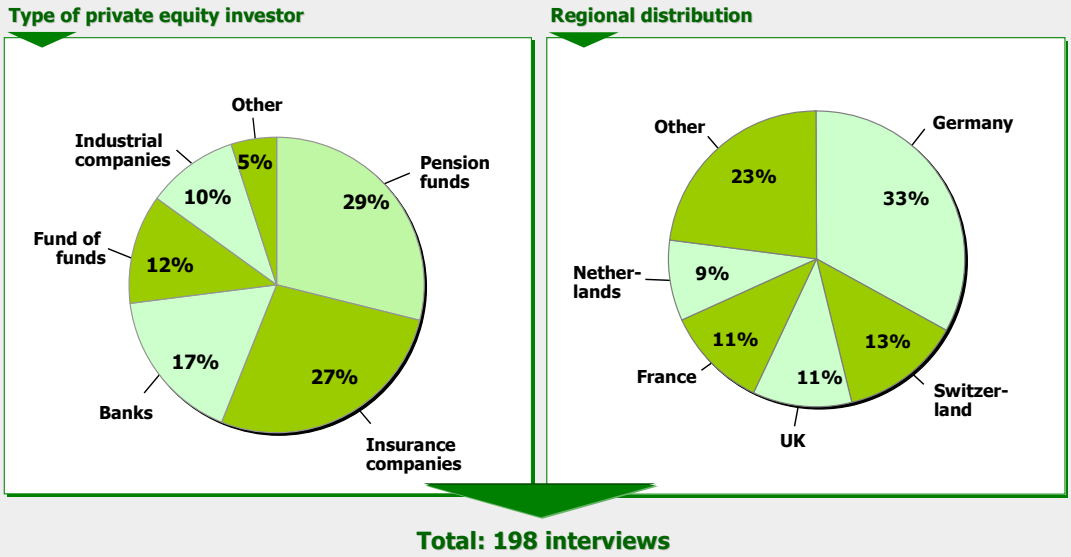
Competent interview partners

At the core of this study are the **198 interviews** with institutions that have either already invested in the private equity class or have the potential of investing in private equity funds. Our contacts were primarily the heads of private equity at the institutions included in our survey.

In selecting our almost 200 interview partners, we were careful to ensure a balanced distribution in terms of geography and investor type.

Distribution of interviews

Balanced distribution of interviews by investor type and region



Source: Mackewicz & Partner (2003/2004 empirical analysis)

Representative portrayal of market setting

Eighty percent of the interviews cover the three most important investor groups for private equity funds in Europe – banks, pension funds, and insurance companies. At the same time, Germany, Switzerland, the UK, France and the Netherlands – Europe's leading private equity nations –

form the geographic core of our empirical study, representing 75 percent of all institutions interviewed. Thus, our study paints a highly representative picture of the market setting.

The initial interview question enabled us to appropriately differentiate between those active and those not active in the private equity asset class:

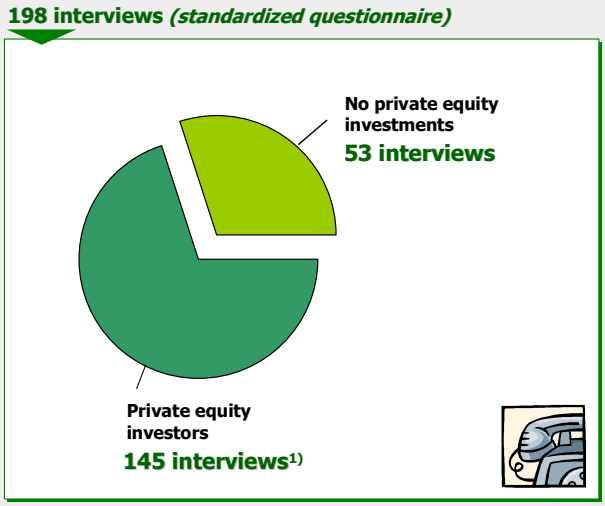
[?] DO YOU HOLD INVESTMENTS IN THE PRIVATE EQUITY ASSET CLASS?

Three-quarters of those surveyed hold private equity investments

Of the 198 institutions we surveyed, 75 percent (145 institutions) did hold investments in the private equity asset class. This high share is not a chance phenomenon; it can be explained by our address database being specific to the private equity segment. Of those 25 percent not active in private equity investments to date, almost half do plan on making private equity investments within the coming five years (see Chapter 8: „Outlook"). The rest do not intend to invest in this asset class.

Population of the empirical analysis

Of the almost 200 institutions surveyed, 75 percent already hold private equity investments



1) Basis for empirical analysis
Source: Mackewicz & Partner (2003/2004 empirical analysis)

Non-investors cite lack of understanding

Even though the number of survey participants not interested in private equity investments was very limited, we did investigate the reasons behind this lack of interest. One of the main arguments against private equity investments per se is insufficient comprehension of this business segment. One striking aspect is the divergence of opinions between those who actively invest in private equity and those who do not. Institutions with no involvement in private equity funds perceive higher risk associated with this asset class than do active investors. Added to this are uncertainties regarding the legal and tax context along with the

negative market image that established itself in the minds of many an asset manager in 2002 and 2003. Hence, intensive and objective information campaigns are needed to whet the appetite of potential investors for the private equity asset class.

In contrast, the majority of institutions already investing in private equity sooner see a possibility of increasing the capital allocated to private equity in subsequent years. These **145 active investors** serve as the basis to bring the status quo on the private equity market into clearer focus and for the empirical analysis that follows.

3. Summary

The outlook for the private equity sector is promising. Our 2002 study already predicted increasing significance for the private equity asset class. The results of this study confirm this trend, now likely to set in after a time lag. Following a two-year dry spell with hesitant attitudes toward investing Europe's private equity market, this asset class is once again advancing and building momentum.

Private equity once again advancing and building momentum

Within the scope of our survey covering 198 institutional investors in Europe (145 with actively interested in private equity), we were able to identify groundbreaking trends on the levels of

198 institutions surveyed; of these, 145 with an active interest

- Institutional investors and
- Private equity funds (umbrella and individual funds).

We could already observe these market trends and investment capital redeployments in our 2002 study; these will continue with increased intensity during the coming years.

Institutional investors

- The institutional investors in Europe that we surveyed intend to increase their share of private equity investments from the current average of 1.1 percent to 3.2 percent of total assets over a five-year horizon

Rise in allocation from 1.1. to 3.2 percent

- This would mean that a good EUR 130 billion in additional capital (global perspective) would flow into this asset class
- Private equity funds would need to be able to accommodate this EUR 130 billion and place it with promising companies capable of meeting investors' returns expectations
- The additional capital freed up for private equity invest-ments will come predominantly from European pension funds and insurance companies

Pension funds and insurance companies

- We expect above-average allocation growth, particularly from insti-tutions in Great Britain, the Netherlands, and France.

UK, NL, F

- For the most part, investment capital will remain in Europe and benefit the buyout segment

Europe

- Fund of funds (umbrella funds) will also profit from the additional capital earmarked for private equity

Buyout

- This development will be to the detriment of venture capital funds in particular
- Ninety percent of those surveyed continue to rate future prospects for returns on private equity investments as „good" or „very good" – a more than unambiguous vote of confidence

Good outlook for return on investment

Target returns: 18.1 percent

- Institutions surveyed specify target returns for their future investments in excess of 18 percent
- At 16.4 percent, the actual returns achieved lay almost two percentage points above the market average over the past ten years (14.7 percent p.a. for private equity)
- On average, investors have almost eight years' experience as private equity investors – institutional investors in the UK have the most experience in Europe by far
- Generally speaking, Europe's private equity industry is still relatively young, despite significant regional differences
- Over recent years, some investment decisions were made based on „gut instinct" – currently, a more systematic approach is being applied

Professionalization and increased requirements

- In general, „professionalization" is apparent among institutional investors
- Requirements placed on fund management by institutional investors are increasing
- A professional approach can mitigate alleged risks associated with this asset class

Strategic asset allocation

- The majority of institutions surveyed work with their own small teams using internal resources to ensure competent strategic asset allocation and build their private equity program
- However, when selecting target funds, most institutions continue to take a „passive" approach
- Investors consider asset management experience and track record to be the most important criteria when selecting a target fund

Private equity funds (umbrella and individual funds)

- We expect higher allocations for private equity funds in the coming years
- The increased capital available will be distributed among a larger number of target funds
- European buyout funds will remain the most popular among institutional investors
- Fund volumes in Europe will lie in the range of EUR 50 million (early-stage funds) to a maximum of EUR 5 billion (buyout funds)

Greater performance differences

- Top-quartile funds will have the luxury of inviting investors to participate; other funds will have to prepare for high-effort fund-raising activities
- The gap between the „best-of-class" and the „laggards" will grow larger
- Funds with below-average performance will have limited or no success in achieving their fund-raising objectives

- Consequently, we expect further consolidation among fund providers, especially in the European venture capital segment
- There will also be further mergers and takeovers in the umbrella fund (fund of funds) segment
- In parallel, fund of funds will gain in importance as an investment vehicle for institutions, especially for investors new to private equity
- Private equity funds will need to become client service organizations

Customer orientation

Within the context of the general and cycle-based market recovery, it is important to consider the high share of institu-tions that intend to increase their private equity allocation along with those who plan to make initial private equity investments in the coming two years. Two-thirds of the 145 active investors surveyed intend to increase their private equity investment share. Almost half of those institutions who hold no private equity investments (53) intend to invest in the private equity asset class in the near future; most, within the next 24 months.

High number of investors new to private equity

Market outlook

- For 2004, we forecast increased investment activities and fund-raising volumes in Europe
- Over the next five years, the European private equity sector will experience continual growth
- According to forecasts from institutions surveyed, net investments in Europe will grow by around 10 percent each year up to 2008 to exceed EUR 40 billion
- Fund-raising volumes will once again increase as well
- Awareness of private equity's economic importance will grow
- Private equity will gain greater acceptance among companies in search of capital

Higher aceptance

- Despite this, private equity will not become a mass product; it will maintain its highly selective character

Selective product

- The private equity sector – investors and fund providers alike – will undergo further professionalization
- There is a lot of ground to make up – and not only for institutional investors

A lot of ground to make up

As we see it, private equity will make a stronger contribution to risk diversification and increased returns in the portfolios of institutional investors – this, largely independent of the general climate on financial markets.

Private equity as an integral portfolio component