

INSTITUTIONAL INTELLIGENCE

Private Markets Due Diligence Survey

Insights into the key factors influencing
one of the most critical junctures
between investors and fund managers

Released May 2019



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EXECUTIVE SUMMARY



Graeme Faulds

Director of Product
eVestment Private Markets

Due diligence remains the foundation for investors looking to build a quality portfolio and generate above market returns. It is arguably the point at which investors have greatest influence on the outcome of their commitments and an area we have observed an increased focus on in recent years. Consequently, due diligence is one of the most important junctures between investors and fund managers and a crucial part in forming and building successful, long-term relationships for both parties.

This is why eVestment Private Markets conducts the only annual industry survey specifically focused on the key elements of the due diligence process from the investor, consultant and fund manager perspectives. This year, we're pleased to present you with the fourth edition of our report in association with Nasdaq, the parent company of eVestment.

With a renewed set of questions and topics explored for 2019, the survey continues to uncover the emerging factors impacting fundraising, performance analytics and manager selection.

KEY FINDINGS

Private markets returns expected to decline, but respondents see some specific opportunities.

Respondents' greatest concerns for the future of private markets were identified as having a generally negative impact on returns, with more than 40% of investors expecting a decline in performance for both existing and prospective investments. When investigated by sub-asset class, the weight of opinion was against private equity, venture capital and real estate. Real assets and infrastructure were strategies that investors were most bullish on.

Competition for deals is the number one concern for both investors and fund managers.

Investor and manager respondents both voiced their highest level of concern about competition for deals, with investors indicating a stronger level of concern. This topic was only rated the fourth highest concern in our 2018 survey, but climbed to top this year's survey – potentially as investors and managers begin to realize the effect of record fundraising levels flooding the market with available capital and an ever-growing list of fund managers chasing the same assets.

Close to two-thirds of investors and fund managers expect a market correction within the next two years.

The prospect of a market correction was a top three concern for both investors and fund managers, and the majority of both groups reported it would be within the next two years. While investors indicated this would lead to an increased focus on monitoring their portfolio, fund managers saw the biggest impact on the timing of exits.

Fund managers underestimate the importance of metrics and analytics during due diligence.

In terms of specific elements of the due diligence process, it was clear that fund managers underestimate the importance investors place on key pieces of analysis such as loss ratios, PME and the impact of fees. A new element uncovered this year was the growing importance of calculating horizon-based returns – perhaps in an effort to better assess private market performance alongside other asset classes as allocations grow in size and the strategy evolves from alternative to mainstream.

RESPONDENT PROFILE

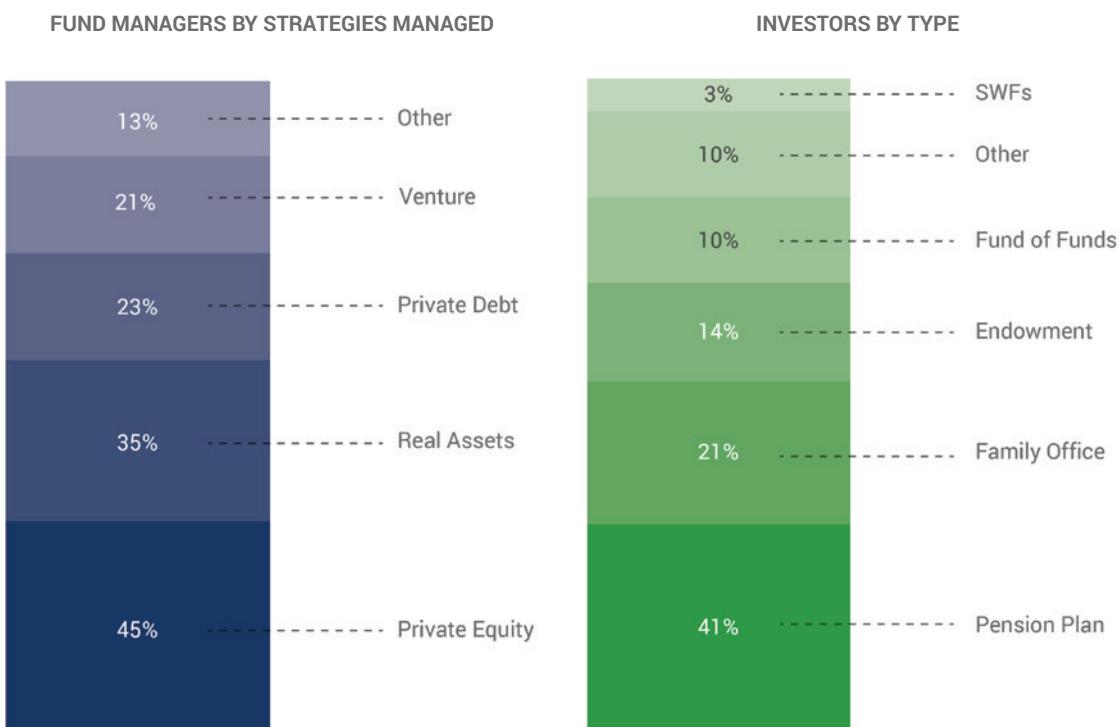
In early 2019, eVestment Private Markets surveyed institutional investors, consultants and private markets fund managers across the Americas, EMEA and APAC regions. The survey investigated their concerns, perspectives and practices to uncover the key trends that are driving private markets investing, manager selection, fundraising and allocation decisions.

Investor and consultant respondents (referenced as “investors” throughout the report) to the online questionnaire included some of the world’s largest pensions, endowments and fund of funds, with institutional assets under management/administration (AUM/AUA) totaling more than

USD 765 billion and aggregated private markets AUM/AUA of more than USD 131 billion.

Private markets fund managers were also separately surveyed to explore their views and practices on a range of topics. The online questionnaire covered a portion of the same questions investors were asked in order to draw comparisons and contrasts, in addition to questions specific to the fund manager perspective. Fund manager respondents to this questionnaire manage more than USD 600 billion in private markets funds, with one-fifth managing more than one sub-asset class strategy.

Figure 1. Survey Respondent Profile





KEY CONCERNS

Competition For Deals #1 Concern For Both Investors & Fund Managers

When asked to indicate their level of concern about the impact of a range of factors on the private markets industry, investor and manager respondents both voiced their highest level of concern about competition for deals.

Forty-one percent of investors indicated they were very concerned about competition for deals and 25% of fund managers indicated similarly (*Figure 2*). Only 3% of investors and 16% of fund managers expressed no concern.

Competition for deals was only rated the fourth highest concern in our 2018 survey, but topped this year's list. This rise in concern could suggest that investors and managers are beginning to realize the effect of record fundraising levels flooding the market with available capital and an ever-growing list of fund managers chasing the same assets.

Given their level of concern, investors' due diligence may start to include an increased focus on managers' deal sourcing processes and their ability to deploy capital.

Investors Show Concern Over Valuations, Yet Fund Managers' Perspectives Differ

Private company valuations was another key concern in this year's survey, at least for investors: 38% of investors indicated they were very concerned (*Figure 3*), ranking it second on their list. Fund managers attributed less concern to this area however, with 36% of respondents indicating they had no concern over company valuations whatsoever, ranking it seventh. These fund manager respondents may feel confident in being disciplined in deploying capital and generating returns, even with rapidly increasing purchase price multiples.

Figure 2. How concerned are you about the impact of..."Competition for Deals"

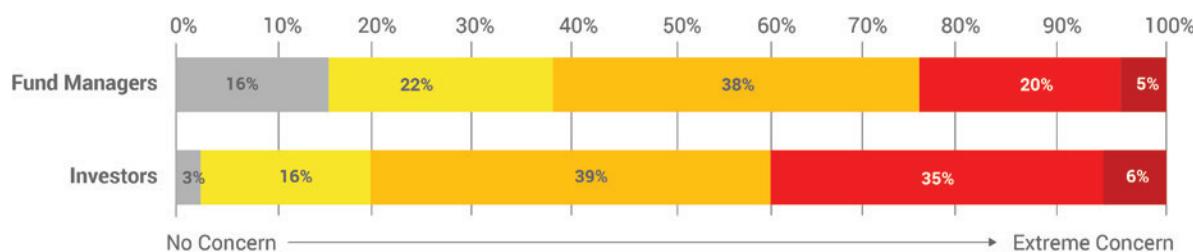
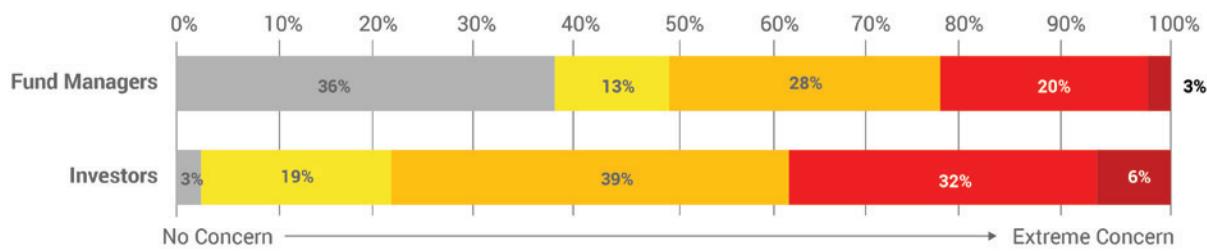


Figure 3. How concerned are you about the impact of..."Private Company Valuations"



Not Concerned Slightly Concerned Moderately Concerned
Very Concerned Extremely Concerned

Predicting the Next Market Correction and Future Performance

At time of writing, U.S. and European stock markets have experienced a 10+ year bull run and talk of a market correction is omnipresent in mainstream media – but how much focus is the private markets community placing on this possibility?

In our findings, a market correction was a top three concern for both fund managers and investors, with 21% and 29% respectively indicating they were very concerned about this possibility (Figure 4).

When asked about the timing of a correction, approximately two-thirds of investors and fund managers believed it would occur within two years (Figure 5).

Figure 4. "How concerned are you about the impact of...a Market Correction"

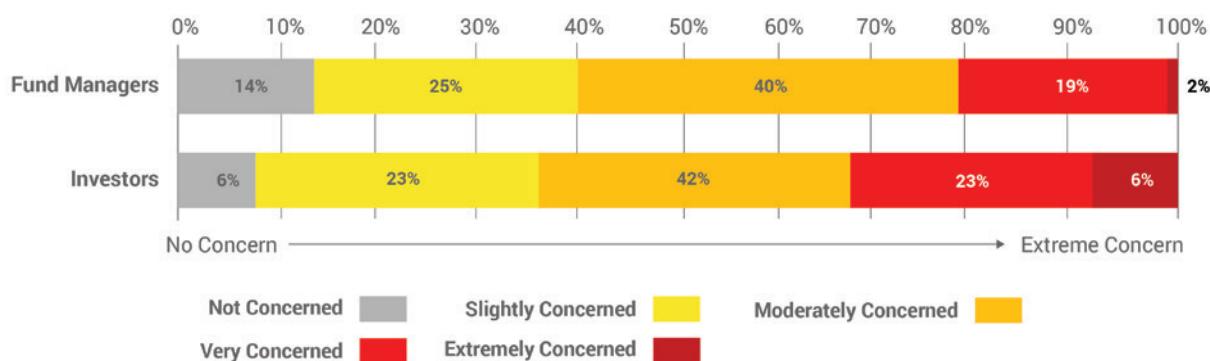
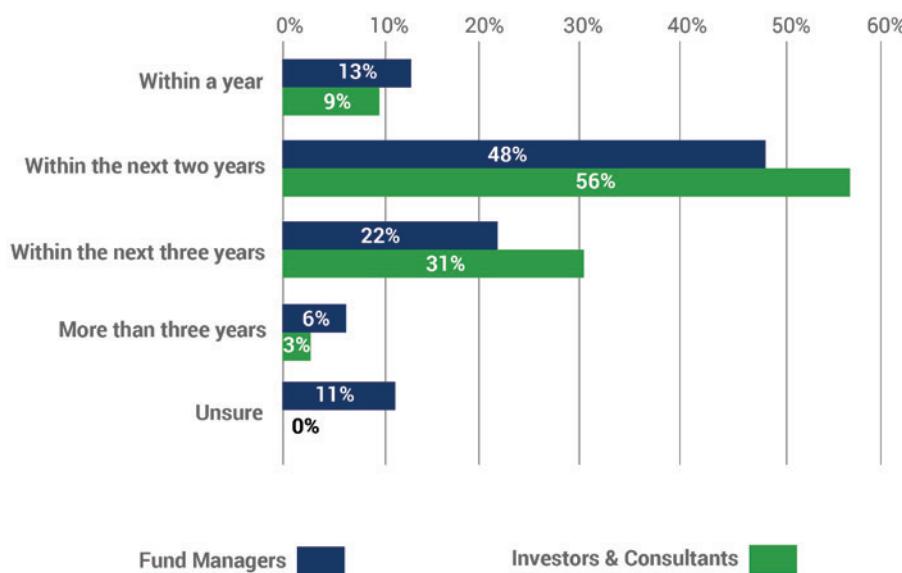


Figure 5. "When do you predict there will be a significant market correction?"



Fund Managers Less Concerned Than Investors On Future Performance

Despite significant concerns about competition for deals and a market correction, close to one-third of fund managers indicated no concern regarding future performance of their strategies (Figure 6).

In contrast, this relatively optimistic view was not shared by investors: just 6% of investors voiced no concern and close to one-third of investors were very concerned. This highlights that no matter how comfortable a fund manager feels in their ability to mitigate risks and produce returns, they need to have strong responses prepared to help alleviate investors' strong concerns.

Figure 6. "How concerned are you about the impact of... Future Performance?"

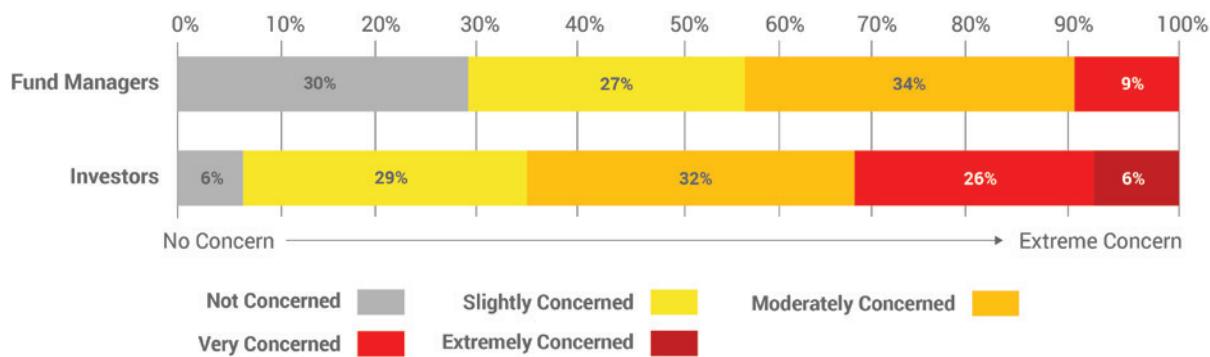


Figure 7. "How concerned are you about the impact of..." (Fund Manager Responses)

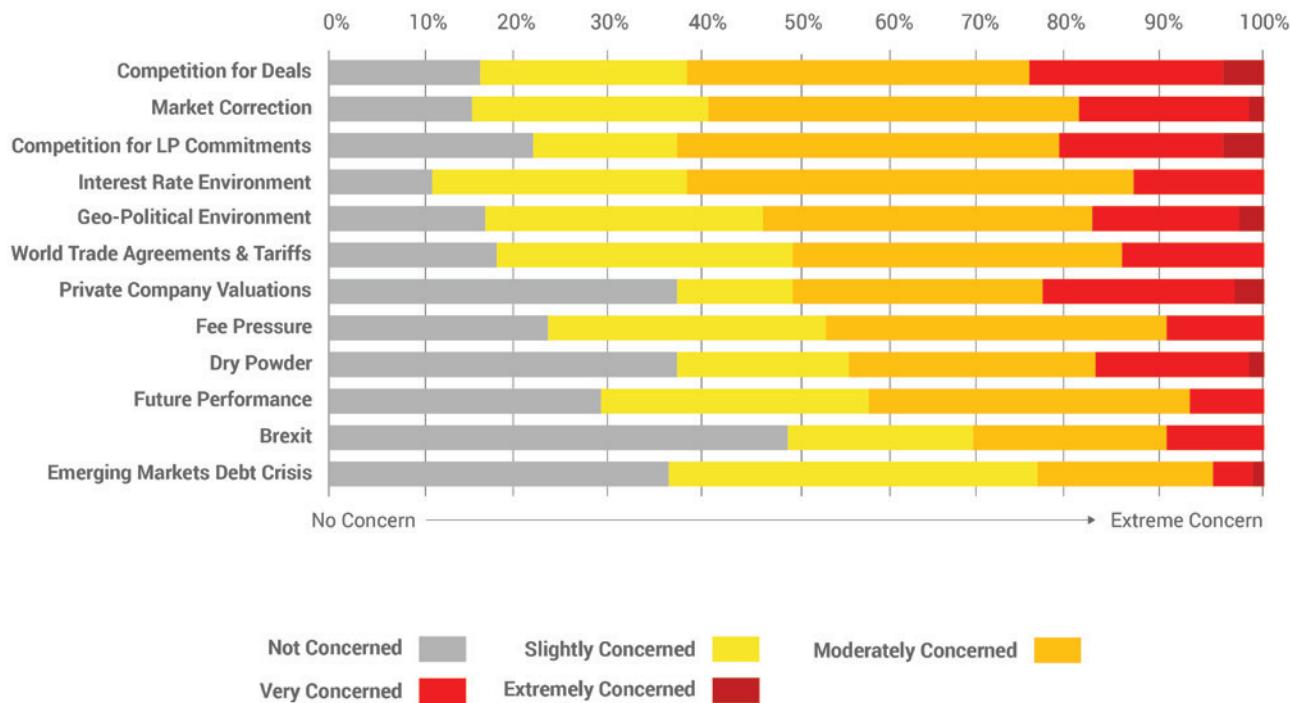
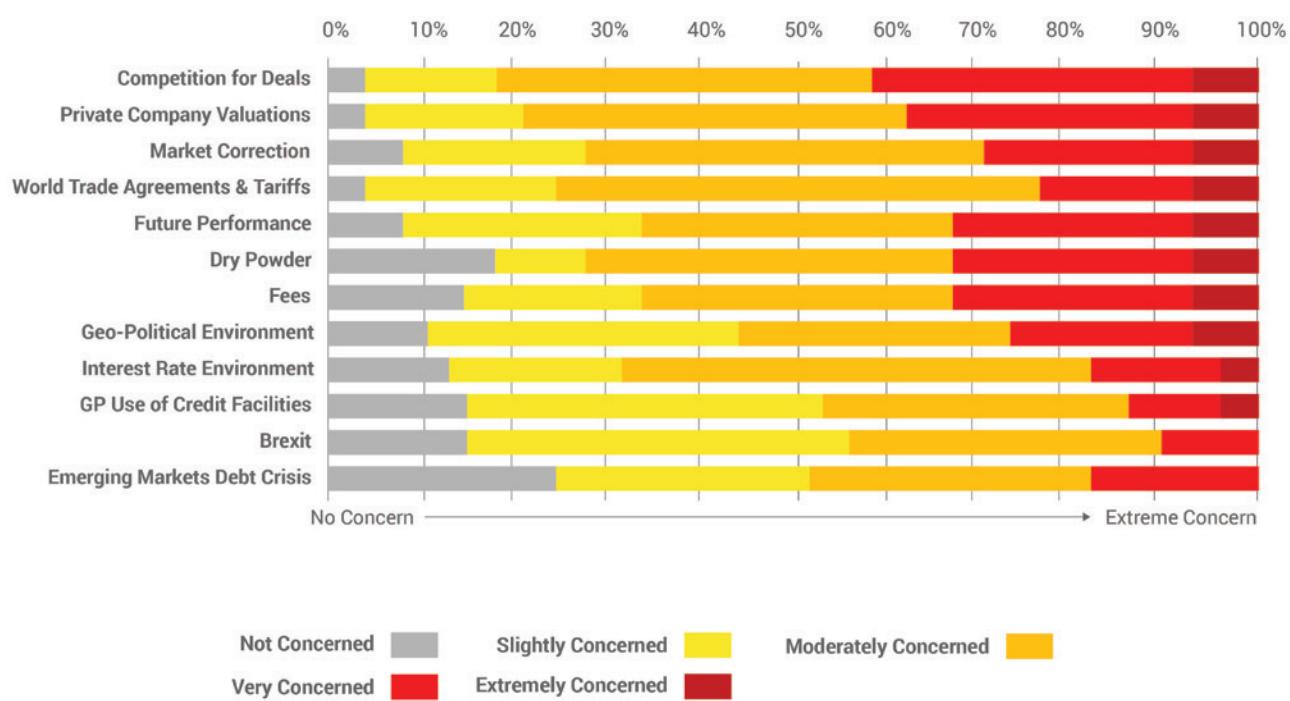


Figure 8. "How concerned are you about the impact of..." (Investor and Consultant Responses)



How Are Concerns Impacting Fund Manager Decision Making?

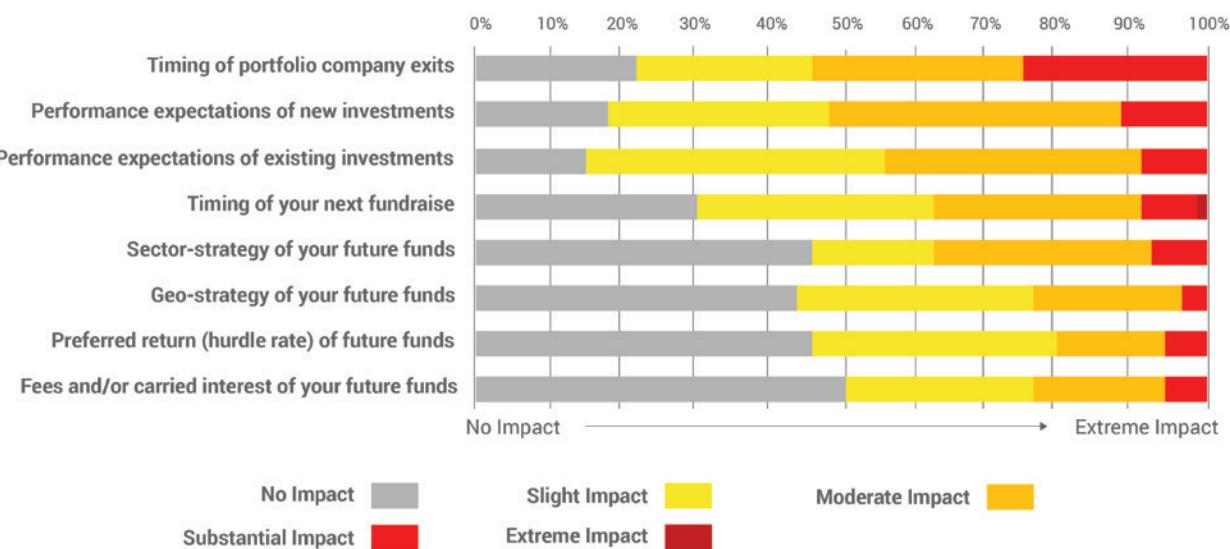
Taking into consideration the concerns they raised earlier in the survey, fund managers were asked to indicate to what extent these are impacting their decisions on a range of factors (*Figure 9*).

Of note were the top two areas of potential impact. One in four fund managers indicated a substantial impact on the timing of future portfolio company exits. Although almost

as many, 23%, expected no impact. More fund managers expected the performance expectations of future investments to be impacted, but just 14% indicated a substantial impact.

Unsurprisingly, close to half of all fund managers indicated that the highlighted concerns would have no impact on the strategy and terms of their future funds.

Figure 9. "How are the factors of most importance to you impacting your decisions about..." (Fund Manager Respondents)



Investors' Concerns Lead to Increased Focus on Portfolio Monitoring

As opposed to indicating severity of impact, investors were asked to indicate the direction of impact on a five-point scale from substantial decrease to substantial increase (Figure 10).

Driven by their top concerns, 45% of investors expected to increase their focus on monitoring existing investments. This indicates a similar outcome to the last financial correction, when investors significantly increased their demand for information on existing portfolios in an effort to better understand their risks and exposures.

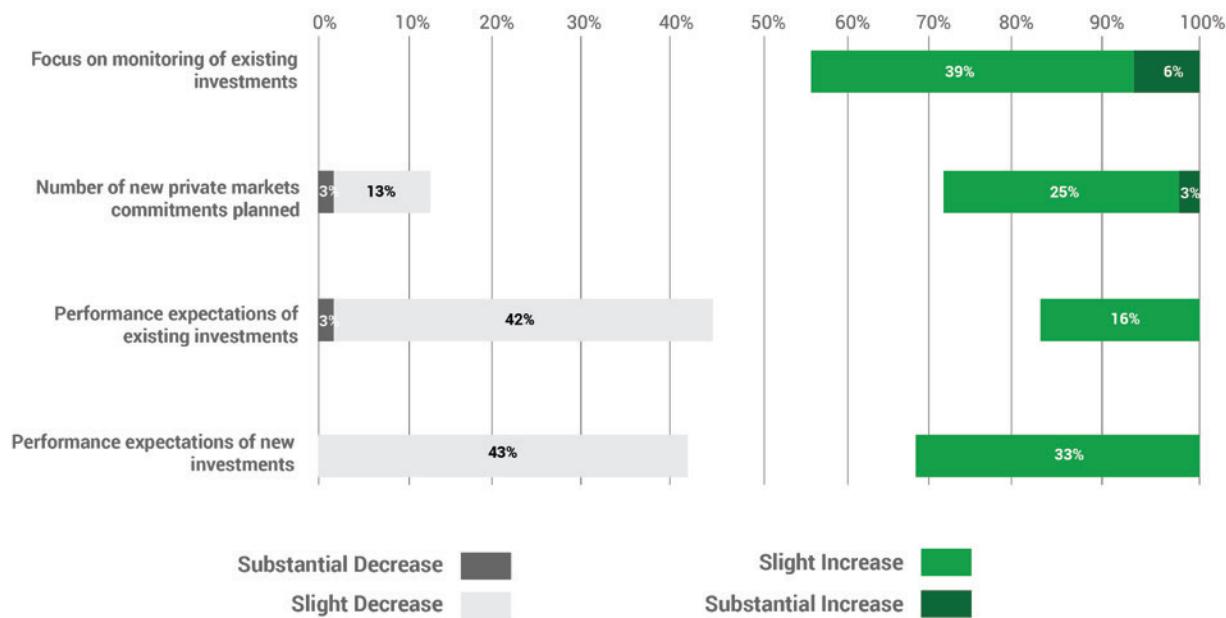
On a positive note, while 16% of respondents suggested they would be reducing the number of new commitments made in 2019, 28% expected to increase new commitments.

When asked about the impact on performance expectations, the outlook was largely negative: 45% of investors projected a decline in the performance of existing investments and 43% a decline in the performance of new investments.

However, this question also highlighted the greatest difference in opinion between respondents. A full third of investors projected an increase in performance for new investments.

To examine this topic in more depth, the survey also asked both respondent groups more detailed questions about their performance expectations by sub-asset class.

Figure 10. "To what extent are the factors of most concern to you influencing your..." (Investor and Consultant Respondents)





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PERFORMANCE EXPECTATIONS

What Lies Ahead for Private Markets Returns?

As the private markets industry matures and goes from niche to mainstream, what expectations do investors and managers have for the future performance of the asset class?

To assess future performance expectations, our survey first asked respondents about their current Internal Rate of Return (IRR) performance expectations by sub-asset class (*Figures 11,12*).

Predictably, fund managers focused on gross returns while investors gave net return expectations, and so there is greater variability of expected returns amongst the former. What is consistent is the higher expected returns in private equity and venture capital versus the other sub-asset classes.

Figure 11. Fund Managers' Current Return Expectations

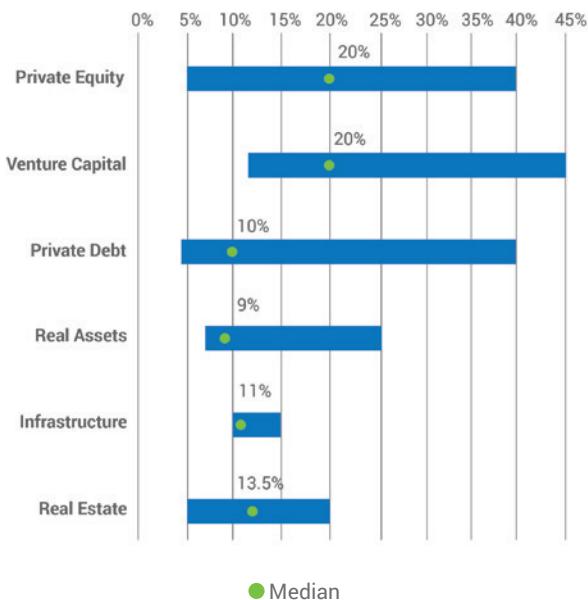
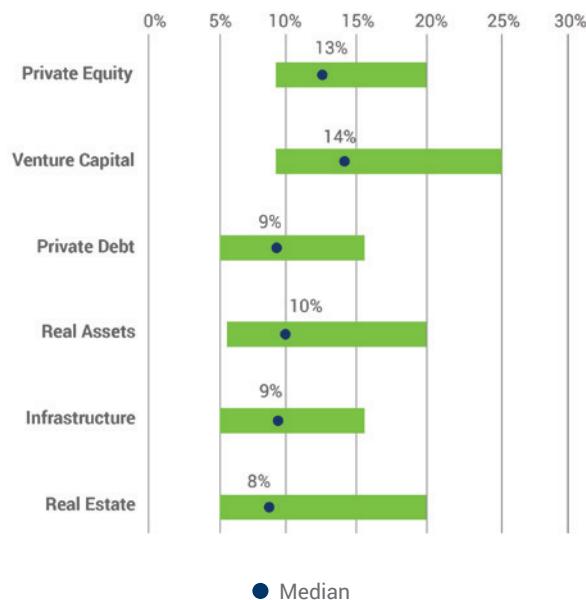


Figure 12. Investors' Current Return Expectations

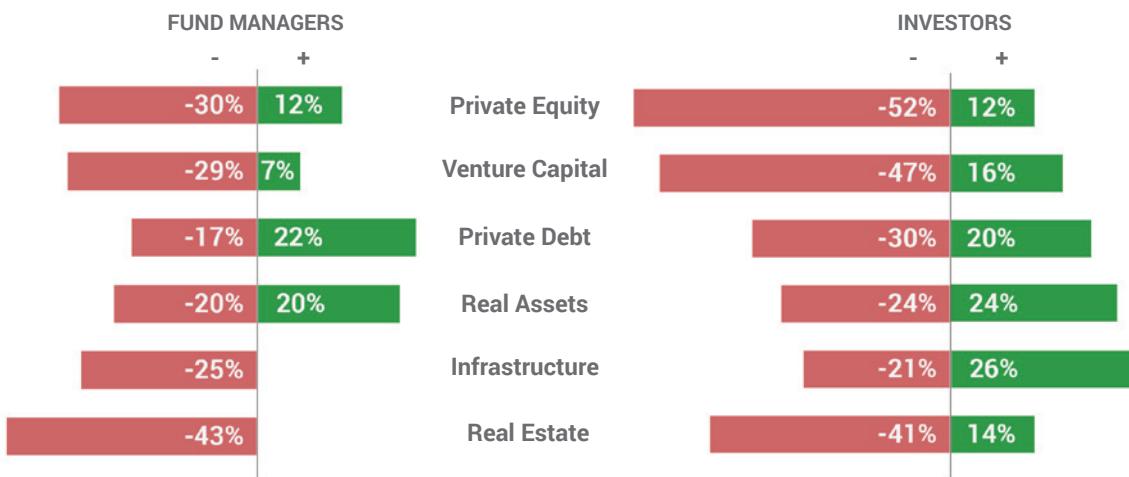


With their expectations as a base, respondents were then asked to indicate whether they expected future performance to increase, decrease or stay the same (*Figure 13*).

In general, respondents expected most strategies' performance to decline. Specifically of note is that over half of investors and 30% of fund

managers expect private equity returns to decline. Expectations for private debt were more mixed, while investors were on balance viewing both real assets and infrastructure positively. The view on expected performance of real estate was consistent across fund managers and investors with over 40% of each predicting a decline in future performance.

Figure 13. Future Return Expectations





FUNDRAISING AND LP/GP RELATIONS

Investors and Fund Managers Misaligned on Plans

For both investors and fund managers, building and retaining long-term relationships has long been a key component of success in their respective fund investing and capital raising activities. However, our survey found that plans for building and growing these relationships may not be completely aligned between the respondent groups.

Fund managers seek to diversify investor bases

Eighty-six percent of fund managers surveyed reported that at least 50% of their previous fundraise was made up by existing investors (Figure 14).

This finding is perhaps unsurprising given the proportion of over-subscribed funds announced in recent years as investors re-up to their

top performing managers, redeploy record distributions and attempt to maintain allocation targets by negating the denominator effect of rising public markets.

However, even with robust investor bases a significant proportion of fund managers understand the importance of diversifying: three-quarters of fund managers are actively looking to increase the number of investor relationships they currently have in their next fundraise (Figure 15).

Yet this may be no easy feat to achieve, as our investor respondents' allocation plans did not completely align with fund managers' capital raising intentions: three-quarters of investors indicated they were looking to maintain or decrease their number of GP relationships (Figure 16).

Figure 14. "What proportion of your last fundraise was made up by existing investors?" (Fund Manager Respondents)

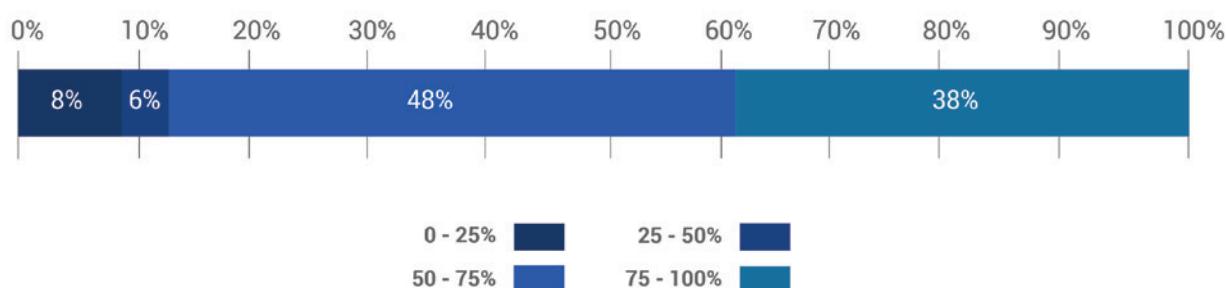


Figure 15. Fund Manager Fundraising Plans



Figure 16. Investor & Consultant Commitment Plans



Nearly 3 out of 4 Fund Managers plan to increase their investor base while only 1 out of 4 investors plan to increase their fund manager relationships.

While one could look at the data and see a challenge, others may see an opportunity: one in four investors are looking to increase their number of manager relationships.

This highlights that the ability to grow investor rosters does exist for fund managers, but only for those that know how to identify this one in four and establish strong relationships early.

The need for building relationships with investors early is reinforced by findings on how far out investors begin to track a fund manager with a view to making a new commitment: the majority, 57%, said it was one to two years (*Figure 17*).

Approaches to Intermediaries and Advisors

The level of oversight and involvement by third parties can greatly affect how investors allocate and make investment decisions, and was an area our survey explored. Over half of investors, 54%, stated they did not use consultants at all, while only 36% stated they used consultants in their due diligence (*Figure 18*). Furthermore, only 4% stated they use a consultant for 'Full Outsourced Manager Selection and Due Diligence.' This suggests that even those investors that do have a consultant relationship in place still take ownership of evaluating and inputting into final investment decisions.

Figure 17. "We manage our forward calendar of fund manager commitments..."
(Investor and Consultant Respondents)

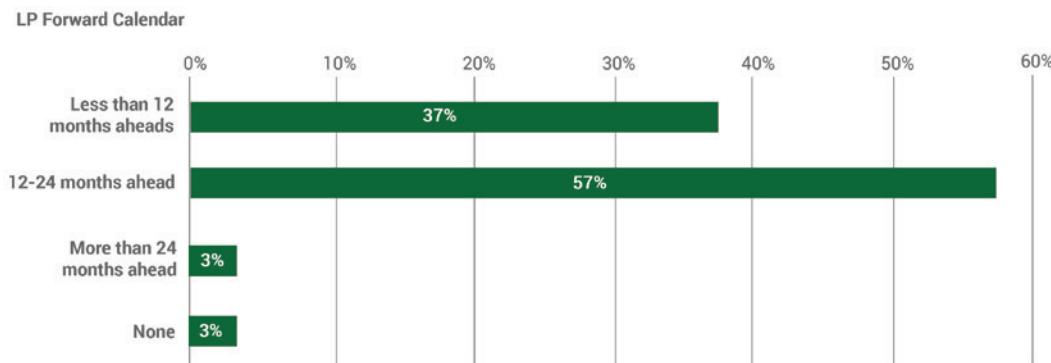
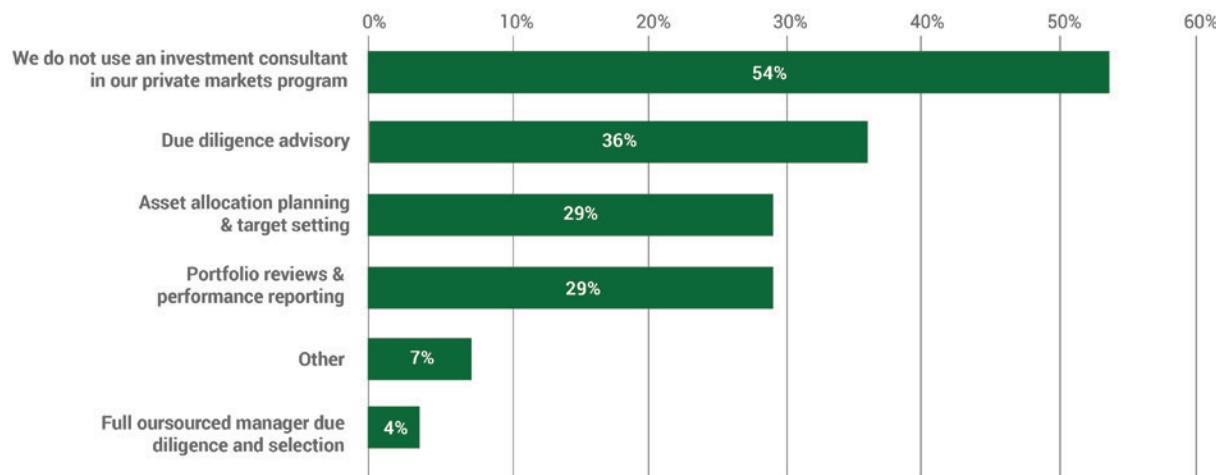


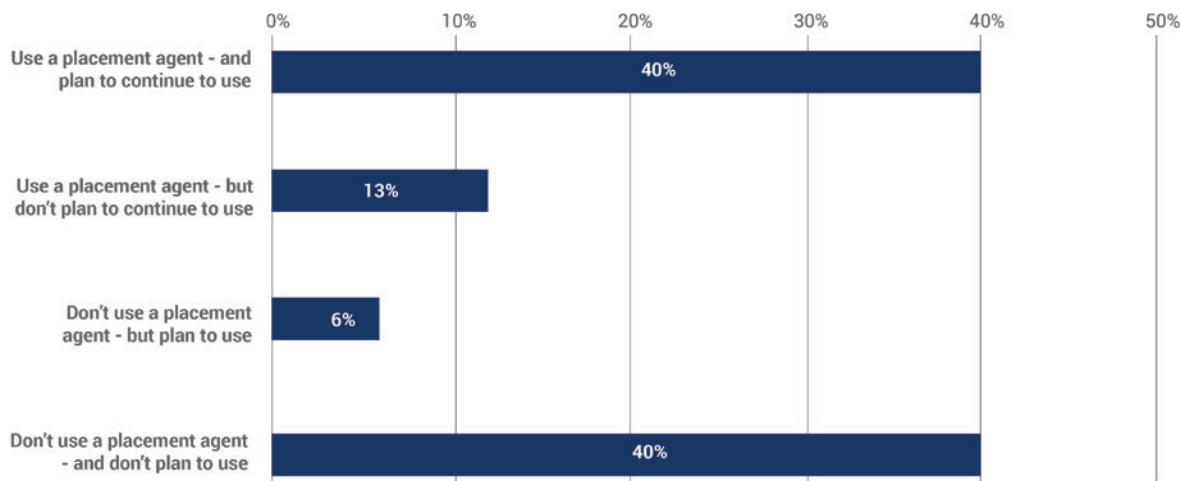
Figure 18. "Which areas of your private markets program does your institution use an investment consultant in?" (Investor and Consultant Respondents)



When it comes to outsourcing and utilizing advisors in their fundraising, fund manager respondents were broadly split about their use of placement agents: 46% indicated their intention to use a placement agent in their next fundraise, and 53% indicated their intention to not use a

placement agent (*Figure 19*). The correlating factor, however, was that fund managers are mostly content with their current approach: just 19% of managers were planning to amend how they use advisors in their next raise.

Figure 19. "Which option best describes your relationship with placement agents?" (Fund Manager Respondents)





KEY FACTORS IN DUE DILIGENCE

What's Important In: Quantitative Due Diligence

In the 2018 edition of this survey we found three-quarters of investors recalculate manager performance more often than not. As explained by the 2018 respondent group, this is done during their due diligence processes to "trust but verify," ensure all analysis is being done a truly like-for-like basis and to gain deeper insights into the drivers of fund performance.

This year's survey explored this topic further. Investors and fund managers were queried about the analysis they place the most importance on during their respective quantitative due diligence and portfolio analysis processes. In general, the findings highlighted that managers underestimate the level of importance of the analysis that investors perform.

Loss Ratios

One stark contrast identified in the findings was on the level of importance of Loss Ratios. This

was ranked second by investors, yet only fourth most important by fund managers.

Over two-thirds of investors, 68%, indicated Loss Ratios as very important in the due diligence process versus just 32% of fund managers (*Figure 20*). In fact, a full third of fund managers ascribed no importance to Loss Ratios.

Public Market Equivalent Analysis

Another striking contrast was in relation to Public Market Equivalent (PME) analysis. The survey findings show that this benchmarking practice remains an important tool in investors' due diligence process, with 43% suggesting it was very important (*Figure 21*). Yet fund managers do not share the same opinion, as just 15% of fund managers ascribed PME the same level of importance.

Figure 20. "How do you rate the importance of...Loss Ratios"

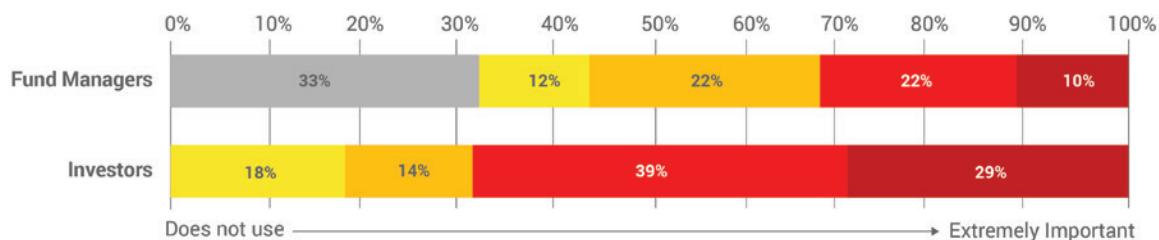
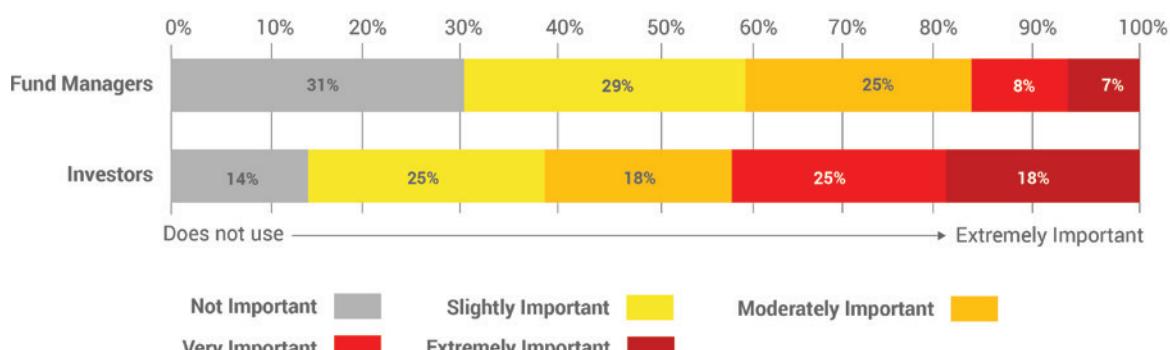


Figure 21. "How do you rate the importance of...Public Market Equivalent Analysis"



Previous editions of this survey have shown that investors can be very sophisticated in their use of PME analysis, leveraging different blends of indices and methodologies. In fact our 2018 report highlighted 46% of investors and consultants were using more than one index, and a significant proportion using more than one methodology, in their PME analysis. As such, managers would be well prepared to have the flexibility to quickly and precisely benchmark against a variety of indices to be able to have better informed discussions on their funds' performance.

Horizon Returns

A new factor to appear in this year's study was the use of Horizon IRRs: calculating performance across one-, three-, five- and 10-year time periods.

As private markets allocations have grown in size in many institutional portfolios, reporting and benchmarking performance against other asset classes has become a key requirement, and is represented using these horizon-based return periods.

Perhaps given this trend, a quarter of investors indicated Horizon IRRs were very important as opposed to 42% of fund managers who placed no importance on their use (*Figure 22*).

Again, while managers may have no need to calculate Horizon-based IRRs for their own reporting, having the ability to display and understand their performance in this way can only help in pitching and conversing with their investors.

Figure 22. "How do you rate the importance of...Horizon Returns"

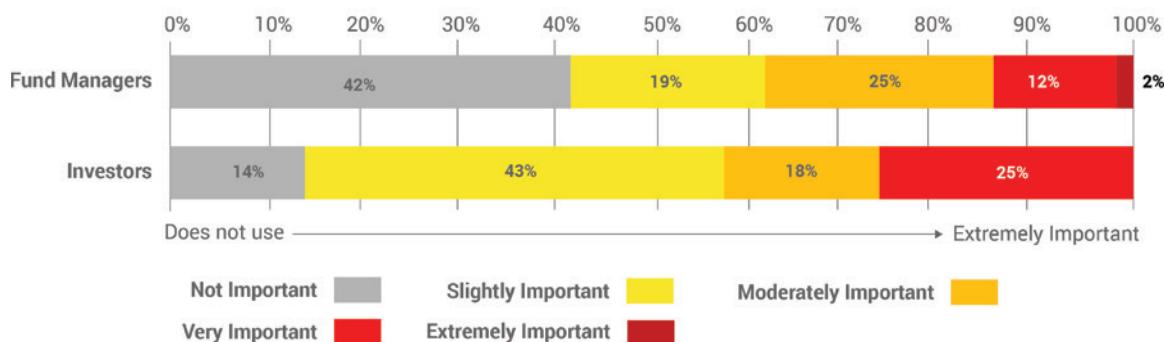


Figure 23. "In your own performance analysis, how do you rate the importance of the following?" (Fund Manager Respondents)

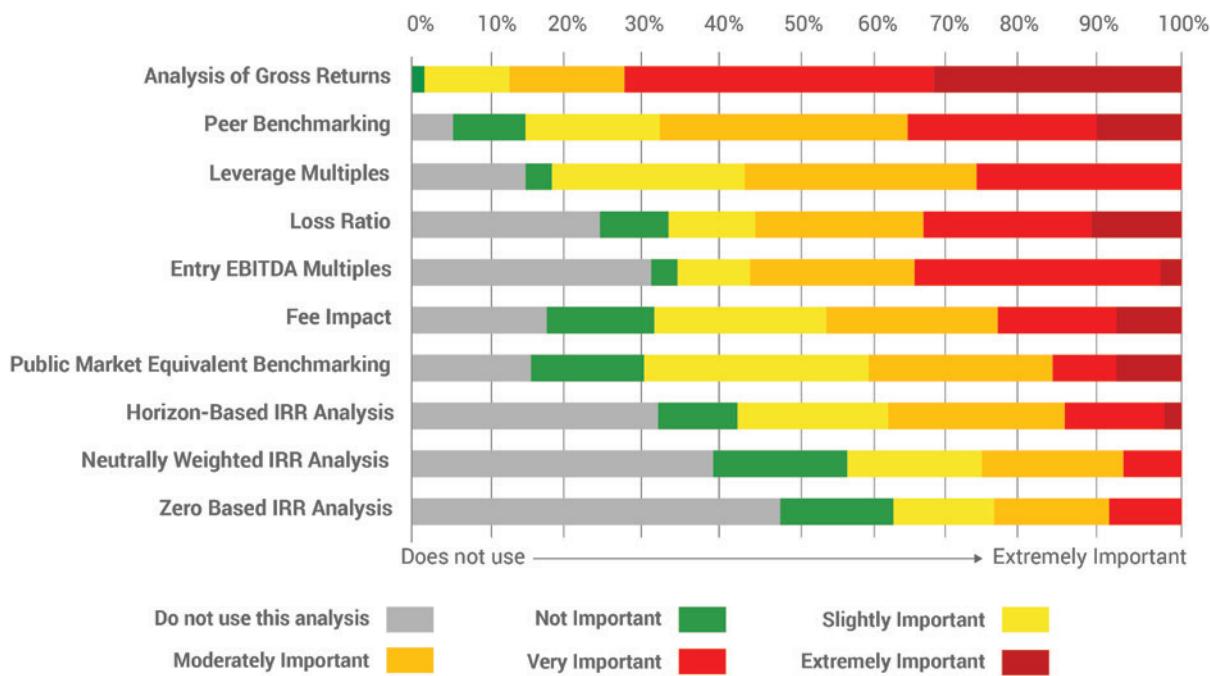
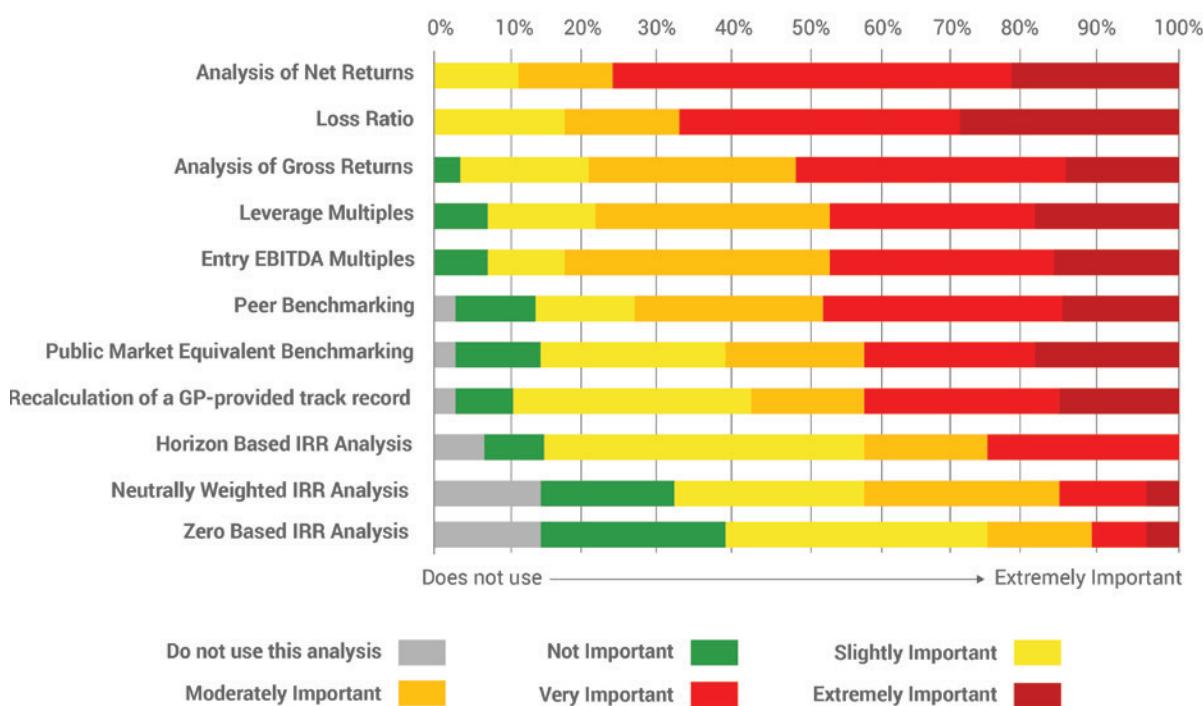


Figure 24. "In your quantitative due diligence, how do you rate the importance of the following?" (Investor and Consultant Respondents)



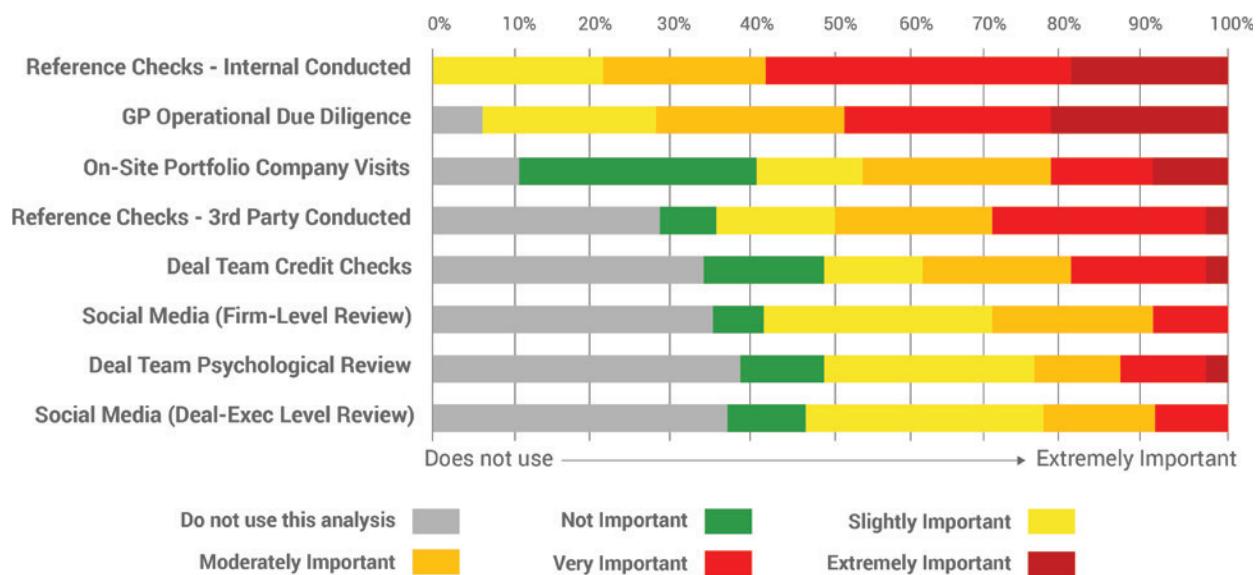
What's Important In: Qualitative Due Diligence

In addition to questioning on quantitative due diligence factors, investors were also asked about how much importance they place on a variety of their qualitative due diligence practices.

The most important aspect of qualitative due diligence to investors was reference checks, with 57% of respondents indicating it to be very important (Figure 25). Furthermore, 29% also attributed similar levels of importance on the use of third-party reference checking.

Interestingly, while a third of investors placed no importance on social media reviews, some do factor this into their due diligence process. As firms become more digitally savvy, transparent, and the industry moves through generational shifts, this could well be a factor that increases in importance in the years ahead.

Figure 25. "In your qualitative due diligence, how do you rate the importance of the following?" (Investor and Consultant Respondents)





ESG AND DIVERSITY

How Institutionalized Are ESG & Diversity Policies?

Environmental, Social and Governance (ESG) Investing and Diversity are two topics that have risen in prevalence within asset management in recent years. Our survey explored to what extent private markets firms are deploying formal policies and actions, and how investors' commitment decisions are influenced by these.

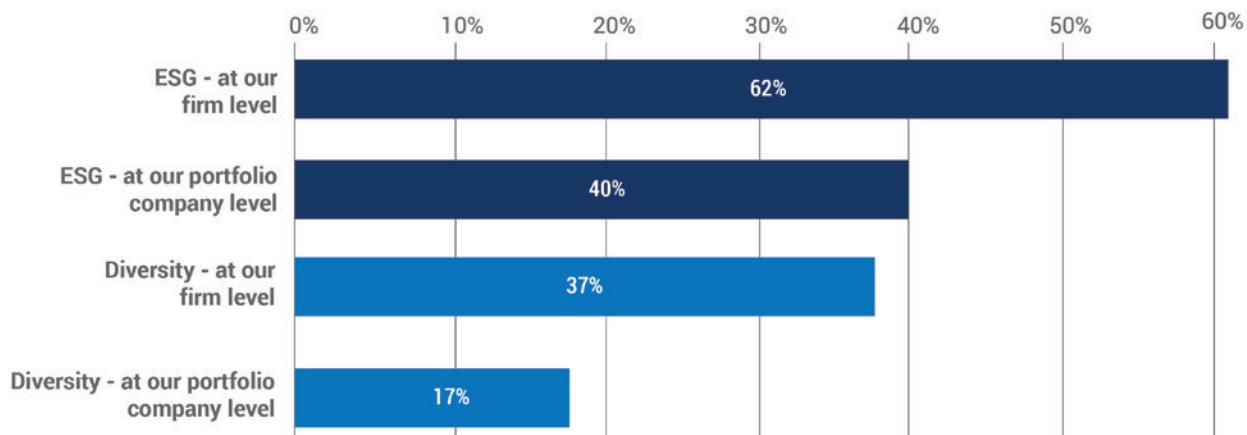
Fund Manager Policy Implementation Outstrips Investor Commitment Impact

For ESG, 62% of fund managers have a formal policy at the firm level and 40% at the portfolio

deal level (*Figure 26*). While the numbers for Diversity policies are lower, they exhibit a similar pattern: more have implemented or enforced these policies at their own firms than their portfolio companies.

While room for improvement exists within fund manager adoption of policies, the results outweighed the relative importance investors reported placing on these factors during their due diligence process.

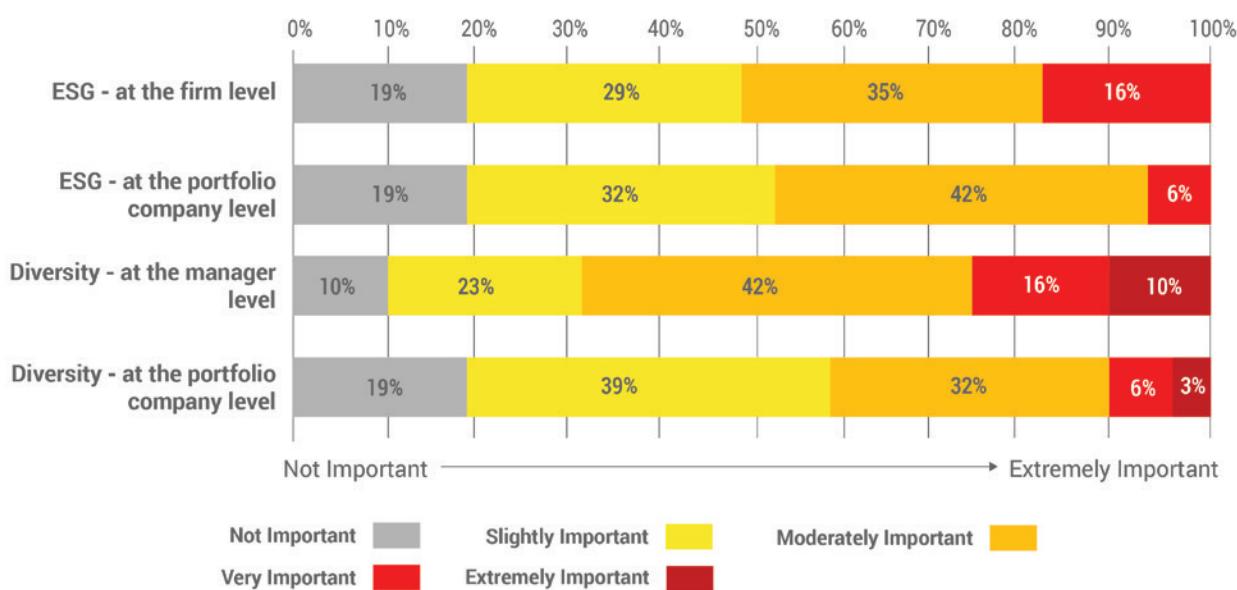
*Figure 26. "Which of the following do you have a formal policy for?"
(Fund Manager Respondents)*



In relation to ESG policies, just 16% of investors felt a formal ESG policy at the manager level to be very important. Even fewer, 6%, felt similarly at the portfolio company level (*Figure 27*). In fact, nearly one in five investors reported they give no consideration to ESG policies during due diligence.

While investors were less vocal on the importance of ESG, Diversity did rank higher on investors' list of priorities. Twenty-six percent of investors felt Diversity at the firm level to be very important (*Figure 27*), more so than for ESG. One respondent suggested the reason was that a fund manager should reflect society to ensure they "pursue a good cross section of potential opportunities."

Figure 27. "How important are the following factors to you when evaluating a private markets manager?" (Investor and Consultant Respondents)



ABOUT EVESTMENT

eVestment, a Nasdaq company, provides institutional investment data, analytics and market intelligence covering public and private markets. Asset managers and general partners reach the institutional marketplace through our platform, while institutional investors and consultants rely on eVestment for manager due diligence, selection and monitoring. eVestment brings transparency and efficiency to the global institutional market, equipping managers, investors and consultants to make data-driven decisions, deploy their resources more productively and ultimately realize better outcomes.

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