FEG INSIGHT

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WHAT IS YOUR PRIVATE EQUITY RISK APPETITE?

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As we approach the end of the year, the avalanche of holiday cards from family and friends both near and far descends upon many of us. The holiday card has transitioned from a simple greeting of well wishes in the new year to a collage of all that was accomplished and experienced—however big or small—over the last 12 months. Beyond the pictures of children losing teeth and pets with holiday outfits, are the snapshots and recaps of vacations and trips experienced throughout the year.

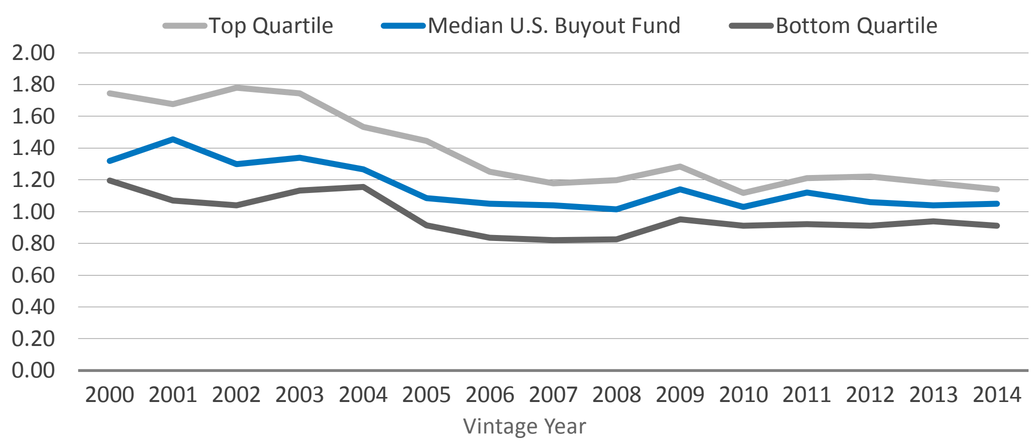
The choices one makes about where to go and how to spend your time away from your professional life can be quite revealing about your sense of adventure and personal risk appetite. As I look through the holiday cards, I see many beach vacations where days are spent soaking up the sun and listening to the tide roll in and the biggest risk is a sunburn. I also see newlyweds backpacking through Europe in search of the authentic experience of another culture. At the far end of the spectrum, I see friends who are zip lining through rain forests in exotic locations, squarely in the red zone of the Zika virus heat map. One must wonder how much their respective investment portfolios mirror their vacation risk appetite.

WHAT IS YOUR PRIVATE EQUITY RISK APPETITE?

Private equity is at the high end of the risk/reward spectrum. There is an opportunity for higher returns for those investors willing and able to withstand the risks of private equity. Investors seeking unique, high potential return strategies for their portfolios have been increasing allocations to private equity funds over the last decade. This trend has gained momentum despite the greater risk, higher fees, illiquidity, and blind pool risk associated with private equity funds. Many investors have accepted these risks in search of return, understanding that in order to gain access to the large and unique opportunity set of private companies, taking additional risks is required.

Industry data indicate that private equity funds have produced premium returns compared to the public market. Steven Kaplan, Professor of Entrepreneurship and Finance at the University of Chicago and co-creator of the Kaplan-Schoar public market equivalent (PME) benchmarking approach, found that the median U.S. buyout fund outperformed the public market from 2000-2014. For venture capital funds, returns have been less consistent and manager selection more critical.

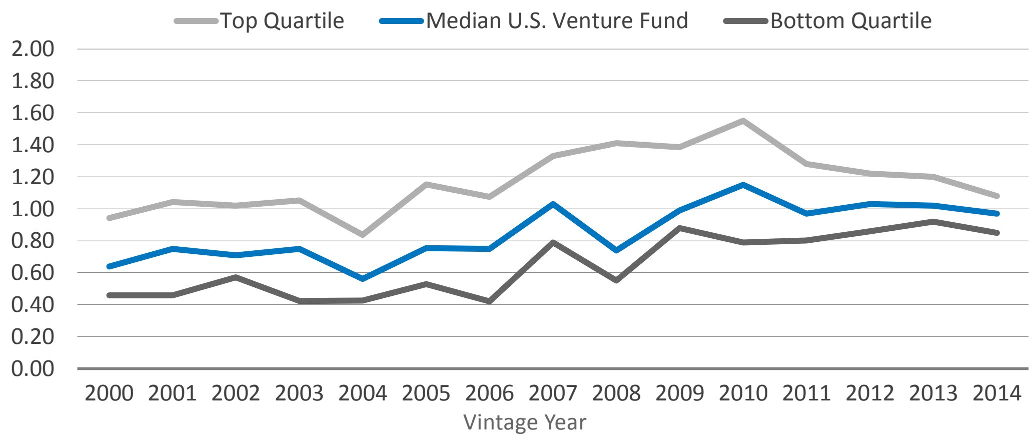
U.S. BUYOUT FUND PME PERFORMANCE
As of December 31, 2016



Data source: Steven Kaplan, "Private Equity and Venture Capital: Past, Present and Future."

Over the same period, the median U.S. venture capital fund produced premium returns to the public market in four of the 15 years, while the top quartile venture fund produced premium returns in 13 of the 15 years. The inefficiencies of the private market, the broader opportunity set, and the potential for post-investment improvements are what give those skillful private equity fund managers the opportunity for premium returns.

U.S. VENTURE FUND PME PERFORMANCE
As of December 31, 2016



Data source: Steven Kaplan, "Private Equity and Venture Capital: Past, Present and Future."

Private equity opportunities are not only found in the U.S. There exists potential for investors to find premium return opportunities across the globe. Much like the choices one faces when choosing a vacation destination, investors can allocate to the U.S. or to more high risk and exotic locations. Europe and Asia are the two primary private equity regions outside of the U.S. Private equity funds exist elsewhere, but the industry remains nascent and relatively unproven in Latin America, Africa, and most of the Middle East.

The economies, political structures, and private equity opportunities vary widely among and within each of these regions, further supporting the need for thorough analysis and due diligence. Our conclusion is that attractive return opportunities exist, though manager selectivity is of even greater importance when investing in private equity funds outside of the U.S., as the median performance of U.S. funds has exceeded non-U.S. funds in recent years.

EUROPE

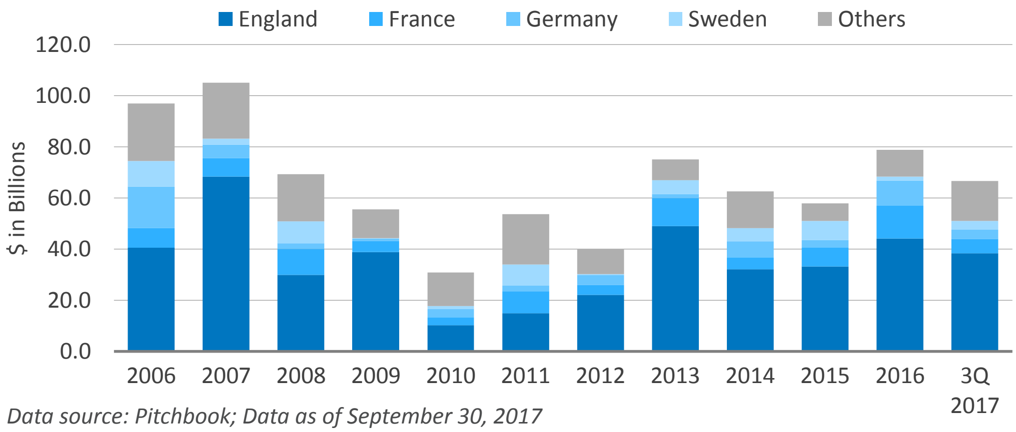
The European Union consists of 28 countries, including the United Kingdom—until the country fully leaves the EU effective March 2019. At present, the EU private equity market is dominated by the UK, with France and Germany playing meaningful, albeit smaller roles. The opportunity set within Europe varies, but primarily consists of family-owned or founder-owned businesses, with some turnaround and restructuring plays and some pockets of technology innovation.

The industry sectors also tend to vary with the geographic area. For example, Germany, Austria, and Switzerland tend to consist of precision manufacturing and engineering services companies. The UK includes business services and consumer companies.

Lastly, the Nordics include technology-enabled businesses, which is not surprising considering that they are home to both Nokia and Ericsson, as well as several energy-related companies.

Private equity has experienced robust fundraising and investment activity in recent years, both in the U.S. and Europe. This year is on pace to be the biggest fundraising year for European private equity funds since 2007.

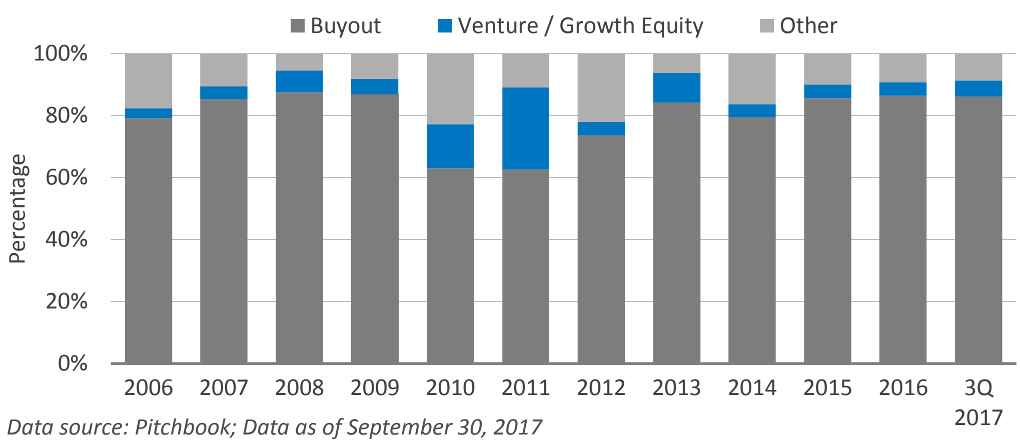
EUROPE PRIVATE EQUITY FUNDRAISING VOLUMES
As of September 30, 2017



Data source: Pitchbook; Data as of September 30, 2017

Limited partners have continued to allocate increasing amounts of capital across Europe. One of the areas where the markets differ, however, is in the focus of the funds. The European market largely consists of buyout funds where over 85% of the capital is raised, while relatively little is committed to venture capital and growth equity funds.

EUROPE PRIVATE EQUITY FUNDRAISING STRATEGY
As of September 30, 2017

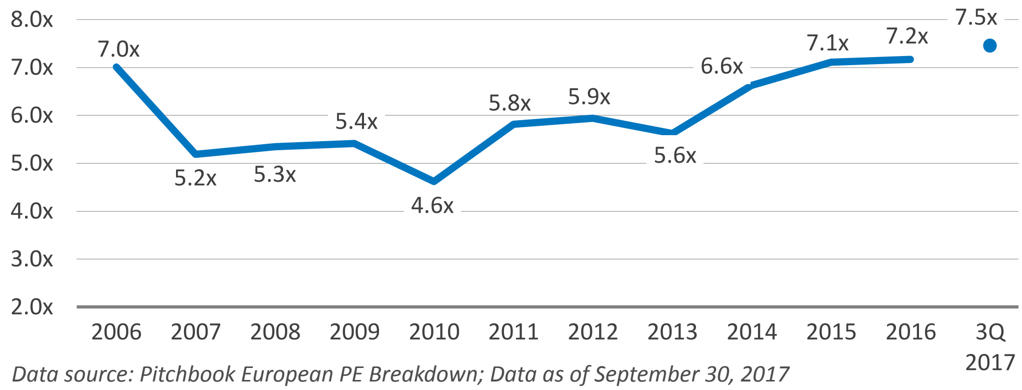


Data source: Pitchbook; Data as of September 30, 2017

The immediate repercussion of capital inflows is the rising purchase price multiples of potential portfolio companies. The median enterprise value for European merger and acquisitions has increased from a low of 4.6x EBITDA in 2010, to 7.5x EBITDA in 2017. The values in each of the last 3 years exceed those seen at the previous peak prior to the global financial crisis.

The differences in companies and varying political and economic climates throughout the European regions are also reflected in the dispersion of purchase price multiples across Europe. The UK market experienced purchase price multiples in excess of 10x EBITDA each year beginning in 2014 (source: Pitchbook). The variety of opportunity, price multiples, politics, and economic conditions provide reason to view the European PE opportunity not as one homogenous market, but a conglomeration of markets, each with their unique set of opportunities and risks.

MEDIAN EUROPEAN ENTERPRISE VALUE/EBITDA

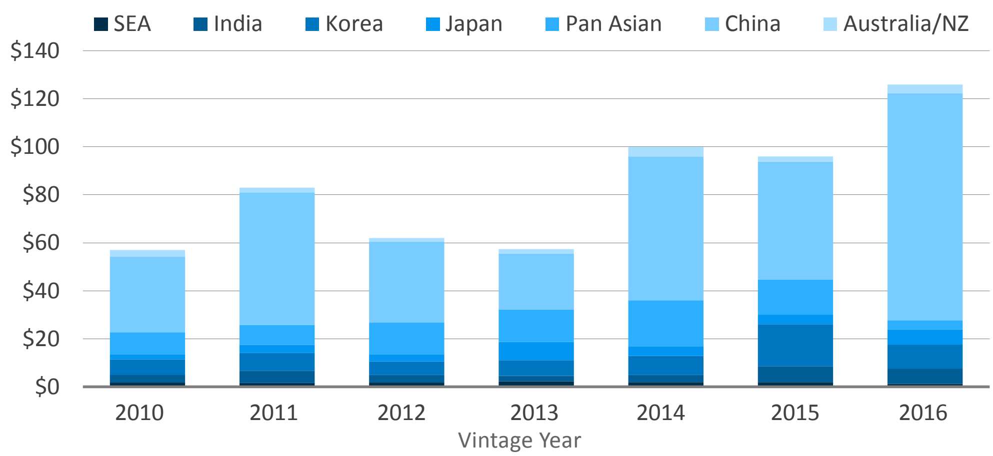


Data source: Pitchbook European PE Breakdown; Data as of September 30, 2017

ASIA

As opposed to the environment found in Europe, the story in Asia is one of high growth and an emerging middle class. Not surprisingly, China dominates the Asian private equity market, whether measured in terms of capital raised, capital invested, or simply the breadth of the opportunity set. China has accounted for approximately 60% of the private capital raised in Asia since 2010. While Asia includes 4.5 billion people across 48 countries, Greater China drives the Asian private equity market, although Japan, India, and Korea also play active roles.

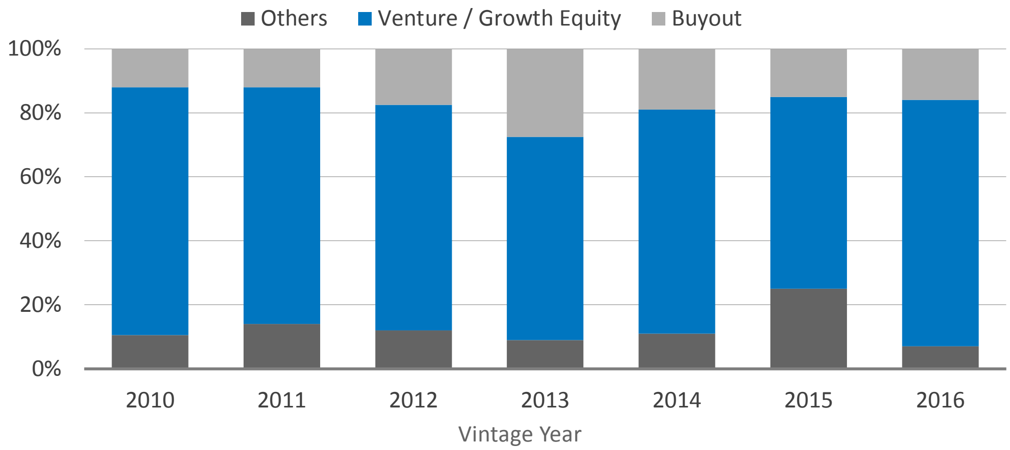
ASIA PRIVATE EQUITY FUNDRAISING VOLUMES ($ IN BILLIONS)



Data source: Pitchbook; Data as of September 30, 2017

The private equity funds in the region tend to reflect the macro theme of high growth and a developing market, as venture capital and growth equity funds account for over 70% of the private equity funds raised in Asia.

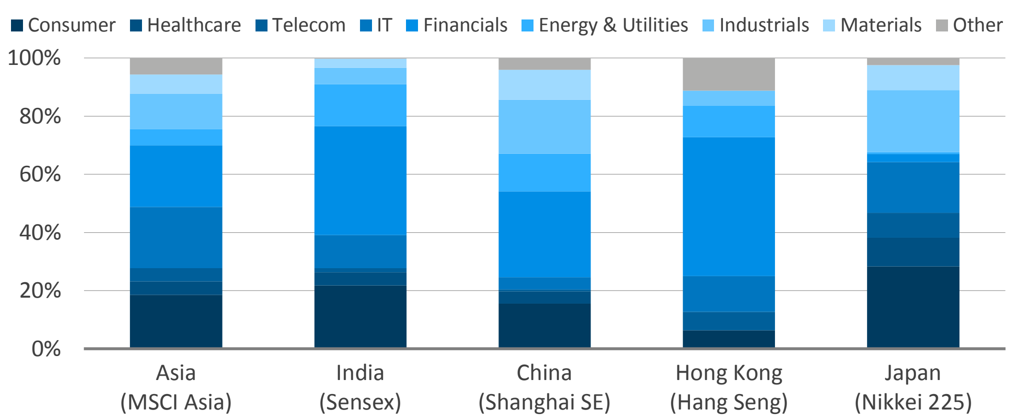
ASIA PRIVATE EQUITY FUNDRAISING STRATEGY



Data source: Pitchbook; Data as of September 30, 2017

Public market investors in Asia—particularly China—have heavy exposure to financials, energy, industrials, and materials-related companies, but this is not the heart of the growing middle-class story in Asia. Sectors such as technology, health care, and consumer are more directly affected by the growing middle class in China. These sectors, however, account for less than 30% of the market capitalization of public companies listed in Hong Kong and China. Although public equity investors face this limitation, private equity investors are uniquely positioned to gain more meaningful access to companies in these growing sectors.

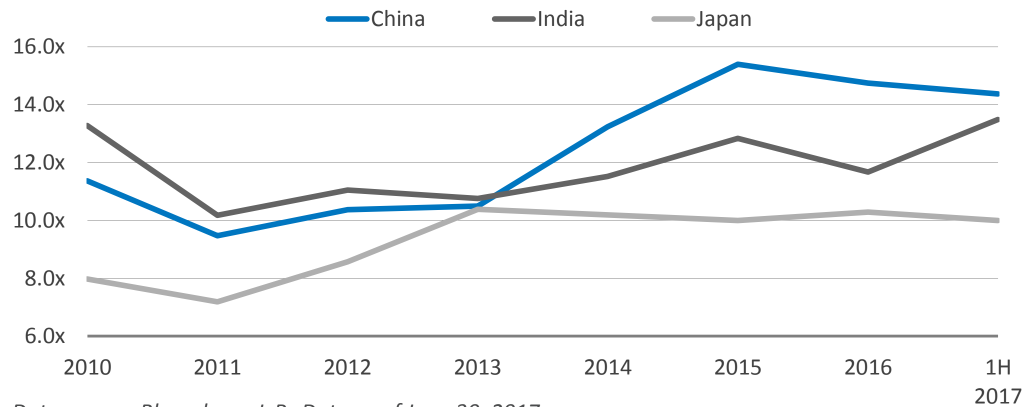
ASIA PUBLIC MARKET SECTOR EXPOSURE



Data source: Bloomberg; Data as of June 30, 2017

Similar to Europe, private company valuations in Asia have grown meaningfully with the inflow of capital to private equity funds, with purchase price multiples reaching double digits and pre-money valuations rising in recent years. These valuations support the need to source skillful managers that can be selective across the many opportunities in this growing region.

MEDIAN ASIAN PRIVATE EQUITY PURCHASE PRICE MULTIPLES (M&A)

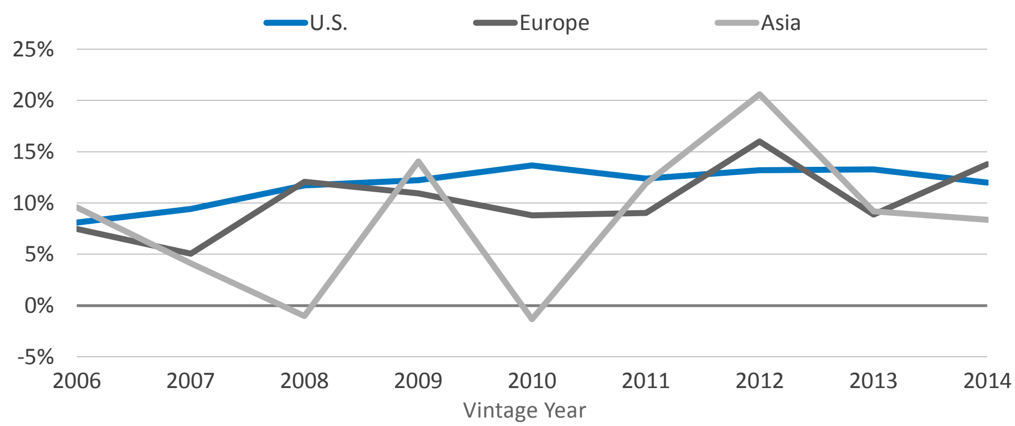


Data source: Bloomberg, L.P.; Data as of June 30, 2017

PERFORMANCE

The conditions of the markets vary across the globe, consequently private equity fund performance should be expected to vary. In the early 2000s, U.S. funds lagged behind funds in Europe and Asia. More recently, the median U.S. fund generally outperformed European and Asian peers for vintage years 2006-2013. It is worth noting that U.S. funds benefitted from one of the longest bull markets in history, as the U.S. led the global recovery from the financial crisis.

MEDIAN NET INTERNAL RATE OF RETURN (IRR)



Data source: Pitchbook; Data as of September 30, 2017

RISKS

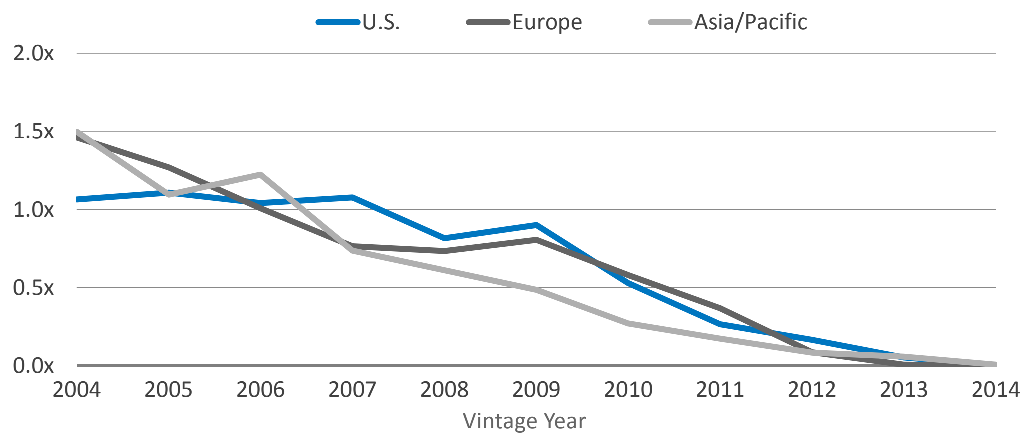
Non-U.S. private equity investing incurs a unique set of risks in contrast to what investors typically experience in the public market. Although currency and political risk are omnipresent when allocating outside of one's home country, private equity investors also need to be mindful of the robustness of a country's private equity markets. This includes the number of privately-held companies, the willingness of a company's management to transact, and the tolerance for private equity fund managers to become involved with the company to build and grow the business.

Markets in the U.S. and the UK are established and robust, and the role of private equity funds is generally understood by family-owned businesses or founder-led companies. In the DACH region (Germany, Austria, Switzerland), there has been less activity because businesses are more likely to remain family-controlled, rather than sold to private equity funds for the sake of liquidity.

Further, each country has unique circumstances with the development of their exit market and capital flows. Investors need to consider how public offerings are viewed and how merger and acquisition activity is viewed as well. In robust exit markets like the U.S., companies have several potential avenues to be sold, such as going public, being acquired by a strategic partner, or purchased by a larger private equity fund.

Comparably, the exit markets in Asia—particularly China—are not as active. While net IRRs of Asian-based funds look relatively attractive, investors have not experienced the same level of realizations and distributions as the U.S.-based funds, and ultimately, securing the returns earned is essential.

MEDIAN DISTRIBUTION TO PAID-IN (DPI)



Data source: Thomson One; Data as of March 31, 2017
Includes Buyout & Growth Equity, Venture Capital

CONCLUSION

The U.S. does not have a monopoly on successful private equity fund managers and there is relatively little to prevent managers in other countries from replicating a successful private equity strategy. Premium return potential resides both inside and outside of the U.S.

FEG's view is that private equity remains an access class, not an asset class. Whether or not an investor includes non-U.S. private equity in their portfolio gets back to the original question of risk appetite and whether it makes sense for the investor's risk/return objectives.

Average private equity performance does not always justify the risks associated with private equity investing. Investors with a risk tolerance for non-U.S. private funds need to consider the unique risks associated with investing outside of the U.S. and set a high bar with respect to manager selection. Meanwhile, FEG will continue to travel the globe in search of strong risk/return opportunities while viewing such opportunities with a critical eye for how to allocate a finite amount of illiquid capital within a portfolio.

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