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Annual Investor Survey 2023

Private equity in the spotlight – how leading investors navigate the slowdown

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Summary

Montana Capital Partners AG (together with its affiliates "mcp") is excited to share the results of its 2023 Annual Investor Survey, which puts the spotlight on how leading institutional investors including banks, asset managers, pension funds, and insurance companies (classified as "institutional investors"), as well as family offices, foundations, and endowments (classified as "family offices and foundations") approach the private equity asset class and the secondaries market in particular.

Geopolitical tensions and macroeconomic uncertainties have increased further over the past year. The private equity market has remained broadly resilient but nevertheless experienced a slowdown in both dealmaking and fundraising activity. At the same time, a 65% decline in exit volume in the first half of 2023 compared to the same period last year has led to an increasing wall of unrealized assets.[1] In combination with increased capital call activity to manage higher interest costs for credit lines, this has impacted the cashflow planning and allocation targets of investors in private equity funds, leading to more challenging fundraising prospects for GPs and increased demand for liquidity solutions in the near-term.

Our report offers insights into the investment strategies and preferences of leading investors in the asset class and aims to provide valuable guidance in a challenging market environment.

KEY FINDINGS

- **Distributions have slowed and the need for liquidity becomes a key reason for considering secondary sales.** Distributions in private equity portfolios have slowed down significantly, with two thirds of respondents having received lower than expected distributions in 2023 and even a third indicating that the impact was significant. While 26% of respondents adopted a "wait and see" approach and, for now, have not revised expectations for 2024, 44% expect lower distributions in their portfolio than initially modelled. Not surprisingly, the need for liquidity jumped to the top of the list of the key reasons to consider secondary sales of private equity commitments.
- **Mid-market buyout and secondaries are investors' favorite strategies.** Proven and defensive strategies are key priorities for investors in the current environment. Mid-market buyout and secondaries, selected by 75% and 66% of investors, remain the top two strategies as investors seek stability, performance, and early liquidity. Often quoted key benefits of the mid-market are the higher potential for operational improvements on the portfolio company level compared to the larger end of the market, as well as less reliance on financial engineering to drive returns.
- **Secondaries allocations are expected to increase, with robust demand for LP-led and multi-asset GP-led transactions.** Current market developments provide an attractive backdrop for secondary dealmaking in the near-term, and 85% of respondents plan to maintain, increase, or for the first time introduce an allocation to secondaries. The most favored transaction types are LP-led transactions in the small and mid-market segment (selected by 37% of respondents) and multi-asset GP-led transactions (a priority for 24% of respondents). This comes as no surprise: small and mid-market LP-led transactions are typically less competitive than transactions at the larger end of the market, and multi-asset GP-leds provide an opportunity to gain exposure to high quality assets while maintaining some level of diversification.
- **The private equity fundraising environment will remain challenging in 2024**. While private equity performance has remained broadly resilient in 2023 with 78% of investors seeing positive or flat performance to date, more investors than last year expect a decrease in their overall private equity allocation in the next twelve months (9% of investors vs. 3% last year). The current slowdown in distributions will lead almost half of respondents to reduce their deployment pace, and 25% to decrease their commitment sizes. Securing allocations from LPs is therefore likely to become increasingly competitive for GPs.

ABOUT MCP

Founded in 2011, Montana Capital Partners AG is an established global private equity secondaries investment manager with a focus on the mid-market. As an adviser to five funds, all of them raised at their respective hard caps, mcp manages total assets of EUR 3.2 billion (USD 3.5bn) for its investors.[2]

mcp pursues a differentiated investment approach centered on proactive sourcing, customization of liquidity solutions for counterparties, mitigation of the risk profile of its transactions, and focus on the secondary mid-market. mcp employs more than 30 professionals[3] and has invested in more than 120 transactions since its inception.[4]

In 2021, mcp joined forces with PGIM, the USD 1.3 trillion AuM[5] global investment management business of Prudential Financial, Inc. (PFI, NYSE: PRU), to strengthen its market positioning and global footprint. The firm benefits from PGIM's global network and expertise, while providing access to a new and differentiated investment opportunity to PGIM's clients. For more information visit www.mcp.eu.

We hope that the mcp Annual Investor Survey 2023 offers you valuable insights to navigate the current market environment. Please do not hesitate to get in touch in case of any questions.

[1] *Bain & Company Private Equity Midyear Report 2023.*
[2] *As of June 30, 2023. Conversion from EUR to USD at 1.0866.*
[3] *As of June 30, 2023.*
[4] *As of June 30, 2023.*
[5] *As of June 30, 2023. Source: PGIM.*

Investor allocations to private equity

Investors continue to show a robust appetite for private equity, as evidenced by the 84% of family offices and 41% of institutional investors which allocate more than 10% of their portfolio to the asset class – a slight increase from 81% and 39%, respectively last year. This represents a significant level of assets under management and can be attributed to both the continued attractiveness of private equity for investors, but also to its outperformance relative to other asset classes.

At the same time, private equity is experiencing a slower growth of allocations to the asset class. In comparison to last year's results, fewer investors have increased their allocations over the past twelve months, and an increasing number expects to decrease their commitments over the next twelve months. This is likely in part a result of the underperformance of other asset classes in their portfolio, which requires many investors to actively address overallocation and liquidity constraints by reducing their commitment sizes and slowing the pace of their deployment (see also figure 22). Considering these headwinds, the appetite for private equity appears very resilient with more than 80% of respondents maintaining or increasing their allocation over the next twelve months.

For instance, a European family office investor commented on their unwavering appetite for the asset class: **"Our private equity allocation is set for the long-term and rooted in the belief that private equity will continue to outperform public markets. We will maintain our target allocation".**

In contrast to that, a large European asset manager adopted a different strategy and stated: **"The denominator effect and the strong performance of our private equity portfolio have led us to being overallocated to the asset class. We therefore plan to reduce our commitment volumes to balance our allocation".**

Figure 1

What is your current allocation to private equity?[6]

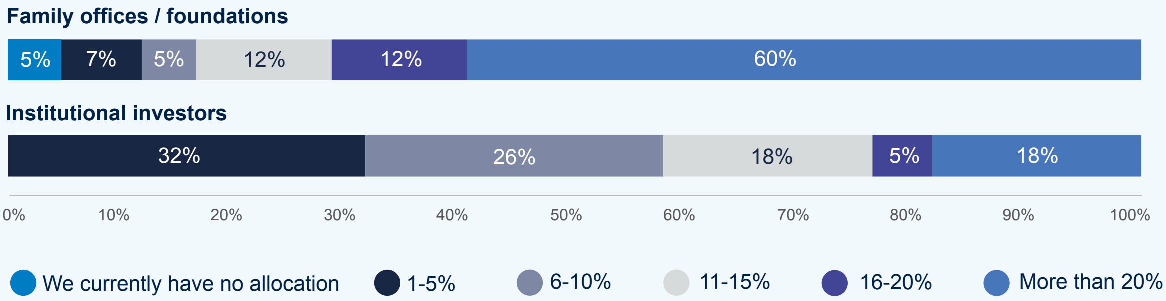


Figure 2

How has your allocation to private equity changed in the last 12 months?

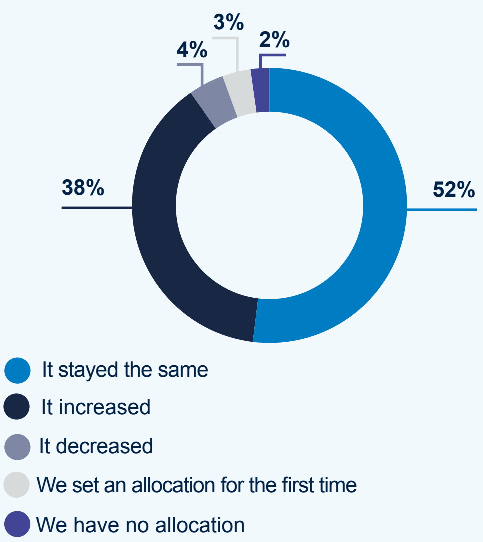
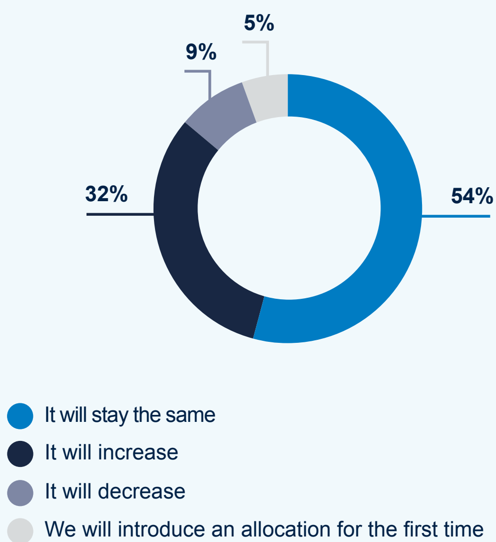


Figure 3

How do you expect it to change in the next 12 months?



[6]Percentages throughout the report may not sum to one hundred due to rounding

Investment preferences

Investors continue to prioritize investment strategies that have historically proven to be resilient in times of economic downturns and high interest rates, such as mid-market buyout, secondaries, and private debt. In contrast, the arguably higher risk strategy venture capital, which ranked 5th place last year and frequently ranked in the top three in prior years, now ranks lower in investors' preferences. The same extends to sector preferences, where investors continue to favor software and technology, healthcare, and business services. These strategic choices seem prudent in the current market environment and align with investors' concerns regarding a potential economic downturn in the coming year (see also figure 7).

On secondaries, a German family office investor commented: **"We see strong tailwinds in the secondary market currently, driven by liquidity needs from institutional investors, and we expect that secondary fund managers will be able to take advantage of attractive dealflow in the near-term"**.

Another investor added: **"On a risk-adjusted basis, secondaries have generated better returns than our primary fund investments".**

An ESG policy remains either important or essential for 66% of respondents when making investment decisions in a fund. For European investors, this figure is more pronounced and increases to 73%, while only half of non-European investors view it as significant in their investment decision-making.

Figure 4

What are your strategic preferences in the current market environment?

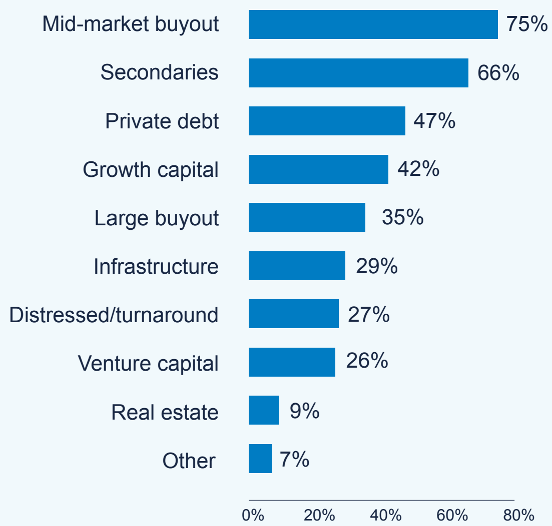


Figure 5

Which sectors currently present the most attractive risk/reward profile?

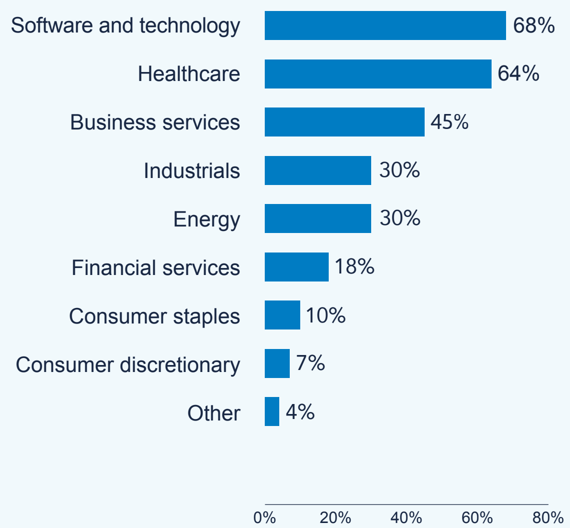
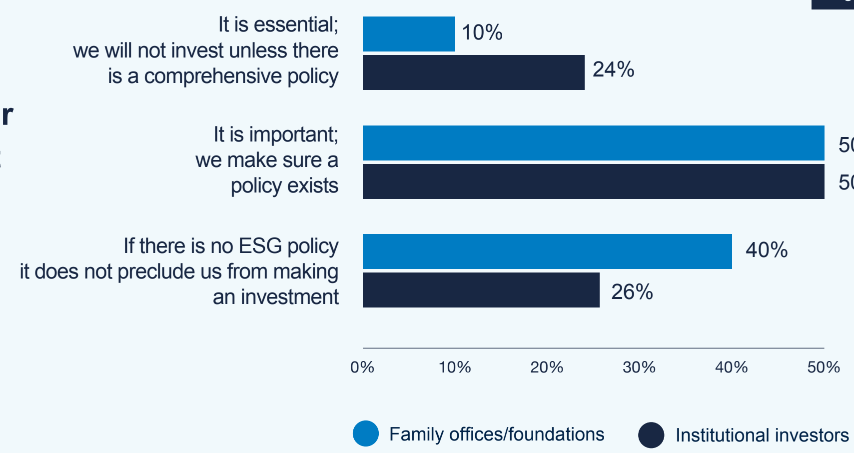


Figure 6

To what extent does a GP's ESG policy impact your decision to invest in a fund?



Market trends and performance

Public markets have rebounded strongly since 2022 and private equity has proven resilient despite a volatile economic backdrop in 2023. Almost three quarters of investors have seen positive or at least stable performance in their private equity portfolio thus far this year. Investor concerns continue to revolve around a potential economic recession and inflated private equity valuations. However, the proportion of respondents expecting a correction in private equity buyout multiples has significantly diminished when compared to the previous year. Currently, just over half of investors anticipate a decline in multiples, in contrast to 89% last year.

An investor from a European private bank expects a flight to quality: **"Valuation multiples will likely correct for weaker companies facing operational challenges, but they are expected to remain resilient for high-performing companies".**

In addition, investors expect that GPs will need to adjust their expectations to the current economic and fundraising environment, for instance by revising down their target fund sizes. Approximately half of the respondents expect fund terms to become more LP-friendly. One investor from a European bank offered a nuanced perspective: **"We hear about a softening of terms in response to the difficult fundraising environment, but we have not experienced it ourselves. The stakes are high, the market has become very competitive, and some GPs will be able to gain market share from others".**

To sustain returns and attract capital, GPs will need to focus on operational improvements, potentially harnessing the power of artificial intelligence (AI). Notably, 29% of respondents have identified value creation at the portfolio company level as the aspect of private equity set to benefit the most from AI. One investor emphasized: **"Generative AI will have a profound impact on business models and the current hype will accelerate advancements in that area. For private equity, AI lends itself best to value creation on the company level and there are already many software solutions that can drive efficiencies".**

Figure 7

What is your main concern regarding market activity for the next 12 months?

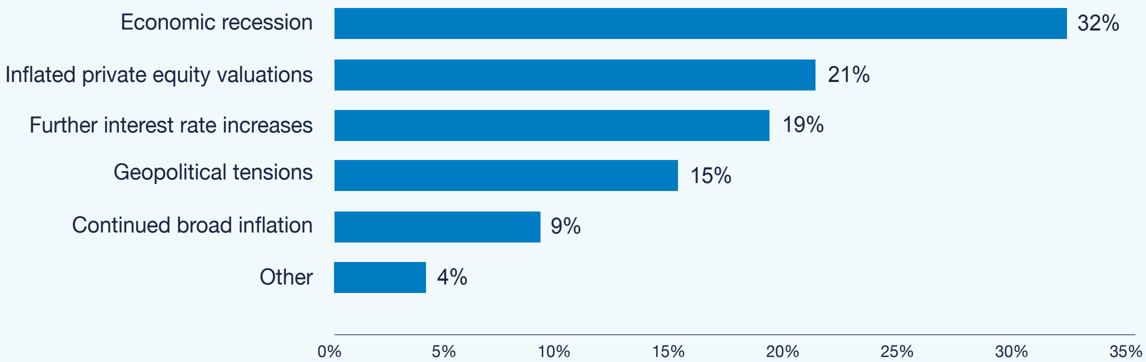


Figure 8

How do you expect average private equity buyout multiples to develop over the next 12 months?

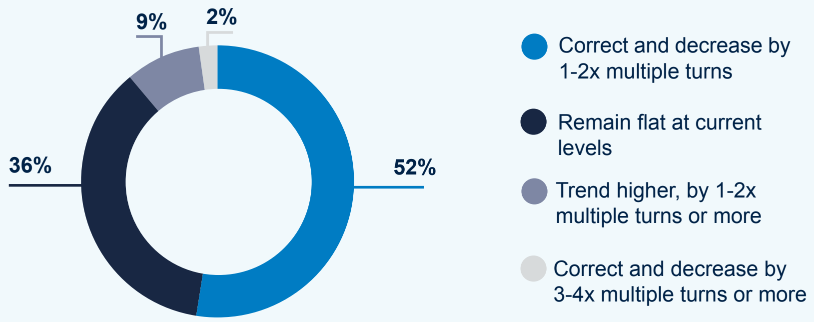


Figure 9

How has your private equity portfolio performed in 2023 to date?

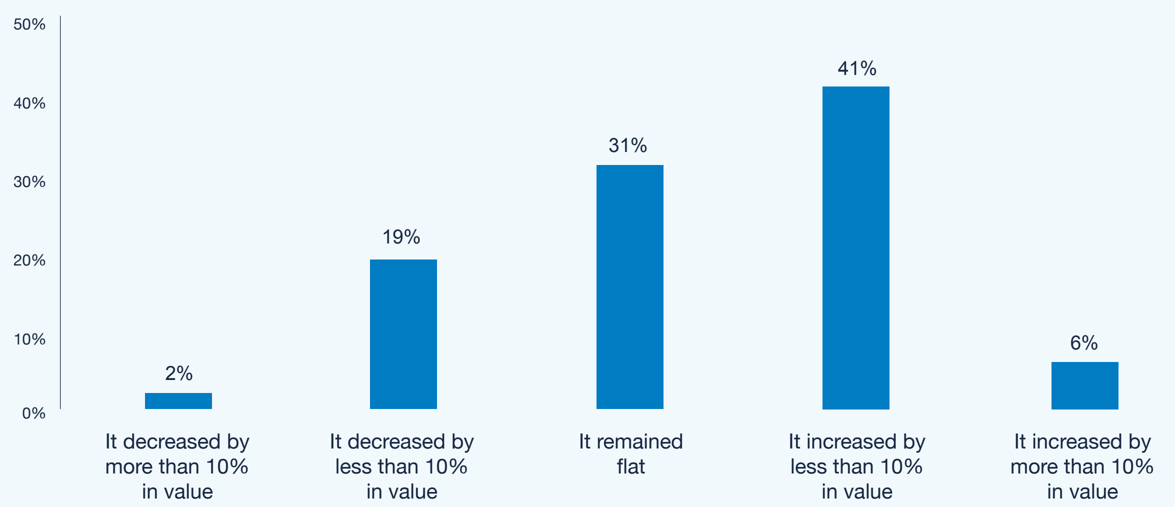


Figure 10

What will be the main consequences of the difficult fundraising environment for private equity GPs?

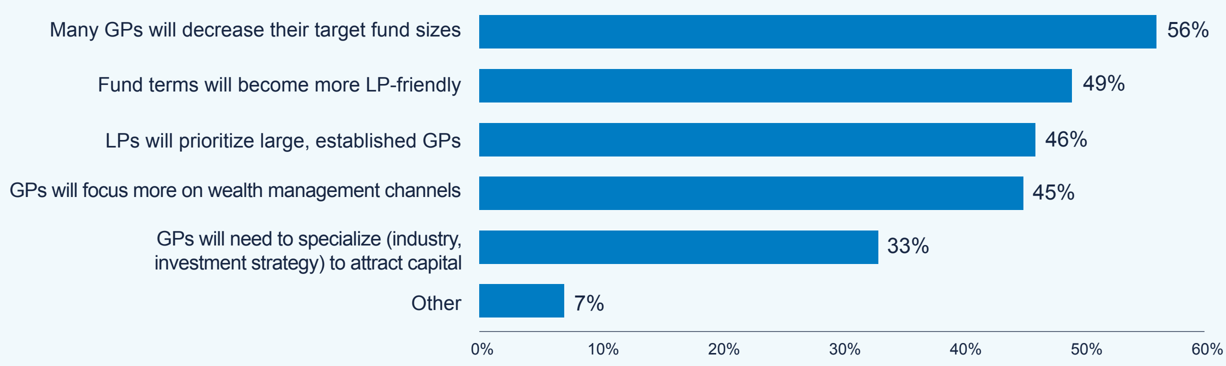
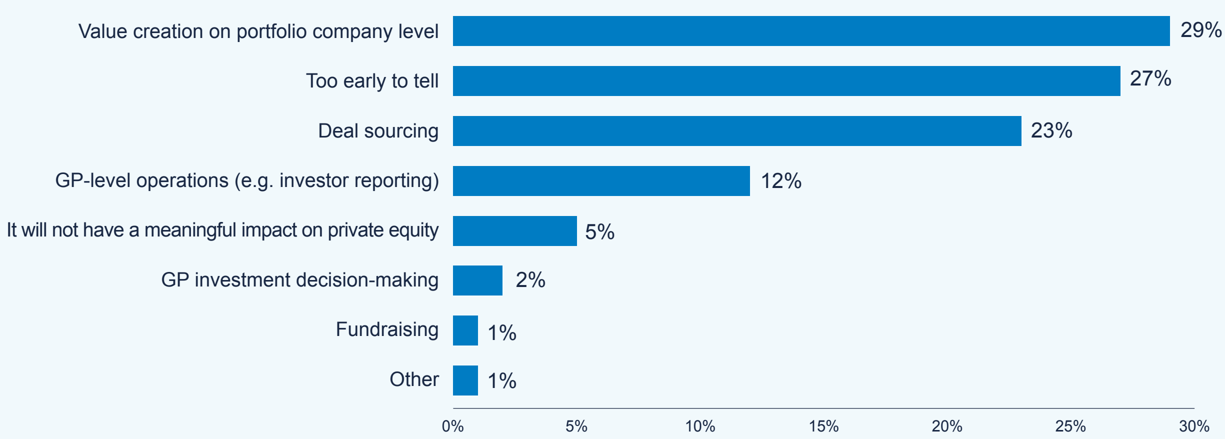


Figure 11

Which aspect of private equity will benefit the most from AI?



Secondaries – investor allocations and preferences

The vast majority of respondents (72%) actively invest in secondary funds, which are typically broadly diversified, with an expectation for early cashflows, and reduced blind pool risk compared to primary strategies. Secondaries become particularly attractive when distributions slow down and the need for liquidity among LPs increases, leading the latter to consider selling positions on the secondary market.

In fact, for the first time in the history of this survey, the need for liquidity, together with strategic repositioning, is the number one reason for respondents to consider selling positions. Considering this, it comes as no surprise that there is a strong interest in secondaries, with an overwhelming 85% of investors planning to either maintain, increase, or introduce an allocation to the strategy over the coming 12 months.

Figure 12

How would you describe your relationship with secondaries?

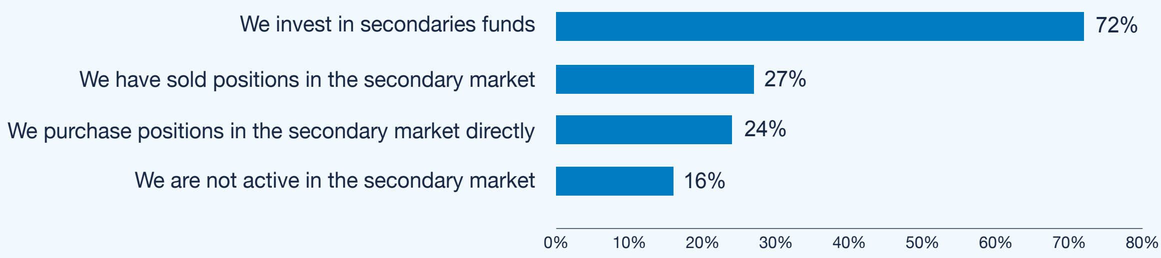


Figure 13

What proportion of your private equity allocation is dedicated to secondaries strategies?[7]

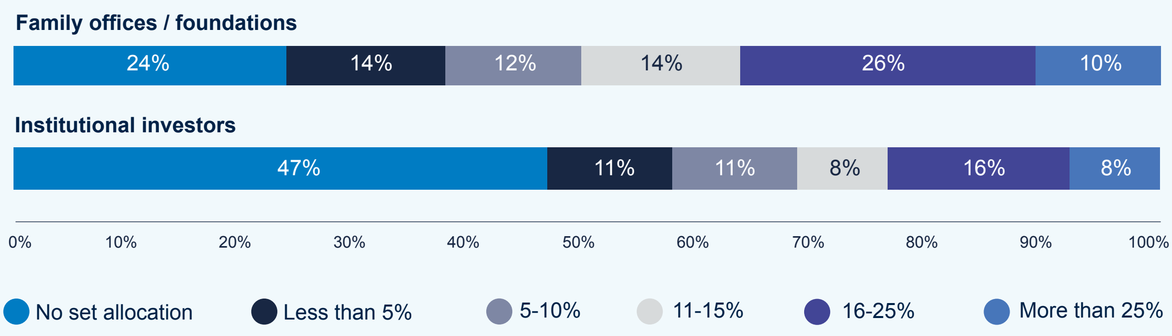
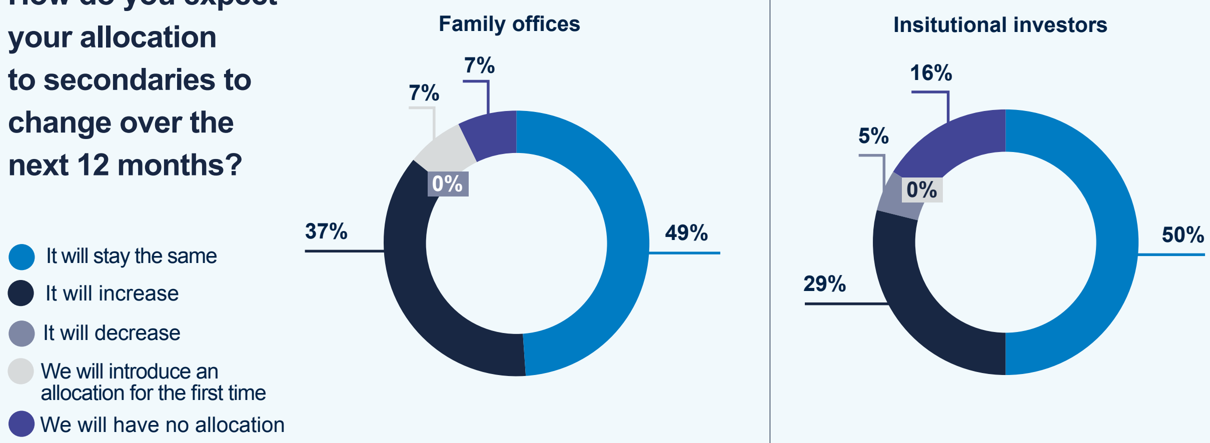


Figure 14

How do you expect your allocation to secondaries to change over the next 12 months?



[7] Commitments to secondaries funds and/or direct secondaries purchases

Within secondaries, small and mid-market LP-led transactions (selected by 37% of investors) as well as multi-asset GP-led transactions (preferred by 24%) stand out as the top priorities for investors in the upcoming year. The often-cited bid-ask spread was less of a concern for respondents in 2023 thus far, as the majority of their pursued secondary sales successfully closed at the expected price. Only 28% of transactions did not close or closed at a lower price than hoped.

An investor from a European private bank emphasized: **"LP-led transactions are the bread and butter for secondary investors and are very attractive in the current environment, especially as distributions slow down. GP-led transactions are generally an attractive addition to enhance absolute returns".**

Figure 15

Do you expect to sell positions on the secondary market in the next 12 months?

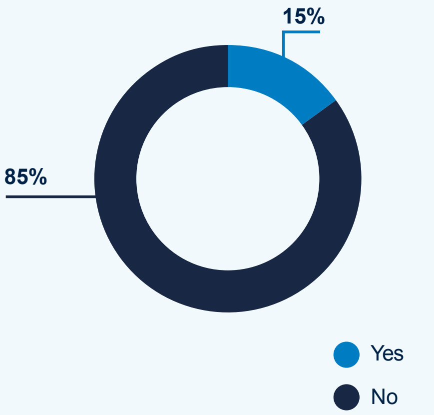


Figure 16

What would be your most likely reason for selling positions on the secondary market in the current market environment?

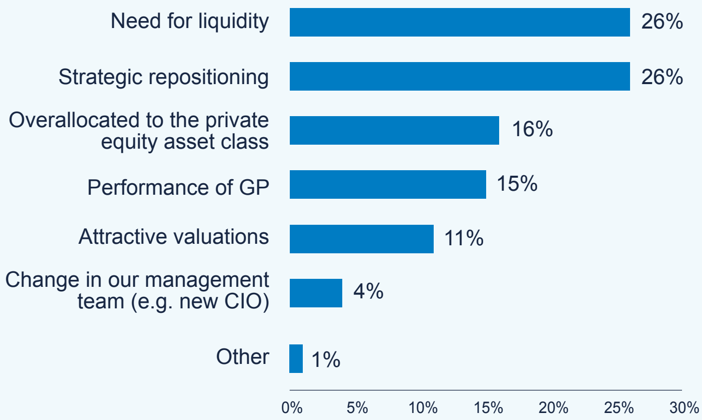


Figure 17

As an allocator of capital to secondaries strategies over the next 12 months, which would you prioritize?

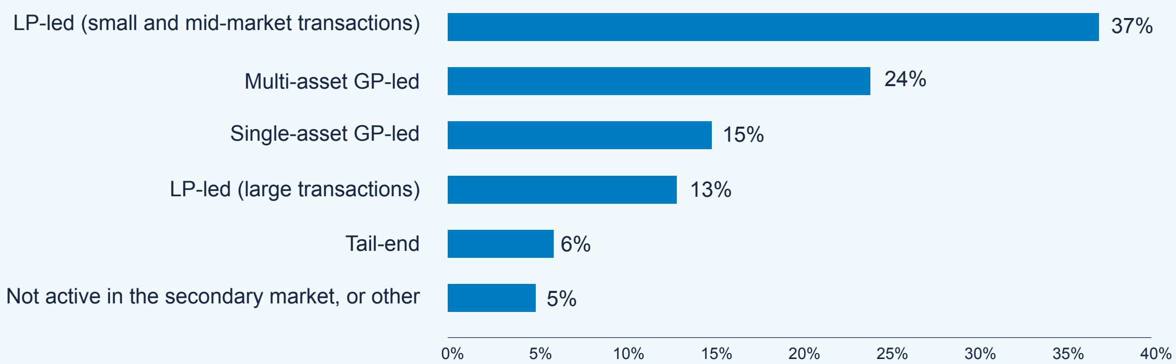
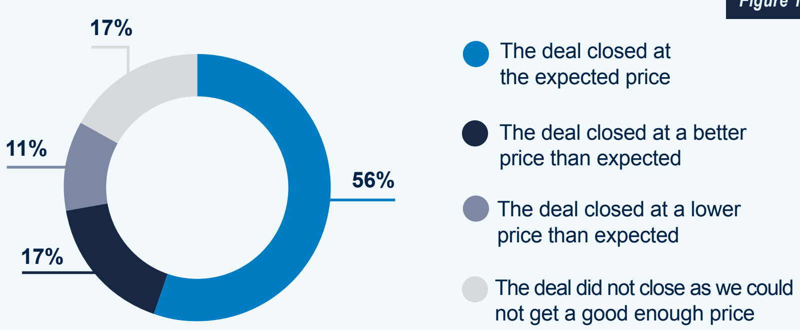


Figure 18

To the extent you tried to sell positions on the secondary market in 2023, what was the outcome?



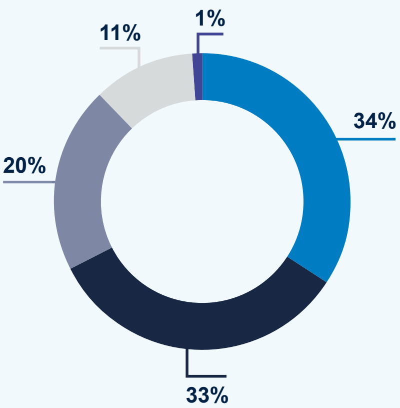
Portfolio management – managing liquidity amidst slowing distributions

Two thirds of respondents had distributions in 2023 that fell below their initial expectations. Despite the consensus on the ongoing slowdown in distributions, investors have differing expectations for cashflow developments in 2024. Almost half of respondents have adjusted their distribution forecasts downwards, while the remaining half have retained their expectations or even anticipate higher distributions in the year ahead. The level of concern regarding the distribution slowdown also varies across investors. While 60% are either somewhat or very concerned, 40% of investors do not see a reason for alarm.

An investor from a European family office expressed the belief that **"distributions will revert back to normal in the second half of 2025, when the macroeconomic environment becomes less volatile, and people look beyond the current challenges".**

Figure 19

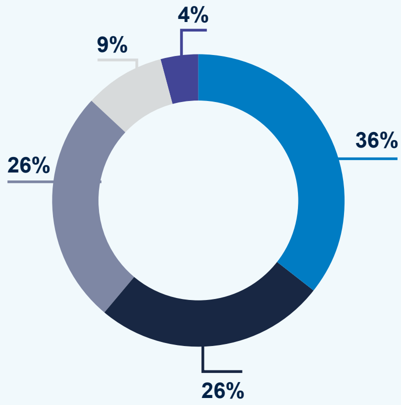
How has your private equity portfolio performed on a cashflow basis in 2023 to date?



- Distributions were slightly lower than expected
- Distributions were significantly lower than expected
- Distributions were in line with expectations
- Distributions slightly exceeded expectations
- Distributions significantly exceeded expectations

Figure 20

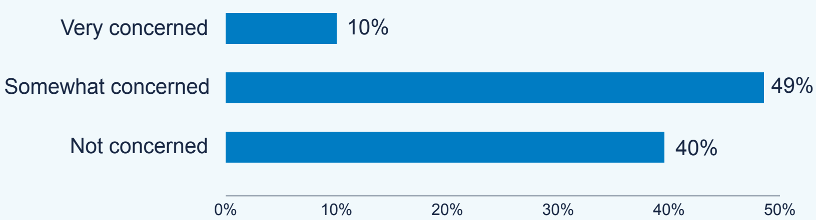
How have your cashflow expectations for 2024 changed since last year?



- We expect slightly lower distributions for 2024
- We expect slightly higher distributions for 2024
- Expectations for 2024 have not changed
- We expect significantly lower distributions for 2024
- We expect significantly higher distributions for 2024

Figure 21

How concerned are you about the slowdown in distributions in your private equity portfolio?



Investors agree on strategies to manage the current slowdown in distributions. A significant 70% of investors intend to either reduce their deployment pace or decrease average commitment sizes, which will likely present a headwind to GP fundraising efforts. At the same time, investors value relationships and 22% of respondents would even consider selling older vintage commitments in order to reinvest in the same GP's newest vintage.

An investor from a large asset management firm confirmed: **"We are actively exploring the sale of commitments with managers with whom we do not plan to re-up, in order to generate sufficient liquidity for new investments".**

Figure 22

How will the current slowdown in distributions impact your private equity deployment in the next 12 months?

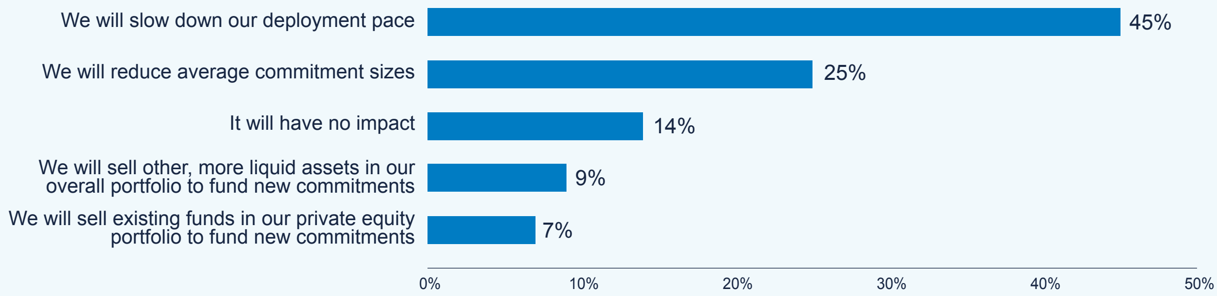


Figure 23

Would you consider selling older vintages in order to invest in the same manager's newest vintage?

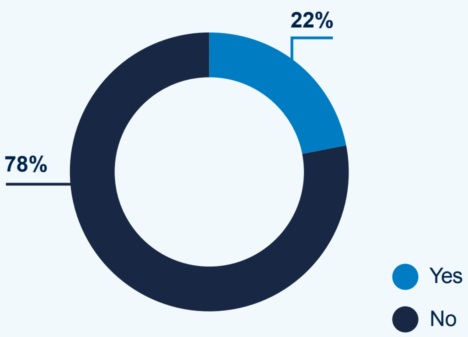


Figure 24

Which private equity vintage years would you be most open to selling over the next 12 months?

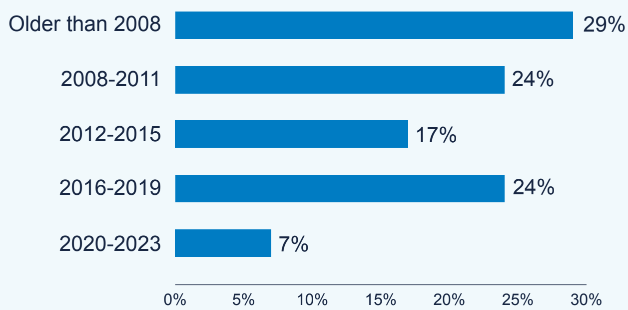
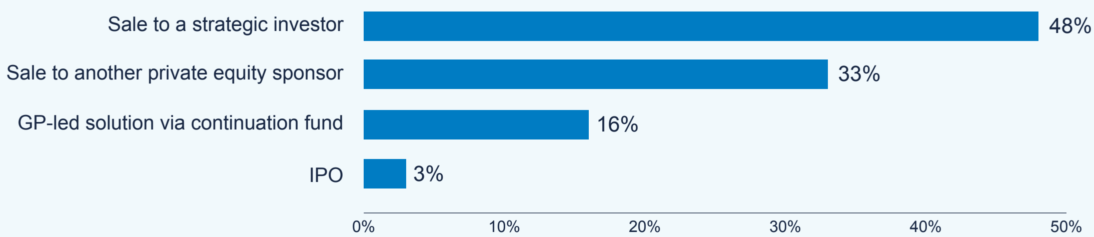


Figure 25

What will be the most attractive exit route for private equity-backed companies in the next 12 months?



Participant information

This year, mcp collected responses from 94 investors representing some of the industry's leading family offices and institutional investors worldwide. Participation has been diverse in terms of institution types, geography, and size.

46% of respondents represent single or multi-family offices and 54% represent various types of institutional investors. Almost half of the surveyed firms have been operating for more than 20 years.

Figure 26

What type of institution are you?

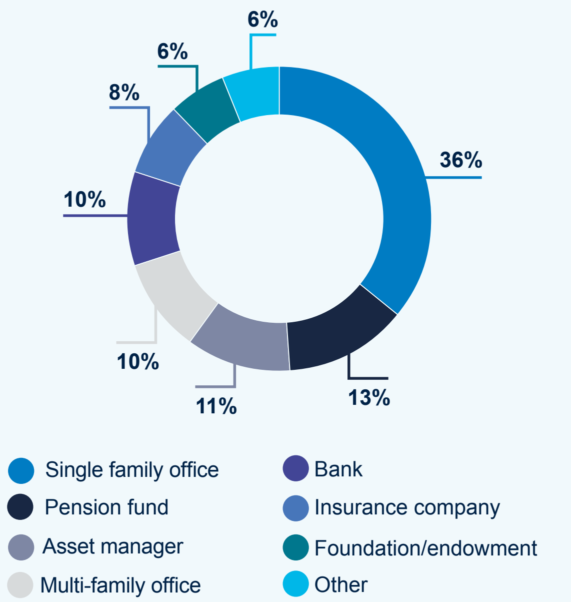


Figure 27

Where is your institution located?

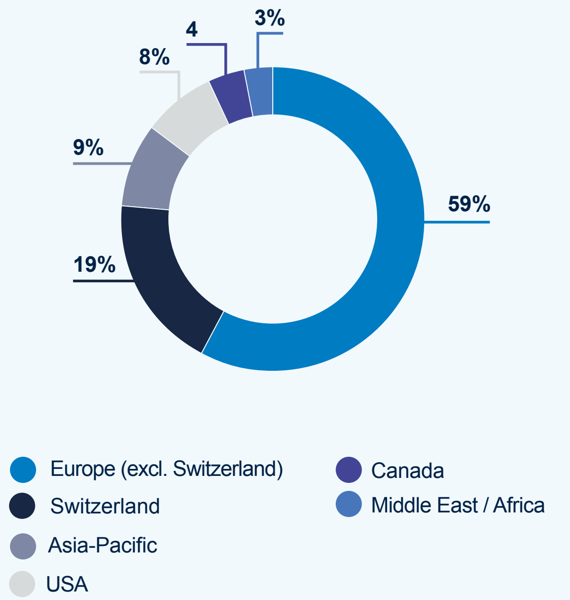


Figure 28

How long have you been operating?

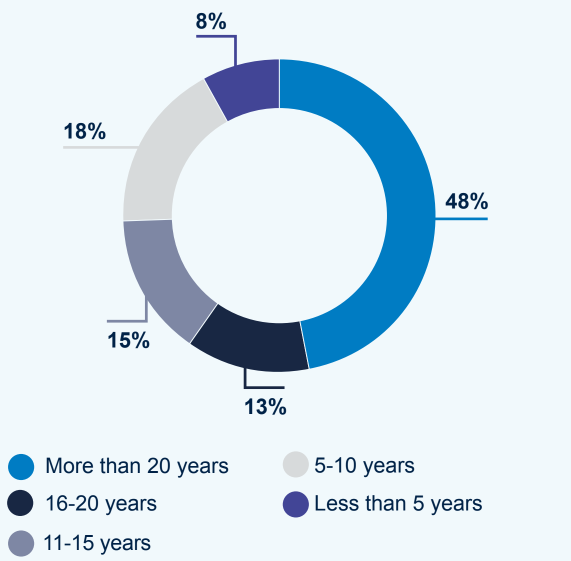
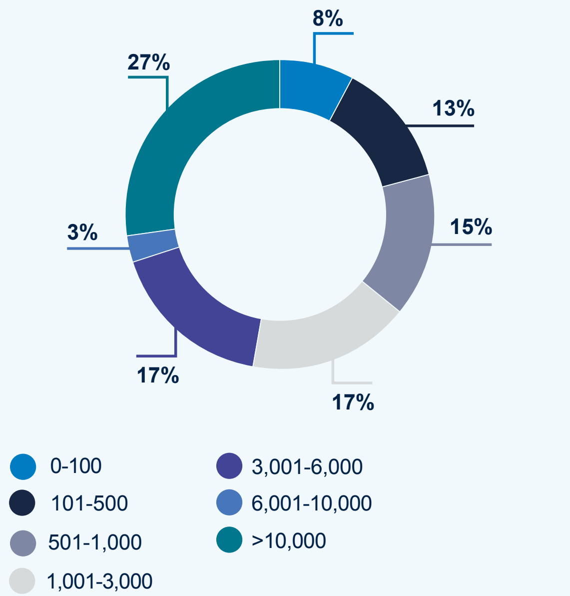


Figure 29

What is your AuM (in EUR million)?



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