Private equity: A study of UK institutional investors
FOREWORD

Private equity is considered by institutional investors globally to be one of the most important alternative asset classes. Investment in the sector offers significant opportunities for returns enhancement well beyond that offered by public equity markets, and a growing proportion of institutional investors now consider private equity to be an essential element of their investment portfolios, based on its perceived ability to provide diversification and generate superior returns.

According to this study, more than 40% of institutional investors in the UK currently invest in private equity. This figure confirms that in the UK, private equity has, for some time, been a broadly accepted, mature asset class and, as this study suggests, UK institutional investors’ maintain a strong appetite for investing in the sector.

This survey is the latest in a series of studies sponsored by Zurich based private equity fund of funds manager, Adveq, with a view to improving the level of information about institutional investors’ attitudes to private equity investing. Adveq has already engaged in similar studies in Germany, Switzerland, the Nordic Region, The Netherlands and Australia, together with renowned partners such as the University of St Gallen, the University of Applied Science in Wiesbaden, the Stockholm School of Economics, the University of Tilburg, and the University of New South Wales, Sydney.

This UK study, based on a two to five year timescale, looks at the current and intended future investment behavior of UK company pension funds, occupational pension schemes, insurance companies, banks, and integrated financial service providers regarding private equity investing. The study also considers the risk tolerance of institutional investors in the UK and it is hoped that this will provide an understanding of the factors that motivate institutional investors to allocate capital to private equity. The study surveyed 2401 pension funds, insurance companies and financial advisors.

CMBOR is grateful to Adveq for their support in undertaking this survey.

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1. EXECUTIVE SUMMARY

There are a wide range of options available to institutional investors and it is generally the more traditional asset classes, such as stocks, bonds, real estate or cash equivalents, which attract the majority of investment capital. However, fund managers are increasingly searching for alternative forms of investment and, particularly when stock market performance is poor, are looking at less common asset classes such as private equity.

In the UK, investors in private equity range from institutional investors such as pension funds and insurance companies, who invest billions of pounds on behalf of others, to high net-worth individuals.

The purpose of this study is to examine the private equity investment activity of UK investors in terms of their current and future allocation to the asset class. In particular, we questioned pension funds, insurance companies, and financial advisors in order to identify the significant features of their current investment strategies and likely future trends. Specifically this survey looks at the following aspects:

- Background information
- Current and future investments in private equity
- Aims and objectives of private equity investment
- Responsibilities of private equity investment
- Risks associated with private equity investment
- Choosing an investment partner
- The future of private equity investment

The study surveyed 2401 pension funds, insurance companies and financial advisors. 239 institutions have responded (response rate 9.9%) and 102 institutions have returned the questionnaire with detailed information on their institutions and their private equity strategy.

The key findings are:

- Most of the respondents are single company pension funds (26%), followed by local authority pension funds (25%) and then multiple company pension funds (21%).
- The majority of the respondents (63%) have less than GBP 1 billion of current investments under management, while 6% of respondents manage more than GBP 30 billion.

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1 In this study private equity investment refers to all private equity/venture capital investments in all company stages; seed, start-up, development/expansion and management buyouts/management buy-ins. It also includes mezzanine and bridging finance. Investments in private equity can either be direct or indirect via funds or via funds of funds.
Allocation to private equity

- Just over 40% of respondents are already investing in private equity.
- Of these, just over a quarter currently invest up to 2% of their total available capital, one tenth invest between 2% and 10%, and finally, less than 3% of respondents invest more than 10% of their total available capital in private equity.
- The next two to five years will see UK institutions slightly reduce their allocation to private equity. 38% of institutions state that they will invest in private equity in the future.

Types of private equity investment

- Direct company investments are reported to be the least popular form of investment and this is predicted to remain unchanged in the future.
- Direct fund investments currently account for 52% of the total, but this will decrease to 44% in the future. In contrast, fund of funds investments currently account for 31%, but are expected to increase to 38% in the future.
- Expansion/buyout investments will be more important than venture capital, with UK expansion/buyout investments being the most popular, followed by the US and continental Europe.

Regional focus

- Currently, the majority of private equity commitments by UK institutions are directed towards the UK market which accounts for 54% of allocation.
- Western Europe currently accounts for 20% of overall allocation, the US for 20% and Asia for 2%.
- This will remain virtually unchanged, with the UK remaining the most important market, although allocation will fall slightly to 53%. Western Europe will account for 19% of UK institutions’ future private equity allocation, and Asia and emerging markets for 1%.
- In contrast, allocation in the US is set to increase slightly from 20% to 23%.

Private equity objectives

- The most important reasons for investing in private equity are to achieve a greater return relative to other asset classes, to diversify the portfolio and to obtain a positive annual return.
- Respondents seek to generate, on average, a 12.8% absolute return. They also expect the returns from private equity to be 420 basis points (4.2%) higher than the return from publicly quoted investments.
- The majority of respondents (65%) indicated that their return on investment was as expected, 13% thought the return was greater than expected and the remaining 23% stated that the return was lower than expected.
2. **BACKGROUND INFORMATION**

The survey aimed to capture information on the background characteristics of investors and advisors in terms of:
- Type of organization
- Current assets under management
- Length of experience in private equity investing

2.1. **Type of organization**

The investing companies in the sample can be grouped into several categories. The majority of respondents are single company pension funds (26%), followed by local authority pension funds (25%) and pension funds of multiple companies (21%).

Fig. 2.1: Type of organization

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2 Source of all figures in this report CMBOR/Adveq.
2.2. Current assets under management

The value of current assets under management of the respondents is shown in Fig. 2.2 and includes funds in all asset classes.

The majority of respondents (63%) have less than GBP 1 billion of current assets under management, while a significant proportion (30%) manage funds of between GBP 1 billion and GBP 10 billion. 1% of respondents have between GBP 10 billion and GBP 30 billion of assets, and 6% manage assets of more than GBP 30 billion.

Fig. 2.2: Current assets under management

2.3. Length of private equity investment experience

If the respondent is already investing in private equity, the length of time they have been investing is shown in Fig. 2.3.

The majority of the respondents have been investing in private equity for eight years or more (53%), and most have more than ten years experience. 27% of those investing in private equity have up to four years experience, and a further 19% have been investing in the asset class for between four and eight years.

Fig. 2.3: Length of experience
3. CURRENT AND FUTURE INVESTMENTS IN PRIVATE EQUITY

Information on current and future investment has been gathered based on several different areas:

- Current and future private equity investment
- Distribution according to type
- Distribution according to region
- Distribution according to type and region

3.1. Current and future private equity investment

In total, 41% of the respondents are already investing in private equity at the time of the survey. This breaks down as follows:

- 28% invest less than 2% of their total funds under management in private equity
- 7% invest between 2% and 5%
- 3% invest between 5% and 10%
- 3% invest more than 10%.
- 59% do not currently invest in private equity

According to the survey, future planned private equity investment by UK institutions is set to see a slight decline, down from 41% now to 38% in the future.

When analyzing planned investments in private equity, however, the results look promising for the private equity industry (Fig. 3.1). The percentage of respondents planning to invest between 2% and 5% of their total assets under management in private equity is set to increase from 7% currently to 24% in the future. In addition, the private equity investment in the <2% and above 5% ranges will also remain fairly stable.

Fig. 3.1: Current and future private equity investments
3.2. Private equity commitments according to type

There are three types of private equity investment: direct company investment, direct fund investment and fund of funds investment. The respondents in this survey indicated that their most common route to investment was via direct fund investment, both now and in the future. In addition, the survey showed that UK institutions expect fund of funds investments to become increasingly popular route to private equity in future at the expense of direct fund investments.

Fig. 3.2: Distribution of committed private equity by type

Direct fund investments currently account for 52% of the total, although this is projected to decrease to 44% in the future. In contrast, fund of funds investments currently account for 31%, but are predicted to increase to 38% in the future.
3.3. Private equity commitments according to region

Respondents were asked to categorize their private equity commitments by region with the outcome shown in Fig. 3.3.

Fig. 3.3: Distribution of private equity commitments by region

The majority of private equity commitments has been directed towards the UK market (54%), and planned future commitments in the UK remaining essentially unchanged at 53%. Central Europe and Asia are the least significant of all the regions both now and in the future. Planned commitments in the US and Central Europe will be slightly higher than current; while there will be a slight decrease in private equity commitments in Western Europe.
3.4. Private equity commitments according to type and region

Respondents were asked to indicate approximately how their private equity commitments were distributed according to type and region. The current distribution is shown in Fig. 3.4 and the expected future distribution in Fig. 3.5.

Fig. 3.4: Distribution of private equity commitments by type and region: Current

Note: Investments in Central Europe, Asia and the rest of the world have been omitted from this chart.
Figures 3.4 and 3.5 highlight the regional differences with respect to investment type. In general, direct fund investments are the most popular form of investment across all regions with fund of funds investments taking second place. Direct company investments are the least common type of investment.

Fig. 3.5: Distribution of private equity commitments by type and region: Planned

Note: Investments in Central Europe, Asia and the rest of the world have been omitted from this chart.

Across all regions, direct fund investment will remain the most popular route to private equity in the future, but will show a slight decline on current investment activity.

Fund of funds investments are considered most important for gaining access to private equity investments in the US and Western Europe and will see an increase in the future compared to current allocations.
Direct company investments will be most popular in the UK and Western Europe. In the UK there will be an increase of direct company investments in the future, but they will decrease in popularity in Western Europe, the US and Asia (Fig. 3.6).

Fig. 3.6: Direct company investments: Current and future commitments

![Bar chart showing current and planned direct company investments by region](image)

Private equity committed to direct funds is expected to decrease over time in all regions apart from Central Europe (Fig. 3.7).

Fig. 3.7: Direct fund investments: Current and future commitments

![Bar chart showing current and planned direct fund investments by region](image)
Private equity invested in fund of funds is planned to increase in the future in most regions, most significantly in Western Europe where it will increase from 26% to 35%. The only decrease in this segment is projected to be in Central Europe.

Fig. 3.8: Fund of funds investments: Current and future commitments
4. **AIMS AND OBJECTIVES OF PRIVATE EQUITY INVESTMENT**

The following areas relating to the aims and objectives of investing in private equity have been examined:

- Purpose of investing in private equity
- Expected returns and comparison with actual returns
- The benchmarks used for comparison
- Private equity investment strategy
- UK legal and regulatory environment

4.1. **Purpose of investing in private equity**

Respondents were asked to rate various criteria associated with what they wished to achieve by investing in private equity. Each criterion was ranked between 1 (least important) and 5 (most important). The results are the following.

![Fig. 4.1: Aims of investment in private equity](image)

The most important reasons for investing in private equity are to achieve a greater return relative to other asset classes (4.5), to diversify the portfolio (3.8) and to obtain a positive annual return (3.0).

4.2. **Expected returns**

The expected absolute return (annual net return after deducting the management fee of the fund or fund of funds) and the difference between the absolute return from private equity compared to public equity demanded by investors are important issues.

The respondents indicated that they wanted to generate on average of 12.8% absolute return. They also expected the absolute return from private equity to be 419 basis points (4.2%) higher than the absolute return from public equity investments.
Table 4.1: Private equity returns

<table>
<thead>
<tr>
<th>Criteria</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly under-performed</td>
<td>3.2</td>
</tr>
<tr>
<td>Under-performed</td>
<td>19.4</td>
</tr>
<tr>
<td>As expected</td>
<td>64.5</td>
</tr>
<tr>
<td>Out-performed</td>
<td>12.9</td>
</tr>
<tr>
<td>Strongly out-performed</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

It is important to ascertain whether these expectations have been met in reality. When asked whether the investments in private equity had met these expectations the majority of respondents (64.5%) indicated that their return on investment was as expected. A further 12.9% thought the return had exceeded their expectations and the remaining 22.6% stated that the return was lower than expected.

4.3. Benchmarks

In order to gauge the performance of private equity investments it can be useful to compare the return from private equity against the return from various benchmarks. Overall, 82.4% of the sample use a benchmark, but 17.6% do not and instead follow an absolute return strategy. Of those respondents who do use a benchmark, the largest proportion (31.1%) indicated that the FTSE All Share index is the most appropriate.

Table 4.2: Benchmarks

| Benchmarks                                                      | %    |
|                                                               |------|
| MSCI World                                                     | 16.2 |
| S&P 500                                                        | 12.2 |
| FTSE ALL Share                                                 | 31.1 |
| Hang Seng Index                                                | 1.4  |
| Nikkei Index                                                   | 2.7  |
| Euro Stoxx                                                     | 4.1  |
| Thomson Financial/Venture Economics Benchmarks Report          | 5.4  |
| Internal industry rating by fund manager                       | 5.4  |
| Absolute return strategy                                       | 17.6 |
| Other                                                          | 4.1  |
| Total                                                          | 100.0|

The second most popular benchmark is the MSCI World index (16.2%), followed by the S&P 500 (12.2%).
4.4. Private equity investment strategy

In addition to examining how current and future investment strategies are developed, the survey also looked at the factors which influence strategy. Respondents were asked to rank a number of factors on a scale of 1 (least important) to 5 (most important). The five factors deemed most important for the mid-term (two to five years) private equity investment strategy are shown in Fig. 4.2.

Fig. 4.2: Mid-term investment strategy

<table>
<thead>
<tr>
<th>Factor</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return expectation for PE investments</td>
<td>4.2</td>
</tr>
<tr>
<td>Risk diversification</td>
<td>3.5</td>
</tr>
<tr>
<td>Stock market developments</td>
<td>3.3</td>
</tr>
<tr>
<td>Own structure of liabilities</td>
<td></td>
</tr>
<tr>
<td>Transparency &amp; liquidity of PE market</td>
<td></td>
</tr>
</tbody>
</table>

The most important criterion for determining the mid-term private equity investment strategy is return expectations (4.2) followed by risk diversification (3.5) and stock market developments (3.3).

4.5. UK legal and regulatory environment

It is useful to understand from the respondents’ perspective on whether changes in the UK legal and regulatory environment will affect their mid-term (two to five years) private equity investment strategy. Respondents were asked to rank each potential change on a scale of 1 (least important) to 5 (most important) as you can see in Fig. 4.3.

Fig. 4.3: UK legal and regulatory environment

<table>
<thead>
<tr>
<th>Change</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability of target company’s pension fund</td>
<td></td>
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<tr>
<td>Greater transparency in PE house reporting</td>
<td></td>
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<tr>
<td>Removal of tax relief on loan stock payments</td>
<td></td>
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<tr>
<td>Enhancement of tax credit for R&amp;D</td>
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<tr>
<td>IFRS</td>
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<tr>
<td>Basel II</td>
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</tbody>
</table>

Study of UK institutional investors’ attitudes to private equity investing – 2005
The changes which respondents think are most likely to affect the mid-term private equity investment strategy are the liability of a target company's pension fund (3.1), followed by greater transparency in reporting by private equity houses (3.0) and the removal of tax relief on loan stock payments (2.9).
5. RESPONSIBILITIES FOR PRIVATE EQUITY INVESTMENT

In order to understand how the responsibility for private equity investments is allocated in a firm and how decisions are professionally arrived at, the respondents were asked questions in the following areas:
- How responsibility is organized
- How many people are responsible and their experience

5.1. Organization of responsibility

The responsibility for private equity investment differs from one organization to another. The most common situation in the survey group is that there was no clear definition of responsibilities (Fig. 5.1)

Fig. 5.1: Private equity investment responsibility

Where responsibility is defined, the most common response was in the ‘Other’ category (23%) which includes trustees, external investment manager and investment committee. In second place was the inhouse private equity unit with 18%.

5.2. Number and experience

Responses to questions about the number of people engaged in and responsible for private equity investment and their experience were gathered. On average, between three and four people are specifically assigned to private equity investments. The heads of department have banking and insurance experience (17 years), operational experience (nine years) and relevant private equity experience (14 years). In addition, the heads of department have been involved in between seven and eight exits.
6. **RISKS ASSOCIATED WITH PRIVATE EQUITY INVESTMENT**

The issue of the risks associated with private equity investment is clearly of interest. Two specific areas were evaluated:
- What are the risks
- The approaches to risk reduction

### 6.1. The risks

It is as important to examine the risks associated with investing in private equity as it is to look at the expected returns. Respondents were asked to rank the perceived risks on a scale of 1 (least important) to 5 (most important) with the results shown in Fig. 6.1.

Fig. 6.1: Main risks and hurdles associated with private equity investments

Lack of liquidity (3.7), lack of performance transparency (3.7) and legal and contractual issues (3.4) are perceived to be the three most important factors contributing to risk.

The least important are perceived to be lack of long-term commitment (2.8), the effort to convince internal committees (2.9) and general regulatory issues (3.0).

Each perceived risk was given a score greater than 2.5 thus they are all viewed as being of greater than average importance.
6.2. Risk reduction

In order to address the perceived risks inherent in private equity, investors can make use of a number of different approaches. In general, they can do this by different means of diversification, collaboration with advisors or fund managers, and by developing their own know how. Respondents were asked to rank the approaches to risk reduction on a scale of 1 (least important) to 5 (most important) as shown in Fig. 6.2.

According to the respondents, the most important route to risk reduction is diversification through an increase in the number of investments (4.2), followed by the development of internal know how (3.7). Diversification through investing in different sectors is the third most important approach (3.6).

The least important approaches are working together with private equity fund managers (3.1) and diversification through international investments (3.2).

Each approach to risk reduction was given a score greater than 2.5 thus they were all viewed as being of greater than average importance.
7. CHOOSING AN INVESTMENT PARTNER

For an investor there are two potential investment partners:
- Fund manager
- Fund of funds manager

Our survey asked the respondents for their opinion on choosing the right fund or fund of funds manager.

7.1. Choosing a fund manager

Investors can assign private equity fund managers to invest their money on their behalf. By using a fund manager it is easier to achieve diversification and it is not necessary to build up the same level of know-how required when investing directly.

Respondents were asked to rank the criteria they would consider important when choosing a fund manager on a scale of 1 (least important) to 5 (most important). Vide Fig. 7.1.

Fig. 7.1: Choosing a fund manager

<table>
<thead>
<tr>
<th>Criteria</th>
<th>1</th>
<th>2</th>
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<tbody>
<tr>
<td>Stability of management team</td>
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<td>Industry know-how</td>
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<td>Fund manager track record</td>
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<td>Financial experience</td>
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<td>Operational experience</td>
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<td>Hands-on approach</td>
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<td>Independence of fund manager</td>
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<td>Network of fund manager</td>
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<td>Fee structure</td>
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<td>Terms of investment</td>
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<td>Carried interest structure</td>
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<td>Corporate governance</td>
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<td>Transparency in investment process</td>
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<td>Quality of financial report</td>
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<td>Size of team</td>
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<td>Quality of co-investors</td>
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<td>Image and degree of recognition of the fund</td>
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<td>Offering of customized products</td>
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<td>Using fund managers as sparring partners</td>
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</table>
According to this survey the three most important factors when choosing a fund manager are stability of management team (4.4), industry know-how (4.3) and the fund manager track record (4.2). Financial and operational experience also have a significant impact on the fund selection (both with 4.1).

Of less importance are the possibility of using the fund manager as a sparring partner for the development of a direct investment program (1.9), offering customized products (2.1), and the image and degree of recognition of the fund (2.5).

### 7.2. Choosing a fund of funds manager

Given the different approaches to investing in private equity there are also slightly different investment criteria. Respondents were asked to rank the criteria they would consider important when choosing a fund of funds manager on a scale of 1 (least important) to 5 (most important), as shown in Fig. 7.2.

**Fig. 7.2: Choosing a fund of funds manager**

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<th>Criteria</th>
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<tbody>
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<td>Fulfillment of corporate governance requirements</td>
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<td>Quality of financial reports sent to investors</td>
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<td>Image and degree of recognition of the fund of funds</td>
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<td>Offering of customized products</td>
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<td>Quality of co-investors</td>
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<td>Transparency in selection process of funds</td>
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<td>Carried interest structure</td>
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<td>Operational experience</td>
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<td>Fulfillment of corporate governance requirements</td>
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<td>Quality of financial reports sent to investors</td>
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The top three criteria are fund of funds manager track record (4.6), access to exclusive top quartile funds (4.4) and stability of management team (4.3). Financial experience (4.1) and industry know how (4.1) are also considered key criteria.

Using the fund of funds manager as sparring partner for their own program (2.5), the quality of co-investors (2.7) and the offering of customized products (2.7) are regarded as the least important criteria by UK institutions.
8. **The Future of Private Equity Investment**

Two aspects of private equity investment in the future were examined:
- How important will private equity segments be in the future
- The popularity of socially/environmentally responsible investment policies

### 8.1. The importance of private equity segments in the future

Respondents were asked to rank the importance of various private equity segments over the next two to five years on a scale of 1 (least important) to 5 (most important). The results are as shown in Fig. 8.1.

Differences can be detected according to investment stage (seed, start-up, expansion or management buyout) as well as to geographic regions.

![Fig. 8.1: Importance of private equity segments in the future](image_url)
Expansion/buyout investments are regarded as being more important in the future than their venture capital counterparts. Investment in the UK expansion/buyout market will be the most important (3.6), followed by the US (3.3) and continental Europe (3.2). Overall, UK institutions see the UK as the most important market followed by the US, continental Europe, and then the Asian and emerging markets. Alternative ways to invest in private equity through the acquisition of secondary funds and sustainable/socially and environmentally responsible investments will be of average importance in the future (3.0).

8.2. The Importance of socially and environmentally responsible investments

Respondents were asked to rate the importance of a sustainable/socially and environmentally responsible investment policy (covering all investments, not just private equity). They rated this type of policy as being of higher than average importance at 3.1 on a scale of 1 (least important) to 5 (most important).

In addition, respondents were asked if they had such a policy (once again covering all investments, not just private equity) and, if not, whether they planned to formulate one within the next two to five years. The results are shown in Fig. 8.2.

Fig. 8.2: Environmentally responsible investment policy

A majority of respondents (64%) stated that they did have a policy for sustainable/socially and environmentally responsible investments. Of those companies which do not currently have a policy, a small proportion plan to formulate one within the next two to five years. As shown in Fig. 8.2 above, this will lead to an increase in companies with this type of investment policy to 70%.