

PRIVATE EQUITY TRUSTS OFFER DEEP VALUE

Private equity investment trusts are still trading at distressed discounts to net asset value. Do they deserve them?

Stephen Wilmot reports

Private equity is a deeply unloved asset class. For many, it embodies all the ills of high-tech capitalism: returns earned through a smokescreen of debt, financial engineering and rising valuation multiples rather than productivity or innovation. In the new age of austerity and transparency, it looks distinctly passé.

But that perception also gives it classic contrarian investment potential. Smaller investors can access the asset class through investment trusts that buy into a range of 'limited partnership' schemes otherwise backed by endowments and pension funds. These trusts did bounce with the stock market last year, but are still trading at distressed levels by historical standards (see chart below). For those willing to overlook the swings of fashion and the scars of history, they could be one of the few remaining pockets of deep value left by the receding crisis.

That depends on whether you think the crisis really is receding, of course. Private equity's reliance on debt and its use of stock market multiples as a basis for valuation make it highly cyclical, so in a renewed downturn scenario it would suffer disproportionately (its common classification as an 'alternative' is somewhat misleading). It's not surprising that fears of more rot in the European banking system have darkened sentiment towards the sector in recent weeks and pushed discounts back out.

But if the recovery in corporate earnings maintains its current course, private equity investment trusts still look too cheap. There may be no immediate catalyst, but with a two- or three-year time horizon, investors can reasonably expect double-digit returns as asset values rise with profits and discounts close.

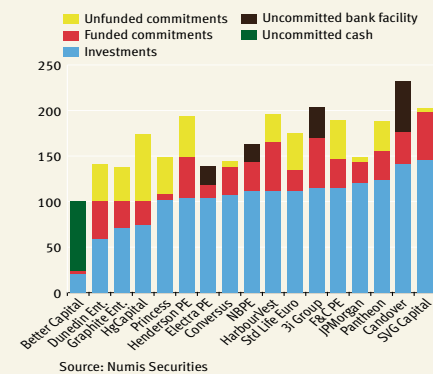
Private Equity Investment Trusts – average discount/premium ex 3i



Source: Thomson Datastream, Oriel Securities



Investments, leverage and commitments



Research by LPX Group shows that when listed private equity companies traded at a discount over the past 16 years, they tended to outperform the MSCI over the following three years – as one would expect. Debt is now dearer, so asset values will not grow by the 20-30 per cent a year once considered almost normal. But at least some of the difference should be made up by narrowing discounts, even if they don't reach a premium this time around. Iain Scouler at brokerage Oriel Securities says the “natural discount” of private equity trusts could be as much as 10-20 per cent – but that still implies a big bounce in valuations.

It's true that investors need to be wary of discount figures in sectors like private equity, where the value of holdings is estimated. Valuations are typically only updated every quarter or half-year, creating a lag effect in a downturn as investors anticipate reductions in estimates of net asset value (NAV). Yet now the cycle has turned, that lag should act in investors' favour. Valuations have been aggressively downgraded and are now looking cautious, says John Newlands at Brewin Dolphin. When this caution becomes clear – which will inevitably be when asset sales are realised – discounts should normalise.

Debt fears exaggerated

Debt levels were another major concern last year, as investors feared trusts wouldn't be able to meet their top-of-the-market commitments to existing holdings without dilutive rights issues or fire sales. Even after a year of hard work restructuring balance sheets, gearing and commitment levels remain mixed (see chart above) and all the trusts have further leverage at the individual holding level because buyouts are generally backed by bank debt. But investors' fears look a bit exaggerated. Commitments will only be called gradually over a period of years, by which time the trusts should have raised cash from distributions or disposals. The current discounts more than account for any uncertainty. ▶

Six trusts set for a rebound

Electra Private Equity

One of the oldest and largest private equity trusts, Electra is a hybrid vehicle that invests mostly in unlisted companies, but also in other private equity funds and even some public companies. Its holdings are highly diverse, ranging from the global leader in animal identification tags to Guildford-based fund manager Premier Asset Management. The performance record, with growth in net asset value (NAV) of 73 per cent over five years, is better even than Hg Capital, and there's scope for further growth as nine of the 52 companies it owns directly are currently valued at nil – conservative to say the least. But its share price growth has lagged and it now trades at a 30 per cent discount to NAV. This can't be explained by its balance sheet, which has plenty of uncommitted borrowings. Electra looks a clear anomaly.

Dunedin Enterprise

Mr Newlands at Brewin Dolphin praises Dunedin's “tight-fisted Scottish approach to valuation”. Yet the trust trades at a 37 per cent discount even to its cautious estimate of NAV. If you factor in the 44 per cent of NAV held in cash and the 21 per cent invested in other listed private equity trusts that

can be easily liquidated if necessary, that's an obvious bargain. The £123m trust does have unfunded commitments of £53m – but given all its spare cash and the modest rate at which commitments are typically called this doesn't look a problem. With above-average past performance and broad sector diversification, the discount seems to reflect little more than Dunedin's low profile as a minnow in a niche sector. That should change when earnings and disposals pick up.

SVG Capital

Unlike the conservatively managed trusts above, SVG was a major victim of the credit crunch. It entered the downturn with a huge debt-pile that massively magnified the market fall. Over three years NAV has declined a full 83 per cent – the second worst in the peer group. Now SVG looks like an excellent recovery play, though. The trust has significantly reduced its commitments, while Permira, the private equity firm that manages most of its holdings, has been busy restructuring capital at the portfolio level. With just 20 per cent of debt maturing before 2014, leverage is no longer

the pressing issue it was. That said, it ▶



▶ The key to unlocking the sector's value is deal activity. This can take three forms. Private equity companies can offload a holding by a) taking it public, b) selling it to another private equity company on the so-called secondary market or c) finding a trade buyer. Flotations were popular in the technology boom but burnt sellers in the bust. This paved the way for secondary market sales to become the norm last decade, when managers made fabulous returns – and then steep losses – by bidding each others' assets up to quite unsustainable multiples.

Secondary market subdued, flotations risky

Managers are wary of repeating the mistakes of the immediate past, so the secondary market has been subdued over the past 18 months. KKR's acquisition of Pets At Home from Bridgepoint is a lone example of activity – and one below KKR's usual capitalisation range. But many private equity schemes have so-called 'equity overhangs' – capital raised in the boom years that managers are contractually obliged to deploy – suggesting activity may pick up after the summer.

Flotations look risky, too, now the stock market has turned. BC Partners and Cinven sparked hopes of a return to the glory days when the travel booking company Amadeus raised €1.3bn in Madrid in late April – 6.7 times their original investment in 2005. But other plans have been put on ice. The risk is there for all to see in the case of Gartmore: Hellman & Freidman took the fund management group public in December, but its 24 per cent stake has since shrunk to just over half its opening value.

After a strong year for corporate cash-generation, trade sales look a safer bet. Apax Partners sold Tommy Hilfiger to the Phillips-Van Heusen Corporation in March for 4.5-5 times its original investment price. Such examples remain a relative rarity, however, and earnings growth will have to settle into a pattern before industry embarks on a major buying spree.

So the catalyst for a mass re-rating is not immediately visible. But if it were, discounts would probably be narrower. High yields pulled property trust discounts back from the brink last year, while a year of strong performance has helped listed hedged funds. In time, deal activity should do the same for private equity – and past experience suggests it's better to buy before the action.

Besides having a little patience, investors also need an ability to avoid the duds and the dullards, of course. Hg Capital is without doubt the highest-quality name in the sector, and it has an exceptional track record that is based on zero leverage at the trust level – clear evidence that, done well, private equity can be a very powerful tool of wealth creation. But on a discount of 10 per cent, the good news is priced in. So instead, we've picked six deeply discounted trusts that look set for a rebound – see page 26.

▶ may still hamper realisations: in February Permira canned its planned flotation of clothing retailer New Look, which accounts for 4.1 per cent of SVG's NAV, amid concerns over its £1bn debt. But there's scope for considerable gains even without deals. NAV bounced 30 per cent in the second half of last year, but is still lagged by the share price, which is trading on a 33 per cent discount. This isn't one for the faint-hearted, but it could be a real winner.

Northern Investors

Northern Investors Company (NIC) was established in the Thatcher years with the worthy but unpromising cause of providing finance for unlisted companies in the north of England. But Reading-based manager Tim Levett says the Northern tag is now an anachronism, and his track record is strong, with 28 per cent NAV growth over five years. The trust is also unusual for private equity in paying an income. Having increased dividends every year since 1997, the company's shares are now trading on an attractive yield of 4.9 per cent. That looks sustainable too: after some lucrative realisations last year, NIC has net cash of £16.9m on its balance sheet. So size again seems to be the only reason for the 41 per cent discount – NIC's market capitalisation of £30m falls under the radar of most analysts and investors. But that's an opportunity for individual buyers. They will probably have to wait until sentiment improves for the shares to be re-rated, but the yield should limit any short-term downside.

Pantheon International Participations

Discounts look even more distressed in the fund-of-funds sector, mainly because underlying holdings are invariably less transparent than in a direct fund. Pantheon's track record is reassuring, though, stretching back to 1987 with 34 per cent NAV growth over five years. It's also one of the best diversified vehicles on offer, with over 3,000 underlying company investments all over the globe. The 46 per cent discount at which its ordinary shares trade (it also has redeemable shares) mainly reflects concerns over its gearing and commitment levels, which are among the highest in the peer group. But commitments won't all be called at once and Pantheon's mature portfolio is cash-generative, which boosts funding. The gloom looks excessive.

NB Private Equity Partners

NB Private Equity is a newer fund of fund also trading at an abnormally wide discount, currently 40 per cent. It doesn't have the comfortingly long track record of Pantheon, but it has outperformed the peer group since being set up nearly three years ago and has none of Pantheon's commitment issues. Managed by Neuberger Berman (the old asset management arm of Lehman Brothers, now independent), it is a play on the US economy, but otherwise highly diversified, with minimal company-specific risk. Here the discount is just a question of profile: NBPE is listed on Euronext and the Specialist Fund Market, rather than the main London Stock Exchange. Track record and realisations should change that in time.

