A Value Opportunity in UK Listed Private Equity Funds

Summary

The UK listed private equity sector suffered a huge sell-off during the global credit crisis in late 2008, as investors fretted that forward commitments these funds had traditionally made could not be financed by either disposals of existing investments or through bank borrowings. But investors over-reacted and the sector had no widespread problems either realising investments or gaining access to bank borrowings. Consequently, most funds in the sector recovered substantially in 2009 and 2010. But discounts across the sector remain elevated at an average of 33% to net asset value, and the business and financial risks are a good deal lower today than they were in 2008. As the growth in the sector's asset values has matched, if not exceeded, the growth in earnings in the wider UK equity market in the past decade, the current unusually wide discounts appears to signal a low-risk value opportunity. Growth in asset values of even 5-6% per annum combined with a narrowing of the discount to the historical average of 10% suggests returns from the sector of 12-13% on a five-year timeline from here, which should be substantially ahead of the returns available from the UK equity market over the same period. Quality funds offering good dividend income include HG Capital (2.9% yield) and Princess Private Equity (7.3% yield). Other funds that stand out include Electra Private Equity, Pantheon International Participants and Aberdeen Private Equity.

Key Buy Recommendations

	Ticker	Price
Princess Private Equity	PEY-L	614
HG Capital Trust	HGT-L	968
Electra Private Equity	ELTA-L	1630
Pantheon Int'l Participants	PIN-L	681
Aberdeen Private Equity	APEF-L	53

Introduction

Investing in private equity is not for the amateur investor but in every bull market investment intermediaries, stockbrokers and other product sellers offer up a selection of supposedly great investment opportunities in private companies to their clients. The difficulty the client has is that he/she does not have required experience of particular business sectors and has no real understanding of how to place a value on the investment opportunity. And, as usual, the product seller is getting paid to raise the money for the business so he/she will be mostly inclined to give the opportunity a favourable review.

I believe most private investors should avoid investing directly into individual private equity deals and, instead, invest in private equity via a fund where the fund manager has the experience necessary to make value/risk judgments, and where he/she is clearly on the same side of the table as the investors in the fund.

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Sub Sector of the UK Equity Market

Investing in unquoted companies via quoted funds is a sub-sector of the overall stock markets but it is one I like and understand.

Fund managers who invest in private companies have to be more rational as they know they can't sell their investments in the short-term. Funds in the UK listed private equity sector have been trading at steep discounts to their underlying net asset values (NAV) since the global credit crisis in late 2008. Yet few got into financial difficulty and most have delivered growth in their net asset values over the short and long-term equal to, if not better than, the UK stock market.

I have been concerned for a while that the extra value on offer was signaling risks that I was not correctly identifying - the so called value trap - rather than there actually being good value on offer. We were all reminded of the 'Value Trap' in 2008. The banks were cheap when measured against any yardstick but they were going bust - it was a classic value trap!

Table 1 lists a wide selection of private equity funds listed on the London Stock Exchange. I have provided specific coverage of four of them previously - HG Capital, Electra, Graphite Enterprise and Princess Private Equity. But there are

Name	Ticker	Share Price (Stgp)	Net Asset Value (Stgp)	Discount
Princess Private Equity	PEY-L	614	882	-30.4%
HG Capital	HGT-L	968	1116	-13.3%
F&C Private Equity	FPEO-L	148	239	-38.1%
Graphite	GPE-L	393	557	-29.4%
Electra Private Equity	ELTA-L	1630	2301	-29.2%
Pantheon Int'l Participants	PIN-L	681	1152	-40.9%
Stan Life Euro Private Equity	SEP-L	131	226	-42.0%
NB Private Equity	NBPE-L	$7.10	$10.65	-33.3%
JP Morgan Private Equity	JPEL-L	$0.90	$1.27	-29.1%
Aberdeen Private Equity	APEF-L	53	99	-46.5%
Average				**-33.2%**

Table 1

Note: Share prices and net asset values @ 10th Feb 2012

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others that look equally worthy. The average of the ten funds is trading on a 33% discount to their underlying NAVs with HG Capital at the smallest discount of 14% and Aberdeen Private Equity at the widest discount of 46%. The funds have different business models - some invest directly into specific companies, others invest in specialised private equity funds and some do a bit of both. But the overall 33% discount is substantially wider compared to the average of the UK Investment Trust Sector, which currently sits on a discount of circa 10%.

The persistence of these discounts in the UK private equity fund sector is a feature of the post-global credit crisis market. The key issues in late 2008 for investors in this sector were the high level of forward commitments private equity funds had coming into the credit crisis. Forward commitments by a private equity fund have to be funded either through the sale of existing investments or bank borrowings. In late 2008, investors panicked sensing that, due to the severity of the downturn, deals in the private equity sector would dry up and banks would not have the cash to lend to them. On both counts investors over-reacted. Not only did the sector easily handle these over-commitments but most funds - that needed to - gained access to bank credit. The result was a collapse in shares prices of 70% across the sector in late 2008 and a phoenix-like recovery in 2009 and 2010. But wide discounts persist.

Like the analysis of any company, the risks in the sector can be broken down into the same categories (i) the business risks (ii) the financial risks and (iii) the valuation risks.

On the valuation side, the unusually wide discounts suggest great value. In terms of financial risk, given how investors panicked on the sector in late 2008, almost every fund has made efforts to reduce forward commitments and negotiate firm credit lines even at somewhat higher bank margins. ***Table 2*** (on the following page) provides us with a fairly good idea of the financial risk or otherwise in the various funds that I have chosen to focus on (as the list is not exhaustive).

Princess Private Equity, for example, has net cash of €4 million on its balance sheet and has a bank credit facility it can call on, which is currently undrawn, of €88 million providing it with funding of €92 million. It has forward commitments to companies and other funds of €144 million. Hence, its net unfunded commitments are €52 million or 10% of its asset portfolio. As forward commitments are drawn down at a slow rate over a number of years, and are mostly covered by disposals in the year, a 10% unfunded commitment appears very conservative to me.

Likewise, HG Capital has net cash, and while it has unfunded forward commitments it is in the unusual position of being able to walk away from those commitments if it has to (as the commitments are to other in-house HG Capital private equity funds). So there is no financial risk in HG Capital Trust. Similarly, Electra Private Equity, which has sold 20% of its assets since September last, is in a net cash position with no net commitments. Pantheon International Partners, Graphite, Standard Life Euro Private Equity, NB Private Equity and JP Morgan Private Equity all look compelling with only modest commitments and trading on huge discounts to NAV. Both F&C Private Equity and Aberdeen Private Equity need closer attention.

In F&C Private Equity's case, the directors have highlighted that the fund's outstanding commitments are the lowest they have been since inception in 2001, and that, in any event, most of these forward commitments are unlikely to ever be drawn down. Also, its portfolio is relatively mature and realisations have been consistently exceeding new commitments for the past few years.

In Aberdeen Private Equity's case, its net unfunded commitments are currently €59 million or 43% as a percentage of the existing portfolio value. The fund has the authority to borrow up to 25% of the fund value but the fund manager has not yet seen the need to look for a bank facility.

Name	Portfolio Assets (Stg£ m)	Net Cash/Debt (Stg£ m)	Undrawn Credit Facilities (Stg£ m)	Unfunded Commitments (Stg£ m)	Commitments as % of Fund Assets (Net)
Princess Private Equity	614	4	80	144	9.8%
HG Capital	292	70	40	0	-37.7%
F&C Private Equity	223	-39	40	88	39.0%
Graphite	359	61	60	137	4.5%
Electra Private Equity	850	189	0	89	-11.8%
Pantheon Int'l Participants	826	57	100	211	6.5%
Stan Life Euro Private Equity	401	-12	108	143	11.7%
NB Private Equity	$522	$16	$250	$306	7.7%
JP Morgan Private Equity	$648	$25	$45	$113	6.6%
Aberdeen Private Equity	$137	$32	$0	$91	43.1%

Table 2

Note: Data compiled from most recent fact sheets and interim and annual reports.

Indeed, in its most recent Interim Report, the fund manager highlighted a new $10 million commitment to a new fund, the Lion Capital 111 Fund. That's a sign of confidence in the fund's cash flows. Again, I just don't see the unfunded commitments being a real issue.

My conclusion is that there is little financial risk across the listed private equity sector. That leaves us with business risk. I have constructed a chart of the growth in net asset values of thirteen private equity funds listed on the London Stock Exchange from 2000 to 2011 inclusive. And in ***Chart 1***, I have compared the collective growth in these funds to the growth in earnings in the UK FTSE 100 Index over the same period.

Chart 1 highlights that while the growth in net asset value across the private equity sector appears to have been no better than the FTSE 100 stocks, neither has it lagged, not by much anyhow. From 2000 to 2011 inclusive, the UK listed private equity sector grew its NAV by 6.5% per annum compound. In comparison, earnings at the FTSE 100 companies grew by 7.2% per annum compound (excluding exceptional write-offs). The NAV of the private equity funds is after annual and special dividend payments whereas the earnings series for the FTSE 100 companies is before dividend payments. Hence, it is likely that the private equity sector has actually delivered higher growth. Hence, there is no problem with growth in the UK private equity sector.

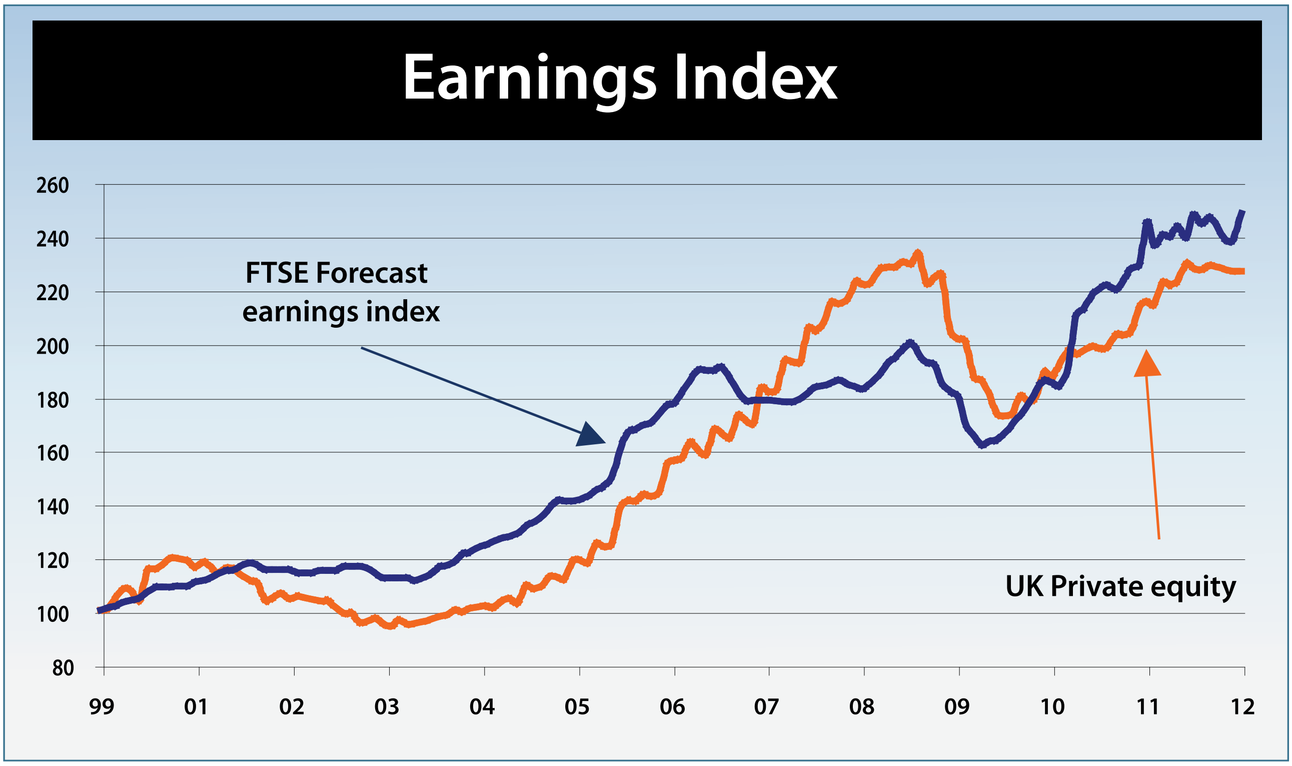

Chart 1

Could it be the geographic spread of the private equity fund sector's assets that is spooking the market? ***Table 3*** below highlights the geographic mix of assets for each fund.

The geographic spread of their collective investments looks solid enough. A couple of funds have a high dependency on the UK/Europe - F&C Private Equity, HG Capital, Standard Life Euro Private Equity and Electra Private Equity. Perhaps that is weighting on the sector somewhat as sentiment surrounding the economic outlook in Europe among investors remains poor. But for well financed private equity funds, recessionary conditions provide opportunities and better value so Eurozone exposure is not something I am personally concerned about in the sector.

In summary, I can find no compelling reason why the private equity sub-sector is so poorly rated. Aside from Eurozone exposure, business risks look low. Financial risks are also low with most of the private equity funds having de-risked their unfunded commitments considerably since the global credit crisis in 2008. As I have mentioned before, if you are looking for income and value the HG Capital Trust (2.9% yield) and Princess Private Equity (7.3% yield) are the picks. If income is not a priority for you then the following selection would be my choice - Electra, HG Capital, Princess Private Equity, Pantheon Int'l Participants and Aberdeen Private Equity.

Name	North America	Net Global	Credit UK	Europe /UK	Asia & Other	Total
Princess Private Equity	55%			34%	11%	100%
HG Capital			51%	49%		100%
F&C Private Equity	7%	5%		87%	1%	100%
Graphite	12%	2%	41%	45%		100%
Electra Private Equity	5%		51%	40%	4%	100%
Pantheon Int'l Participants	53%			36%	11%	100%
Stan Life Euro Private Equity	19%	7%	25%	49%		100%
NB Private Equity	77%			19%	4%	100%
JP Morgan Private Equity	27%	6%		48%	19%	100%
Aberdeen Private Equity	44%	37%		15%	5%	100%

Table 3

If the private equity trust sector can grow its asset values by even 5% per annum over the next five years and discounts to NAV narrow back to the 10% long-term average on that timeline, then shareholders can look forward to 12-13% annual returns from a selection of these funds over the next five years. In my view, therefore, the entire private equity sector offers the prospects of better returns and, it seems, with less risk than the overall market.

Aberdeen Private Equity Trust	www.aberdeenprivateequity.co.uk
Electra Private Equity Trust	www.electraequity.com
F&C private Equity Trust	www.fcpet.co.uk
Graphite Enterprise Trust	www.graphite-enterprise.com
HG Capital Trust	www.hgcapitaltrust.com
JP Morgan Private Equity Trust	www.jpelonline.com
NB Private Equity Partners Trust	www.nbprivateequitypartners.com
Princess Private Equity	www.princess-privateequity.net
Pantheon International Participants Trust	www.pipplc.com
Standard Life European Private Equity Trust	www.slcapital.com

The above table provides you with the website site addresses for each private equity fund listed above. On the websites you can access fact sheets, Annual & Interim Reports and often some webcasts and conference calls from management.

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