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Shadowy image

By Neal Underwood

Exposure to private equity can give access to high-growth companies and good managers. But a lack of transparency and poor liquidity deter some advisers from considering the asset class for their retail clients. Neal Underwood reports.

With the retail distribution review (RDR) getting ever closer, advisers should be considering all the asset classes that are available to them to ensure that their clients are being offered the most appropriate investment solutions. One area that has been largely forgotten in the retail arena is private equity. There are, for example, 13 vehicles in the private equity investment trust sector, which receive relatively few assets from retail investors. According to FE Trustnet, there are 22 private equity vehicles into which advisers could be putting retail clients' money. Some of these are investment trusts, others are private equity companies, such as 3i, which are available for investment via investment company vehicles.

Private equity is, put simply, investment in unlisted companies that are privately - not publicly - owned. Most private equity investment is conducted by private equity firms that raise funds from institutions, such as pension funds, for investing in high-growth businesses or for acquiring businesses in which greater efficiencies could be achieved. The term "private equity" embraces management buy-outs and buy-ins, development capital and venture capital, which is investment in start-up and early-stage companies.

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Scorpio Partnership, a wealth consultancy, and LPEQ, a European trade body of listed private equity investment companies, produced a report on how wealth managers are allocating their clients' assets. The study showed that allocations to alternatives rose to 17% in the second quarter of 2011, compared with 7% in the fourth quarter of 2009, and all portfolios were expected to increase this allocation yet further. While hedge funds dominate, taking 58% of assets, private equity accounts for just 11% of allocations to alternatives.

Advocates for the private equity industry are fighting back. Andrea Lowe, an executive director at LPEQ, argues that private equity offers the best returns for the risks that it takes of all alternative investments. She notes that nearly 40% of respondents to the survey plan to invest in listed private equity in the coming year. She highlights liquidity as one of the main advantages of using listed private equity, as well as the ability to reach and control an allocation to private equity, diversification, gaining private equity exposure at discounted prices, administrative simplicity and transparency of the underlying investments.

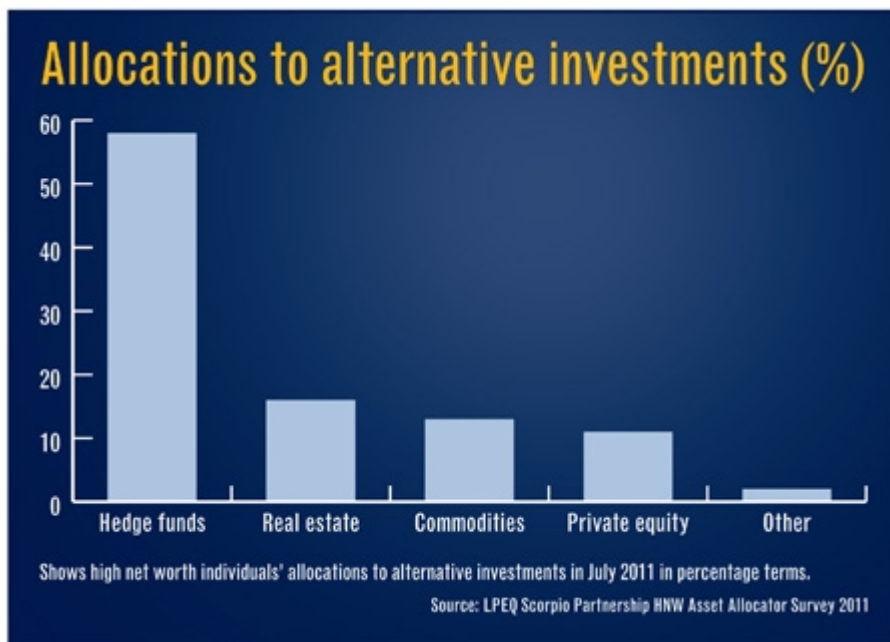
The private equity process often involves a private equity fund management firm raising a limited-partnership fund, typically of 10-year duration. This is then invested in the first three to four years of its life in buying majority, or sometimes minority, stakes in companies that meet the fund's investment criteria. The private equity manager helps the companies in

which it invests to develop, restructure and grow profitably. This usually involves taking a seat on the board and providing a range of assistance, including strategic advice on capital markets and financing, market analysis, networking and sourcing additional management. Successful fund-raising by a private equity firm depends on returns made by previous funds, so building a successful track record is crucial.

Although listed stocks still dominate investors' equity portfolios, Lowe also argues that private equity offers several advantages when compared with investing in listed equity. Companies backed by private equity funds are developed or made more efficient with the active participation of the private equity manager's team working alongside management to targets. At least one member of the private equity team will have a non-executive seat on the company's board.

Private equity-backed companies have a few highly incentivised shareholders, including management, all working to achieve the same objectives, says Lowe, and companies backed by private equity can grow, or be restructured, out of the public eye - and that of competitors - without the constraint and distraction of performance being honed for quarterly or six-monthly reporting.

The field of investment opportunities is also much larger: in Europe, there are more than 100,000 private companies but only 2,500 listed companies. Private equity managers conduct detailed market, financial, legal, environmental and management due diligence, typically over eight to 20 weeks before investing, says Lowe. In addition, the private equity manager has control over the timing of a sale of the business.



In the second edition of *Private Equity Demystified - An Explanatory Guide* by John Gilligan and Mike Wright of the ICAEW Corporate Finance Faculty, the authors note that private equity fund managers have four principal roles: raising money from investors to make

investments, mainly in businesses that are, or will become, private companies; sourcing investment opportunities and making investments; actively managing investments; and realising capital gains by selling or floating those investments.

Richard Hancock, an investment analyst at Financial Management Bureau, says private equity does form a part of his research when looking at portfolios of funds. "I wouldn't allocate [to private equity] explicitly but I would favour funds of funds, which do. As a company we like the idea of the American endowment model, the multi-asset approach. For a normal core portfolio allocation to private equity we wouldn't do it ourselves, but we use Rathbone's multi-asset funds, which use the Princess and HgCapital investment trusts, and Saltus, who have an allocation to private equity via the PowerShares ETF and investment trusts. They will also buy direct private equity. We do favour managers who have an allocation there."

Hancock's biggest concern regarding private equity is liquidity. "You could get into investment trusts. There are liquid ways of accessing it. I think it's best accessed with a lock-in, if you go into a fund for five years."

"If you take a rational view and focus on quality it makes a lot of sense but you have to be patient"

David Coombs, the head of multi-asset investments at Rathbone Unit Trust Management, uses private equity vehicles in two of his funds. In Rathbone Enhanced Growth, which takes the same risks as the MSCI World index, he has a 7.5% allocation to private equity.

He says: "The types of vehicles we tend to buy are single-manager investment trusts; we can't buy closed-ended limited partnerships because they're too illiquid." Coombs holds Ashmore Global Opportunities, Electra and HgCapital. "This fund has a five to 10-year time horizon, so I'm happy to take positions [in private equity] at these levels."

In the Rathbone Strategic Growth fund, which takes lower risks, Coombs holds two private equity funds of funds: Princess Private Equity Holding and Pantheon International Participations. "These give broader diversification and were both bought on big discounts of 50% or more. At those levels the risk was priced in on a five-year horizon." The private equity weighting in this fund is 3.9%.

Coombs views private equity less as an alternative investment and more as an equity play that rises and falls more than the markets and diversifies returns. "I don't see it as a risk diversifier at all. In Enhanced Growth I can't think I'd have less than 5% in private equity. It absolutely fits the bill. We're focusing on quality. A lot of private equity funds are not over-leveraged. The quality managers survived the 2008 drop-out. If you take a rational view and focus on quality it makes a lot of sense, but you have to be patient. Market conditions don't suit initial public offerings right now. You need a long-term horizon."

David Hambidge, the investment director of pooled funds at Premier Asset Management, says that valuations of closed-ended private equity funds look attractive, but argues that one typically needs to perform more due diligence to understand them. He also highlights the problem of gearing.

He says: “Banks weren’t particularly keen to lend to the sector, and [zeroes] were suited to a less liquid asset class. You’re getting paid a relatively attractive return to lend money to the private equity sector. We got involved in a modest way, and yields have contracted in the last 12 months or so. That’s where we are, as a lender, and happy to be so.”

Private equity and debt investment trust sectors

Fund	Invests in	Strategy
Aberdeen Private Equity	Private equity funds, hedge funds and other speciality funds	Multi-manager
Better Capital	Distressed businesses	Single manager
Dundedin Enterprise	European private equity funds	Multi-manager
F&C Private Equity Restricted Voting	Global private equity funds	Multi-manager
Graphite Enterprise	Global unquoted companies	Single manager
HarbourVest Global Private Equity	Private equity funds, typically HarbourVest private equity funds	Multi-manager
HgCapital	Unquoted companies in the UK and Continental Europe	Single manager
Mithras	Private equity funds	Multi-manager
Northern Investors	Unquoted companies in the UK	Single manager
Pantheon International Participations	Global private equity funds and unquoted companies	Multi-manager
Princess Private Equity Holding	Global private equity and private debt funds	Multi-manager
Private Equity Investor	Unquoted American VCT info tech funds	Multi-manager
Standard Life European Private Equity	Private equity funds predominantly in Europe	Multi-manager
Duet Real Estate Finance	European commercial real estate debt	Single manager
Greenwich Loan Income (AIM)	Debt securities of small to medium sized technology-related companies in UK/Europe	Single manager
NB Distressed Debt	Long-biased, opportunistic stressed, distressed and special situation credit-related investments	Single manager
Psource Structured Debt	Asset backed loans and debt made predominantly to publicly traded small companies in US and Canada	Single manager
Real Estate Credit Investments	Debt secured by commercial or residential properties in Western Europe and the UK	Single manager

Shows the investment trusts in the AIC Private Equity sector and trusts in the AIC Debt sector with less liquid underlying investments. Source: Association of Investment Companies (AIC)

Hambidge notes that many private equity vehicles were hit hard in 2008, but says he constantly looks at all asset classes. “On the face of it, private equity investment trusts look relatively attractive. One or two private equity companies have been thumped in the last few weeks, and therein lies the opportunity.”

Aviva Investors’ multi-manager team uses private equity as an integral part of its portfolios. It says the private equity ownership model can offer significant benefits over public ownership. The enhanced governance model and superior alignment of interests, combined with active ownership, should translate into enhanced returns over public equities, in Aviva’s view. At the same time, the multi-manager team understands that achieving these enhanced returns depends on both the quality and the experience of the people involved.

Selecting the right investment is therefore the critical consideration in the asset class, says the firm. In aggregate, private equity returns have provided inadequate compensation for the associated loss of liquidity, says the team. Returns are also dispersed across individual funds and stages of investment. However, the team says it is possible to identify top-performing funds with the degree of consistency that clients require.

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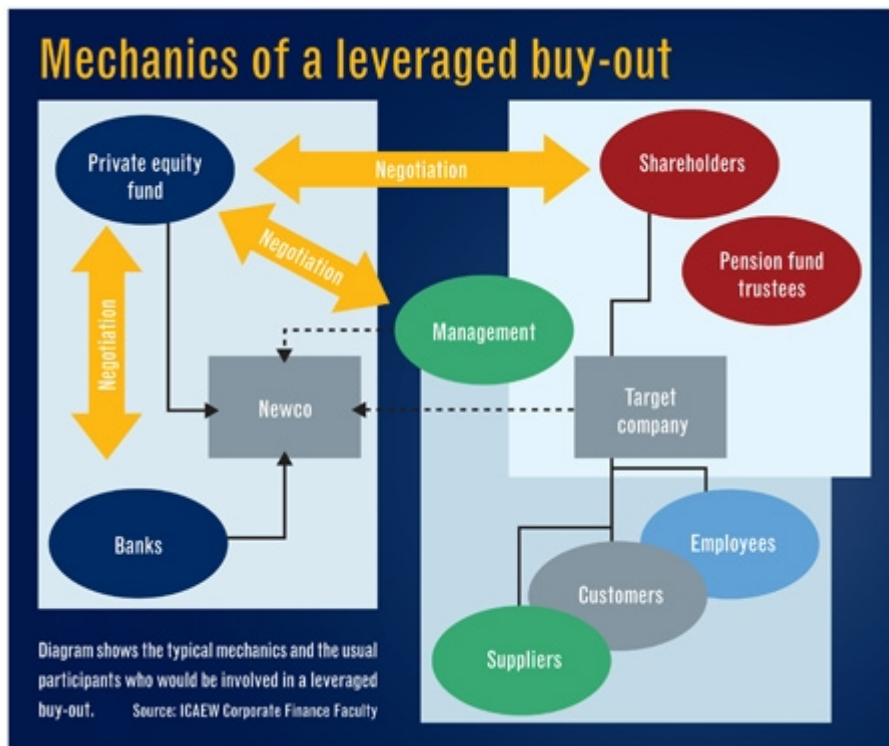
Aviva argues that a fund of funds structure can broaden portfolios to a sufficient extent. It can also limit investments to between eight and 12 primary private equity funds that are due to operate in any particular timeframe. As each primary fund normally invests in more than 10 companies, this creates economic exposure to more than 80 companies in the fund of funds portfolio, which should be enough to ensure diversity across geographies, sectors and stages of investment.

But investment selection is only a part of the process, says Aviva. It also attaches a lot of value and importance to engaging its partners and managing its investments all the way through to realisation. It takes 10 years or more to achieve this. To facilitate effective monitoring, the firm is represented in about half of the advisory or observer boards of all the funds in which Aviva Investors invests.

Investing alongside other private equity players and buying private equity assets on the secondary market can also provide attractive ways to enhance returns and make portfolio management more flexible. However, these need to be approached with a high degree of caution, in Aviva's view. For this reason, the team says it is critical that it has a complete understanding of all the potential risks in achieving the prospective returns. It also needs a high degree of conviction in any investment decision and an understanding of what the investment will add to the overall portfolio.

One thing advisers and their clients should bear in mind is that private equity investment is a long-term activity. Funds are typically structured for 10 years - and can sometimes be extended if conditions require this - precisely because they need to allow for sustained company growth and for various cycles. These include the fund-raising cycle, where private equity firms tend to fund-raise every three-to-five years; specific industry cycles, for example in energy or chemicals; stockmarket cycles, where high prices present the best time for many exits and low prices offer the best time for acquiring stakes in companies; and ups and downs in domestic economies.

One thing that private equity investment trusts have in common is they tend to offer illiquid opportunities that may be difficult to access in open-ended form. It could be argued that some of them are little more than straightforward company holdings, which private equity houses charge huge fees to manage, as well as generating worrying leverage along the way. But the returns can be rewarding in some cases, provided the investor is prepared to stick around for long enough.



At the same time, though, the nature of private equity investment trusts can make it difficult for their boards to manage them effectively. It is harder to sell illiquid holdings, for example, than to fund share buybacks and narrow discounts.

Throgmorton is one of the largest specialist accountancy and professional services providers to the hedge fund, private equity and corporate finance industries. It provides business, financial and administrative outsourcing to more than 300 corporate and personal clients. One of the company's main businesses is helping American fund managers set up shop in Britain. The firm's clients include some leading private equity players, although it is not keen to name them.

Throgmorton highlights several trends in the private equity industry. "Our clients tell us that private [equity] remains a sought-after asset class owing to its superior investment returns," says Roger Ganpatsingh, a director at Throgmorton. The firms Throgmorton deals with have seen more interest from wealthy families and individuals. "There's appetite out there as the returns are not there elsewhere," says Ganpatsingh. As far as less sophisticated retail investors go, he suggests they may still view private equity as too volatile.

"The overriding message from private equity houses is that investors have understood the constraints placed on private equity managers during the downturn," says Ganpatsingh. "Commitments by investors remain underutilised, but, stating the obvious, investors would rather wait for the right opportunities to present themselves than rush into bad investments. Where managers have been constrained by fixed investment periods, for commitments secured as long ago as 2006, those managers have been able to gain approval from investors to extend those investment periods."

Investors are being more realistic regarding potential returns on investments. Clients have reduced the rate of return they are expecting from 30% to 15-20%, says Ganpatsingh. "Having said that, there is some pressure to realise exits and to prove that deals have delivered. For new commitments, the message is that those expectations are starting to rise again. There is a sense that we are back at square one with a clean slate and that upside opportunity will gather pace."

Ganpatsingh points out that the squeeze on credit continues to restrain private equity activity. "The ceiling for debt funding on deals sits at about the £25m to £30m level. Syndicated debt funding remains elusive, with banks reticent to underwrite larger sums. Private equity managers are using a bigger spread of lenders than they have in the past. Bond markets still provide availability for credit above the £150m level, with added benefits of relatively lower borrowing costs and fewer, if any, loan covenants."

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In terms of investment trends, most deals are focused on the lower and mid-market levels, with the £1 billion-plus highly leveraged mega-deals proving scarce. "Clearly the credit squeeze has had a material impact on those larger deals, firstly in terms of raising debt and secondly in terms of the cost of that debt," says Ganpatsingh.

"The larger deals may look to target 20% uplifts in ebitda [earnings before interest, tax, depreciation and amortisation]. When compared with the two to three-fold increase in ebitda targeted on the lower and mid-market deals, it is clear that increased funding costs can render the leveraged mega-deal unworkable. Structured deals focused on delivering upside through financial engineering are dead for the time being."

Ganpatsingh also notes that changing regulations in Europe have affected private equity. "The Alternative Investment Fund Managers catch-all directive will have some impact on private equity managers and who they can market to. There are heavier capital requirements, bigger restraints on remuneration, the imposition of third-party custodians or depositaries and more detailed reporting requirements. That is developing into something workable and manageable and will help with the return of investors' confidence."

Private equity houses have unsurprisingly shifted their interest away from businesses that are heavily exposed to consumers and government spending. Sectors of interest include support services, outsourcing, energy, carbon-related businesses and clean technologies. A weaker sterling has also been positive for British export businesses such as high-end manufacturing.

"Private equity houses see a lot of opportunities and low valuations," says Ganpatsingh. "Plenty of firms are in a bit of a frenzy to get these valuations; you'll get some valuation increase just from a turn in the market, so they're really deal drunk."

There are disadvantages in investing in private equity. Opportunities can be difficult to access. Limited partnerships may only be marketed to institutions and wealthy people. The minimum investment accepted is usually more than £1m. But these concerns can be overcome by investing in a listed private equity vehicle.

There is also the worry of illiquidity. Private companies may not be saleable, either because they are not performing to plan or because market conditions are not conducive to borrowing, selling assets or floating them. Shares in public companies can almost always be sold if cash is required, although prices will vary widely, depending on market conditions.

A long-term investment perspective is necessary for private equity programmes, although individual companies may produce good returns over quite short periods.

In addition, there can be high costs associated with private equity investments. Fund managers charge relatively high fees for managing capital committed by external investors, generally about 2%. If their fund performs well, the manager takes a sizeable proportion, generally 20%, of realised returns in excess of hurdle rates.

Some advisers also say they find it difficult to evaluate private equity investments. Carl Lamb, a director at Almary Green Investments, says private equity is not something the firm tries to get involved in. "You need to be able to look under the bonnet. The client needs to understand it and so do we."