Listed Private Equity

Risk in LPE: Perception versus reality

2 March 2017

In our second report on listed private equity (LPE), we examine public market investors' perception of risk in the LPE sector and investigate whether perceived risk matches reality. We support the analysis with manager and investor interviews.

LPE still at a discount despite solid performance

Our first report published in September 2016 highlighted the large discount to NAV (net asset value) of the sector despite strong returns. Since then the discount has narrowed somewhat, partly due to strong NAV returns and corporate activity. According to the AIC the discount for the private equity sector is currently 14% despite double-digit annual returns over the last five years. The aggregate discount does not necessarily indicate value at the individual LPE company level, as some companies trade at significant premiums due to their hybrid asset manager or LPE structure, which is logically rated more highly by the market.

Is LPE perceived as higher risk?

While some pension funds and family offices allocate as much as 30% to private equity (PE), public market investors still tend to treat LPE with caution, citing leverage and commitment risk, lack of disclosure, high valuations and discount volatility as issues. Much of this caution stems from a few high-profile missteps during the financial crisis, but the sector's 10-year return history has been affected and this influences investment consultants' asset allocation recommendations.

Reality: Risk-reward in LPE appears in line

Using more than 23 years of return and risk data we show that LPE displays a similar risk-reward profile to major equity indices and US real estate investment trusts (REITs). Although we saw acute NAV discount volatility during the financial crisis, few portfolio companies failed. The PE ownership model tends to mitigate risk as a result of portfolio diversification, extensive due-diligence, alignment of stakeholders and value creation through active management. Moreover, the drivers of problems during the crisis – aggressive leverage and commitment – are no longer a feature. There has thus been a structural reduction in the risk profile of LPE following the financial crisis. Most major LPE companies are currently running a net cash position and commitment risk is much more tightly managed. This gives us optimism for the future and suggests the risk-reward could improve.

Companies in this report

3i Group
Aberdeen Private Equity Fund***
Altamir SCA***
Candover Investments
Deutsche Beteiligungs AG***
Gimv*
HarbourVest Global Private Equity***
HgCapital Trust*
Partners Group
Standard Life Private Equity Trust***
SVG Capital

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**Client of Edison.
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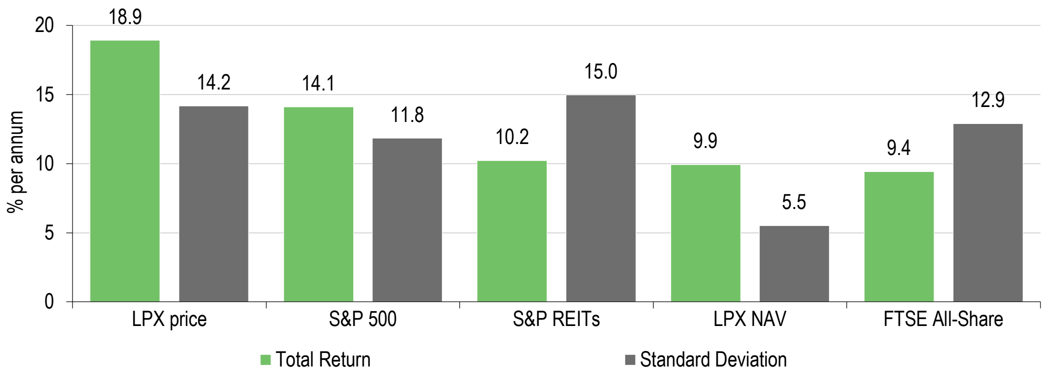
LPE at a large discount despite strong performance

Our first note in September 2016 highlighted that the LPE sector was trading at a large 20% discount to NAV despite strong returns. Since then the discount has narrowed somewhat, partly due to continued strong NAV returns and corporate activity such as the HarbourVest bid for SVG Capital. According to the Association of Investment Companies (AIC), the private equity sector is currently trading at an average discount to NAV of 14%. This compares unfavourably to the overall investment company universe NAV discount of 3% excluding 3i and venture capital trusts (VCTs).

The aggregate discount does not necessarily indicate value at the individual LPE company level of course, as some companies trade at significant premiums due to their hybrid asset manager or LPE structure, which is logically rated more highly by the market. Companies with this structure include 3i, Deutsche Beteiligungs AG, Gimv and Partners Group.

The large discount appears to be at odds with recent investment performance. We illustrate average annual returns and risk (as measured by the standard deviation of returns) in LPE using weekly local currency data for the LPX Europe Index (price total return and NAV). We compare this with similar data for for the S&P 500 Index, the S&P REITs Index and the FTSE All-Share Index in the chart below.

Exhibit 1: Total return and standard deviation – five years to January 2017

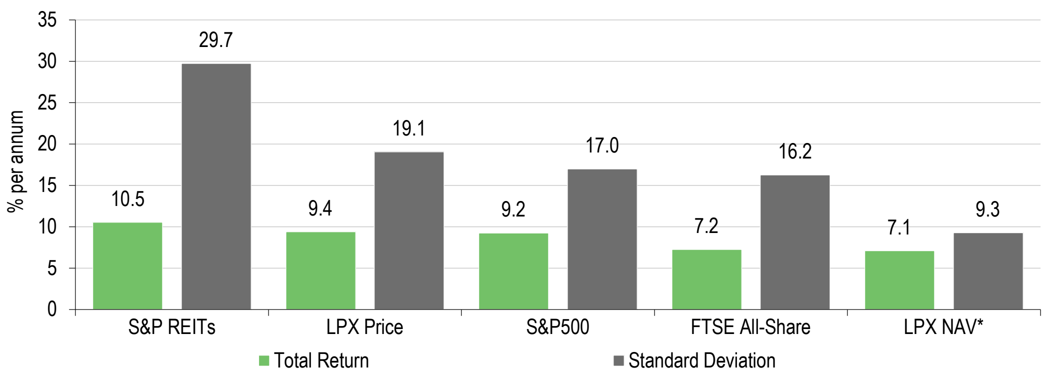


Source: Bloomberg

The LPE sector has clearly generated strong returns over the last five years: the average annual total share price return of the LPX Europe Index is 19%, while NAV returns have been close to 10% with very low volatility. The stronger price returns vs NAV returns is explained by the narrowing of the discount over time since the financial crisis (see Exhibit 5 on page 4). These figures compare favourably with our selected equity comparables. In fairness we would not overstate the importance of the very low volatility of the LPX NAV series as NAVs are typically only reported quarterly, with full valuations conducted on a six-monthly basis. This tends to reduce volatility due to the lag of reporting and incorporating market multiples in the short term.

Perhaps more surprisingly, the long-term risk-return profile of LPE also compares well with other equity investments. We illustrate this in the next chart, which summarises LPX Europe total return index data using the maximum available 23 years of data (apart from the LPX NAV series where only 13 years of data are available). We can see that the risk-return picture for LPE is very similar to the S&P 500 and FTSE All-Share. Returns have been lower than US REITs but with significantly less risk. Note the NAV return may be greatly understated (even though volatility is very low) as only 13 years of data are available, so 10 years of positive growth figures are not included. Even so, NAV total returns still compare well with the FTSE All-Share Index.

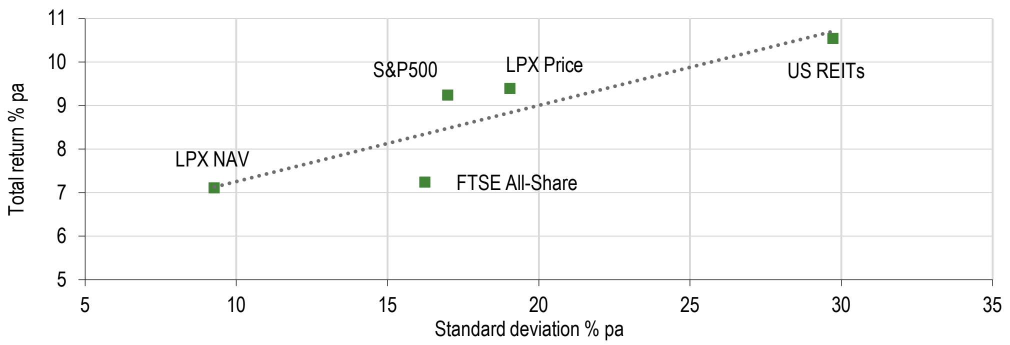
Exhibit 2: Total return and standard deviation – December 1993 to January 2017



Source: Bloomberg. Note: *December 2003 to January 2017.

We can also illustrate the longer-term picture in a scatter plot of risk and return. The line of best fit is illustrative, but we can see that LPE could form a useful risk-reward diversifier in investment portfolios.

Exhibit 3: Long-term risk-return local currency



Source: Bloomberg

Thus in an environment of equity markets near all-time highs, the current discounted valuation of LPE appears out of line with both recent and long-term investment performance and volatility. Hence, we attempt to answer the question of why the public market appears to be putting a larger risk premium on LPE compared to other equity-like assets.

Public market investors' perception of risk in LPE

The financial crisis has negatively affected investors' perception of risk in LPE.

We illustrate the market's perceptions of risk in LPE using interviews with experienced investors in the LPE and investment company space generally.

Pension funds and family offices allocate as much as 30% to PE, but according to Simon Moore at Seven Investment Management, "Public market investors still tend to treat LPE with caution, citing leverage and commitment risk, high valuations, poor disclosure and discount volatility."

Paul Cattermull of Brewin Dolphin adds, "Much of the caution stems from a few high profile corporate missteps during the financial crisis". Indeed a few large components of the index including 3i, Candover and SVG Capital suffered problems due to excessive leverage at the listed company level and large unfunded commitments resulting in fire sales and dilutive equity raises.

We use 3i as an example below. Total NAV at year-end March 2016 is 2.5x the figure in 2009 and 10% above the figure reported for 2008. On a per share basis however, the NAV per share has been hugely diluted by the nine-for-seven rights issue in June 2009 at a huge discount in order to reduce excessive debt levels. Other companies at the time such as SVG Capital were affected by aggressive commitment strategies.

Exhibit 4: 3i Group impact of dilutive share issuance

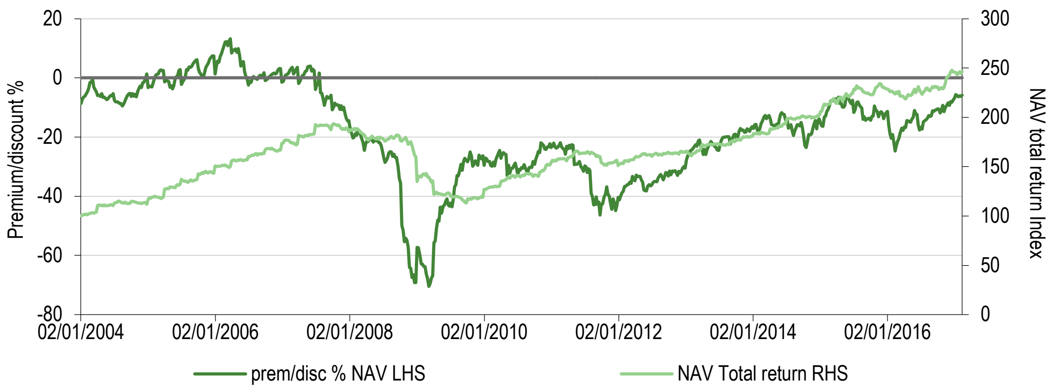
Year to end March	2008	2009	2016
Equity (£m)	4,057	1,862	4,455
Diluted shares (m)	605	602	961
NAV per share (£)	6.70	3.09	4.63

Source: 3i Group annual reports

We can see clearly how the perception of risk has been influenced by the events of the financial crisis. The chart below illustrates the premium/discount to NAV for the sector as represented by the LPX Europe Index. (Note that the current indicated discount of around 6% is lower than the aforementioned 14% figure from the AIC data, but this is explained by the relatively high weightings in Partners Group and 3i, which trade at significant premiums.) We believe the LPX Europe Index is the best available proxy for the LPE sector in Europe with a long history of data.

One can see that the LPE Europe Index traded at a premium in the mid 2000s and fell to an extreme discount during the financial crisis, when the sector traded at up to a 70% discount to NAV.

Exhibit 5: LPX Europe Index



Source: Bloomberg

This extreme volatility proved incredibly painful for investors, as illustrated in the table below. The NAV decline of 41% (with a lag) was somewhat *superior* to the 45-55% declines in the FTSE All-Share and S&P 500 total return indices, but the cumulative peak-to-trough fall in the LPX price total return index was 84% as the NAV discount widened dramatically, peaking at around 70%. Even so, it is noteworthy that S&P REITs, which are a much larger and widely accepted asset class, did not perform that much better than LPE.

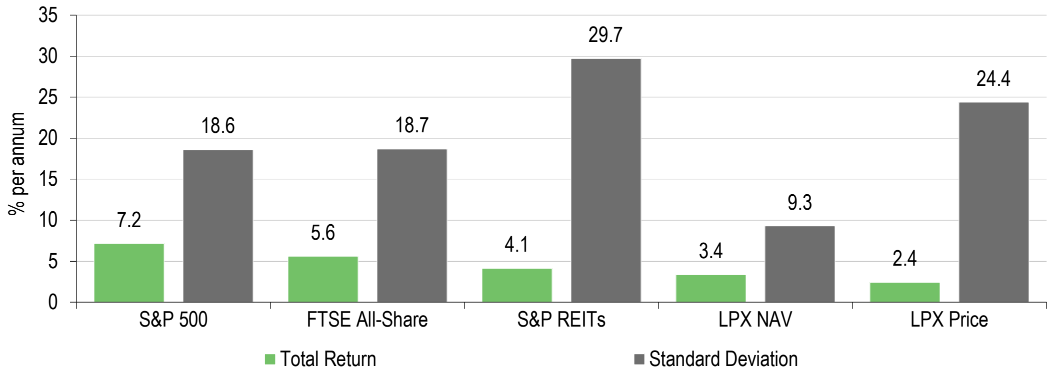
Exhibit 6: Peak to trough performance

2007-09	S&P 500	FTSE All-Share	PX NAV	S&P REITs	LPX price
Peak to trough performance	-55%	-45%	-41%	-74%	-84%

Source: Bloomberg

The impact of the financial crisis on the LPE sector has had a meaningful impact on the 10-year performance figures. As we show in the chart below, the average annual price total return for the LPX Europe Index is only 2.4% over the last 10 years (compared to the 19% for the five years to January 2017) with a relatively high standard deviation of 24.4% (14.2%). Likewise, the NAV return is only slightly better at 3.4% compared to 10%.

Exhibit 7: Total return and standard deviation – 10 years to January 2017



Source: Bloomberg

What is also clear is that although LPE did not perform well over this period, major equity indices have also exhibited mediocre performance. The very high volatility in US REITs for instance is striking at close to 30%.

Possible misperceptions of risk in LPE

To summarise the analysis above, it would appear that LPE is viewed by public market investors as much riskier than other equity-like comparables. This seems to stem largely from the performance during the financial crisis, which still lives on in investors' memories. This perception appears at odds with the strong recent performance of the LPE sector, as well as the solid long-term risk-reward profile, which notably includes the financial crisis years and does not differ significantly from that for the major equity indices.

The financial crisis has had more than just a psychological impact, however. As we showed above, the 10-year performance and risk figures are not flattering and this has created *institutional* effects. As Paul Cattermull, portfolio manager at Brewin Dolphin explained, "The 10- to 12-year return history for the asset class has been affected and importantly, this influences investment consultants' asset allocation recommendations to their clients such as pensions funds, wealth and asset managers."

This implies that that there could be a continuing pervasive impact on the LPE sector valuation from the financial crisis*. Looking forward this might actually represent an opportunity for investors of course*, to the extent that the discount might narrow as the unfavourable comparatives drop out of the analysis over the next couple of years or so.

We discuss the major risk issues commonly raised by investors in LPE in the next section, drawing on a number of interviews conducted with LPE managers and investors.

The PE model and risk mitigation

Roger Pim, manager of Standard Life Private Equity Trust, believes there is a general lack of understanding of the PE model and the risk profile of the companies underlying it. "The universe of unlisted companies is far larger than the listed space and LPE just gives you access to these. The PE space is overwhelmingly weighted towards buyouts rather than more risky venture capital. These buy-out companies are usually very established companies often with well-known brands – think Formula one, Pret a Manger and Hugo Boss etc – but they just happen to be privately owned rather than listed. There are many attractions for not being a listed company. When Dell was taken private one of the key reasons given was the much greater efficiency gained from being a private company. CEOs can spend as much as 30% of their time dealing with regulators and shareholders."

John Newlands, head of investment companies research at Brewin Dolphin, raises public relations dynamics as a factor behind public perception. "The media is far more likely to focus on high-profile deals which have gone wrong than the thousands of deals which have added significant value, enabling businesses to become more efficient, grow and make a positive contribution to the economy and employment."

Paul Cattermull concurs with the view that the PE and LPE industries have been historically less active in promoting the sector and believes "there is a need to bring the asset class to life with case studies. LPE gives investors access to a strong investment process, management process, disruptive technologies and new markets."

The fact that the PE investment and ownership model is highly focused on mitigating risk may not be fully appreciated by public market investors.

To begin with, managers apply a rigorous portfolio approach to investing. All the LPE managers we interviewed stressed the importance of portfolio diversification in mitigating risk. Funds are usually well diversified by stage (venture, growth, buyout), industry, geography, time (vintage) and general partner (GP) in the case of fund-of-funds LPE companies. Roger Pim emphasises the inherent diversification of investing across Europe as it is so heterogeneous with very varied cultures, economies, financial systems and industries.

Alex Barr and Colin Burrow, co-managers of Aberdeen Private Equity Fund, describe the process of manager diversification: "When selecting a GP we look at exposure to the same GP across the portfolio, dynamics of the team, remuneration policies and key man risk. The performance track record in buyouts needs to be consistent, with a good spread by year and across the portfolio. This obviously does not apply to venture where returns are expected to be quite lumpy. Finally it is important to ensure that any GP has not raised too much capital relative to the opportunity set. This is to avoid pressure to deploy funds and reduce quality or diversify into areas of less competence."

PE fund-of-funds managers in particular actively think about risk in a portfolio context and are highly diversified with often hundreds or even thousands of companies. On the direct side, most LPE companies also follow a portfolio approach. For instance, Deutsche Beteiligungs AG (DBAG) has 24 companies focused mainly on the German industrial sector. Thomas Franke, head of investor relations, highlights that "DBAG normally participates in ca. 10% of the 30-40 buyouts in Germany per year, so the chances of a high correlation of the businesses is low. We certainly wouldn't have say five companies with 80% of their business in China for instance."

Maurice Tchenio, chairman and CEO of Altamir Gerance, comments "we don't invest in competing companies and our portfolio is very diversified across our four sectors of specialisation. We try to find investments less correlated to the economy."

The PE investment model takes a long-term view and is highly focused on risk management from the outset of making an investment. GPs employ significant resources to their investments, maintaining relatively large specialist teams that apply in-depth analysis to industries and companies. A GP can follow a company for several years before investing.

The exit strategy is also clearly determined at the beginning of the investment including the appropriate multiples that might be achieved. GPs typically add significant value through active management including the realisation of efficiency savings, help in expanding organically or through acquisition and financing. In fact, Paul Cattermull highlights the quality of management in PE as a key differentiator: "The cadre of management in PE is superior, they combine the skills of management consultant, investment banker and investment analyst."

Another key factor driving risk management is alignment of stakeholders. GPs usually co-invest along with the limited partners (LPs) and are incentivised through carried interest, which is only earned on realisation gains.

The rigorous approach of the PE investment model is borne out in practice: actual ‘companies lost’ have been low even during the financial crisis. For instance, Roger Pim suggests “perhaps only a dozen or so out of several hundred funds that we have been involved in have not delivered cost.” This real experience differs from perception with high-profile media coverage of companies such as EMI etc.

The importance of investment discipline is also emphasised by Maurice Tchenio: “The cardinal rule in private equity is to make a multiple of our investment on our winners and not to lose more than 1x on our losers.”

Thomas Franke agrees: “while a small number of large LPE companies had problems during the financial crisis, many others managed things much better. We did not lose a single company during the financial crisis. PE has become less and less about financial engineering and more about creating value added at the company level. The industry is becoming increasingly differentiated from the pre-crisis years.”

Cyclical factors

Investors appear to worry that LPE is highly leveraged to the economic cycle.

Of course macroeconomic cycles and financial market gyrations are not under the control of managers and funds are usually structured with a five-year investment period, with investors expecting the funds to be deployed. Managers and GPs tend not to try to predict where we are in the cycle but focus on the bottom-up fundamentals. Alex Barr and Colin Burrow explain that “clearly there is a cycle, but its very difficult to predict and we run an evergreen (ie cash flows are recycled back in) portfolio”. Indeed, as Roger Pim makes clear, “Investment in private equity is a long-term commitment, so one can expect to experience a down-cycle at some point during the lifetime of an investment. The commitment to PE is longer than the duration of many marriages in the UK.”

However, risk is still being managed at the company level. Thomas Franke notes, “you can’t avoid cycles, we aim to be sure that the financial structure of investments is secure when a downturn comes. We actively stress-test our investments such that they would still meet debt covenants with for example a 50% fall in EBIT.” Maurice Tchenio also emphasises the importance of company selection: “we try to find companies that are not highly correlated with the economic cycle.”

Funding and commitments

Lessons have been learned from the financial crisis.

Funding (commitment) risk is greater in LPE than in the GP-LP model. Individual LPs must honour legal commitments to meet funding calls, with draconian default sanctions applied if these are not met. LPE companies, on the other hand, must manage cash flows in order to meet commitments to the underlying funds. If there has been an over-commitment to underlying funds and insufficient cash is available, debt has to be taken on and/or assets have to be sold or capital raised potentially at distressed prices. This was a key lesson from the financial crisis.

According to Maurice Tchenio, commitment risk is the biggest risk within LPE, He cites the aforementioned problems at a few companies during the financial crisis. “LPE companies have to manage cash and ensure there is enough to meet commitments, however excess cash dilutes returns so it is a balance.” He also notes that Altamir SCA, and some other funds (eg HgCapital Trust, Deutsche Beteiligungs AG) have an opt-out on commitments, which forms an important downside risk protection.

The misperception here appears to be that LPE companies are still highly vulnerable to commitment risk but the reality is different. Lessons have been learned post-crisis and commitments are now very much more tightly controlled with companies maintaining higher levels of liquidity (see 3i data under leverage below).

Fund-of-funds LPE companies are generally far less exposed to commitment risk due to their highly diversified nature. As Richard Hickman of HarbourVest Global Private Equity (HVPE) highlights, the annual cash generation within HVPE was "7% of the portfolio at the worst point in the cycle during the financial crisis and has been as high as 30% in recent years, providing ample liquidity."

Leverage

Leverage in LPE is perceived by public market investors to be a key differentiating risk compared to other equity-like assets.

There are two levels of leverage to consider. The first concerns that employed in the underlying portfolio companies. The quantity employed depends on the company, industry and other risk factors that are managed by experienced teams at the GPs.

It is true that more leverage is usually employed in PE but the aim is to produce the most efficient capital structure. The PE business model depends on managing leverage well to deliver attractive returns across the cycle, which the industry has achieved in aggregate.

Thomas Franke backs up this point: "during the crisis people expected many companies would be lost due to leverage but this was overwhelmingly not the case." Alex Barr and Colin Burrow also suggest that "leverage levels are less aggressive than pre-crisis – both the quantum and structure of debt is more conservative."

Richard Hickman points out the potential misperception in the market on leverage: "LPE is still often perceived by the market as geared equity, but this is less true than it used to be. HVPE is incredibly diversified. Moreover venture and growth-stage investments total 32% of the fund and these tend to have lower debt levels. Furthermore, we currently hold net cash at the listed entity."

The second level of leverage to consider is whether any is employed at the listed entity level. This proved to be one of the key factors affecting certain LPE companies during the financial crisis, but in contrast, most companies now run a net cash position.

To illustrate this, we once more turn to the accounts of 3i Group, which are representative of how leverage at the listed entity is significantly lower now compared to pre-crisis for the LPE sector. The table below highlights debt and liquidity metrics for 3i. We can see that 3i is running a net cash position currently (which is typical across the sector today) compared with a net debt-to-equity position of 40% pre-crisis and 103% in 2009. The equity-to-assets, net debt plus commitments-to-equity and liquidity ratios are all significantly better than in both 2008 and 2009.

Exhibit 8: 3i Group has reduced balance sheet risk significantly post crisis

Year to end March (£m)	2008	2009	2016
Total assets	6,990	4,930	5,863
Equity	4,057	1,862	4,455
Net debt	1,638	1,913	-165
Investment commitments	356	390	669
Available liquidity	1,106	1,030	1,352
Net debt/equity	40%	103%	-4%
Net debt + commitments/equity	49%	124%	11%
Liquidity/assets	16%	21%	23%

Source: 3i Group annual reports

Roger Pim summarises the approach of the industry well: "we would normally expect to run a net cash position of zero (at the LPE company) over the cycle but currently hold more than 10%, reflecting where we are in the cycle."

Thus it is clear that although it was valid to worry about excessive leverage (and unfunded commitments) during the financial crisis, the risks from these areas are dramatically reduced looking forward. There is always a risk that markets can correct but the potential severity of any drawdown in the LPE sector should be lower than before the financial crisis all other things being equal.

Valuation

Valuation in LPE is a significant risk in the minds of investors.

Based on our investor interviews, there is still uncertainty in the market on the quality of the valuation process in LPE and questions arise around time lags, levels of disclosure and valuation methodologies.

Valuation risk in LPE is a function of the underlying valuations of the portfolio. From the perspective of a GP, they want to ensure that the entry price and assumed exit multiples are compatible with their return targets over the life of the investment. As Richard Hickman points out, "We often see GPs factoring-in valuation multiple declines against their operational improvements."

From the investors' point of view, they are concerned that the valuation multiples across the portfolio accurately reflect economic reality at any point in time.

One way of managing valuation risk is through diversification by vintage as well as by company, industry and geography. Valuations generally conform to the International Private Equity and Venture Capital (IPEV) valuation guidelines, but as with any valuation estimate there is an element of judgement and multiples are informed by public market valuations. Unlike public equity markets, which mainly use forward earnings projections to value companies, buyout funds usually value holdings using trailing earnings multiples and managers can apply liquidity discounts. Again, in contrast to public markets, realisations are usually dominated by corporate transactions, which can capture additional substantial premiums for change in control due to expected synergy effects.

Another primary concern currently is that PE valuations are high in absolute terms and exacerbated by $1tn of 'dry powder' or committed funds not yet invested.

The valuation pressure is not uniform, however, being more concentrated in the large buyout market, particularly successor funds and in the US. Alex Bar and Colin Burrow remark "every GP says they won't overpay and there are record levels of dry powder, but this tends to be in the larger deal funds. We are mitigating valuation risk by focussing on managers in the lower and mid-tier market where there are greater inefficiencies and more attractive pricing."

It is also important to understand where PE and LPE sit in terms of the universe of investment opportunities. Maurice Tchenio believes the 'dry powder' issue is overstated: "The PE market is around $3.5tn and the listed space is more than 10 times larger. However, the universe of unlisted companies is larger than that of listed companies. Thus there is ample capacity to invest committed funds into the private company space."

A number of managers have also pointed out that high valuations in LPE are not unique; valuations are also elevated in public markets and appear to present a greater risk at the moment. Roger Pim sees "prices creeping up in PE" but adds "we often find within portfolios that it is the listed holdings that are actually valued the most aggressively." Alex Barr concurs and suggests that funds that have greater listed company exposure may be more exposed to market volatility and this is a factor that investors should assess: "There is usually some listed exposure in GPs. Larger ones will own a name that is in part-public and part-private ownership (eg due to management lock-ups). We are actively selling down some of our listed exposure."

Thomas Franke makes similar observations: "Valuations are high in public equities but less so in PE. PE has a better grip on the assets so can live with higher valuations. Multiples are currently not much above one point higher than average."

Roger Pim points to continued strong realisation gains: "valuations are full but not aggressively so and are currently around 1-2 points above long-term averages. The ultimate test of portfolio valuation is the exit multiple and realisations are typically being made at 20% premiums to the most recent valuation."

Disclosure

Disclosure is more limited in LPE than other investment companies but improving.

An element of perceived risk related to valuation is that of disclosure. LPE funds report NAVs less frequently than investment companies in general and detail is limited compared to the availability of data in LP structures. LPE NAVs are usually published quarterly and with a lag of one to three months.

While LPs in a traditional PE fund usually receive regular and very detailed reports on the performance of the underlying portfolio companies, investors in LPE funds receive much less detailed information, often in a more aggregated form. This is because of confidentiality obligations and the understandable desire not to put market-sensitive information into the public domain. For direct investment strategies, disclosure may include any combination of revenues, profits and EBITDA at the fund level or for a selection of portfolio companies.

That said, disclosure has been improving over time as LPE companies increasingly recognise the importance of disclosure for investors. For instance, some LPE funds-of-funds are now publishing monthly estimated NAVs and more portfolio detail is being disclosed generally. Although the public market investor does not have all the information with the frequency they might wish for, they should be aware that the GPs managing the funds have an extremely high level of management information to hand.

For fund-of-funds strategies, the investor is effectively buying the manager's access to and ability to interpret the wealth of information given at the LP level and benefit from their expertise in allocating capital commensurately.

Liquidity and discount volatility

LPE offers far more liquidity than PE.

PE is clearly an illiquid investment requiring a long-term commitment by the investor. Even though there is a secondary market, realised prices can be at significant discounts with poor predictability on cash flows.

In LPE liquidity risk is greatly reduced as the investment is listed. Although liquidity in the traded shares may also not be particularly high and the shares may trade at a discount to NAV, there is a daily price and investors know when they will receive the cash. Paul Cattermull is a strong advocate for the LPE vehicle: "The LPE closed-end structure is absolutely the right one for investing in PE. It's a buy and hold strategy and the choice is either LPE or nothing. Liquidity is becoming less of an issue as several LPE companies have a market value greater than £1bn now."

Discount volatility can arise from daily variation in demand and supply of shares, uncertainty due to disclosure issues (see above) and general market conditions. According to Roger Pim, "Discount volatility is an issue in the short-term that investors have to deal with, but the discount also reduces risk around the underlying portfolio valuation and can be viewed as an opportunity to acquire assets cheaply. Discount volatility becomes less important over a three- to five-year horizon as operational performance tends to dominate."

Alex Barr and Colin Burrow also highlight the fact that they currently see “a large gap between LPE discounts in the teens relative to secondary market transactions in the mid-single digits” indicating a mispricing of LPE currently.

Richard Hickman looks at discount volatility somewhat differently: “you can’t have it both ways, LPE gives investors the liquidity they can’t get as an LP, but you have to accept the discount volatility in return.” Paul Cattermull reiterates this point: “The volatility in LPE stems from the underlying, which is equity and then the wrapper or listed structure which can be volatile. However LPE is an attractive long-term asset class so the alternative for public market investors is nothing at all.”

The future – reason for optimism

We have demonstrated that LPE has delivered competitive returns compared to equity indices and closed-end structures like US REITs over both recent years as well as very long time periods. The high-profile mistakes made by a few companies during the financial crisis have negatively affected public market perceptions on the riskiness of LPE resulting in persistent large discounts to NAV and secondary PE prices.

There is good reason for optimism regarding the perception of LPE moving forward, however.

The LPE sector is trading at a meaningful discount, which reduces valuation risk compared to equity markets in general. In addition, the less flattering risk-return profile over the last 10 years will arithmetically fall out of the comparisons over the next couple of years or so, which should improve the sector’s relative attractiveness from an investment consultant’s point of view.

The PE ownership model itself is relatively unchanged and has proved to be a highly effective and successful vehicle to create value in unlisted companies with tight control over risk. We have discussed how the PE model mitigates risk and this resilience has been demonstrated in reality during difficult times as evidenced by the low incidence of failed investments during the financial crisis.

Finally, lessons have been learned from past mistakes at the LPE company level. The relatively aggressive leverage and commitment strategies at a few LPE companies are no longer a feature for the sector. This augurs well for the relative performance of LPE in future down cycles, which will inevitably occur and suggests potential for the risk-reward to improve further.

Thomas Franke summarises the LPE model succinctly: “I have been working 16 years at Deutsche Beteiligungs AG. The PE asset class should outperform as so much time and effort is made on the investment decision – much more than any public equity investment. What PE does with each company individually and across the portfolio on average is superior.”

Appendix: About LPEQ

LPEQ is an international platform of listed private equity companies. Its principal purpose is to engage with investors to deepen understanding of the key investment considerations when looking to invest in the private equity sector. Please see www.LPEQ.com.

LPEQ membership:

Aberdeen Private Equity Fund	www.aberdeenprivateequity.co.uk/itprivateequityfund
Altamir SCA	www.altamir.fr
Deutsche Beteiligungs AG	www.dbag.de/home-en
Electra Private Equity PLC	www.electraequity.com
F&C Private Equity Trust plc	www.fandc.com/fandc-private-equity-trust
Gimv	www.gimv.com/en
HarbourVest Global Private Equity Limited	www.hvpe.com
HBM Healthcare Investments Ltd	www.hbmhealthcare.com/en
HgCapital Trust plc	www.hgcapitaltrust.com
ICG Enterprise Trust plc	www.icg-enterprise.co.uk
JPEL Private Equity Limited	www.jpelonline.com
JZ Capital Partners Limited	www.jzcp.com
NB Private Equity Partners Limited	www.nbprivateequitypartners.com
Oakley Capital Investments Limited	www.oakleycapitalinvestments.com
Pantheon International Plc	www.piplc.com
Princess Private Equity Holding Limited	www.princess-privateequity.net
Spice Private Equity Ltd	www.spice-private-equity.com
Standard Life Private Equity Trust PLC	www.slcapital.com/slpet/index.html

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