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Update | Investment companies

14 September 2016

Standard Life European Private Equity

Reinvestment phase underway

Over the past few years, Standard Life European Private Equity Trust (SEP) has been benefitting from a high level of distributions. Now, as equity markets become more volatile, SEP's managers think that we could be shifting from a realisation phase into an investment phase. They think the underlying managers should be deploying cash at attractive valuations, laying the foundations for continued good performance in the years to come. In the meantime, they believe the mature portfolio should support continued strength in the net asset value.

European private equity fund of funds

Standard Life European Private Equity Trust aims to achieve long-term capital gains through a diversified portfolio of private equity funds investing predominantly in Europe. SEP occupies a unique position within the UK-listed private equity sector as the only fund of funds focused solely on Europe. Its portfolio is also more concentrated than most funds in its peer group, with around half of the portfolio accounted for by the top 10 holdings of leading private equity funds raised by leading managers.

Like many private equity funds, SEP has no formal benchmark. The normal size of the underlying companies is between €100m and €2bn and therefore its portfolio is most closely correlated to European small cap indices; the MSCI Europe Small Cap Index has been used in this report.

Year ended	Share price total return (%)	NAV total return . (%)	MSCI Europe Small Cap TR (%)	MSCI Europe total return (%)	LPX Europe total return (%)
31/08/12	2.8	(3.6)	1.5	4.7	(2.3)
31/08/13	25.9	5.4	36.4	23.2	39.4
31/08/14	15.7	9.0	12.6	10.3	8.1
31/08/15	(2.4)	8.5	10.0	(0.6)	12.2
31/08/16	23.8	23.4	18.7	14.5	20.5

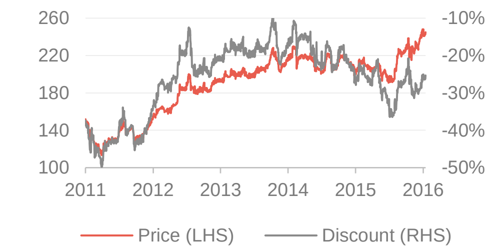
Source: Morningstar, Marten & Co.

Sector	Private equity
Ticker	SEP LN
Base currency	GBP
Price	245
NAV	328.14*
Premium/(discount)	(25.3%)
Yield (%)	2.1

* Morningstar estimate, last published 325.4p at 31 July 2016

Share price and discount

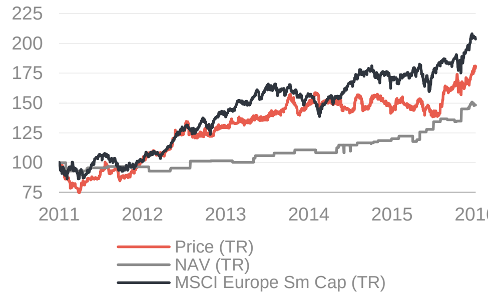
Time period 31/08/2011 to 12/09/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/08/2011 to 31/08/2016



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	May 2001
Manager	SL Capital Ptnrs.
Market cap (GBP)	377m
Shares outstanding	153.7m
Daily vol. (1-yr. avg.)	130k shares
Net gearing	Nil

Click here for our initiation note

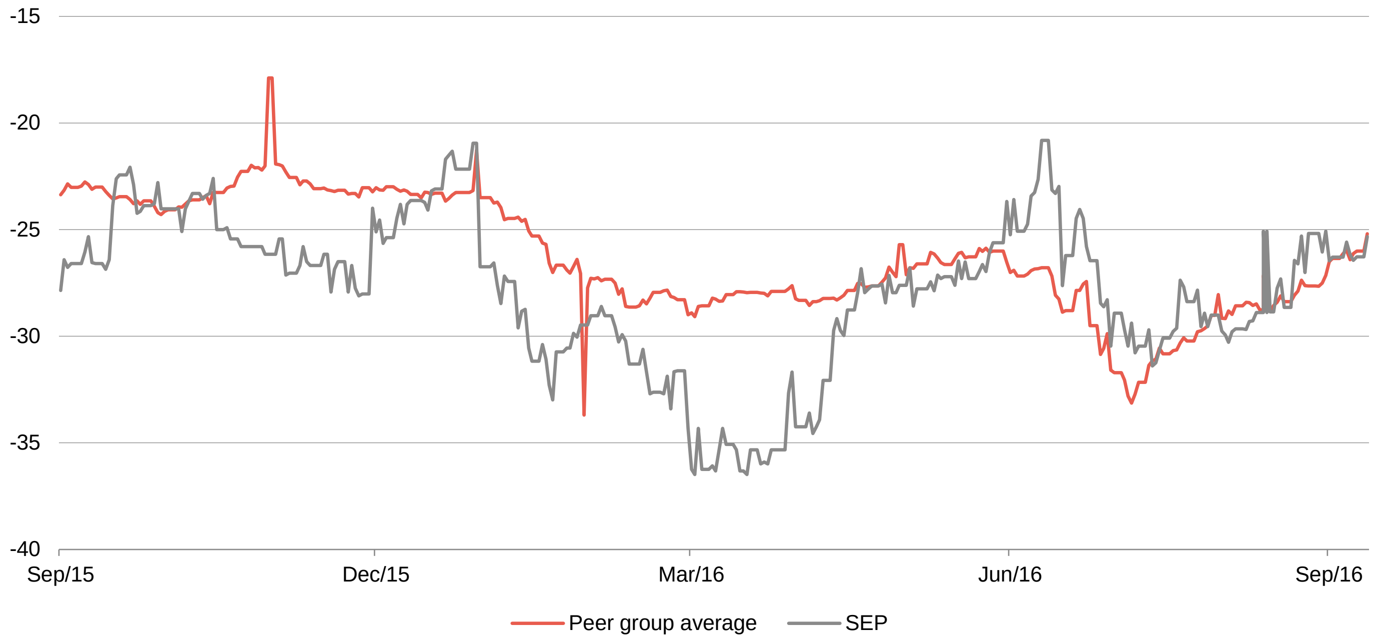
Market backdrop

Economic downturn in UK and continental Europe offers a buying opportunity for private equity

For financial markets, the main event of the past couple of months was the UK's vote to leave the EU (Brexit). Markets seemed to be surprised by the result and the pound fell sharply against the US dollar and the euro. As Figure 1 shows, discounts on listed private equity funds, which had already been drifting out in advance of the referendum, widened. It seems as though the positive translational impact of the fall in the pound on net asset values (NAVs) was not reflected in share prices. SEP was not immune from this, although its discount, which had been wider than the peer group average for most of the past year, has tended to be narrower than this average since the initiation note was published in May.

The managers believe that the weakness in SEP's share price over the past few months is unjustified, telling us that the current period of market volatility could be setting up the fund for another period of good performance.

Figure 1: Discounts on London-listed private equity funds over the past year



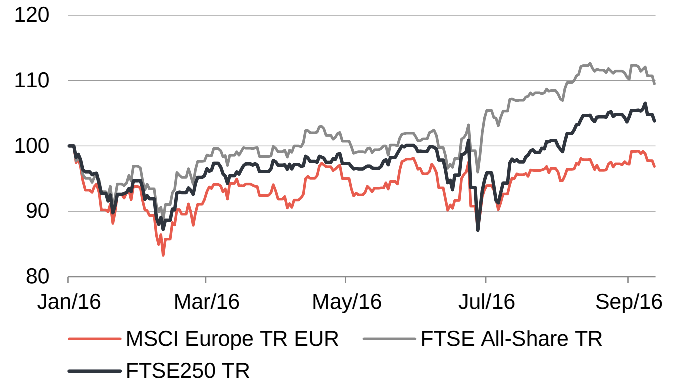
Source: Morningstar, Marten & Co

As the weeks have passed since the vote, investors seem to have become more sanguine about Brexit. As can be seen in Figure 2, European markets, as represented by the MSCI Europe Index (in euro terms) have been fairly flat, while the UK market, as represented by the FTSE All-Share Index, shrugged off the post-referendum result wobble and hit new highs, buoyed by the impact of the weak currency on overseas earnings. Even the more domestically focused FTSE 250 Index, which includes many stocks that were hit quite badly in the aftermath of the vote, has been recovering and is now well into positive territory. Sterling has not bounced, however, as can be seen in Figure 3.

The managers say a weak pound (relative to the Euro) is positive for SEP's NAV

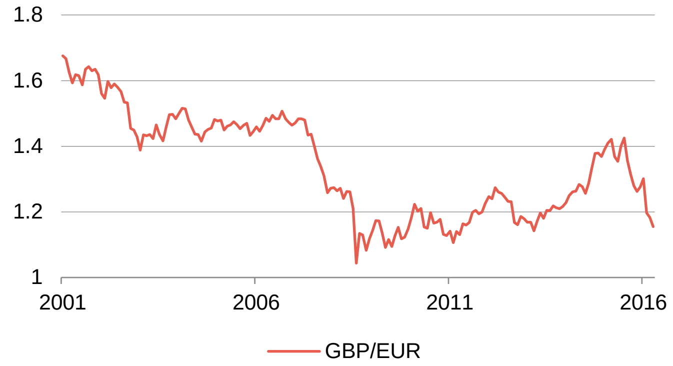
For SEP, which has just 15% of its portfolio invested in the UK, the fall in sterling has provided a boost to its NAV. The managers are pleased that exchange rates, which for six years were a drag on returns, have now turned in the fund's favour. They believe that further sterling weakness is likely and that will provide a tailwind to performance.

Figure 2: UK and European equity markets (local currency) year to date



Source: Morningstar, Marten & Co

Figure 3: Pound/euro exchange rate over the past 15 years



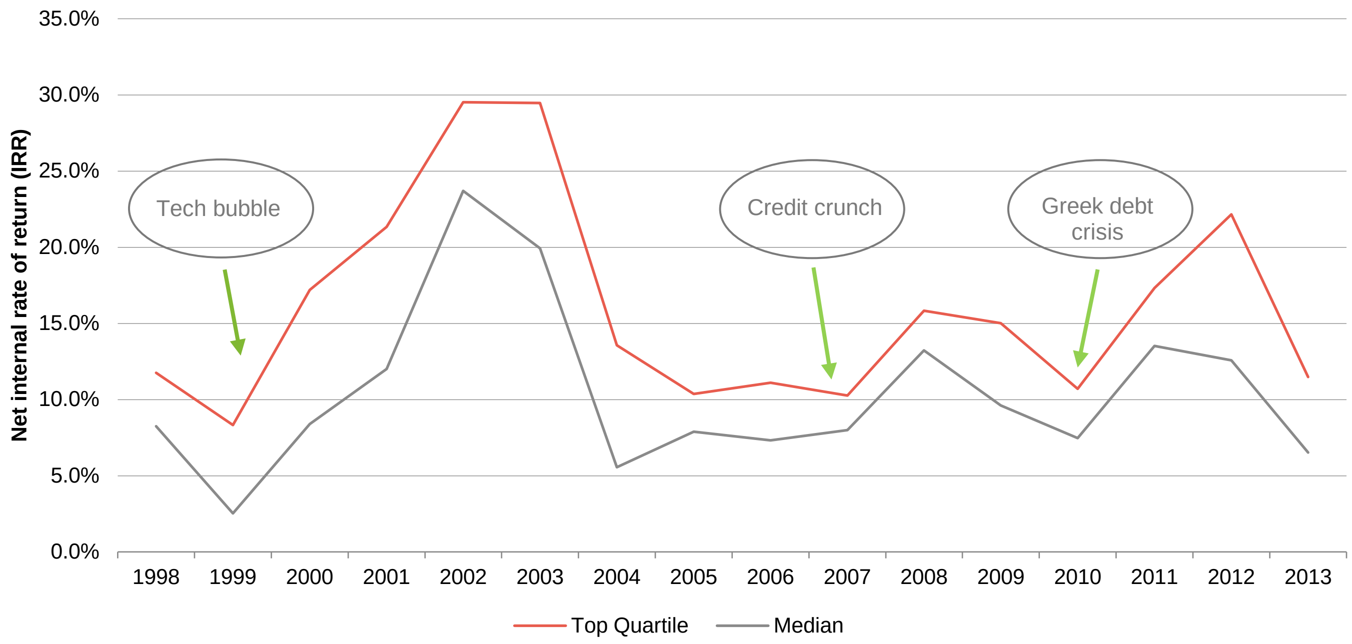
Source: Morningstar, Marten & Co

The managers have concerns about the UK economy and think that there is a good chance that it will experience a recession later this year and into 2017. This will have some knock-on effect on the European economy, which has its own problems. At the same time, the managers have some concerns about the political front in Europe. However, they think that the downturn may be relatively short-lived and that European corporates should continue on their slow recovery path. They believe firmly that private equity backed companies will continue to achieve higher profit growth rates in this environment compared to their listed peers.

The private equity market

Private equity returns benefit from periods of volatility

Figure 4: Performance of private equity investments by vintage



Source: SL Capital from Cambridge Associates

Private equity returns spike post recessions and after volatile periods

Private equity funds should benefit if volatile markets allow a window to buy assets more cheaply. Figure 4 shows how private equity investments made in the year shown perform subsequently. For example, the best 25% of investments made by funds in 2002 (after the collapse of the technology bubble) made an internal rate of return of 29.5% whereas the median fund made 23.7%. By contrast, the median return on investments made in 2010 was 7.5%. The data suggest that the returns achieved by private equity investments made during periods of economic uncertainty are much superior to returns achieved on investments made in the "good times".

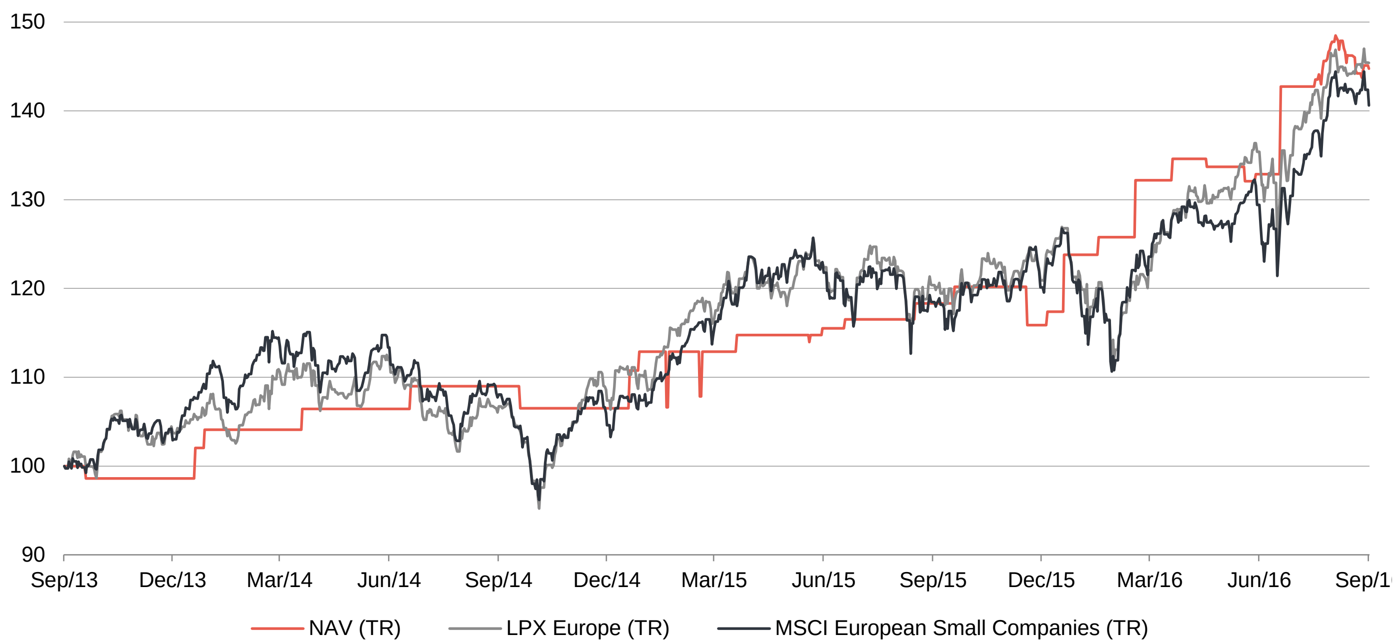
In Figure 4, by far the best returns are achieved on investments made at the height of the dot-com crash. Perversely, these periods of uncertainty are also often the periods when some investors in private equity funds panic, sell out and discounts widen.

"Private equity funds have been operating in a sellers' market"

The managers believe private equity funds have been operating in a sellers' market for some years. This has been a good period for SEP, as is evidenced by its performance over the past three years (shown in Figure 5 below). SEP's NAV has been outperforming its listed peer group as represented by the LPX Europe Index and comparable equity markets as represented by the MSCI European Smaller Companies Index.

As explained in the initiation note, exits usually translate into an uplift in NAV which the managers think is a reflection of the conservative approach to valuation adopted by most private equity funds. Typically, a premium is achieved as companies are sold.

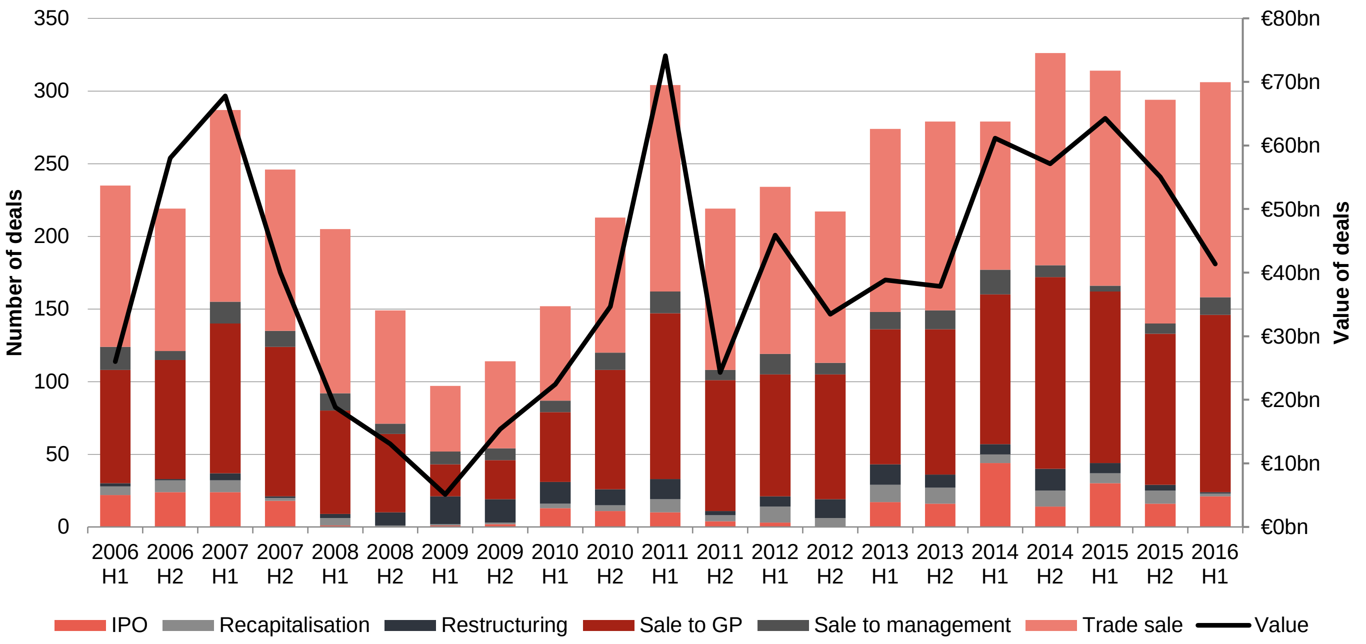
Figure 5: SEP NAV over three years compared with LPX Europe and MSCI European Smaller Companies (rebased)



Source: Morningstar, Marten & Co

Figure 6 shows exit activity (private equity funds selling out of investments) in Europe over the past decade, analysed by type of deal. A lot of emphasis is placed by some investors on the health of the IPO market (the start of trading in a company's shares on a stock exchange) as an indicator of exit activity, but IPOs are dwarfed by sales to trade buyers and other funds (sales to GPs or general partners – the managers of limited partnerships). Although the number of exits is yet to slow, the total value of those exits has been falling sharply and is running at less than two thirds of the level it was a year ago. The managers think that, while the exit environment is past its peak in terms of value, as the larger companies have already been exited, the volume of deals remains high as mid-market portfolio businesses are sold.

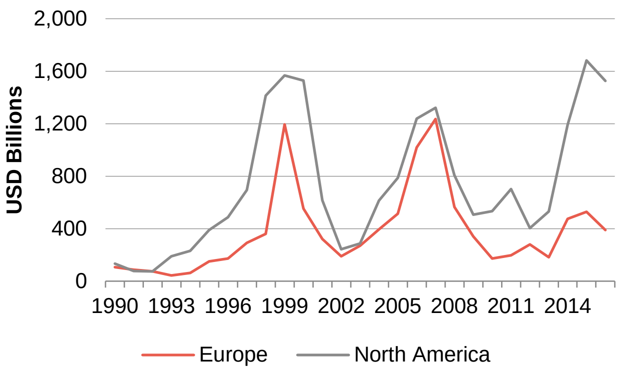
Figure 6: European exits by type over 10 years



Source: SL Capital

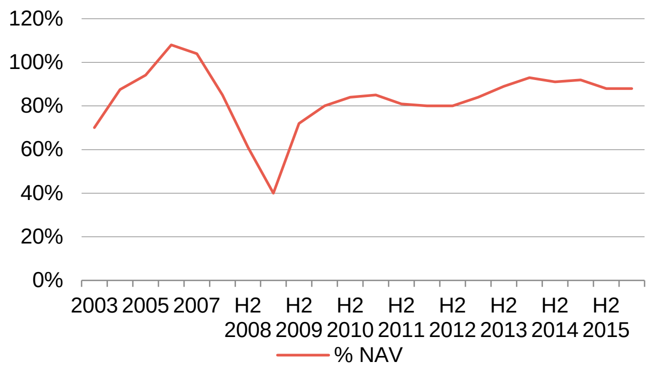
Looking at Figure 7, in Europe, in particular, merger and acquisition (M&A) activity appears to be past its peak and the value of deals is declining even in North America, though generally M&A activity remains more buoyant there. The managers expect the situation to continue as the private equity market starts to shift from a realisation phase to an investment phase and, as volatility increases, Europe will benefit more on a relative basis over the more highly priced US.

Figure 7: M&A deals by value



Source: SL Capital

Figure 8: Pricing of Limited Partnership funds in the secondary market

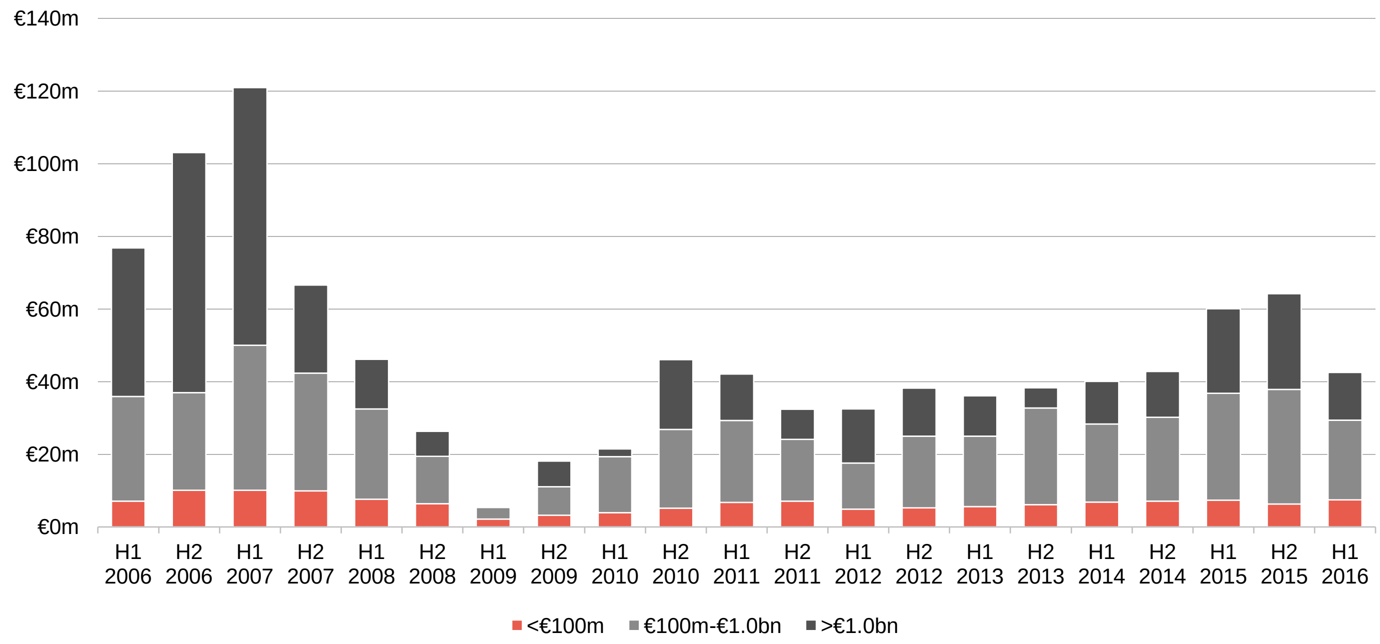


Source: SL Capital (from Cogent)

As Figure 8 shows, discounts on the values of transactions in Limited Partnership (LP) funds in the secondary market (when an existing fund is sold on as opposed to the primary market where investments are made into new funds) were running at a level of 12% at the end of June 2016. It will be interesting to see if this changes much in the second half of 2016 but, on average, pricing has been fairly stable since the end of the financial crisis and the managers do not see why this would change in the short term.

The managers expect to see increased value in certain segments of the secondary market. The managers also reiterate the point made in the initiation note, that a 12% discount for deals in the secondary market sits at odds with SEP's much wider discount.

Figure 9: Buyouts by size



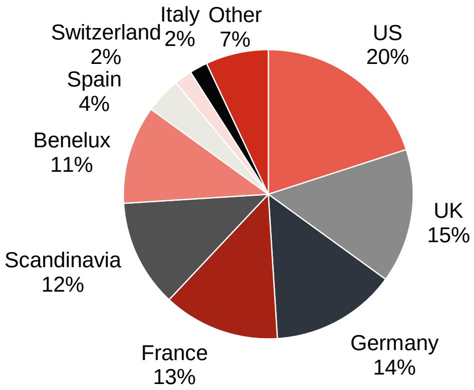
Source: SL Capital (from Incisive Media)

Figure 9 shows private equity backed buyout activity in Europe, analysed by size of deal. The chart suggests that fewer deals were done in the €100m plus bands in H1 2016 than in the previous 12 months, partly explained by the impact of the EU referendum vote. There have been a number of new fund launches, however, which implies that there is quite a bit of 'dry powder' for new acquisitions within the European private equity market. This capital has been raised against the expectation of an improved opportunity set for the funds.

Asset allocation

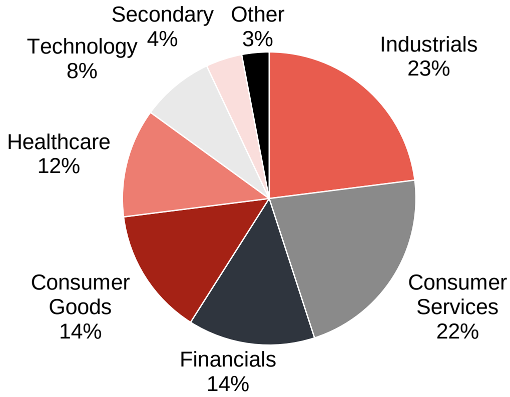
The initiation note described the investment process in some detail. Since it was published in May 2016, the information available on the portfolio has been updated from 30 September 2015 to 31 March 2016. Figure 10 shows the geographic split of the portfolio. According to data source, Preqin, the UK accounted for 57% of assets under management in the Pan-European private equity industry at the end of June 2016. SEP's 15% weighting to the UK is low for a Pan-European fund therefore, reflecting the managers' belief that it is harder for the managers of private equity funds to generate returns in a private equity market that is as crowded as the UK's. Given that many of the UK companies in the portfolio will be exposed to export markets, SEP's exposure to the pound is fairly low. Figure 11 confirms that the portfolio is exposed to a broad spread of industrial sectors. The geographic and sector weightings were not much changed from September 2015 to March 2016, with the most significant change being a drop of 3% in the allocation to financials.

Figure 10: Geographic split as at 31 March 2016



Source: SL Capital

Figure 11: Sector split as at 31 March 2016

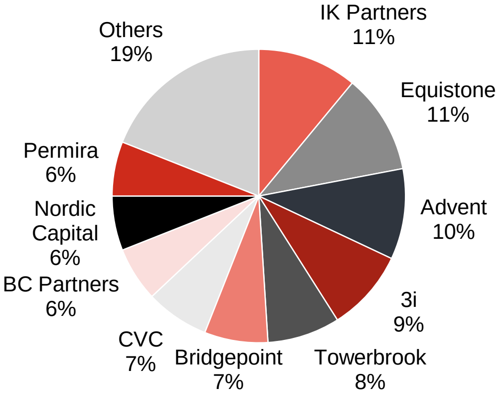


Source: SL Capital

As explained in the initiation note, SEP's managers are happy to focus the portfolio on a core group of managers that it knows and trusts. The top 10 private equity managers (see Figure 12) account for 81% of the portfolio. TowerBrook, which they added in December 2015 through the purchase of a $60m commitment to TowerBrook III in the secondary market, complements the existing investment in TowerBrook IV. The managers believe that a more difficult economic environment should suit TowerBrook, as it will sometimes buy distressed debt as a prelude to taking control of a company ("loan to own").

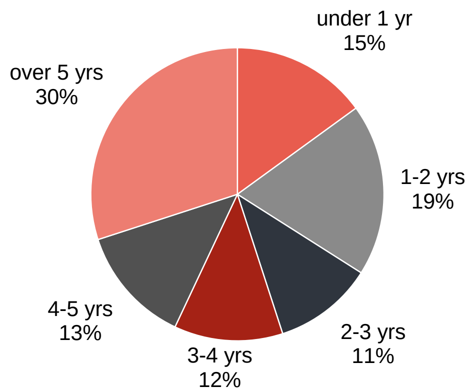
The allocation to each private equity manager often includes funds from more than one vintage. The maturity profile of SEP's portfolio, shown in Figure 13, shifted somewhat from September 2015 to March 2016 as the exposure to funds more than five years old dropped by 5% (after they made distributions to SEP) and funds one to two years old increased by 7% (following the TowerBrook deal). The maturity of the portfolio has become more balanced over the past three years with the aim of achieving consistent growth and a steady exit profile.

Figure 12: Split by manager as at 31 March 2016



Source: SL Capital

Figure 13: Maturity profile as at 31 March 2016



Source: SL Capital

Figure 14 shows the top 10 underlying investments in the portfolio at the end of March 2016. The largest company in the portfolio is Action, a 3i backed fast growth non-food discounter with more than 680 stores across the Benelux, French and Germanic markets. The business now has net sales of €2.0bn and grew revenues by more than 30% last year with 141 store openings and strong organic growth. This company undertook a €1.2bn refinancing in early 2016 with proceeds returned used to refinance existing debt and return capital to shareholders. This strong performance and proceeds received meant that the company was valued at 12x cost at 31 March 2016.

Figure 14: 10 largest underlying holdings

Company	Business	Fund	Value 31 Mar 2016 £m	% of net assets Mar/16	% of net assets Sep/15	Change
Action	Non-food discount retailer	3i Eurofund V	18.8	4.0	3.4	0.6
Parques Reunidos	55 leisure parks in Europe and the Americas	Candover 2005	8.1	1.7	1.7	-
Scandlines	Ferries between Sweden and Denmark	3i Eurofund V	7.4	1.6	1.2	0.4
Schenck Process	Measuring and process technologies	IK 2007	5.8	1.2	1.2	-
AWAS/Pegasus	Commercial aircraft leasing	Terra Firma III	5.6	1.2	1.2	-
Not disclosed	Card payment services	Advent VI	4.3	0.9	1.3	(0.4)
Amor	Retailer of affordable jewellery	3i Eurofund V	4.3	0.9	0.8	0.1
Technogym	Fitness equipment	Candover 2005	4.2	0.9	0.9	-
Cerelia	Ready to use chilled dough	IK VII	4.1	0.9	0.7	0.2
Lindorff	Debt collection and accountancy services	Nordic Capital VIII	4.1	0.9	0.9	-

Source: SL Capital, Marten & Co

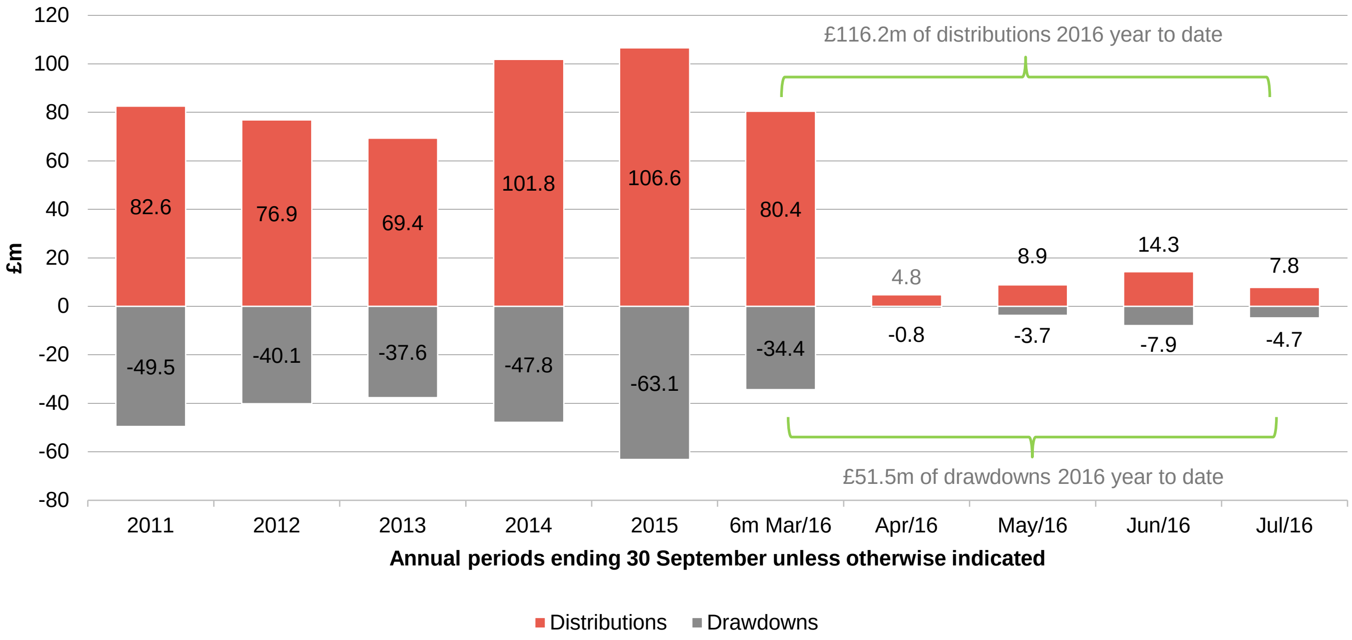
Balance of cash, debt and outstanding commitments.

Thanks to the buoyant period for exits, SEP has built up a sizeable ‘war chest’ (even after deploying considerable capital though purchases of LPs in the secondary market.

SEP’s cash balances will allow tactical investments to enhance performance

SEP had £68.9m in cash at the end of June plus £40.5m worth of index tracker funds (tracking UK and European equity indices – the initiation note explains the reasoning behind the allocation to index trackers) giving it liquid resources of £109.4m. By the end of July this had risen to £111.7m. In addition, SEP has an £80m syndicated revolving credit facility provided by Citibank and Societe Generale (which is available until December 2020). Against this, outstanding commitments at the end of July 2016 totalled £313.3m, but the managers estimate that up to £55m of this is unlikely to be drawn and much of this will be met by distributions from existing fund investments. As explained in the initiation note, balancing liquid resources against outstanding commitments in a way that minimises cash drag on the fund is a key part of the managers’ role. SEP’s managers feel that they have ample headroom to make new commitments.

Figure 15: Distributions versus drawdowns



Source: SL Capital, Marten & Co

Many of the underlying funds also have cash to deploy today into new opportunities. SEP's more recent primary commitments include:

- Equistone Partners Europe V, a €2.0bn fund investing in regional European buyouts valued between €50m and €300m in France, Germany, Switzerland and the UK. The managers say it has firm has strong local market franchises that have strong origination, acquire strategically valuable assets and position them well for exit. SEP committed €30m.
- Advent International GPE VIII, a €12bn global fund with a European nexus investing in buyouts valued between $200m and $3.0bn. The core focus is around Europe and North America and core sectors include financial services, healthcare, industrial, consumer and technology. The managers say the firm is a highly respected global organisation with 174 investment professionals across 11 offices in 10 countries and a strong track record over many years. SEP committed €45m.
- Astorg VI is a €2.1bn fund headquartered in France targeting European B2B niche market leaders. Targeting mid- market buyouts valued between €100m to €1.0bn, Astorg invests in businesses that have strong operating margins, high quality management and are of scale. The team of 14 investment professionals have a strong long-term track record. SEP made a €23m commitment to the fund.
- Cinven Fifth Fund is a €7.0bn fund focused on European buyouts with an enterprise value of greater than €300m. The firm adopts a sector based approach to target high quality companies in the TMT, consumer, industrial, business services and healthcare markets. The 65 investment professionals operate from 5 offices across Europe and support offices in North America and Asia. Cinven can demonstrate a track record of investing in 112 companies since 1998. SEP committed €28m to the fund.

SEP's managers say that all the managers running these funds are market leaders and have complementary strategies that achieve high performance through the cycle. It believes these new commitments are well placed to take advantage of any market downturn in the core European markets.

Previous research publications

Additional information is available at the fund managers' website, www.slcapital.com/slepet/index.html

Readers interested in further information about SEP may wish to read the initiation note *Sitting in a sweet spot*, published on 10 May 2016. The contents pages have been reproduced below. You can read the notes by clicking on the menu below or by visiting QuotedData.com.

Sitting in a sweet spot – 10 May 2016

QuotedData

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