MARTEN & CO

Update | Investment companies

3 July 2017

Standard Life Private Equity

Loading the portfolio

SL Capital Partners, the manager of Standard Life Private Equity Trust (SLPE), observes an improving outlook in Europe. However, it thinks that some form of market disruption could occur during the next 12 to 24 months. This might lead to greater volatility and an improved pricing environment for those of its underlying funds that wish to make acquisitions. SLPE has been selective with its primary commitments and secondary fund purchases, aiming to be well positioned in advance of any market setback (see page 3).

European-focused private equity fund of funds

Standard Life Private Equity Trust aims to achieve long-term total returns through a diversified portfolio of private equity funds, the majority of which will have a European focus. Historically, SLPE has occupied a unique position within the UK-listed private equity sector as the only fund of funds focused solely on Europe and, while it has refined its strategy, it says it will continue to be the most European-focused fund in its peer group. Its portfolio is also more concentrated than most of its peers; the top 10 private equity fund managers comprise 65% of the net asset value and the top 30 underlying companies represent 30%.

Like many private equity funds, SLPE has no formal benchmark. Historically, the portfolio has been most closely correlated to European small cap indices and we expect this to continue. We have used the MSCI Europe Small Cap Index as a means of comparison.

Year ended	Share price total return (%)	NAV total return (%)	MSCI Europe Small Cap TR (%)	MSCI Europe total return (%)	LPX Europe total return (%)
31/05/13	45.3	4.6	42.2	37.7	50.3
31/05/14	18.6	6.8	21.1	11.9	11.6
31/05/15	0.7	7.8	9.0	5.2	16.7
31/05/16	9.0	15.1	5.4	(5.0)	(2.2)
31/05/17	40.0	26.1	32.0	32.7	39.6

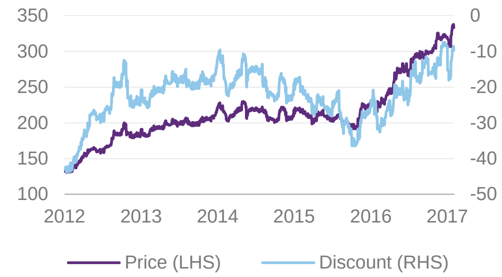
Source: Morningstar, Marten & Co.

Sector	Private equity
Ticker	SLPE LN
Base currency	GBP
Price	333.25p
NAV*	369.13p
Premium/(discount)	(9.7%)
Yield**	3.6%

* Morningstar estimate, last published 373.7p at 31 May 2017.
** based on rebased dividend of 12p per share for 2017 year.

Share price and discount

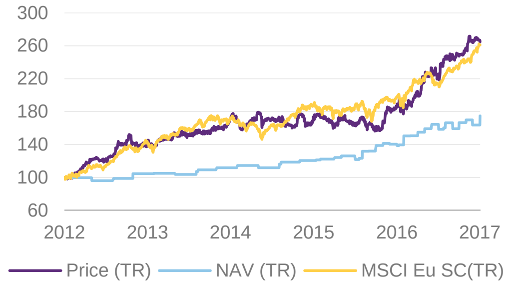
Time period 31/05/2012 to 30/06/2017



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/05/2012 to 31/05/2017



Source: Morningstar, Marten & Co

Domicile	United Kingdom
Inception date	May 2001
Manager	SL Capital Partners
Market cap	512.2
Shares outstanding	153.7m
Daily vol. (1-yr. avg.)	152.7k shares
Net cash	19.7%

Click here for our initiation note
Click here for our most recent update note

Recent developments

Dividend equalisation and coverage

SLPE has rebased its dividend to 12p for the current year. This has been well received by investors.

In our February 2017 note, *More than doubling the dividend*, we discussed the strategy changes, approved in January, which included rebasing the dividend for the year ending 30 September 2017, to 12p per share (the total dividend for the 2016 year was 5.4p per share). SLPE's managers say that this higher yield (3.6% as at 30 June 2017) has been well received by investors.

SLPE is equalising its dividend payments. The interim dividend has been announced at 6p.

With the announcement of its interim results on 7 June 2017, SLPE's board proposed an interim dividend of 6.0p per share, reflecting its strategy to equalise the two dividend payments that SLPE makes during the year. Previously, the total dividend payment was split roughly one-third and two-thirds across the interim dividend and the final dividend respectively.

Revenue income strong during the first half of 2017

As anticipated, the interim dividend of 6p per share is uncovered. Revenue income for the six months ended 31 March 2017 was 4.56p per share. However, dividend cover is higher than SLPE's manager had expected (as discussed on page 2 of our February 2017 note, SLPE's manager thought that, over the longer term, approximately 50% of the dividend will be covered by current year revenue). The manager says that revenue generation during the first half of calendar 2017 has been very strong and, at the current run rate, the full-year dividend could be 75% covered.

Recapitalisations and exits, driven by low interest rates and buoyant exit markets, have contributed to revenue generation this year.

SLPE's manager says that a key factor in the increase in income has been the level of recapitalisations and exits. Many private equity transactions tend to be structured with a thin layer of ordinary shares, followed by a larger layer of preference shares (these tend to have a yield of between 8% and 12%) and then debt. When a company is refinanced, or an exit is achieved, the preference element is usually repaid and the rolled up interest is paid out to investors. Exit activity has been high (private equity markets are buoyant) as has refinancing activity (driven by low interest rates as companies seek to de-risk and lower their cost of capital). These activities have been unlocking income for investors.

Standard Life and Aberdeen Asset Management merger

SLPE's board has been given assurances that the core team will continue to manage the trust.

On 6 March 2017, it was announced that Standard Life (the ultimate parent company of SL Capital Partners) and Aberdeen Asset Management had agreed terms for a recommended all share merger of the two companies. The merger has since been approved by the shareholders of both companies and completion is scheduled for 14 August 2017.

The resulting entity is to be called Standard Life Aberdeen with the asset management business to be renamed Aberdeen Standard Life Investments. SLPE's manager says the private equity arms of both businesses have comparable AUM's and a similar approach and ethos. In the meantime, SLPE's board has been given assurances that SLPE remains a strategically important vehicle for the manager and that there are no plans to materially change the teams approach to how its managed as a result of the merger.

Market outlook

SLPE's manager is expecting a similar environment in 2017 to 2016 and expects the period of strong net realisations to draw to a close in the medium term.

SLPE's manager says that, in part reflecting the long-term nature of private equity, little has changed regarding its outlook since we wrote in May and September 2016. Considerable detail is provided in these notes and readers interested in the manager's outlook should review both (details are provided on page 10 of this note). However, in summary, the manager is expecting to see a similar environment during 2017 as was experienced during 2016. Further realisations are expected at decent exit multiples, but the manager reiterates its view that the period of strong net realisations will draw to a close in the next 18-24 months.

An improving outlook in Europe, but challenges lie ahead

An improving outlook and greater stability in Europe. SLPE's manager is expecting volatility to increase, creating opportunities, and is investing ahead of this.

In Europe, the main focus of SLPE's portfolio, the manager observes an improving outlook, accompanied by greater stability. For example, The European Commission's Spring 2017 Economic Forecast says that, "The European economy has entered its fifth year of recovery, which is now reaching all EU Member States. This is expected to continue at a largely steady pace this year and next". SLPE's manager says that, whilst the current backdrop is benign, it is expecting volatility to pick up in the next 12-to-24 months driven by the Brexit process or perhaps another market 'shock'. The manager comments that this should improve the pricing environment for private equity buyers and it is making both primary commitments, and secondary fund purchases, in anticipation of this volatility, given the private equity funds five-year investment period.

Equipped with a considerable 'war chest'

SLPE's manager has a considerable 'war chest' of liquid assets. These can be deployed to acquire cheaper assets in less buoyant markets. The manager sees potential market dislocations as buying opportunities.

As discussed in our previous notes, SLPE's managers have allowed its cash levels to rise in anticipation of being able to invest in assets more cheaply in the future when markets are less buoyant. They believe that this will pave the way for a period of strong returns in the future. SLPE continues to maintain a significant cash balance (£112m as at 31 March 2017) as there are a number of challenges ahead which could upset markets and lead to an uptick in volatility. SL Capital Partners says that, ideally, it would like to see more in the way of market dislocations as this would likely create buying opportunities. Either way, it believes that SLPE's portfolio is well-positioned for the long term as, in its view, SLPE is backing high quality managers who add value that should ensure positive relative returns independent of the cycle. The asset allocation section highlights some of the managers that SLPE's manager has been making commitments to.

Buoyant fundraising environment requires some caution

SLPE's manager is turning down private equity groups that it considers are being too aggressive in their capital raising efforts.

Private equity managers took advantage of a fundraising 'window' in 2016, on the back of a strong period of realisations, to secure new capital and, as discussed on page 4, SLPE has been active in this phase of reinvestment, making primary commitments to a number of funds. However, the manager says that, in this buoyant environment, some caution is required and it is turning down groups who it thinks are being too aggressive in their capital raising efforts.

SLPE's managers caution on private equity managers engaging in 'style drift' and exceeding their remit.

Crucially, SLPE's manager says that it is important to ensure that an underlying manager will not be tempted to engage in style drift and will not over-extend itself in terms of what it can reasonably deploy. For example, the manager has recently made commitments to CVC Capital Partners Fund VII (see below) and IK Investment Partners Fund VIII. Both of these funds are bigger than their respective predecessor funds, but SLPE's manager is comfortable that they both have strong momentum and so deployment is less of an issue. The IK Investment Partners fund raised US$1.85bn (its predecessor raised US$1.45bn) and, based on its managers' previous record, SLPE's manager is comfortable they will be able to invest the proceeds in a timely fashion. In the case of the CVC fund, it will be focused on doing more deals of the same size. SLPE's managers consider CVC has the scale and resources to generate the necessary pipeline and execute its strategy effectively.

Asset allocation

SLPE's manager focuses on a core group of underlying managers that it knows and trusts.

Readers interested in SLPE's investment process should see our **initiation note** of May 2016, which describes this in more detail. However, to summarise, SLPE's manager tends to focus on a core group of underlying managers, who it knows and trusts. In terms of underlying managers, the portfolio is concentrated; the top 10 underlying managers tend to account for approximately 80% of SLPE's investment portfolio (see Figure 1 overleaf). Near-term changes in allocations tend to be driven by realisations and the pace of reinvestment. As at 31 March 2017, SLPE had total net assets of £567.2m (368.9p per share), £470.2m invested in 49 private equity funds and cash of £97.7m. The portfolio provides exposure to circa 350 underlying private companies.

Evolution, not revolution – edging up North American exposure

Following the changes in strategy approved at the end of January 2017 (please see our February 2017 note), which included the removal of the geographic size limits, SLPE's manager expects to increase the trust's exposure to North America over time. It has just committed to CVC Capital Partners' latest fund (Fund VII). This closed on 1 June 2017 and has over US$16bn of equity capital to invest. This is CVC's flagship fund. It will be focused on investments in Europe and North America.

In looking to increase SLPE's exposure to North America, SLPE's manager says that it will not be looking to the 'conglomerate' private equity houses, as frequently private equity is only one of many investment activities these pursue and it is not necessarily their main focus. SLPE's manager prefers houses where private equity is the core of their activities. The manager highlights Advent International as being an example of a manager that they rate highly. It says that Advent is overwhelmingly focused on private equity, has a strong US team, and an international focus. The manager say that a number of high quality North American funds are being assessed with a focus on the core mid-market opportunity. In addition, the revised secondary strategy will target north American transactions.

However, despite its intention to deploy more capital into the US, SLPE's manager says that the bulk of recent investments have been to European private equity funds and so SLPE will, in the medium term, retain its focus as a European fund of private equity funds.

Fundraising activity has been strong

SLPE's manager says that the fundraising environment for private equity has been strong and it has made significant primary commitments. In addition to the commitment to CVC, mentioned above, SLPE's manager has made commitments to Equistone Partners, Advent International, Astor Group, IK Investment Partners and HG Capital. The manager expects to make further commitments to new funds from Equistone and Nordic Capital later this year along with PAI Partners.

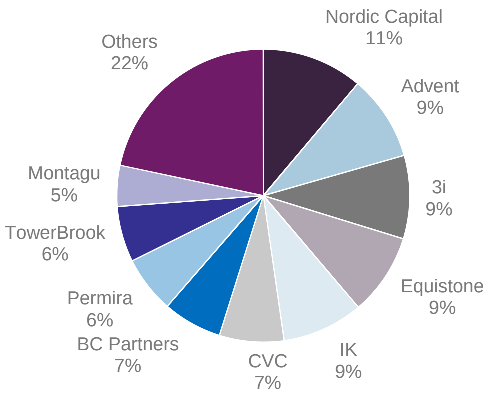
Secondary investments continue

The manager has also been making secondary fund purchases (£20.2m was invested during the six-months to 31 March 2017 in three transactions: Nordic Capital VII, Towerbrook Investors III and Towerbrook Investors IV). The manager says that it has been loading the portfolio and has been focusing on the older vintage years (years four and five) where SLPE has a lower exposure than for years one, two and three (see Figure 2).

Reflecting the superior returns that can be achieved when making secondary fund purchases, the manager is looking to build on SLPE's exposure and is targeting an allocation of 30% within SLPE's portfolio. However, the manager says that the high level of distributions from this strategy, which have tended to be biased towards the longer maturities, have made it difficult to both maintain a full weighting and raise the allocation to secondaries to 30%.

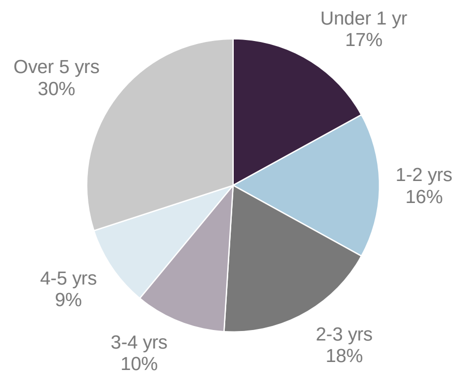
Figures 2, 3 and 4 illustrate that the portfolio is diversified by maturity, sector and geography.

Figure 1: Split by manager as at 31 March 2017



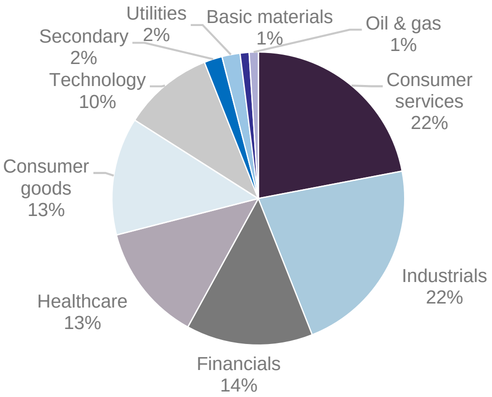
Source: SL Capital

Figure 2: Maturity profile as at 31 March 2017



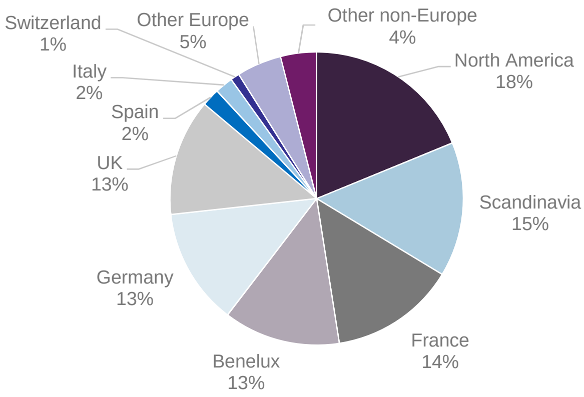
Source: SL Capital

Figure 3: Sectoral exposure as at 31 March 2017



Source: SL Capital

Figure 4: Geographic exposure as at 31 March 2017



Source: SL Capital

Figure 5 shows the top 10 underlying investments in the portfolio at the end of March 2017. The largest company in the portfolio continues to be Action, a 3i- backed fast-growth non-food discounter with more than 800 stores across the Benelux, French and Germanic markets. A further discussion of Action and its strong performance during the last year is provided in our **September 2016 note**.

Figure 5: 10 largest underlying holdings as at 31 March 2017

Company	Business	Fund	Position value 31 Mar 2017 £m	% of net assets 31 Mar 2017	% of net assets 30 Sep 2016	Change
Action	Non-food discount retailer	3i Eurofund V	36.0	6.3	6.1	0.2
Scandlines	Ferries between Sweden and Denmark	3i Eurofund V	11.4	2.0	1.7	0.3
Lindorff	Debt collection and accountancy services	Nordic Capital Fund VIII	7.8	1.4	1.3	0.1
Schenck Process	Measuring and process technologies	IK Investment Partners 2007	6.4	1.1	1.2	0.1
Munters	Air treatment and climate solutions	Nordic Capital Fund VII	6.2	1.1	0.4	0.7
Not disclosed	Health and retail business services	Advent Global Private Equity VI	5.8	1.0	1.0	0.0
Handicare	Technical aids for the elderly/physically disabled	Nordic Capital Fund VII	5.4	0.9	0.3	0.6
Norican Group	Industrial goods and services	Altor Fund IV	5.1	0.9	0.8	0.1
Vistage	Leadership & business development for key execs	TowerBrook Investors III	5.0	0.9	0.8	0.1
Cerelia	Ready to use chilled dough	IK VII	5.0	0.9	0.9	0.0

Source: SL Capital, Marten & Co

Figure 6: 10 largest private equity funds as at 31 March 2017

Fund	Strategy	Geography	Fund value 31 Mar 2017 £m	% of net assets 31 Mar 2017	% of net assets 30 Sep 2016	Change
3i Eurofund V	Mid-market buyouts	Europe	43.3	7.6	7.6	0.0
IK Investment Partners VIII	Mid-market buyouts	Northern Europe	33.2	5.9	5.8	0.1
Nordic Capital Fund VII	Complex buyouts global healthcare	Northern Europe	31.9	5.6	2.7	2.9
BC European Capital IX	Mid to large buyouts	Europe, USA	30.7	5.4	4.9	0.5
Permira V	Transformational buyouts	Global	27.2	4.8	4.5	0.3
Equistone Partners Europe Fund IV	Mid-market buyouts	UK, France, Germany	22.1	4.0	5.0	(1.0)
Montagu IV	Mid-market buyouts	Northern Europe	21.2	3.7	4.0	(0.3)
Nordic Capital Fund VIII	Complex buyouts global healthcare	Northern Europe	20.5	3.6	3.0	0.6
Advent Global Private Equity VII	Global buyouts	USA, Europe	17.6	3.1	3.8	(0.7)
Equistone Partners Europe Fund V	Mid-market buyouts	UK, France, Germany	16.4	2.9	2.8	0.1

Source: SL Capital, Marten & Co

Balance of cash, debt and outstanding commitments

As at 31 March 2017, SLPE had outstanding commitments of £312.2m to 49 private equity funds. Of this, SLPE's managers believe that £55m is unlikely to ever be called, which leaves a net figure for commitments likely to be drawn of circa £257m. In addition to its cash balance of £97.7m (as at 31 March 2017), SLPE also has an undrawn £80m revolving credit facility which expires in 2020 (see page 20 of our May 2016 initiation note for more details). SLPE's manager says that it would expect SLPE to draw down its credit facility in full but, based on these figures, SLPE would need to find a net circa £78m to meet these commitments as they stand. Cash realisations during the six-months to 31 March 2017 totalled £73.5m (15 exits at an average 2.1x cost) and, while the manager expects that the period of strong net realisations is drawing to a close, with more balance between realisations and drawdowns going forward, it is confident that the balance of SLPE's commitments can be readily funded through distributions over the typical five-year investment cycle.

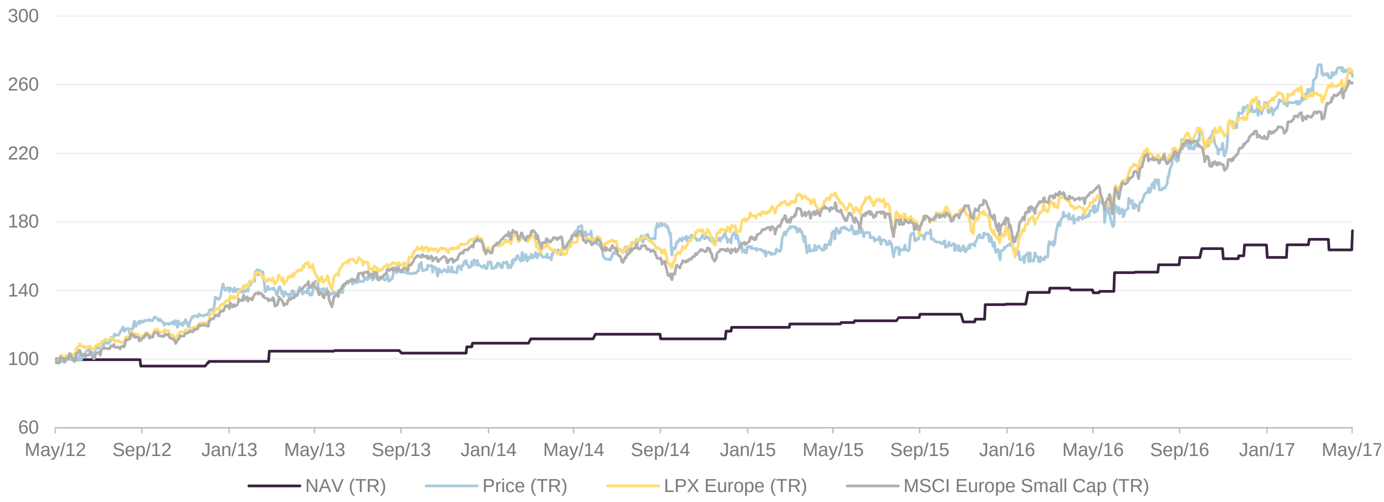
Performance

Please click here for an up to date peer group comparison of SLPE versus its private equity peers.

Figure 7 shows the progression of SLPE's NAV and share price total returns, over the past five years, alongside those of the LPX Europe and the MSCI Europe Small Cap Index. It can be seen that SLPE's NAV has followed a path of steady progression in contrast to the higher volatility witnessed in the listed equity indices and its own price series. SLPE had previously faced a currency headwind from its significant European exposure with a weakening euro (SLPE does not hedge currency exposure). However, this has reversed and has been a significant tailwind during the last year as sterling has weakened following the results of the EU referendum. A strong exit environment is also driving NAV growth.

Reflecting the longer-term nature of SLPE's investments, we believe that the longer periods (three to five years) are the most appropriate for analysing its performance.

Figure 7: SLPE NAV and price performance compared with the LPX Europe and MSCI Europe Small Cap. Indices (total returns) over five years



Source: Morningstar, Marten & Co

Figure 8: Cumulative total return performance to 31 May 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
NAV TR	6.9	5.0	10.3	26.1	56.5	74.9	106.0
Price TR	0.3	7.0	18.3	40.0	53.6	164.7	36.5
LPX Europe TR GBP	4.7	11.2	22.2	32.0	51.6	161.0	128.6
MSCI Europe TR EUR	5.3	9.3	19.4	32.7	32.6	104.2	75.0
MSCI Europe Sm Cap TR	3.4	6.8	15.5	39.6	59.4	167.5	62.5

Source: Morningstar, Marten & Co

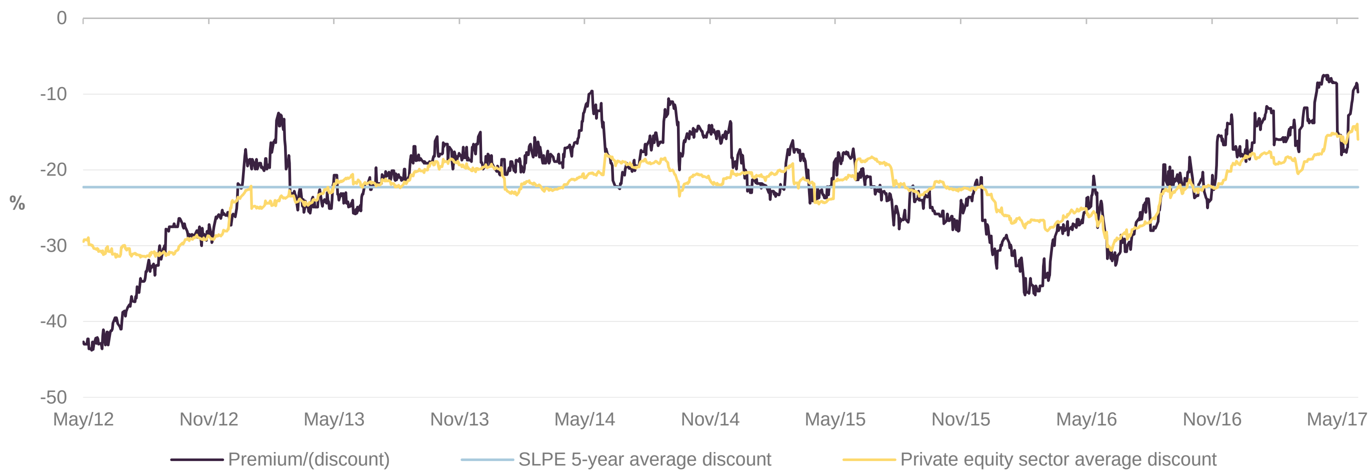
Discount

Figure 9 shows SLPE's discount over the last five years versus its five-year average and the average discount (arithmetic) for the private equity sector (excluding 3i and companies whose market capitalisations are below £15m). It can be seen that, in common with the broader private equity sector, SLPE's discount has been on a broad trend of tightening during the last 12 months, although SLPE has experienced a greater tightening than the sector average. Reflecting this, SLPE is currently trading at a tighter discount than both the sector average and its own five-year average.

The narrowing within the sector coincides with a period of strong realisations which has generally boosted performance. Exits achieved from funds such as Electra Private Equity and HgCapital at decent premiums to last published NAV may have underscored, in investors' minds, the latent value within the listed private equity sector. In addition, cash exits for investors in SVG and Electra have freed up cash to reinvest in funds such as SLPE. In SVG's case, Harbourvest's willingness to pay US$807m in October 2016 for a portfolio that had only recently been valued at $802m also serves to increase investors' confidence in the valuations placed on assets used to calculate listed private equity NAVs.

SLPE has also benefitted from applying greater resources to educating investors about its proposition, as well as introducing various measures as part of the strategy changes in January, which appear to have been well received by the market.

Figure 9: Premium/(discount) over five years



Source: Morningstar, Marten & Co.

Fund profile – European private equity

SLPE has a more focused underlying portfolio than most funds of funds with circa 350 underlying companies.

SLPE is a pure fund of private equity limited partnerships ('LPs' or 'funds'). It has a strong bias to (western) Europe and an increased focus on North America. SLPE acquires its investments through both primary and secondary transactions but, unlike some of its peers, does not make direct co-investments (see below). SLPE operates in this way as its managers believe that the 'conviction' fund of fund approach is optimal to achieve adequate diversification. The manager believes it is important not to be over diversified either and dilute returns unnecessarily. Therefore, SLPE operates with a fairly tight number of funds compared to peers (between 35 to 40 active positions), which equates to about 350 underlying companies. The funds that SLPE invests in are focused on making equity investments; there is no allocation to funds focused on mezzanine debt, for example.

Focused purely on primary and secondary transactions

SLPE's approach involves a mix of primary commitments and secondary purchases

SLPE has adopted a two-pronged approach that involves both making primary commitments to new funds managed by firms and teams that the manager rates highly, and purchasing private equity funds in the secondary market at attractive values. It does not make direct co-investments. This is not because its managers lack the necessary skills (this an activity that SL Capital engages in for other mandates)' but it is not considered to be appropriate for SLPE. The managers say that, given the size of a typical co-investment opportunity, including this strategy within SLPE has the potential to increase volatility and losses.

History

SLPE was listed in May 2001. The trust's portfolio was seeded with a portfolio of 19 private equity funds from Standard Life's balance sheet and Standard Life remains a significant supportive shareholder in the company. The manager is SL Capital Partners (SL Capital) which is part of the Standard Life group.

Previous research publications

Additional information is available at the fund manager's website, **www.slcapital.com/slpet/index.html**

Readers interested in further information about SLPE, such as investment process, fees, capital structure, trust life and the board, may wish to read our initiation note ***Sitting in a sweet spot***, published on 10 May 2016, as well as our previous update notes (details are provided in Figure 10 below). The contents pages of our initiation note have been reproduced below. You can read the notes by clicking on them in Figure 10 or by visiting our website.

Figure 10: Marten & Co. previously published research on SLPE

Title	Note type	Date
Sitting in a sweet spot	Initiation	10 May 2015
Reinvestment phase underway	Update	14 September 2016
Dividend doubled to 4.0%	Update	22 February 2016

Source: Marten & Co.

Sitting in a sweet spot – 10 May 2016

4	**Why is European private equity attractive?**
5	Private equity discounts are still too wide
5	**Fund profile – European private equity**
6	Focused purely on primary and secondary transactions
6	History
6	**Investment process**
6	A mix of top down and bottom up
8	Fees on the underlying funds
8	Managing commitment levels
9	Portfolio construction
9	**Manager's view**
11	**Asset allocation**
13	Commitments
14	The underlying portfolio
16	**Performance**
17	**Peer group comparison**
18	**Dividend**
19	**Discount**
20	**Fees and costs**
20	**Capital structure and life**
21	**Board**

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IMPORTANT INFORMATION