

# Eight Steps for Analysing Listed Private Equity Companies

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LISTED PRIVATE EQUITY

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Historically, investors wanting to invest in private equity had a problem. The sector was generating strong returns and outperforming wider market indices, but there were relatively few accessible vehicles in which to invest.

Today, there is a wide choice. With some 250 firms to choose from globally, listed private equity has given many investors access to the asset class for the price of a share.

Investors can buy shares in direct investment companies or funds of funds companies. These can be listed in the UK, continental Europe or the USA and they can invest in one or many countries and regions following a wide variety of investment strategies. The issue now for the private investor is not so much one of availability but of how to analyse listed private equity companies and to select the appropriate firms for their portfolio. The following eight steps are designed as a useful guide to this process.

## 1. Take time to understand what you are intending to buy

### Different types of listed private equity vehicles

Not all listed private equity vehicles are structured in the same way. The spectrum covers direct investment companies to funds of funds and includes hybrids of each.

Direct investment companies, such as HgCapital, invest funds in individual companies that together comprise portfolios of directly-held private equity investments. Funds of funds companies, such as Pantheon International Participations and Euronext-listed Conversus Capital, invest in the funds managed by a number of direct investment companies that themselves invest in individual companies. Funds of funds, therefore, select fund managers to back rather than companies. The hybrids, such as Graphite Enterprise and Electra Private Equity, vary in the degrees to which they invest in individual companies as well as in funds.

Direct investment companies normally provide exposure to a single private equity manager, whereas funds of funds can provide a much broader exposure to the private equity and venture capital market.

Certain listed private equity investment companies such as Germany's Deutsche Beteiligungs AG, consist of both the fund manager and the investments in its portfolio; with others, such as Dunedin Enterprise and Standard Life European Private Equity, the management of the company is contracted out to a third party. The names of the company and its manager might be similar (e.g. F&C Private Equity – the investment company – and F&C Asset Management – the manager); it is important not to confuse the two.

### Different investment strategies

Private equity managers follow a wide range of investment strategies and a private investor should select the manager whose strategy they believe will be most successful and which will most appropriately fit within their broader investment portfolio.

Private equity fund managers have a number of variables within which they will define their investment strategy including:

- **Company size** – which can range from start-ups to large, mature businesses
- **Geographic focus** – ranging from dedicated investment in a single region to broad coverage of multiple countries and continents
- **Industry focus** – ranging from dedicated focus on a single industry to broad coverage of all sectors
- **Capital type** – with funds focusing on providing a range of capital, from equity to debt financing
- **Investment type** – with some managers focusing on primary assets, others both primary and secondary assets

Any private equity manager will define their strategy within the parameters of the criteria listed above, with some managers being highly specialised and others following a more generalist approach.

### **How do private equity fund managers operate?**

The starting points for private equity fund managers considering companies to back are commonly cash flow and operating profit growth. This sets them apart from fund managers focused on public companies, who may invest for reasons such as the dividend, the quality of the asset base or the possibility of a takeover.

To the private equity fund manager, cash flow can be used for improving operational efficiencies, funding growth and acquisitions, reducing debt or buying back equity. A clear focus on cash flow and operating profit also allows the manager to negotiate appropriate levels of debt for a company.

It is only by demonstrating growth that private equity managers can achieve profitable exits – and only by achieving good exits and so delivering strong returns can they raise future funds. Private equity managers achieve this by extensive due diligence ahead of making investments, actively supporting strategies for growth during their ownership of a business and delivering on a clear exit plan. Private equity managers ensure all parties are focused on delivering strong returns through the alignment of interest between their investors, themselves and the company managers. Typically the private equity managers and the managers of the portfolio company all have a personal financial stake in their companies.

Private equity fund managers typically have board representation with their portfolio companies. This allows them to influence key business decisions and receive regular trading updates from portfolio company managers, benefits typically not available to investors in public companies.

## **2. How experienced is the private equity company and what sort of track record does it have?**

This is the critical issue in assessing any fund management company and is no different for a manager of a portfolio of private equity investments.

Key questions in evaluating a private equity manager include: how long has the management company been involved in private equity and how successful has it been? How successful have its funds been over time relative to those of its peers? Is the team a settled one? How large is the listed private equity fund relative to the manager's other responsibilities? How do the investment strategies differentiate the company from its competitors? How have commentators and analysts viewed historic performance?

Sources of information which will enable an investor to address these issues include the private equity media, web-based investor information and brokers' reports.

## **3. How strong a board of directors does the listed private equity company have?**

Investors should expect the board of any listed company to have relevant industry experience and a strong commitment to corporate governance. In the case of listed private equity companies, the high standards required by European primary stock exchanges ensure that this is the case.

Private equity is focused on growing the profitability of businesses and then exiting them through a trade sale, IPO or secondary buyout. The board of a listed private equity company should therefore include directors who are experienced in these areas – either as directors of private equity-backed companies or as managers and advisers. Similarly, a listed private equity company with a presence in North America or continental Europe will encounter issues specific to these markets and will benefit from directors with knowledge of these geographies.

A board's ultimate priority should always be the shareholder. In the case of a listed private equity company this means having responsibility for, among other things, managing any share price discount or premium, regularly reviewing both the performance of, and contractual arrangements with, the company's manager (where the manager is a third party) and ensuring regular dialogue with shareholders – including providing sufficient information for them to understand the risk-reward balance to which they are exposed by holding the shares.

## 4. Cash drag, over-commitment and leverage

Within the universe of private equity investment companies, the balance sheet positions vary from substantial net cash to substantial net debt.

### Cash drag

Many listed private equity companies have historically held net cash in order to facilitate new investment. This has a detrimental impact on performance (known as “cash drag”), with funds on deposit historically earning much lower returns than the overall portfolio.

Holding cash, however, does have benefits. The timings of both new investments and distributions from realised exits in the portfolio are challenging to forecast, and unforeseen events can place sudden and unexpected demands for cash on a private equity company.

### Over-commitment

Listed private equity companies, particularly funds of funds, will commit to make more investments than the cash they currently have available (known as “over-commitment”) in the knowledge that not all commitments will be called, or drawn down, immediately and cash inflows from portfolio realisations should fund some future obligations. Over-commitment enables the company to use its balance sheet resources as efficiently as possible.

However, over-commitment can become a problem if the underlying portfolio companies do not achieve the anticipated realisations, or call on their private equity backers for additional capital. If the listed private equity company does not receive the cash flow it anticipated through distributions from exits, it may have to explore options to improve liquidity including the sale of some assets. Over-commitment works well in rising markets but can prove problematic and risky in a downturn.

### Leverage

The management of working capital is important; some listed companies have debt facilities to facilitate this. Furthermore, underlying companies in portfolios may also be leveraged – and, in the case of buyouts of mature companies, usually are. When debt is readily available and inexpensive, this is an efficient use of capital.

Leverage magnifies returns in rising markets but can have the reverse effect in falling markets. With direct investment companies, an idea of how highly geared the portfolio companies tend to be is important in evaluating their attractiveness. With funds of funds, knowing details of banking covenants, which are usually set out in the annual report, is equally important.

## 5. What about the dividend?

Not all listed private equity companies issue a dividend. UK private equity investment companies have their roots in the traditional UK investment trust, where the great majority of retained earnings (income less management fees) have to be paid to investors. In practice, because of the cycle of investment and exit, dividend payment from direct investment companies tends to be uneven and funds of funds tend not to generate much income, so do not pay dividends.

Continental European investment companies, which are not bound by any necessity to pay dividends, vary in their dividend strategies.

A holding in a listed private equity company is not an income investment but a long-term asset growth stock. Thus, although dividend yield may be part of total return, value appreciation of the shares over time should be the primary objective.

## 6. Discounts and valuations

### Discounts to NAV

The discount at which shares trade relative to the stated net asset value (known as “NAV”) per share is a key consideration when assessing opportunities to invest in listed private equity companies.

A few years ago share prices in the private equity sector were close to parity with the NAVs, or in some cases even went to considerable premiums as investors recognised the returns being made in the sector and the attractions of private equity investment companies as vehicles to participate in private equity. Then sentiment began to turn with the advent of the credit crunch; the premiums were lost and discounts widened ahead of the market decline and banking problems of late 2007 onwards.

There is not necessarily a close correlation between the extent of the discount and performance. Rather the discount reflects a host of factors such as wider market sentiment, performance of the private equity sector as a whole, liquidity, the perceived strengths and weaknesses of the fund manager and the perceived diversification of the investment portfolio or fund.

In recent months there have been several instances where the market capitalisations of some investment companies have fallen to the approximate net cash position or less, leaving the market attaching no value to the portfolio. Clearly such anomalies could be seen as an opportunity for the investor.

### Valuation of the portfolio

Private equity companies value their portfolio companies on the basis of international accounting standards and international guidelines for the valuation of private equity portfolios. For investment in mature companies, each investment is typically valued with reference to the company’s maintainable earnings and the price/earnings ratios of comparable companies. Debt is deducted from the valuation to produce a gross equity value, which can then be reduced by anything from 10%–30% to reflect the illiquidity of the investment.

Each valuation is a matter of opinion, bounded by discipline. For example, maintainable earnings are defined as: the level of post-tax earnings a company can be confident it can maintain for the foreseeable future.

Since valuations of all companies are to some extent matters of opinion the value at which investments are realised will differ from their book values. If investments are commonly realised at a significant uplift to book value (as they should be, given that any discount applied for relative illiquidity should be unlocked upon sale), then the manager’s valuation policies and practices can probably be viewed as disciplined and prudent.

## 7. Look at the Portfolio

The portfolios of both direct investment companies and funds of funds companies tend to be well spread across industry sectors and are likely to also be diversified across national boundaries. Established listed companies also provide access to diversified vintages of investments.

The listed company will publish information regarding the diversification of its portfolio by sector, geography, stage and maturity of investments, as well as detail on the valuation methodology employed. Generally it is favourable for the company to show a portfolio which is well balanced.

Concentration of the portfolio in certain areas may give some clue as to the performance of NAVs. For example, if too much of the portfolio is immature, then upward revision of the NAV in the short term is less likely. Equally, if the portfolio has many companies that have been owned for a long time whilst showing little evidence of growth, this may indicate that the manager has not been active in managing some of the investee companies. A balance of sectors is important too – a high concentration of investments in cyclical sectors may leave the fund exposed in a period of economic or cyclical slowdown.

The significant amount of data available on listed private equity companies allows investors to research them thoroughly and evaluate potential investments. Companies tend to report net asset values on a half-yearly or quarterly basis, and close monitoring of company announcements and media coverage of the sector will allow investors to assess whether the share price is a good reflection of the value of the company.

## 8. Transparency

Transparency is a much-discussed topic within listed private equity. The level of disclosure a fund manager offers and the perception of what is the right amount varies between individuals. Disclosure of gearing, commitments and the diversity of the underlying portfolio or funds, all of which are essential to good decision making, have been discussed above. Other information an investor should expect is a detailed breakdown of the fund manager's major investments, whether they be direct investments or investments held through funds but disclosed on a see-through basis.

For the largest investments, details of the nature and size of equity and loan stake, the cost of the investment, the directors' valuation, brief details of the business and recent trading history may be given. For a fund, similar information may be given. For investments beyond the top ten by size, it is unusual to get more than the name of the direct investment or fund.

Through appropriate disclosure the investor should have sufficient information to monitor the shareholding and to understand what might happen to the portfolio in different scenarios, without expecting detail on every single underlying investment.

### **Private equity is long-term business**

Investing in listed private equity requires long-term commitment in order to deliver strong returns for both the fund manager and the investor.

New private equity investments take a relatively long time to start generating returns given the period between initial investment and first realisations, an effect known as the "J curve". Most listed private equity companies provide access to a range of investments by vintage, which mitigates this risk.

Private equity managers have medium- to long-term investment horizons as it takes time to deliver the profit growth in portfolio companies that their investment model requires. Many steps may need to be taken to ensure a successful realisation which will generate strong returns for investors. New management may have to be recruited, investment made in operations and systems, the business' strategy re-examined and non-core businesses may have to be sold. Successfully executing these steps will take time but they are crucial to how private equity managers create value.

Just as private equity managers' horizons are medium- to long-term, so should those of the investor be. Investors should note that a steady rate of net asset value growth, compounded over five to ten years, can deliver highly attractive returns.

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If in doubt, always seek independent financial advice before making any financial decisions.

# GLOSSARY

<b>Commitments</b>	Capital committed by investors to a fund. This will be requested or "drawn down" by private equity managers on a deal-by-deal basis, rather than all at the outset. In the early years of a fund, the amount committed to the fund will be much greater than the amount drawn down.
<b>Discount</b>	An investment trust is said to be trading at a discount if the share price of the investment trust is lower than net asset value per share. The discount is shown as a percentage of the net asset value.
<b>Distribution</b>	Payments to institutional investors after the realisation of investments of a private equity fund.
<b>Draw-down</b>	Payment of previously committed funds to finance particular investments. Funds are drawn down from investors on a deal-by-deal basis.
<b>Fund of funds</b>	Private equity funds whose principal activity consists of investing in other private equity funds.
<b>Gearing</b>	A company's borrowings as a percentage of equity shareholders' funds.
<b>IPO (Initial Public Offering)</b>	The first time a company trades its shares on a stock exchange.
<b>J-curve</b>	The curve generated in the initial stage of a new fund when the impact of management fees and other costs on the first draw-downs produce a negative return.
<b>Leverage</b>	See gearing.
<b>LBO (Leveraged Buyout)</b>	The acquisition of a portfolio company with a high proportion of bank debt, leaving the portfolio company highly geared or highly leveraged.
<b>MBO (Management Buyout)</b>	An acquisition of a business by its existing management, often with finance from a private equity fund.
<b>MBI (Management Buyin)</b>	An acquisition of a business by a new management team, usually alongside a private equity fund.
<b>Management fee</b>	The fee that the fund manager charges for managing a fund. In a listed private equity company, the fee is normally a percentage of net assets. In a private fund, the fee is normally initially based on commitments.
<b>NAV (Net Asset Value)</b>	The total value of a company's assets less the total value of its liabilities.
<b>Primary assets or investment</b>	The investment made in a new fund which will, in turn, invest in a portfolio of companies.
<b>Private equity</b>	Investment in private, unquoted companies.
<b>PEITs (Private Equity Investment Trusts)</b>	UK listed private equity companies that are also investment trusts.
<b>Portfolio company</b>	In the private equity context, a company in which a private equity fund has invested.
<b>Public to Private</b>	When a private equity investor buys the shares of a public company, thus taking it from public into private ownership.

<b>Realisation</b>	Sale (partial or full) of an investment, which can be to another private equity fund, a trade sale or an IPO (Initial Public Offering) on a stock market.
<b>Refinancing</b>	The process whereby improved operating performance of a portfolio company allows it to increase its debt and return cash to equity shareholders, often leaving the equity stakes unchanged.
<b>Secondary assets or investment</b>	Private equity assets, such as holdings in portfolio companies or in funds, which are sold by institutional investors before the funds themselves are wound up. These assets usually come to market when the selling institution needs liquidity. There are a number of dedicated secondary managers and funds who specialise in buying and managing these assets to the end of the fund's life.
<b>Secondary buyouts</b>	Sale of a portfolio company (usually a buyout) by one private equity company to another private equity company.
<b>Trade sale</b>	Sale of the equity share of a portfolio company to another company in a similar or complementary industry (also sometimes called "strategic sale").
<b>Venture capital</b>	Investing in early stage companies which are often pre- revenue or pre-profit. A sub-sector of private equity.

## **LPEQ**

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