

Demystifying Private Equity Investment Trusts

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Since mid-2001, private equity investment trusts (PEITs) have consistently been the AITC's top performing sector over ten years. They also have had strong recent performance. PEITs have been around for decades, so why are the attractions of PEITs not more widely appreciated? Three reasons for this confusion would include:

- the diversity of the PEIT sector
- unfamiliarity with private equity as an asset class
- particular features of PEITs which enable them to function as the liquid interface of an illiquid asset class.

This article will attempt to demystify PEITs so that investors can have a greater understanding of what drives performance of PEITs, and can better assess the risks of this sector. For retail investors, PEITs provide access to an asset class which has traditionally been restricted to institutions and high net worth individuals through fixed-life limited partnership funds with high minimum subscriptions. The shares of PEITs are listed on the London Stock Exchange and can be bought and sold through a broker in exactly the same way as shares in any listed company. Furthermore, some of the most highly regarded private equity managers in Europe can be accessed through PEITs, with the PEIT providing a showcase for the firm's abilities. Larger investors including family offices, pension funds and other institutions may also have reasons for wanting a more liquid, quoted vehicle for this increasingly-popular asset class.

Introducing the PEIT sector

While most investment trust sectors are grouped by investment region, the unifying characteristic of some twenty investment trust companies in this sector is that they have a significant portion of the company's portfolio invested in the securities of unquoted companies.

Most PEITs invest directly in unquoted companies, but some PEITs are structured as funds-of-funds. Several PEITs also act as fund managers, managing third party funds as well as the PEIT, which is a factor in their rating. And the sector also has split-capital PEITs for those attracted to the characteristics of that structure.

Across PEITs, there are a wide variety of investment objectives and strategies. There are geographical variations too, with PEITs which invest in the UK, Europe, the US and globally. Some also have industry sector specialities. Most define themselves by the investment stage sought, from early stage venture capital through mezzanine finance to management buy-outs, and some specialise in certain deal sizes.

To put the sector in context, it is useful to realise that the majority of PEITs focus on management buy-outs of established businesses, and that the industry generally judges itself on absolute returns, rather than against a

benchmark. Indeed, the AITC changed the sector name from “venture and development capital trust” to “private equity investment trust” to reflect this broader orientation. This renaming also alleviates confusion with venture capital trusts (VCTs) that offer tax advantages specifically to encourage investors to fund small (gross assets of less than £15m) UK-based start-up and early stage companies.

As for private equity funds-of-funds, they do not choose companies in which to directly invest, but instead devote significant resources to investment screening, due diligence and negotiation to select and work with private equity managers who can best achieve results. The funding for private equity managers generally comes from raising partnership funds, and those with an excellent track record can often choose with whom they want to work, so having access to the top funds is a key attraction of private equity funds-of-funds. Additionally, because funds-of-funds diversify their portfolio among different managers and styles, they are less risky than a single manager, although funds-of-funds charge an extra layer of fees for their expertise. An important objective for most funds-of-funds is optimising cash flows (for example, cash calls from the limited partnerships to which they are committed).

While all investment trusts are restricted in the percentage of their assets they can invest in any one company, they can differ widely in portfolio concentration. This is evident among PEITs which range from one single manager turn-around specialist with a handful of investee companies to a global fund-of-funds with investments in over 300 limited partnership funds.

Understanding private equity

Generally, private equity looks to invest in the equity shares of private companies using significant gearing (bank borrowing) to buy the business and then repay the debt from future cash flows of the business. Thus an investor’s assessment of a PEIT’s investment strategy should consider how it will fare in the economic and interest rate environment ahead, which will also affect the competition and price for deals, as well as the exit environment.

There are few hard and fast rules about private equity investment but for the most part private equity seeks to influence the management of a business more directly than can the shareholders in public companies, according to agreed medium-term targets which will facilitate a successful exit from the investment. Companies backed by private equity have a small number of highly incentivised shareholders – including management — all pulling in the same direction. Private equity fund managers take a much more hands-on role, usually with one or two board seats, than traditional fund managers. There is increasing evidence that some top company managers prefer working in the private company arena, where less time is taken up with regulatory compliance and meeting quarterly financial targets, and where the rewards for top performing managers may be better.

Large institutional investors such as pension funds are increasingly looking to private equity and other alternative assets to diversify their portfolio. Accompanying this move is a growing conviction, given the historic success of

established private equity managers, that private equity can realise superior results to public share ownership. This has been achieved through successful governance including appropriate capital management, appointment of good operational management, strong incentives to perform and judicious timing of the entry and exit from ownership of businesses.

The exit is a critical aspect of private equity investment, with key exit routes being trade sales, flotation on a stock exchange, secondary buy-outs (where another private equity firm buys the business to take it further) or recapitalisations. Often an auction among potential buyers will produce the highest price. Private equity managers will try to diversify their portfolio by the year in which investments are made in order to stagger when companies “mature” and seek an exit. Exit times of five years are typical, but can be as little as three years.

Assessing PEIT asset performance

Most PEITs run by a single private equity manager invest alongside the manager’s limited partnership clients. The information PEITs receive and publish is similar to that of the limited partners, and private equity managers will sometimes be restricted, both by regulation and for reasons of confidentiality, in what they can say about their company investments. Until the value of the business is realised at exit, the investment valuations must necessarily be estimates. However, most PEITs follow the International Valuation Guidelines drafted and adopted by the British Venture Capital Association, with a tendency for the resulting valuations to be conservative. As for process, valuations are reviewed regularly by the board of the investment trust and annually by the trust’s auditor.

The price of the shares of the PEIT is quoted daily but as underlying assets are valued half-yearly (or in some PEITs, quarterly), the price tends to move when there is a change of circumstances, e.g. interim/final results or when a significant exit occurs. Accordingly share price movements may be “lumpy” compared to a trust which announces a daily net asset value.

It is the selling or realisation of companies which bring major changes to a PEIT’s valuation and assets. Ironically, it can also bring a burden, since the proceeds of this realisation have to be retained within the trust, rather than distributed to investors which would trigger a capital gain. That cash, staying in the trust until a new investment is identified, can be perceived as a “drag” on performance in rising markets since it is not actively invested. Frustrating to managers, this cash position can lead to demands to return capital, particularly in nervous markets when investment conditions may be at their best. It is important that both the managers of PEITs and their shareholders remain conscious of the significant benefits that accrue to the patient investor, and mindful that the sector’s repeated outstanding ten year performance has been achieved when most PEITs have carried significant cash drags.

PEITs are “evergreen”, or continually investing, rather than having a fixed life span. The investor in a seasoned PEIT does not need to wait through a start-up phase but benefits from an invested portfolio from day 1. Major reasons why

new PEITs are rarely launched are the challenge of creating a private equity portfolio from scratch, plus of course, a potentially long lead time before positive returns are generated.

Considering PEIT pricing

With much debate already in *Scrutineer* on investment trust discounts, this discussion will be restricted to PEIT-specific factors.

A number of PEITs are currently priced at a premium to net asset value which may discourage traditional investment trust investors. There can be circumstances where paying a premium to stated historic NAV makes sense, and investors will seek high quality information about past returns and the status of the portfolio to reach that judgment.

The PEIT sector has experienced periodic bouts of heightened share price volatility. Share buybacks are being considered; however, compared to most investment trusts, a single manager PEIT may have a much smaller window of opportunity to buy back shares, as it may be restricted by material events in all its investee companies. The sector is wrestling with issues such as how to improve liquidity and is actively seeking a wider client base. Generally institutions are less interested (and analyst coverage more sparse) in PEITs of below £100 million, which creates some interesting opportunities for smaller investors.

As a pricing discount or premium is partly a function of supply and demand, it is worth looking at buyers and sellers of PEITs. It is frequently the case that investors in the sector will hold multiple PEITs with different investment objectives, rather than just one. PEITs vary in number of shareholders, with some held by a relatively few institutional shareholders and the most widely held having approximately 30,000 retail and institutional shareholders.

PEITs are not well-suited for frequent trading but considered by many to be ideal for long-term investment such as for self-invested pension plans (SIPPs) or to be held in an individual savings account (ISA) or savings scheme. Private client stockbrokers and wealth managers are important clients of this vehicle.

As has already been discussed, institutional interest, both in private equity generally and in quoted PEITs, has also been increasing. There are even examples where institutions use quoted vehicles to supplement their limited partnerships in order to reach their full desired private equity allocation. One estimate is that there are fewer than 300 listed private equity securities worldwide, so the UK private equity investment trust sector is attracting interest from outside the UK.

Promoting shareholder awareness and communication

The PEIT sector is keen to improve communication with current and prospective shareholders. For Boards, this is an important aspect of corporate governance, but can be time-consuming and is often limited to the AGM and major institutional meetings.

In an effort to address this, Boards of a number of PEITs are currently considering undertaking a collective two-year Sector Marketing Initiative which would research different client groups to better understand how PEITs are (or are not) used in portfolio construction and to identify concerns and misunderstandings about the risks and attributes of PEITs. This endeavour will supplement the valuable work corporate brokers and analysts, and the AITC and BVCA, are already doing and will hopefully result in improved communication all round. As private equity is a cyclical business, the sector is aware that widening and volatile discounts may one day again be a factor. It is hoped that with increased communication and a more informed shareholder base, PEITs will be both admired for their performance — and for how they achieved it.

No doubt readers have views as to how the private equity investment trust sector can be better understood and we look forward to hearing from them.

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