Slow burn

Falling rates have boosted private equity managers' share prices, but what of PE funds?

Update
16 October 2024

Equity markets are forward looking. As the disclaimer you see everywhere says, ***past performance is not a reliable indicator of future results***. Share prices do reflect a company's history clearly, but in a rational market the main influence on share prices is what expectations are of the future.

The 'wisdom of crowds' is the closest explanation of why markets might be efficient, and why share prices reflect all of the information and expectations about companies in the future. Francis Galton, a polymath cousin of Charles Darwin, attended a country fair in 1906 where around 800 attendees were invited to guess the weight of an ox. Galton was surprised to observe that the median average guess was within a fraction of the true weight of the animal. The theory derived from this observation is that a crowd making independent estimates of something will invariably be a good estimate of what the actual value is.

Time and time again though, markets have proven inefficient. Perhaps the rational explanation of market inefficiency is that when the crowd of independent thinkers (active managers, rather than passive) is actually pretty small, then their wisdom isn't that wise. For example, if only three people are estimating the weight of a pig, even if two of them are porcine experts, the third's guess will tilt the average well out of line of what might be considered rational by experts. Perhaps this is the explanation for the UK's poor stock market performance, when most of the crowd is more interested in standing in front of the FAANG or GRANOLAS stalls, trying to guess the weight of the pigs over there?

The same might be said of the listed private equity sector. With high reported costs, and being a relatively small subset of the London listed market, perhaps the reason for persistently wide discounts is that not enough people are interested? Discounts remain wide, perhaps because of general investor apathy, or because of a lack of tangible datapoints that point towards an uptick. Certainly gearing across the sector is rising gently, the result of distributions not matching the pace of investments, which increases risks. That said, leverage and commitment-cover ratios appear to be much lower than they were prior to the GFC, and so whilst worth keeping an eye on, we don't anticipate this is a material risk currently. The FT's negative coverage of the private equity industry doesn't help sentiment. As shrill as the FT's calls of doom have been, so far neither bulls nor bears on LPE have been proven correct. Low realisation activity has led to dull returns over the past couple of years, but there have been no disasters.

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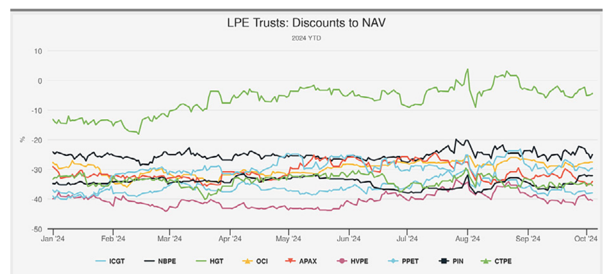
Fig.1: Discounts To NAV



Source: Morningstar

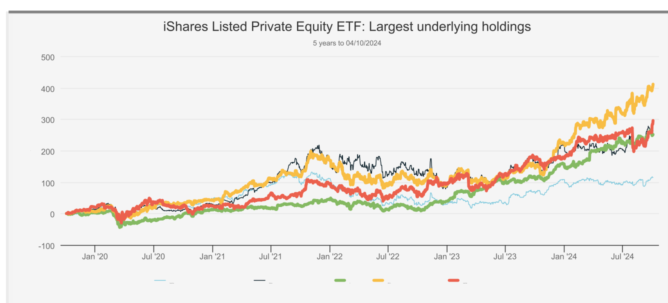
Wake up and smell the coffee

We were jolted out of our reverie when **a colleague noted** the strong performance this year from the iShares Listed Private Equity Index **ETF**. 2023 was a very strong year for this ETF at +38.9%, and calendar year to date hasn't been too shabby either at +15.4% (as at end September 2024). Closer examination of the underlying holdings in this ETF is that it is dominated by the top ten holdings, representing

over 50% of the index. Nine out of ten of these are private equity management companies such as Blackstone, KKR, Apollo Global, etc. As we show below, performance has been driven by these big American private equity goliaths.

If share prices are reflecting future expectations, then the FT's negative commentary (or discounts on London listed private equity trusts) would imply that share prices for these companies should be cratering. But the opposite has occurred. Perhaps share price rises reflect expectations of a huge shift of institutional capital from public markets to private markets. However, this shift isn't going to have strong foundations or last long if the castle of private market excess returns is, as the FT suggests, built on sand.

Fig.2: Big Names Driving Listed PE ETF



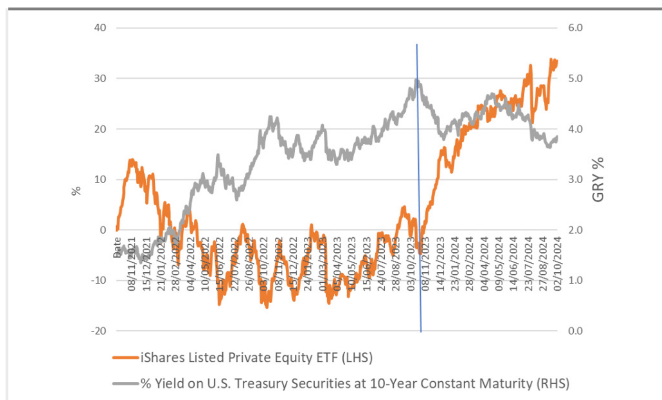
Source: Morningstar

How can private equity managers' share prices shoot up like rockets, whilst listed private equity portfolios remain in the doldrums? In our view, their fortunes are inextricably linked. And not just because they are all constituents (with very different weights) of the $1bn iShares Listed Private Equity ETF! Everything stems from underlying fund performance. Surely the share prices of the likes of KKR and Apollo Global are being bid up in anticipation of a brighter returns environment to come.

Why now?

In our view, the positive sentiment towards private equity managers can be traced back to one macro-variable: interest rates. As the graph below shows, when interest rate expectations started to fall, this fired the starting gun on the strong surge in performance for the ETF. The reasons for this are clear, private equity managers are typically enthusiastic users of leverage when structuring deals. Higher interest rates reduce the amount of leverage that can be used, but are also a determinant of prices that companies can be sold at. Rates rising meant private equity managers have had to dramatically adjust. Now, with rate falls taking longer to transpire than most people expected, it is perhaps unsurprising that deal activity hasn't taken off.

Fig.3: Private Equity ETF And 10 Yr Treasury Yield



Source: St Louis FRED, Morningstar, Kepler Partners

Past performance is not a reliable indicator of future results.

The era of cheap money is most definitely over, but private equity's ability to generate strong market-beating returns is not solely dependent on cheap financing. We believe the long-term outperformance of public markets by private equity is down to the deep expertise within highly resourced private equity management houses, the truly active way in which these managers can influence investee companies, as well as the alignment of interests between manager and investor. Private equity managers are able to generate excess returns through a repeatable process. That said, visibility on long-term rates is clearly helpful: lower interest rates are an enabler, not a precondition. The strong run of PE managers' share prices is the market looking forward, and potentially seeing the end of the slowdown.

Recent commentary from managers echoes this. The managers of **NB Private Equity Partners (NBPE)**, in the 2024 interim results, comment that, "With the demand for liquidity from private equity limited partners continuing, it is possible that deal activity and exits could increase in the short to medium term ... and lower borrowing costs should provide a tailwind for transaction activity." NBPE is the only trust in the LPE group that employs a pure co-investment model for investments, which gives it a good spread of investments, managed by a wide range of third-party managers on a largely fee-free basis. Perhaps reflecting this differentiated approach, NBPE's discount has been consistently narrower than the peer group so far this year. Its mature portfolio means it is potentially in a good position to capitalise when realisation activity starts to normalise.

Pantheon International (PIN)'s final results published in August included commentary that on realisations, "The tide may be starting to turn, which means that several of PIN's portfolio companies, which are already being prepared for exit, will be ready for sale as the outlook improves. Indeed, deal activity does seem to be picking

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up – for example recently released data shows that new transactions in Europe increased markedly in Q2 2024, with newly recorded deals increasing by 5% by number, and by 73% by aggregate deal value."

This time, it's different

So far, we have not seen a significant increase in deal activity or realisations within the listed private equity peer-group portfolios. Until we do, it's fair to expect that

Summary Table Of Capital Allocation Policies

TRUST	FORMULAIC ALLOCATION OF CAPITAL FOR RETURN TO SHAREHOLDERS (OTHER THAN THROUGH DIVIDEND)	DETAILS
APAX	Yes	New capital allocation framework announced in June. The new framework comprises regular dividends to shareholders and the creation of a 'distribution pool', which earmarks funds for share buybacks. €30m was allocated to the distribution pool immediately to take advantage of the investment opportunity presented by the current wide discount and share buybacks have commenced.
CTPE	No	The company continues to appraise the relative merits of using capital for share buybacks versus new investment whilst protecting and growing the dividend (which is set formulaically at the higher 4% of NAV, or the same as the prior quarter).
HGT	No	Clearly defined share buyback policy. The board has developed a process with a number of 'triggers' set by absolute and relative level of share price discount over various time periods. Where two or more such triggers are activated, the board is informed and a decision is taken as to whether to allocate resources to buying back shares.
HVPE	Yes	A distribution pool of capital, funded by 15% of cash realisations from the portfolio will be set aside as ring-fenced for buybacks, special dividends or, should the board feel it's appropriate, fund commitments. So far, $50m has been allocated to the pool, and the balance is currently $35m as at 31/08/2024. The board expect that the total allocated to the pool across the two calendar years 2024 and 2025 will be between $150m and $250m, inclusive of the existing balance, based on detailed modelling from the manager.
ICGT	No	Opportunistic share buyback programme for FY25 of up to £25m.
NBPE	No	Continue to balance new investments with the pace of realisations and other capital needs whilst maintaining a strong balance sheet. The board has stated that, in its view, dividends will remain the primary route for returning capital to shareholders, and that it, "Recognises the importance to shareholders of maintaining the company's annual dividend yield target at 3.0% of NAV or greater".
OCI	No	The board reiterates its commitment to a buyback strategy as one way to maximise shareholder value. "We will instigate further buybacks when we believe we have the appropriate liquidity to do so, taking into consideration outstanding investment commitments, the anticipated cadence of capital calls and future fund opportunities."
PEY	Yes	Capital allocation policy adopted in March 2024: "Once the share price is at a discount of more than or equal to 30% to the last reported NAV, 75% of 'Free Cash Flow' will be used to acquire issued shares, either for cancellation or to be placed into treasury for potential re-issue, until such time as the discount is less than 30%. Where the share price is at a discount of more than or equal to 20% to the last reported NAV, but less than 30%, 50% of Free Cash Flow will be used to acquire issued shares until such time as the discount is less than 20%."
PIN	Yes	A proportion of adjusted net portfolio cash flow (aNPC) will be allocated to share repurchases, where aNPC is defined as distributions from the underlying portfolio less calls and ongoing charges, and expected near-term cash outflows (e.g., debt principal repayments due within six months). aNPC will be assessed at the end of each financial quarter (May, Aug, Nov and Feb) but will be based on a rolling 12-month look-back, with a quarter of that 12-month total amount allocated for that quarter.
PPET	No	The board will continue to monitor the evolution of the PPET share price and, in the event of further sizeable distributions from the portfolio, may look to extend the current buyback programme.

Source: Kepler Partners, as at 30/09/2024

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NAVs may deliver relatively dull returns. However, in contrast to the past, when in order to see any meaningful discount narrowing one needed to see a return of investor enthusiasm, we now have a meaningful number of trusts employing formal 'capital allocation' policies, which we see as a reason why, "This time, it's different," may not be a naive plea.

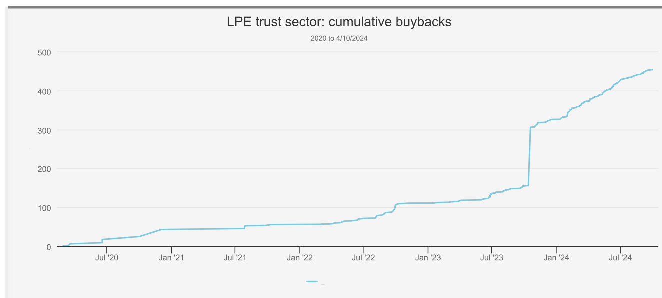
A trend we have started to see in the LPE trust sector is that some boards are setting a formulaic proportion of realisation proceeds be set aside for return to shareholders. As a means of returning capital, buybacks have the advantage of being effective, low cost and very accretive at the current level of discounts. The ability of private equity trusts to return capital is related to their ability to sell investments. As we illustrate in the table below, realisations are increasingly explicitly linked to returns of capital. So far realisation activity has been relatively muted, and so the effect of these new capital allocation policies has not really had much of an impact. When deal activity starts to accelerate – and it is our contention that lower interest rates make this a shorter prospect – discounts should be mechanically narrowed as increasing levels of buybacks start to be deployed. If buybacks start to be employed meaningfully, this should have an impact across the whole sector, irrespective of the specifics of each trust's policy. Of the trusts below, those with formulaic capital allocation policies amount to 49% of total assets of this group of trusts.

Listed private equity trusts have been ramping up capital returns over the last few years, which we show in the graph below (excluding dividends, which can also be seen as a return of capital). The board of PIN has been very much in the vanguard, adopting a formulaic capital allocation policy (more details **here**), as well as having been amongst the most aggressive in completing a tender offer to return capital to shareholders. It has seen the benefit, as its discount to NAV has narrowed in, now standing at 34%.

Aside from PIN, buybacks across the sector have generally been ad hoc and opportunistic but, as we illustrate below, the pace of returns of capital is stepping up over time. With several more trusts having committed to capital allocation policies, we would expect this to be an ever-tightening ratchet, which should gradually bring discounts narrower.

HarbourVest Global Private Equity (HVPE) currently trades on a discount to NAV of 41%, wider than the peer group average. HVPE's manager notes that there are currently early signs that exit activity may be beginning to step up once again, which would be positive for NAV growth and the discount to NAV, which is at historically wide levels. With 15% of realisation proceeds now earmarked for potential distribution to shareholders since the introduction of a distribution pool in February 2024, buybacks may provide something of a backstop for the current wide discount to NAV.

Fig.4: LPE Sector: Cumulative Buybacks + Pin Tender



Source: Morningstar, Kepler Partners

Show me the money

A higher pace of realisations is therefore critical, not just for mechanically narrowing the discount through capital being made available for buybacks, but also because in private equity deals a key driver of valuation gains occurs when a sale has been agreed. Dealing with illiquid investments, this makes a lot of sense – you can only confidently put a value on something when there is a proper 'bid' from a buyer. Evidence for this can be seen in the uplifts that are generally observed when a private equity deal is announced. Historically, uplifts have been in the order of c. 20–30%. When realisations come through thick and fast, this is an important driver of NAV growth.

We have been monitoring the health of the **LPE sector for a while**, looking for early signs of an upturn. Realisation activity has been our main focus. Undoubtedly, activity is currently well below long-term averages. However, as we highlight above, there are signs that the early stages of a recovery are underway. Yet activity levels improving are not being accompanied by large valuation uplifts on sales. Anecdotally, uplifts are occurring at prior valuations or only slightly ahead of NAV. This is not to say they have not been successful investments – returns on invested capital, and IRRs remain strong. However, in our view, this reflects the pressure private equity managers are currently experiencing to return capital to investors. As such, in some cases they may be prioritising banking cash from a winning investment, rather than trying to squeeze every last drop out of the valuation. Short term, this isn't a problem, but we would hope to see uplifts start to return to historic averages as activity hots up.

Clearly each portfolio is different, and the impact of realisations will be felt differently depending on the make-up of portfolios. **CT Private Equity (CTPE)** has a hybrid approach to investing, with long-term commitments made to lower mid-market managers, but over 40% of the portfolio represented by co-investments. When one of these co-investments is realised, it can have a very positive, lumpy impact on cash flow. When CTPE realised

Jollyes in April 2024 at a valuation representing 4.2× cost and an IRR over the six-year hold of 27% p.a., it contributed a chunky £18.3m of proceeds, a very significant sum when compared to total distributions over Q1 2024 of £16.1m. In fact, at the time of the interims, total distributions for the first half of 2024 were £52.3m. This compares with £39.8m for H1 last year and £61.8m for the whole of 2023, providing yet more evidence that distribution activity is picking up.

Conclusion

In our view, 10-year bond yields declining from their highs will be the spark that re-ignites interest in private equity. The positivity evidenced by US private equity managers' share prices makes sense, as lower interest rates improve their ability to do deals and are a precursor to deal activity improving. In time, it is possible we will see a trickle down of sentiment towards the LPE sector. The same factors are at play, and with financing conditions improving, deal activity should start to pick up pace again. This will have a number of positive knock-on effects, most visibly buybacks increasing, but also trust level gearing reducing, NAVs growing, and all of these things leading to discounts narrowing – in some cases mechanically through buybacks. Given the illiquidity of portfolios, there are potential risks for investors if this rosy scenario doesn't play out. However, if realisations step up in pace, LPE trusts could provide fireworks in a portfolio for all the right reasons.

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