EDISON

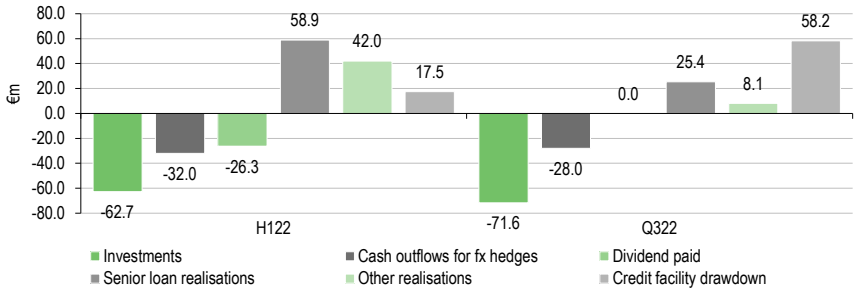
Princess Private Equity

Portfolio resilient, holding-level liquidity strained

Investment trusts
Private Equity

Princess Private Equity Holding's (PEY's) portfolio has fared quite well in 2022, with the +3.7% NAV total return (TR) in Q322 bringing the 9M22 TR decline to a moderate 4.0%. This was likely assisted by PEY's sector mix and the temporary allocation of excess funds into senior loans in H221 (gradually redeemed throughout 2022). However, this was overshadowed by PEY's decision to suspend its second interim dividend amid holding-level liquidity concerns due to high cash outflows for foreign exchange (fx) hedges and subdued M&A markets. This allowed PEY to build a liquidity buffer (c €88m at 18 November) to cushion against potential further headwinds due to a strong US dollar and muted portfolio realisations.

PEY's liquidity affected by fx hedges and limited realisations in Q322



Source: Refinitiv, Edison Investment Research. Note: Total returns in sterling.

Why consider Princess Private Equity now?

PEY offers a portfolio of private companies aligned with secular transformative growth themes (eg digitalisation, ageing society/health awareness, automation and sustainability). It delivered last 12-month (LTM) revenue and EBITDA growth (both organic and through M&A) to end-September 2022 of 25.7% and 18.4% respectively (based on a sample covering 75% of portfolio value). PEY offers investors high exposure to the healthcare sector (21% at end-September 2022, including several healthcare service providers) and also a meaningful allocation to IT (12%, mostly enterprise software) and childcare/education (7%). This may help PEY's portfolio withstand a worsening macroeconomic environment.

The analyst's view

Following the recent sell-off, PEY's shares now trade at a 37% discount to NAV (significantly wider than its five-year average of 15%). The dividend suspension has disappointed some investors but we note that PEY now has a meaningful safety margin in terms of liquidity. We also note that its cash and undrawn facility are higher than the outstanding commitments considered by the company as likely to be called (c €35m at end-September 2022). PEY highlighted that it could resume dividend payments as early as June 2023 if fx markets stabilise and M&A activity in private markets resumes. PEY's near-term liquidity profile could be further assisted by an upsizing of its credit facility or changes to its fx hedging approach. While PEY has stopped any new direct investments for now, it highlighted that its portfolio companies have sufficient resources to continue pursuing add-on acquisitions.

28 November 2022

Price	**€8.94**
Price (PEYS)	**777p**
Market cap	**€618m**
NAV	**€987m**
NAV per share*	€14.27
Discount to NAV	37.4%
Yield	4.3%
Shares in issue	69.2m
Code (EUR/GBP quote)	PEY/PEYS
Primary exchange	LSE
AIC sector	Private equity

52-week high/low	€14.8	€7.8
NAV high/low	€15.8	€13.8

*At end-September 2022

Gearing

Net gearing at 30 September 2022	9.7%

Fund objective

Princess Private Equity Holding is an investment holding company domiciled in Guernsey that invests in private equity and has a minor private debt position. Its portfolio consists mostly of direct investments but may also include primary and secondary fund investments. It aims to provide shareholders with long-term capital growth and an attractive dividend yield.

Bull points

- Focus on building resiliency in portfolio companies and on transformative trends.
- High exposure to resilient sectors (eg healthcare).
- Available at a wide discount to NAV after recent sell-off.

Bear points

- Suspension of interim dividend weighing on investor sentiment.
- A persistently weak exit environment may further impact PEY's new investment activity and liquidity.
- Continued US dollar appreciation would trigger further cash outflows for fx hedges.

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Liquidity situation at holding level tightening in Q322

Impact from fx hedges and low realisation activity

PEY started 2022 with a high liquidity position following the 2021 exits (GlobalLogic in particular), with €135m (or 13% of end-2021 NAV) held in a portfolio of floating rate senior secured loans, which it temporarily invested in back in H221 (as rates on Euro deposits were negative then). Moreover, the company had €55m in undrawn credit at end-2021 (out of the total facility size of €80m). However, as 2022 progressed, PEY's liquidity became increasingly strained, especially towards the end of Q322, due to a combination of:

- The US dollar appreciation versus the euro resulted in c €60m in cash outflows for PEY's EUR/USD hedges in 9M22 (close to 50% of PEY's portfolio is denominated in US dollars and c 90% of its fx exposure is hedged to the euro).
- Significant weakening of M&A activity in the private equity (PE) market leading to just €8.1m in realisation proceeds (excluding senior loan redemptions) for PEY in Q322 (€50.1m in 9M22).
- PEY's relatively high investment activity with €71.6m invested in Q322 (largely agreed in H122), translating into €134.3m in 9M22 (c 13% of opening NAV versus the annual average in 2017–2021 of c 15%).

PEY covered the Q322 liquidity shortfall with senior loan redemptions (€25.4m) and drawdowns on its credit facility (c €58.2m, see exhibit on the front page). However, the remaining senior loan balance declined to €49.5m while PEY's €110m credit line was 92% utilised at end-September 2022. Consequently, on 2 November PEY's board announced the suspension of the second interim dividend for FY22 to preserve capital for potential further cash outflows related to fx hedges (as well as PEY's capital commitments and ongoing charges). Coupled with a pause in capital allocations to new investments starting from July/August, this allowed PEY to amass liquid resources of €88m as at 18 November 2022, including around €50m in cash and €38m in undrawn credit (of a total facility of €110m). PEY has redeemed all of its senior loan investments, which since the initial investment in autumn 2021 have generated a certain capital loss, offset at least in part by coupon income.

Dividend suspension is providing an additional safety margin

PEY's current liquidity compares with its outstanding undrawn commitments as at end-September 2022 of €103.2m. However, these include €45.3m of commitments to PEY's investment manager, Partners Group's direct programmes and third-party funds which are past their investment period (and are thus unlikely to be called). Out of the remaining €57.9m, PEY considers only €35m as likely to be drawn (gradually over the next two to three years). As a result, these commitments are 2.5x covered by PEY's current liquid resources, although the company needs to put aside some liquidity to cover its ongoing charges (c €8m excluding incentive fee in H122) and interest expense (c €3–4m annualised based on the current Euribor rate and drawn part of the credit line). Importantly, as PEY stopped arranging new direct investments in July/August, there are no immediate capital needs with this respect.

Hence, the dividend suspension has provided PEY with a sizeable safety margin in the event of ongoing US dollar appreciation against the euro (the first interim dividend amounted to €26.3m). Further potential support for PEY's near-term liquidity could come from measures currently contemplated by Partners Group and board, such as a moderate upsizing of the company's credit facility or changes to its fx hedging arrangements. We note that PEY's ratio of current total debt facility (€110m) to NAV is c 11% versus up to c 20% for other listed PE companies.

The company highlighted that its dividend policy of paying 5% of opening NAV per annum remains unchanged and, subject to no further significant US dollar appreciation and a normalisation of the

exits environment, it expects to pay the next dividend in June 2023. We believe that the recent decline in M&A activity has been caused by, among other reasons, the uncertain macroeconomic outlook (which makes the pricing of new deals more difficult), as well as lower debt availability.

Near-term debt availability outlook better for small/mid-market buyouts, though still uncertain

The US leveraged loan market saw institutional new-issue loan volumes of a mere US$21.4bn in Q322 (the weakest level since the post-global financial crisis Q409), which compares to a five-year quarterly average of US$96.8bn, according to Partners Group citing Leveraged Commentary & Data (LCD). Similarly, European leveraged loan issue volumes were just €7.0bn in Q322 (only slightly up from €6.6bn in Q222) compared to €24.8bn in Q321 and €41.3bn in Q221. The high-yield bond markets have also experienced a significant slump in new issuances, hitting a 14-year low in Q322, according to PitchBook citing LCD data.

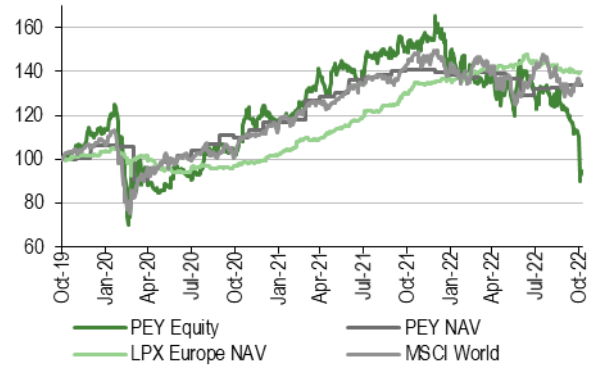
Having said that, debt funding has not dried up completely, as private debt funds (most notably direct lenders) have stepped in and filled part of the funding gap, gaining market share from the high-yield bond and syndicated loan markets. Global private debt funds have grown in recent years and at end-June 2022 had assets under management of c US$1.2tn (including US$425.1bn of dry powder, of which US$168.7bn was in direct lending strategies) versus US$474.3bn (and US$177.6bn in total dry powder) in 2012, according to PitchBook. Private funds more often focus on small- and mid-market buyouts (even if some have also been participating in selected large unitranche financings of several billion US dollars for large/mega buyouts). This is illustrated by the average size of European direct lending deals between Q120 and Q222 of c €220m (although the average was €721m in Q222 alone), according to PitchBook citing LCD data. Therefore, we believe that it may be currently somewhat easier for potential buyers to refinance debt upon acquisition in the case of PEY's small/mid-cap buyouts (54% of PEY's portfolio at end-September 2022) compared to large/mega buyouts (32% of PEY's portfolio at end-September 2022). Nevertheless, we acknowledge that a combination of high interest rates and a likely global economic downturn in the coming quarters may put further pressure on M&A deal activity.

NAV TR of 3.7% in Q322, reducing the ytd fall to 4.0%

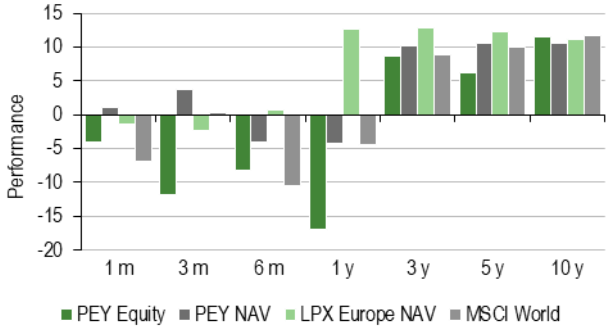
Despite macroeconomic headwinds, PEY's NAV remained resilient throughout 9M22, with a modest decline of 4.0% and a positive NAV TR of 3.7% in Q322. This compares with a 25.4% fall in total return terms of the MSCI World Index. Firstly, as highlighted in our previous note, PEY's performance relative to the broad equity markets has been likely assisted by sector mix (eg its high exposure to healthcare companies of 21% at end-September 2022, including several healthcare services providers, such as EyeCare Partners), coupled with meaningful exposure to IT (12%, with a high proportion of enterprise software companies) and childcare/education (7%). The company estimates that the negative year to date TR of public equities on a sector-adjusted basis (ie reflecting PEY's sector mix) was less pronounced, at 13.3%.

Exhibit 1: PEY's performance to 30 September 2022 in euro terms

Price, NAV and benchmark TR performance, three-year re-based



Price, NAV and benchmark TR performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Exhibit 2: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	LPX Europe NAV (%)	MSCI World (%)	UK All-Share (%)
30/09/18	6.6	10.4	12.1	13.8	4.7
30/09/19	(1.5)	11.8	10.5	9.1	3.4
30/09/20	10.2	10.5	(1.3)	3.2	(18.6)
30/09/21	40.4	26.2	29.6	30.9	35.0
30/09/22	(17.0)	(4.3)	12.6	(4.5)	(6.0)

Source: Refinitiv. Note: All % on a TR basis in euro.

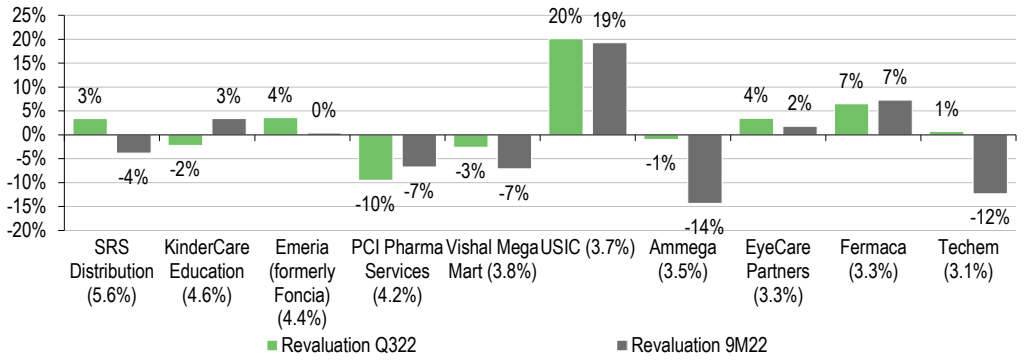
Secondly, Partners Group focuses on driving resilient growth (underpinned by transformative themes) as a form of defensiveness in its portfolio companies. This is also illustrated by PEY's new investments completed in Q322 (agreed in H122):

- **Forterro** (€13.3m invested, 1.4% of NAV) **–** a pan-European software services provider with a portfolio of specialised enterprise resource planning software products serving nearly 8,000 mid-market manufacturing and production companies.
- **Version 1** (€12.1m, 1.2% of NAV) – a digital transformation services provider in the UK and Ireland, providing, among others, application modernisation, cloud migration and cloud-native software engineering.
- **Velocity EHS** (€9.5m, 1.0% of NAV) **–** an environmental, health and safety (EHS) and ESG Software-as-a-Service platform serving over 18,000 customers, helping them manage and improve operational risk, compliance and efficiency.
- **Foundation Risk Partners** (€17.4m, 1.8% of NAV) **–** an independent insurance broker focusing on the US business to business segments of commercial property and casualty, as well as employee benefits.
- **Accell Group** (€8.8m, 0.9% of NAV) – a manufacturer of bicycles and bicycle parts and accessories based in the Netherlands; the largest producer of e-bikes in Europe and the second-largest in bicycle parts and accessories.

Partners Group underlined the higher earnings growth relative to the listed equities average, with LTM revenue and EBITDA growth to end-September 2022 across a sample of PEY's portfolio (covering 75% by value) of 25.7% and 18.4% respectively. The slower EBITDA growth relative to the top-line momentum reflects inflationary pressures experienced more broadly in the global economy. Having said that, the average EBITDA margin remains above 20% (21.1%) and Partners Group is confident about the positive effects from cost optimisation measures introduced across the portfolio earlier this year and the pricing power (assisted by a solid market position) of its portfolio companies. Moreover, 85% of PEY's portfolio company debt is hedged at a fixed rate (the average net debt to EBITDA multiple at end-September 2022 for the above-mentioned sample was 6.3x vs 5.8x at end-2021).

In Exhibit 3, we present the valuation changes over Q322 and 9M22 across PEY's top10 holdings (representing c 39.5% of NAV at end-September 2022). One holding that stands out in terms of positive revaluation is United States Infrastructure Corporation (USIC), a North American provider of utility location services (making up 3.7% of PEY's NAV at end-September 2022). In August 2022, Partners Group announced that it had expanded the company's shareholder base with Kohlberg & Company (a PE firm) acquiring a 50% stake in USIC and Partners Group retaining a 50% co-lead stake. The transaction valued the business at an enterprise value of US$4.1bn, resulting in a 20% revaluation in PEY's portfolio in Q322 (which we believe was partly assisted by the strength of the US dollar).

Exhibit 3: Change in carrying value of PEY's top10 holdings



Source: PEY. Note: Share in NAV at end-September 2022 indicated in brackets.

We note that the greater resilience of valuations across PE portfolios versus public markets is also due to technical factors, which smooth out the portfolio valuations of listed PE companies such as PEY. In accordance with the International Private Equity and Venture Capital (IPEV) valuation guidelines, multiples used to value PEY's holdings are a blend of public market and private M&A deal multiples. The latter tend to be less volatile than listed multiples (and have a 'smoothing' effect), because they are not subject to the same short-term swings in investor sentiment. Moreover, private deal multiples are likely to lag a worsening macroeconomic environment, as fewer deals are carried out and buyers and sellers reassess valuation expectations (with the latter willing to sell only at prices that have not been materially marked down versus previous expectations). Finally, PE companies normally value their new investments in line with the acquisition price over the subsequent 12 months. Here, it is worth noting that PEY updates its portfolio valuations every month (while the frequency of portfolio valuations for listed PE companies is usually lower). PEY's average EV/EBITDA (for the above-mentioned sample) at end-September 2022 was 18.7x vs 15.6x at end-June 2022 and 15.8x at end-September 2022.

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