EDISON

Edison Explains

Listed private equity

Is listed private equity due for a comeback?

What is listed private equity?

Listed private equity (LPE) is a subsector of the private equity market made up of specialist investment firms that invest in unlisted companies.

Unlike traditional private equity (PE) firms, which are privately held by a set of limited partners, LPE funds are owned by shareholders.

What are the risks of an LPE ownership model?

In LPE funds, the investors buy shares in a firm's stock and retain ownership of the company. This structure contains some risks not present in private equity investments.

In a limited partnership, partners must honour their legal commitments to meet funding calls, given the company security in cases funding shortfalls.

If an LPE trust retains insufficient funding, the company cannot call on its investors and must instead take on debt or sell assets at potentially distressed prices. In times of economic hardship, such as the financial crisis, the shortfall can cause LPEs to take on significant amounts of debt, eroding investors' confidence in the fund.

Why is LPE attractive to investors?

The main advantage of LPE stock is that it can be bought and sold at any time, without the risk of being locked out of trading equity.

By extension, LPE suffers less from illiquidity when compared to traditional private equities funds' long-term, 10-year structure and lack of redemption rights, which means LPE investors do not have to liquidate their stake at the secondary market for a large discount due to illiquidity.

That said, the liquidity of LPE can come at the cost of inconsistent discounts, which stems from LPEs' underlying equity and status as a listed asset.

How are LPEs challenging for investors?

LPEs suffer from a lack of disclosure, making it challenging for investors to understand and access LPE investments.

Mostly, this lack of transparency comes in portfolio disclosure, a symptom of confidentiality obligations that leave LPE investors lacking information from which to quantify their investments.

Disclosure around fees and expenses also varies between LPE funds, making it difficult for investors to compare them on a like-for-like basis.

That said, LPE company disclosure has improved significantly as funds begin to recognise the importance of greater transparency.

How large is the LPE market?

LPE funds make up a small portion of the $159bn in PE deals conducted in 2017, with only 250 LPEs in operation as of 2016.

Of these 250 funds, most have been undervalued since the 2008 financial crash. With significant discounts on their net asset value (NAV), indicating that the market considers the value of LPE firms to be below the value of their assets.

Paradoxically, analysing more than 23 years of return and risk data shows that LPE displays a similar risk-reward profile to other major equity indices and US REITS that do not have discounts.

Currently, most LPE companies are running a net cash position and commitment risk is tightly managed, and in the year to 9 February 2018, they returned 16% compared to 8% for the MSCI Europe index and only 2.5% for the FTSE All-Share.

But discounts on LPE remained at 14% in early- to mid-2017, with HG Capital Trust trading at a 25% discount on its net assets.

Why is LPE undervalued?

High discount rates are a legacy of the financial crash, damaging the reputation of LPE.

Edison's insight

"The recent increase in equity market volatility was sharp but by no means unprecedented and occurred against a supportive economic backdrop.

Perhaps surprisingly, the LPX slightly outperformed MSCI Europe in the three weeks to 9 February 2018 and has outperformed by 7%, 40% and 13% over the last one, five and 10 years respectively." Robert Murphy, head of investment trusts.

Extreme volatility and severe discounts in the mid-2000s led to an aggregate NAV drop of 41% and LPE stocks trading up to a 70% discount to NAV, leaving investors reluctant to reinvest even with strong growth numbers.

The market has yet to appreciate that PE investment and ownership models are highly focused on mitigating risk through diversification and that while LPE funds suffered during the financial crisis, no firm went under. This was due mostly to high levels of diversification throughout the industry.

What is the future of LPE?

Assuming flat performance, the LPX global index would show over 66% of LPE firms expected to perform better than the overall market by the end of October 2018. Yet heavy discounts and discount reductions are likely to continue in the short term.

Some LPE funds appear to be trying to increase their appeal through dividend actions. For example, Aberdeen Private Equity Fund announced a 40% rise in dividends plus a reduction in management fees – a trend that might spread as LPEs try to counteract investors' tepid responses to the market.

All in all, as the legacy of the financial crash fades, and LPEs continue to perform strongly, we would expect there to be a lowering of discounts in the medium term and a rise in new investments.