



BRILLIANT KNOWLEDGE

March 2024

PERFORMING A BALANCING ACT

Listed private equity

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Listed private equity

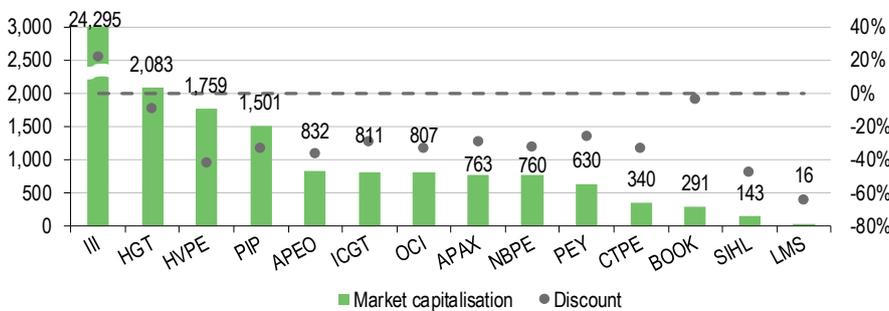
Performing a balancing act



6 March 2024

UK-listed private equity investment companies maintained strong NAV total returns (TR) over the last five and 10 years of c 14% per year on average, despite recent monetary tightening and other macro headwinds. However, they continue to trade at discounts to NAV (c 31% on average) last seen at the onset of COVID-19 and in the aftermath of the global financial crisis (GFC). In this report, we examine which investor concerns may be the root cause of the discounts and to what extent they could be warranted.

Market cap in £m (LHS) and discount to last reported NAV (RHS)



Source: Source: Refinitiv, company data, Edison Investment Research at 5 March 2024.

Gateway to an expanding equities universe

Private equity (PE) has established itself as an important asset class for institutional investors globally (to which they often allocate c 5–15% of their portfolios), as it provides access to actively managed, attractive companies not accessible through public markets. At the same time, businesses increasingly opt to stay private for longer, while the number of listed companies has not expanded in recent years. Consequently, qualified investors ignoring PE potentially miss out on an attractive investment universe, especially in the small- and mid-cap range. Investors can gain exposure to PE through several listed entities which invest in private companies globally (see chart above).

UK-listed PE sector resisting headwinds so far

Portfolio valuations across the listed PE sector have remained broadly resilient since 2021, as many listed PE players report sustained good earnings growth across major holdings. While average holding periods have lengthened and realisation volumes have fallen below historical averages, many listed PE companies continue to report uplifts to previous carrying values on exit and maintain balanced portfolios in terms of vintage. The average overcommitment ratio across the sector is now more conservative than pre-GFC levels and there are tentative signs of an improving outlook for exits. Nevertheless, listed PE companies should emphasise maintaining balance sheet headroom in case there are limited realisations this year. A higher cost of debt is likely to dilute returns and increase defaults across PE portfolios, but the extent of the impact may be limited by PE's active value creation approach, good cash generation and earnings momentum across the sectors on which PE puts an emphasis, as well as covenant-lite debt.

Edison themes

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

Companies mentioned in this report

3i Group (III)
[abrdn Private Equity Opportunities Trust \(APEO\)*](#)
 Apax Global Alpha (APAX)
 CT Private Equity Trust (CTPE)
 HarbourVest Global Private Equity (HVPE)
[HqI \(HGT; formerly HqCapital Trust\)*](#)
 ICG Enterprise Trust (ICGT)
 Literacy Capital (BOOK)
 LMS Capital (LMS)
 NB Private Equity Partners (NBPE)
 Oakley Capital Investments (OCI)
 Pantheon International (PIP)
[Princess Private Equity Holding \(PEY\)*](#)
 Symphony International Holdings (SIHL)

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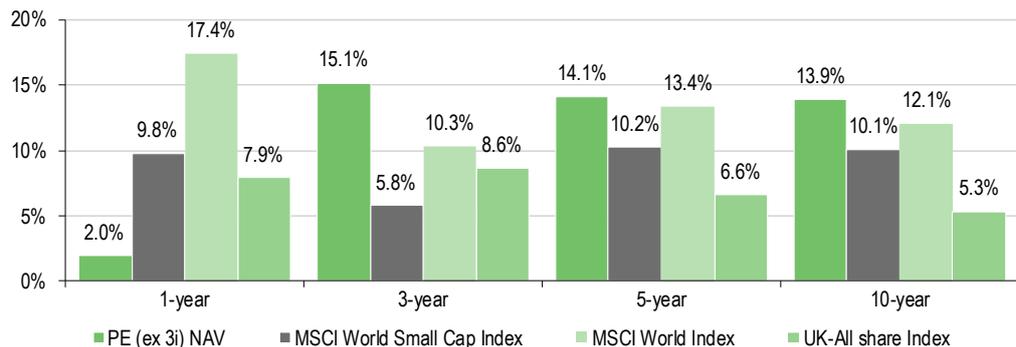
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'Private' still competitive with 'public' despite market headwinds...

Recent activity in global PE markets has been affected by interest rate normalisation and macro headwinds, with global PE deal volumes falling to c US\$1,323bn in 2023, down 25% y-o-y and 40% from the 2021 peak, although close to 2019 levels (based on PitchBook data). Similarly, global PE exit volumes fell by 27% and 66%, respectively. Against this backdrop, UK-listed PE investment companies recorded more moderate portfolio returns in 2023 compared to previous years. The average 2023 ytd NAV TR in sterling terms (ex-3i) was 2.0% (see Exhibit 1), which was also negatively affected by the strengthening of sterling against the US dollar and euro last year. This is notably behind public markets, which benefited from the rebound from 2022 lows, but may partly come from lower volatility of private versus public valuations (see below). However, these short-term headwinds have not derailed the sector's strong performance over the medium and long term, with a five-year and 10-year NAV TR of around 14% pa, significantly above the MSCI World Small Cap Index. We consider small-cap companies a better comparator for the PE industry (given the average size of a PE-backed company) than the flagship indices, which are skewed towards large-caps. That said, the UK-listed PE sector has also outperformed the MSCI World and UK All-Share indices over that period.

Exhibit 1: NAV performance of UK-listed PE companies (excluding 3i) versus public equity indices to end-2023 (total return in sterling terms)*



Source: Refinitiv, Morningstar, company data, Edison Investment Research. Note: Three-, five- and 10-year returns annualised. *Calculated as average returns to end-December 2023 or latest earlier available NAV, weighted with previous year-end NAV for the following companies: APEO, APAX, Candover Investments, CTPE, Dunedin Enterprise, Electra Private Equity (currently Unbound Group), HVPE, HGT, ICGT, JPPEL Private Equity, LMS, NBPE, Northern Investors Company, OCI, PIP, PEY, SVG Capital and SIHL.

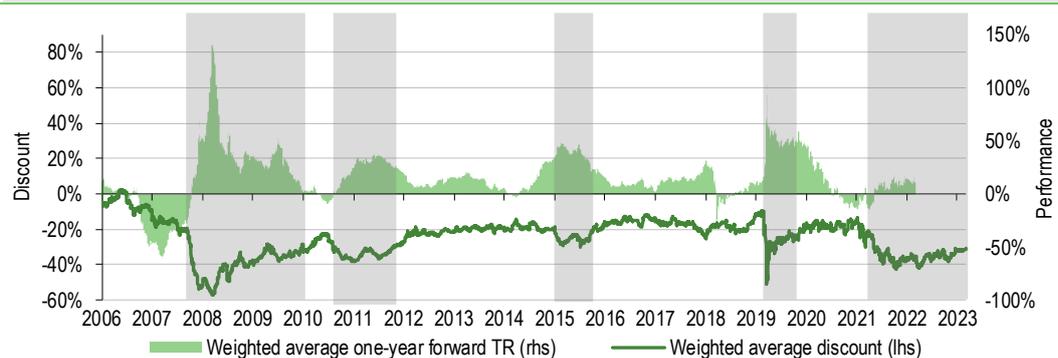
We note that investors normally demand a higher return from PE as an asset class than from the public market to account for its distinct risk profile. According to Cliffwater, most US state pension systems have a PE objective to outperform public equity by a given percentage point amount, most frequently set at 300bp net of fees. Interestingly, the UK-listed PE sector outperformed the MSCI World Small Cap Index by close to 400bp pa over five and 10 years to end-2023.

...but discounts still wide as during GFC or COVID-19

Despite the resilient performance of listed PE companies, discounts to NAV remain wide within the sector (see Exhibit 2), in spite of narrowing recently on average from the peak of close to 40%+ levels to c 31% currently, supported in some instances by the announcement of a share buyback programme (eg PIP, APEO). These discount levels were last seen in the first stage of the COVID-19 outbreak and before that in the initial years following the GFC. During the last three major instances of widening discounts (2011/12, 2015/16 and H120), they subsequently narrowed

primarily on the back of share price appreciation (which would suggest that now may be a good time to buy listed PEs), while during the GFC the discount narrowing came from a combination of downward portfolio value adjustments and share price increases. While the wide discounts reflect a broader trend across UK investment trusts in general, they also likely illustrate investor anxiety around the following three risks: PE valuations, holding-level liquidity given the muted exit environment and leverage across portfolio companies, which we discuss below.

Exhibit 2: Average discount/premium to the last reported NAVs of listed PE companies (excluding those which completed or are currently in the process of winding down) over time



Source: Refinitiv, company data, Edison Investment Research. Note: Weighted by previous year-end NAV. Includes the following companies: HGT, ICGT, PIP, CTPE, PEY (since January 2007), SIHL (July 2007), NBPE (July 2007), OCI (December 2007), HVPE (January 2008), APEO (September 2008) and APAX (June 2015).

PE valuations have remained resilient overall so far

Many investors expected a significant NAV de-rating of listed PE companies post 2021, in line with the sell-off in public markets in 2022. This has not materialised so far, which is to some extent because PE valuations tend to be less volatile than valuations in public equity markets (both to the upside and to the downside). The lower volatility in valuations partly comes from the valuation techniques used across private markets (see our previous [listed PE thematic note](#) for details), most notably the use of blended public and private M&A deal multiples. That said, it is also likely due to high exposure to more resilient sectors (eg IT and healthcare), as well as value-add provided by general partners (GPs). This allowed many listed PE investment companies to maintain a good level of last 12-month (LTM) revenue and EBITDA growth across the top holdings (combined organic growth and through M&A) of c 15–20% (with the date of last available data ranging from June to December 2023). In some instances, growth was even higher, eg HGT posted revenue and EBITDA growth of 25% and 28%, respectively, across its top 20 holdings (78% of total portfolio value) in FY23. PE managers are flexible in terms of selecting the most promising (sub)sectors of the economy and can therefore focus on companies benefiting from transformative, secular trends such as digitalisation and automation, changing consumer preferences with respect to nutrition, an ageing population, leisure and learning or decarbonisation.

UK-listed PE trades at much wider discounts than PE secondaries

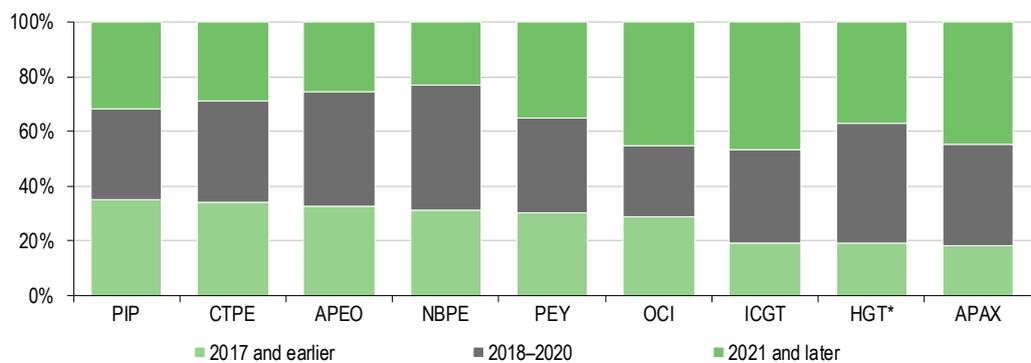
We note that there is a significant discrepancy between current discounts to the NAVs of listed PE companies and the discounts at which limited partner (LP) buyout portfolios have recently been priced in the PE secondary markets which, according to the latest Jefferies' Global Secondary Market Review, stood at just 9% on average in 2023 (vs 13% in 2022 and 3% at the last peak in 2021). The pricing of secondaries was assisted by investor focus on later-stage (the average vintage was 2016 in 2023 and 2014 in 2022) and high-quality assets (ie with no major distressed

selling). Moreover, we believe that the favourable trend in public markets supported private valuations, but also reduced the pressure on LPs from the so-called denominator effect (the increase in percentage allocation to private markets due to the declining value of listed assets). Finally, a significant number of secondary funds have been launched recently, boosting the demand side of the market. Jefferies estimates that fund-raising by secondaries in 2023 exceeded the amount raised in 2021 and 2022 combined, and that the ratio of available capital across the private markets to the LTM secondary volume increased to 2.3x at end-2023 from 2.1x at end-2022.

Listed PE discounts closer to old, tail-end LP portfolios sold recently

The focus on more mature, higher-quality LP portfolios by sellers in private secondary markets suggests that the discounts to NAV of listed PE companies with significant primary fund investments (APEO, CTPE, HVPE, ICGT and, to some extent, PIP) may not be fully comparable with the discounts in private secondary markets, as listed PE discounts apply to the entire portfolios of multiple LP positions of various vintages rather than individual LP portfolios. Furthermore, parties involved in a secondary transaction have better access to information on the underlying private portfolio companies than an investor in a listed PE vehicle. That said, the current discount to NAV of listed PE is close to the c 29% discount paid in 2023 for old, tail-end LP interests (10 years or older) across different strategies including buyouts, but also strategies where LP portfolios are now generally traded at wider discounts (most notably real estate and venture). We note that in contrast, the vintage profile of listed PE companies (capturing both vintage of funds and direct investments) is quite balanced, even if the five-year plus bucket may be somewhat higher than usual given the extended holding periods in the current tougher environment (see Exhibit 3). From this perspective, the listed PE discounts to NAV look excessive.

Exhibit 3: Portfolio by year of initial investment



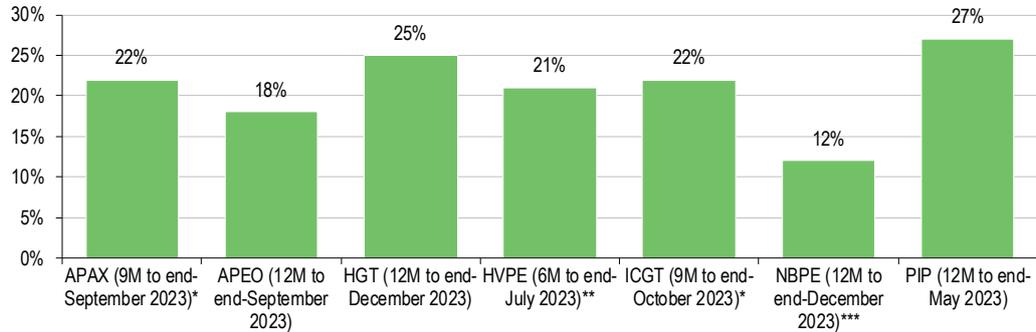
Source: Company data, Edison Investment Research. Note: Based on latest available data – January 2024 for NBPE; November 2023 for PIN; September 2023 for APEO, APAX and HGT; July 2023 for ICGT; June 2023 for PEY and OCI; December 2022 for CTPE. *HGT vintages are 2018 and earlier, 2019–20, 2021 and later.

Several listed PE companies selling holdings at uplifts to carrying value...

The ultimate validation of fair value across PE portfolios remains successful exit activity at or above previous carrying value. Listed PE has a strong, long-term track record of uplifts to carrying values on exit (discussed in our [listed PE thematic note](#) published on 8 February 2023), suggesting a conservative approach to valuations. Even amid the tepid PE markets of 2023, many listed PE companies continued to realise investments at uplifts (even if these were in some cases less spectacular than in previous years), see Exhibit 4. A potential increase in PE exit activity this year could at least partly come from the willingness of sellers to accept lower prices for their assets, which could reduce the average uplifts on exit across the PE sector in the near term. However,

even disposals in line with the last carrying value (ie at no uplift) should be considered a good result.

Exhibit 4: Uplifts on exits in 2023 of selected listed PE investment companies

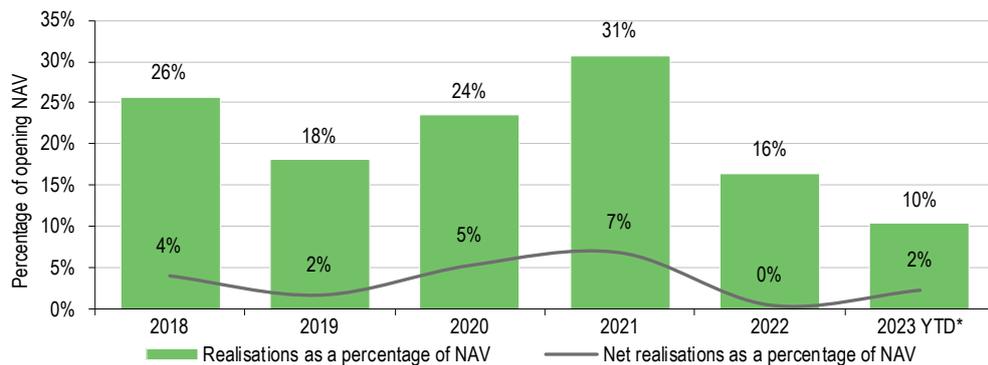


Source: Company data, Edison Investment Research. Note: Uplifts to previous carrying value: APAX, HVPE – to unaffected value, APEO – two quarters prior, HGT – end-2022 fair values, ICGT – one quarter prior, NBPE – three quarters prior, PIP – four quarters prior. *Edison calculation based on H1 and Q3 reported uplifts and realisation volume. **Uplifts on buyouts only, uplifts on total exits (including VC investments) stood at 32%. ***Based on deals closed, as well as deals announced but yet to be closed as of end-December 2023.

...although realisation volumes are below historical averages

We acknowledge that realisation volume is equally important in the context of validating portfolio valuations. If uplifts are achieved on a limited number of deals, the risk remains that these were executed only for a narrow set of top-tier assets, while the broader portfolio includes a considerable proportion of tier 2 and tier 3 private assets which are not being exited because they would have to be sold at a discount to NAV. As a rule of a thumb, an average holding period of three to five years would result in an annual realisation volume of around 25% of NAV (although the ratio may be higher in the case of significant uplifts to carrying value). This is confirmed by the average realisations to NAV over 2018–22 across the listed PE sector, which stood at c 18–30% pa (see Exhibit 5). In 2023, exit activity was more muted, at an annualised rate of c 5–15% of opening NAV in most cases. Therefore, while the sustained exit uplifts to NAV seen recently are encouraging, it is worth monitoring future PE exits for further validation points when realisation activity picks up.

Exhibit 5: Annual realisations as percentage of opening NAV



Source: Company data, Edison Investment Research. Note: Cumulative realisations of chosen PE-focused trusts (APAX, APEO, CTPE, HGT, HVPE, ICGT, NBPE, OCI, PEY, PIN). *Full-year 2023 realisations or latest available data; nine months to end-October for ICGT; nine months to end-September for APAX and CTPE; six months to end-June for OCI.

Good balance between exits to trade buyers versus sponsor-to-sponsor deals

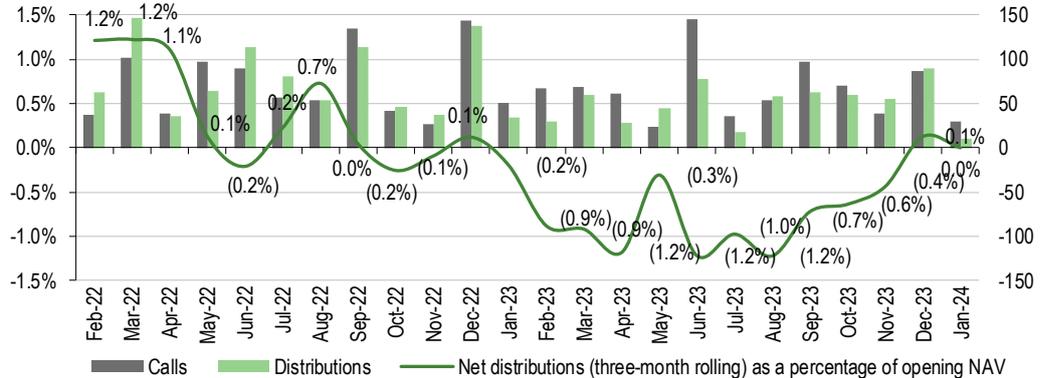
Finally, it is worth looking at PE exits across the global private equity market by type of buyer. Encouragingly, both in the US and Europe, most of the PE realisations were to trade buyers (56% and 40%, respectively), followed by sponsor-to-sponsor deals (41% and 36%, respectively), based on PitchBook data. While IPOs dried up in the US (c 3% of PE exit value), this route represented 24% of European exits, although this was inflated by a few large listings (eg of the British semiconductor business Arm Holdings). Deals between PE funds may be either transactions between funds managed by different GPs or manager-led secondaries, which most often involve the sale of one or multiple assets from one PE fund to a continuation fund (ie a special purpose vehicle set up specifically to buy the assets) or another active PE fund managed by the same GP. GP-led secondaries have gained in popularity in recent years (with their global volume growing from US\$14bn in 2017 to US\$52bn in 2023, according to Jefferies), as they allow a GP to hold on to an asset beyond the lifespan of a particular PE fund by rolling the position into a continuation fund. This allows GPs to run winners for longer, but also to avoid the pressure to sell an asset in an unfavourable market environment. While these deals could potentially also be used to delay the sale of a lower-quality asset, we note that LPs in the selling fund have the opportunity to cash out rather than being forced to roll over their position into the buying fund. Moreover, the transaction often involves the onboarding of new non-PE LPs as minority holders. Nevertheless, we note that GP-led secondaries (where a given LP reinvests in the continuation vehicle) did not play a significant role in realisations across UK-listed PE investment companies in 2023.

Balance sheet headroom partly consumed

PE exposed to fund investments experiencing net capital calls in 2023

Realisation volumes are also important in the context of the holding-level balance sheet strength of listed PE investment companies. This particularly applies to the overcommitment strategy, especially in the case of investment trusts with a significant share of fund investments in their portfolios. An overcommitment strategy is aimed at staying close to fully invested (given the usual time it takes to convert a commitment into an actual investment in an underlying private company) and therefore fund part of the new capital calls with distributions from existing investments. The outstanding commitments of a listed PE company are normally drawn over several subsequent years. However, an overcommitment strategy may result in balance sheet pressure in the event of a mismatch between capital calls and distributions similar to the previous two major market downturns (2000–03 and the GFC), when initially capital calls remained stable (or even increased) while distributions fell significantly. HVPE, PIP and APEO (which report data on a monthly basis) in aggregate experienced net capital calls of c 1% of NAV per quarter between Q123 and Q323 (see Exhibit 6), although PIP and APEO saw net distributions in Q423. We note that these capital calls capture drawdowns from fund investments, as well as capital deployed into direct investments (the latter being at the full discretion of these investment companies).

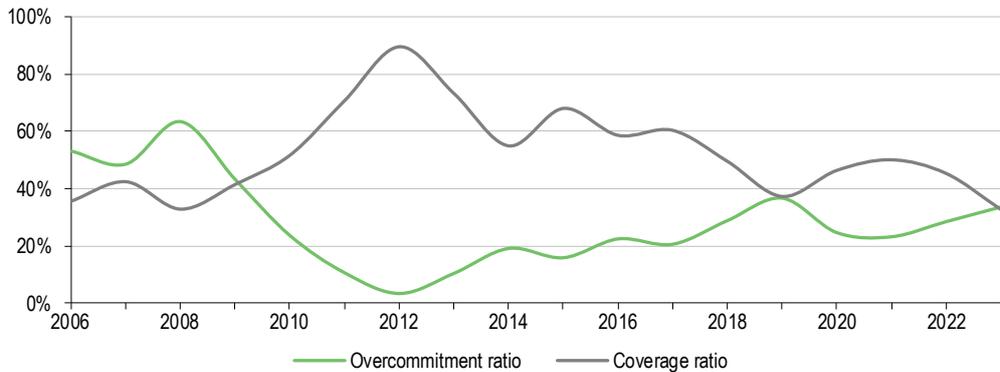
Exhibit 6: Aggregate distributions and capital calls for selected listed PE companies with primary/secondary fund investments (PIP, HVPE, APEO).



Source: Company data, Edison Investment Research

Listed PE companies pursuing primary/secondary fund investments now keep a lower level of outstanding commitments in excess of available resources as a percentage of NAV compared to at the onset of the GFC. The current weighted average overcommitment ratio for the five actively investing PE funds with a meaningful share of primary and/or secondary fund investments (PIP, HVPE, ICGT, APEO and CTPE) stands at c 34% compared to close to 50% in 2007 (see Exhibit 7). The decline is likely in part due to the growing share of direct investments (co-investments and single-asset GP-led secondaries) in their portfolios. At the same time, these funds keep the percentage coverage of their outstanding commitments at c 33%, moderately below the pre-GFC level of 35–42%. Compared to 2021, the weighted average coverage ratio has declined from c 50%, while the overcommitment ratio has increased from c 23%.

Exhibit 7: Historical evolution of the average overcommitment ratio of UK-listed PE companies with a meaningful share of fund investments in their portfolios



Source: Company data, Edison Investment Research. Note: Current figures based on last reported data for each of the funds. Includes PIP, HVPE, ICGT, APEO and CTPE, weighted by their respective NAVs (overcommitment ratio) or outstanding commitments (coverage ratio). The overcommitment ratio is calculated as outstanding commitments in excess of liquid resources as a percentage of NAV; the coverage ratio is calculated as available resources as a percentage of outstanding commitments.

Direct PE also have to manage the balance sheet prudently

Other listed PE companies have changed their entire investment strategy from fund to direct investments (eg PEY) or direct co-investments (NBPE), which are normally characterised by a lower level of commitments to NAV. That said, we note that some listed PE investment companies pursuing a direct investments strategy still invest through private funds managed by their investment manager, which means that they also need to manage their balance sheet to fund commitments. Apart from capital calls, listed PE companies need to factor in other triggers of

potential cash outflows in their balance sheet management, such as funding of direct PE investments agreed but not yet closed, follow-on funding provided to portfolio companies in distress or with a rich pipeline of add-on acquisitions that requires external funding, ongoing charges, dividend payments and foreign exchange hedging arrangements.

Commitment coverage ratios vary across the sector

In this context, we note that current coverage ratios differ significantly across listed PE companies, ranging from anywhere between 20% to more than 100%. While this partly reflects their different exposure to PE investment strategies (primary/secondary fund investments, direct investments, co-investments), it also suggests a varying degree of balance sheet headroom and the requirement to fund new investments with realisations. However, this should be examined together with the stage in the lifecycle of the respective underlying funds to which commitments were made. For instance, some commitments are unlikely to be drawn in full given the underlying fund is already beyond its investment period.

Moreover, we note that the PE secondary market is much more liquid and several times bigger in terms of annual deal value than at the time of the GFC. This may give PE trusts greater scope to sell buyout fund positions in the market to generate cash and release outstanding commitments (if necessary), possibly without having to accept discounts to NAV in excess of 10–20%. For instance, ICGT recently completed a secondary sale of investments (which it expected to generate future returns below the rest of the portfolio) at a 15.9% discount to NAV. The company received gross cash proceeds of £68m (5.1% of end-October 2023 NAV) in December 2023, realising a 1.8x multiple on invested capital (MOIC). The transaction has also reduced its undrawn commitments by £9m and significantly improved its commitments coverage ratio. Another example is HGT's partial secondary sale of its LP interest in Hg Genesis 8 (a 2017 vintage mid-market fund) last year, allowing it to realise a strong 3.2x MOIC. The aim of the transaction was to generate additional liquidity for new co-investments offering greater return potential than the remaining upside from Hg Genesis 8. The LP interest was priced at 100% of end-December 2022 NAV, with £91m proceeds to be paid in two instalments on 31 March 2024 and 31 March 2025.

We see tentative signs of a pick-up in M&A activity and note that 2023 ytd realisations in aggregate were above investments across listed PE (although partly due to lower direct investments), see Exhibit 5. Nevertheless, we believe that listed PE companies need to put an emphasis on balance sheet flexibility in case realisation activity remains subdued in 2024.

Listed PE actively manages financial leverage risks

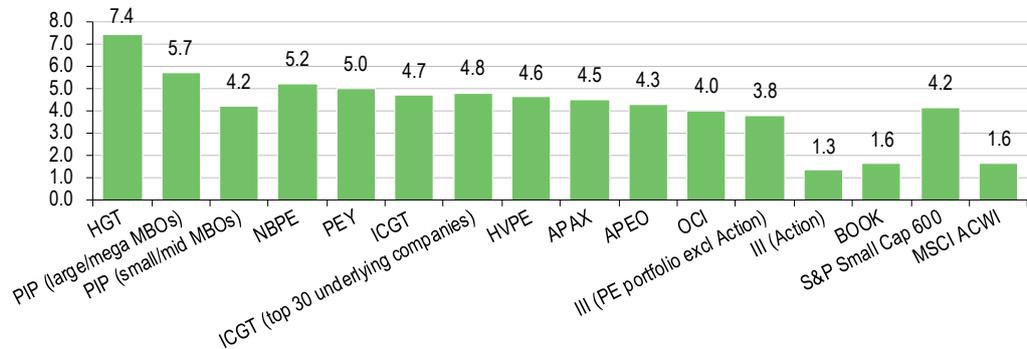
PE-backed portfolio companies are characterised by a relatively high level of leverage in terms of net debt to EBITDA compared to listed companies. Higher leverage becomes particularly important in the context of the current sharp spike in interest rates (given that a significant part of the debt of PE-backed companies is normally floating rate), which puts pressure on the interest coverage ratios of the underlying portfolio companies. NBPE recently reported that the industry-average interest coverage ratio stood at c 1.3x as at end-June 2023, based on Neuberger Berman and Lincoln VOG Proprietary Private Market Database (NBPE's top 30 holdings had a visibly higher ratio of 2.6x at end-June 2023).

Moreover, debt availability has affected deal activity, particularly in the case of PE megadeal volumes (defined as enterprise values of US\$5bn or more), which in Europe fell from €192.3bn in 2022 to €105.1bn in 2023, while the European mid-market was resilient with 12.1% y-o-y growth in deal value, according to PitchBook. In this context, we note that some of the UK-listed PE investment companies put particular emphasis on the PE mid-market. Higher rates and lower

access to debt (especially syndicated loans) is reflected in the share of debt in buyout financing, which in Europe fell from 54.8% in 2021 to 42.6% in 2023 (according to PitchBook).

The lower share of debt, coupled with higher interest rates, may dilute PE returns (Julius Baer highlighted recently that financial leverage contributes on average to 30% of the performance of buyouts). For instance, during the capital markets day in 2023, Hg (HgT's investment manager) highlighted that higher interest rates could reduce its prospective gross IRR by around 3–4pp (vs the 33% 20-year gross IRR to end-2022 achieved by the manager), although in the case of Hg this still leaves a strong return generation potential. Goldman Sachs Asset Management recently highlighted that PE managers should continue to be able to generate attractive returns despite the higher interest rates, with operational initiatives poised to become the main determinant of success. We believe that PE managers focused on the mid-market may see a comparatively lower impact compared to large and mega-buyouts due to more limited use of debt historically.

Exhibit 8: Net debt to LTM EBITDA across listed PE portfolios



Source: Bloomberg, company data, Edison Investment Research. Note: Based on the latest reported data. For some companies, the ratios are provided only for a sample of total portfolio (see company filings for details). MSCI ACWI: MSCI All Country World Index. MBO: management buyout.

We note that translating a higher leverage ratio into higher risk is not straightforward. PE-backed companies tend to perform better in terms of defaults during times of stress than non-sponsored peers, as illustrated by the lower annualised default rate of PE-backed companies in 2008–09 (during the GFC) of 2.8% versus 6.2% for speculative-grade companies, according to Bain & Company's Global Private Equity Report 2011. Similarly, PitchBook Leveraged Commentary & Data indicate a trailing 12-month default rate of loans to PE-backed companies of 1.07% through 31 May 2023 versus 2.42% for non-sponsor-backed companies. Here, we note that neither dataset accounts for distressed exchanges, where a company offers its debtors assets worth less than the value of the outstanding debt.

Firstly, higher indebtedness is in many cases warranted by the private company's high degree of recurring revenue, strong cash flow generation and high earnings growth. Secondly, part of the leverage is normally attributable to debt-financed strategic M&A (to pursue a 'buy-and-build' strategy, see above) aimed at realising synergies that are not immediately reflected in a company's accounts. Thirdly, PE investment companies are often willing to provide additional funding to support a portfolio company during times of stress (acting as 'deep-pocket' investors), potentially warranting the use of more leverage by PE-backed companies. Finally, part of the leverage of PE-backed companies is attributable to shareholder loans provided by the PE owner.

Many GPs have used the high availability of credit (boosted by monetary stimulus) during the COVID-19 pandemic to refinance debt across portfolio companies. Therefore, several listed PE investment companies (eg APAX, PEY, NBPE, APEO, HGT) reported that most of their portfolio company debt matures in 2027 and later, and that a very limited part matures in 2024. Several also highlighted that the interest rate on most of the debt is hedged (although we believe that some of the hedging may have been put in place at a later stage of the monetary tightening cycle).

Furthermore, we note that many GPs have been emphasising the higher flexibility of debt structures in recent years, with a high share of so-called covenant-lite debt. This type of debt is beneficial for equity investors in that it limits the risk of a sudden widespread credit crunch during an economic downturn and provides more room for restructuring efforts if necessary (although it may encourage excessive leverage and translate into lower debt recovery rates in the case of default). Finally, it is worth noting that the current average equity cushion (ie equity to enterprise value) across the top holdings of listed PE companies stands at around 66–76%.

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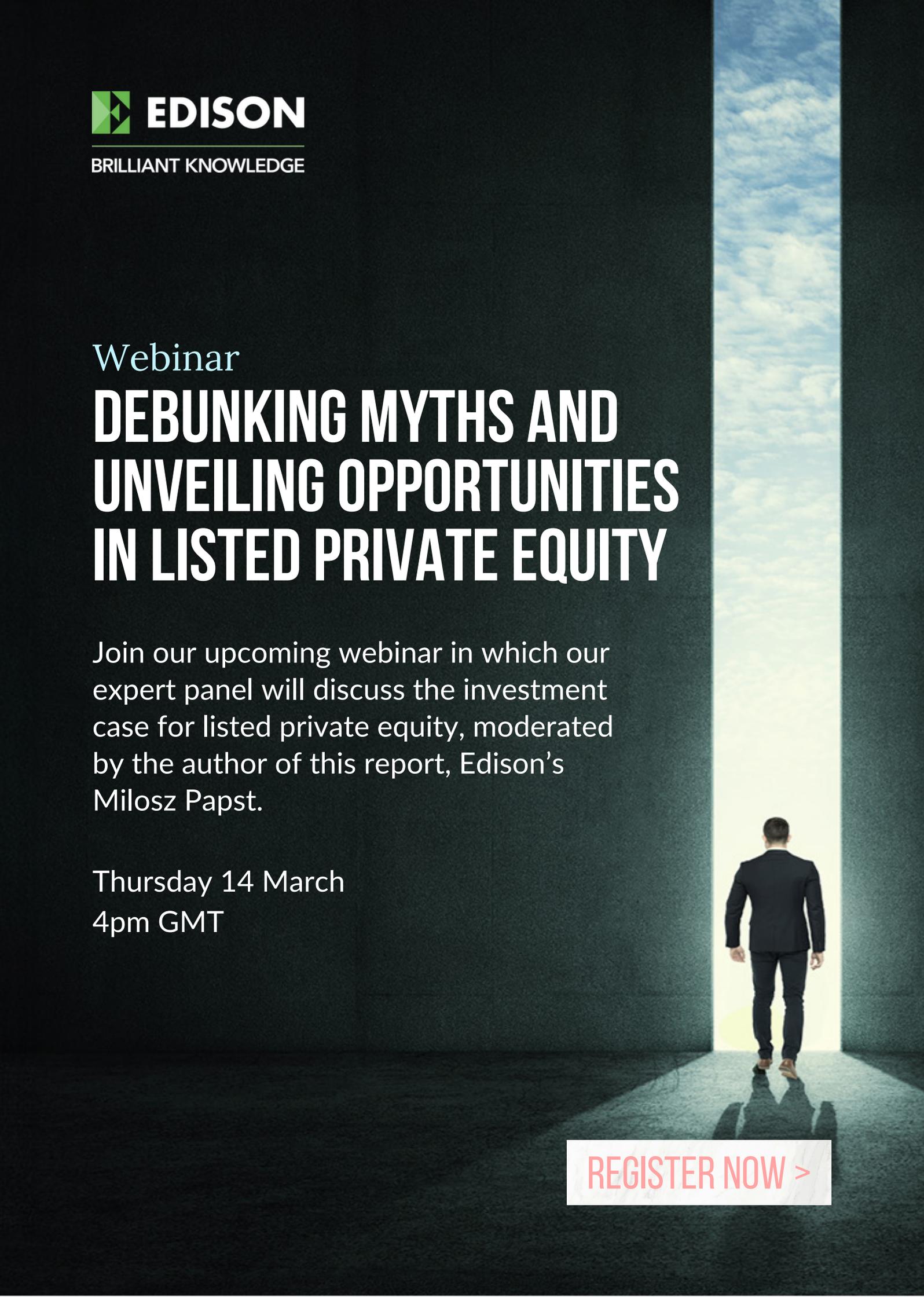
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