NB Private Equity Partners

Update
13 November 2019

Summary

NB Private Equity Partners (NBPE) is unique in the listed private equity (LPE) sector, given that the portfolio consists primarily of co-investments. It is now almost entirely invested in the equity of private companies. Given the range and quality of managers that NBPE invests with, the portfolio can be seen as a good representation of the top tier of US and global private equity deals.

NBPE is currently invested in a total of 120 companies, accessed through over 55 different third party private equity sponsors. The team hopes to increasingly focus its investments, making fewer but somewhat larger investments. At the current stage, the portfolio's top ten equity holdings represent 26% of the total portfolio – not dissimilar to a traditional (quoted) equity fund.

With so many companies and 'sponsors', it is unlikely that investors are exposed to significant specific or key man risk. Whilst being diversified, NBPE offers exposure to a number of key industries: including technology, media and telecoms [TMT] (27%), healthcare (16%), industrials (14%) and consumer (16%). NB focuses on partnering with high quality sponsors, looking for specialist and deep industry knowledge from its partners, and an ability to source differentiated investments as well as deliver operational 'value-add' to investments.

With a high deal-flow of potential deals, and no obligation to invest in any of them, NB should be able to better maintain a fully-invested position for the trust, thereby reducing cash drag with, importantly, no pressure to commit to deals in the future. This is reflected in the numbers: NBPE remains the most fully invested LPE trust in the peer group.

In September 2018, the company announced a clarified dividend pay-out policy of 3% per annum, or greater dividend yield on NAV. At the 30 September 2019 share price, NBPE's dividend yield was 4.2%, which compares with a 3.8% weighted average dividend yield for the AIC Global Equity Income and 3.9% for the AIC UK Equity Income sectors.

Analyst's View

NBPE stands out in the LPE sector in being more highly diversified than directly investing peers, but (in contrast to fund of funds) attracts only one layer of fees on the vast majority of the portfolio. In our view, it can be seen as being a diversified exposure to the top tier of US and global private equity deals.

The co-investment model also has other advantages, not least that the manager is in control of when/whether investments are made, which avoids the need to over-commit or hold significant amounts of cash on the balance sheet. As a result, NBPE's ordinary shares are the most fully invested in the peer group. Being geared clearly adds risks for investors, but it should also help NBPE's NAV perform strongly if the current strong realisation environment continues.

Key Information:

As at	04/11/19
Price (p)	1130
Discount (%)	-24.5
OCF (%)	2.8
Yield (%)	3.1
Gearing (%)	15
Ticker	NBPE
Turnover Ratio (%)	14.4
Shares (£)	46,809,884
Market cap (£)	528,951,689

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Performance so far this year has built on NBPE's strong track record. Over five years, the trust has achieved outperformance relative to its peers and the wider equity market. We see no reason why returns shouldn't continue to be strong, although clearly if sterling appreciates significantly against US dollar, this will present a headwind for returns.

The board has largely completed its structural initiatives for narrowing the discount, and the new chairman seems determined to 'finish the job'. The current share price discount to 30 September 2019 NAV of c.22% remains wide in absolute terms, as well as relative to peers.

We continue to view this as a high-quality fund that has bent over backwards to position itself for UK investors. The wide discount means the current share price is a potentially attractive entry point for those who want US and global private equity exposure.

Analyst's View

BULL	BEAR
Unique investment strategy, delivering sector-leading returns	Geared exposure to companies which are themselves often geared
Low-cost access to direct private equity deals	Illiquid underlying investments could count against sentiment in a bear market
Wider discount and attractive yield	Sterling strength into Brexit and the upcoming election will be a headwind

Portfolio

NBPE aims to produce attractive returns on capital by investing into a diversified portfolio of private equity-backed companies. Uniquely in the LPE sector, the portfolio consists primarily of co-investments. The portfolio continues to evolve in shape, and is now almost entirely invested in the equity of private companies. The majority of portfolio companies are headquartered in North America (77%), with the balance in Europe (19%) and the rest in Asia/rest of world (4%), as of 30 September 2019. Given the range of managers NBPE invests with, the portfolio can be seen as representative of the top tier of US and global private equity deals.

Co-investing is a relatively widely-used method by which private equity sponsors (or managers) buying a company invite other investors (such as Neuberger Berman) into the deal. They offer full transparency, but normally require a relatively quick decision from prospective co-investors. As such, it requires a specialist team able to analyse companies on a deal-by-deal basis, not to mention an excellent network to source such deals. Investing into co-investments has significant cost advantages given that NBPE typically doesn't pay management fees or carried interest on co-investments.

The equity portfolio constitutes 86% of the total portfolio (as of 30 Sept 2019) and 105 companies in total. The team at Neuberger Berman responsible for NBPE is aiming to make fewer but somewhat more significantly-sized investments going forward, thereby increasing concentration. Typically, the team aims to make investments of between $2m and $25m in size, but going forward aims to make more investments towards the top end of this range. We note that of the 120 companies, 51 represented investments of less than $5m (many of these are tail end positions of older or substantially exited investments). The top ten equity investments currently constitute 26% of the total portfolio – which is not dissimilar to traditional (quoted) equity funds in terms of concentration.

Top Ten Equity Investments As Of 30 September 2019

	VINTAGE	SPONSOR	VALUE (% OF PORTFOLIO)
Material Handling Systems	2017	Thomas H Lee	3.7
Engineering	2016	NB Renaissance	3.1
USI Insurance	2017	KKR	2.7
Marquee Brands	2014	Neuberger Berman	2.7
Staples	2017	Sycamore Partners	2.7
Undisclosed business services company	2017	Not disclosed	2.7
Agiliti	2019	Thomas H Lee	2.3
ProAmpac	2016	Pritzker Group	2.3
Autostore	2019	Thomas H Lee	2.1
Telxius	2017	KKR	2
TOTAL			**26.3**

Source: Neuberger Berman

As we illustrate in the Returns section, NAV growth has been strong over the past five years, outperforming the MSCI ACWI and the average trust in the peer group. The table below shows that this has largely been driven by a strong performance from the equity portfolio. For a number of reasons, in recent years the manager has chosen to focus NBPE's portfolio on equity investments and has invested more opportunistically in income investments. As such, equities continue to increase as a proportion of the portfolio. The funds portfolio is in run-off.

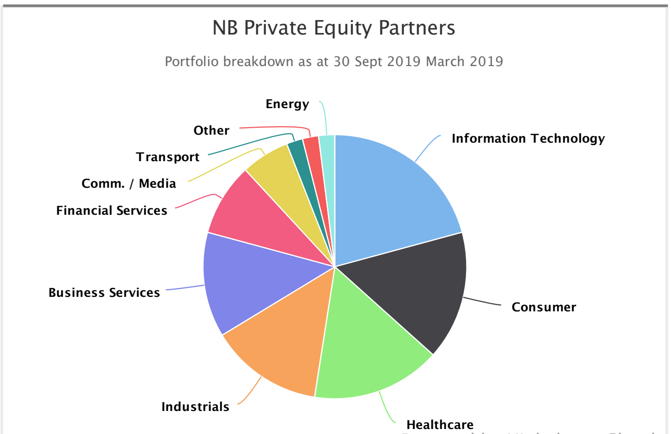
Gross IRR Performance As Of 31 August 2019

	% OF PORTFOLIO	ONE YEAR %	THREE YEAR % P.A.	FIVE YEAR % P.A.	TEN YEAR % P.A.
Equity	86	11.9	18.6	18.2	17.6
Income	10	2.5	7.9	6	11.3
Funds	4	-1	5.7	2.4	10.9
TOTAL		9.9	15.1	11.9	13.5

Source: Neuberger Berman

NB has sourced the current portfolio of investments from over 55 distinct private equity firms. This points to one of the key strengths of NBPE – its diversified nature. With so many companies and 'sponsors' (private equity managers behind each deal), it is unlikely that investors are exposed to significant key man or specific risks. Whilst being diversified, NBPE offers exposure to a number of key industries: including TMT (27%), healthcare (16%), industrials (14%) and consumer (16%). Within these, we understand that the managers are focused on investing in companies that are either defensive in nature or can continue to perform at 'end of cycle' due to perceived secular growth characteristics. The current portfolio breakdown by sector can be seen in the graph below.

Fig.1: Portfolio Overview



Source: Neuberger Berman

Investing in co-investments means that NB has sight of detailed financials and business plans before investing. Aside from the quality of the company and management, NB also looks for what it sees as specialist knowledge and experience from the private equity firm running the deal. In its view, successful co-investing is as much about partnering with high quality sponsors (i.e. private equity firms) as it is paying the right price, and having a quality underlying business. It looks for deep industry knowledge from partners that it invests with, an ability to source investments intelligently and a team that can deliver operational 'value-add' to investments. NB observes that many of its underlying portfolio companies' business plans have M&A or acquisitions as a key part of their growth strategy.

Aside from having discretion over which investments to make, another strength of co-investing is that investment timeframes are shorter. Firstly, capital is only committed when the deal is live, and secondly, a number of the investments that NB participates in are in existing private equity deals which require further equity financing. As such, the portfolio is relatively 'young' when compared to other LPE trusts, with 70% of the portfolio represented by 2016-2018 vintages (average age of investment of 2.7 years) as of 30 September 2019. Given current markets, this isn't necessarily a bad thing – NB reveals that in the first eight months of 2019, 67% of value has been generated from equity investments with a less than four-year holding period.

Co-investing with a wider range of private equity managers means that NB is likely to have a much larger theoretical pipeline of potential investments than peers. With a high level of deal-flow of potential deals, and no obligation to invest in any of them, the manager should be able to better maintain a fully invested position, thereby reducing cash drag, but importantly has no need to commit to deals in the future. This is reflected in the numbers: NBPE remains the most fully invested LPE trust in the peer group – as we discuss in the Gearing section.

Overall, as of 30 June 2019 the portfolio (81% of NBPE's equity portfolio, excluding public companies) is valued at 12.1x EV/EBITDA, and the companies on average had net debt of 4.8x EBITDA. As of the same date, the manager notes the US public markets, as measured by the S&P 500 index, were valued at 12.3x EV/EBITDA. Earnings growth in the portfolio has moderated somewhat since we last wrote up the trust, but still remains strong. Notably, revenue growth remained strong at 6.1% on average over the 12 months to 30 June.

Gearing

Most listed private equity funds have to make contractually binding commitments well before actual investments are made. Given the uncertainty of when investments will be made (cash out), or when other investments will be realised (cash in), they typically arrange flexible gearing facilities, which enable them to stay more fully invested and not hold too much cash on their balance sheets. NBPE is able to manage cash and exposure more tightly than most peers because the managers have discretion to invest on a deal-by-deal basis and, because of the set up and network, they see a regular flow of potential investments. As such, should realisations start to slow or dry up, the managers would simply stop investing.

In the buoyant environment for realisations and NAV uplifts, LPE managers generally want to be as fully invested as possible. However, given the difficulty of managing private equity cashflows, it is relatively rare to find LPE trusts which are consistently fully invested over time: the average cash level across the LPE peer group sector (excluding 3i, and those which are in wind-up or realisation), according to statistics from JPMorgan Cazenove, is around 5% of NAV. Indeed, only NBPE, Princess and BMO Private Equity Trust are fully invested with no net cash on the balance sheet. Amongst these, NBPE's ordinary shares are the most fully invested in the peer group – with what we calculate as 17% net gearing as of 30 September 2019 (gearing less cash, divided by net assets).

This means shareholders have a fuller exposure to private equity deals than other funds. At the same time, being geared clearly adds risks for investors, but it should also help NBPE's NAV perform strongly IF the current strong realisation environment continues. The company has two forms of gearing – a traditional credit facility of up to $150m that expires in June 2021, and two zero-dividend preference (ZDP) share issues that are due to be repaid in September 2022 and October 2024. The ZDP shares effectively provide structural leverage for the company, allowing it to remain fully invested, while the credit facility provides short-term cash management and flexibility.

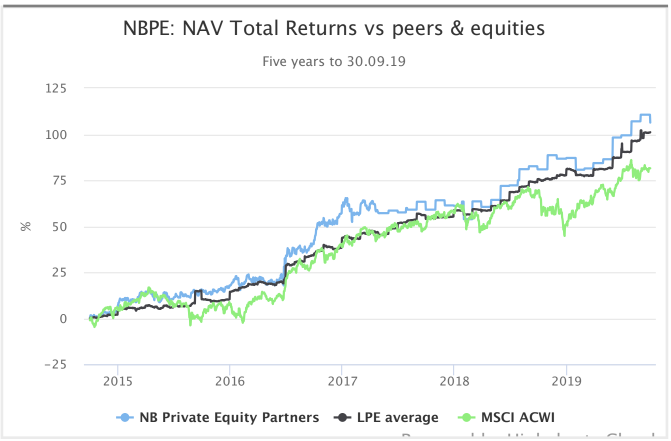
Returns

The performance of the portfolio has been strong: direct equity investments delivered an (annualised) gross IRR of 21% in the six months to 30 June 2019. NBPE has a small proportion of the portfolio invested in listed equities (private companies which have subsequently IPO'd, and which remain in 'lock-up'), which contributed positively to performance, while the smaller income and legacy funds portfolio detracted from performance. This meant that the entire portfolio's gross (annualised) IRR was 17.6% over the first six months of 2019.

Assuming the re-investment of dividends, this translated into NBPE's NAV total return (in US dollars) of 8.7% (9% in sterling) during the first six months of 2019. Over this period, NBPE's share price return was 15.6% in sterling, thus serving to narrow the share price discount to NAV over the first six months of the year. This share price performance compares with the MSCI World index (in sterling) return of 16.3%. It is worth noting that the GBP share class is unhedged, and so for a sterling investor, returns from each will be similar: UK investors have US dollar exchange rate risk with both classes of shares.

This performance builds on NBPE's strong track record of outperformance relative to its peers and the wider market. According to Morningstar, over the five years to 30 September 2019, NBPE's NAV cumulative total returns in sterling have been 106% compared to a simple average return of 101% for the LPE peer group (excluding 3i, and those which are in wind-up or realisation). NBPE has also outperformed the 81.5% total return for the MSCI ACWI Index in sterling.

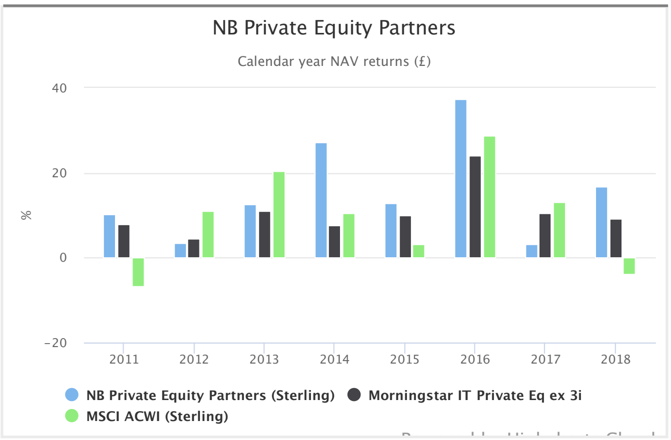
Fig.2: Performance



Source: Morningstar, Kepler Partners

The graph below shows calendar year NAV total returns in sterling, against the Morningstar sector average ex 3i (which includes many of the funds in wind-down). The wild swings in the GBP/US dollar exchange rate have influenced returns, but the overall pattern of good returns each year is clearly observable.

Fig.3: Calendar-Year Returns



Source: Morningstar

As we discuss in the Portfolio section, the team has been focusing on investments that will be reasonably positioned should an economic downturn occur over the next two to three years. It also notes that a lot of money has been raised in the private equity space over recent years (akin to the heady heights of 2007). However, it argues that while prices are indeed elevated, and competition for deals is intense, by focusing only on what it views as the highest quality, specialist private equity managers, the deals it is investing in have solid foundations.

Dividend

NBPE started paying a dividend in 2013 as part of a board-led initiative to try to address the wide discount to NAV the trust traded at the time. However, in September 2018, the company clarified its dividend policy, targeting an annualised yield of 3% or greater on the NAV at the time each semi-annual dividend is declared. As is the case with other LPE trusts that pay a dividend, it is supported by capital – although the cash income received from the 'income portfolio' does contribute. The directors do not connect the level or security of the dividend to the size of the income portfolio, and also state that if a short-term decline in NAV occurs, it is not its intention to reduce dividends.

NBPE declared a $0.29 per share dividend on 17 July 2019, paid on 30 August 2019. On an annualised basis, this dividend payment represents a dividend yield of 4.2% based on the 1 November 2019 share price of £11.20. Dividends are announced in dollars, but GBP shareholders will receive a dividend in GBP translated at the prevailing exchange rate (unless they make an election to receive US dollars). NBPE's dividend yield of 4.2% compares with a 3.8% weighted average dividend yield for the AIC Global Equity Income and 3.9% for the AIC UK Equity Income sectors, further highlighting it as an attractive diversifier for income investors.

We believe that paying the dividend from capital is a prudent option for a private equity trust, certainly compared to a traditional public equity trust, due to the natural cycle exhibited by private equity deal making, and the resulting steady flow of realisations typically received on an annual basis. We might change our view if the trust was trading on a significant premium, but as it currently stands the dividend represents a return of capital at NAV. Given the shares trade on a discount of c.22% as of 29 October 2019, this is attractive for shareholders, especially if they choose to reinvest the dividend.

Management

The board is ultimately responsible for the overall strategy and performance of the company, but has delegated authority to the investment manager to execute this strategy. The investment manager's senior professionals are responsible for the day-to-day management of the company and, with respect to NBPE, management is led by Peter Von Lehe, who is also a director of the company, and Paul Daggett.

They are part of the private equity division of the Neuberger Berman Group, a very large global investment business. The private equity platform has managed commitments of approximately $80bn, which continues to grow, and this gives the team a greater level of access than many of its peers in the sector. The manager can invest across the capital spectrum and leverage the significant resources of a global asset manager.

Investment decisions are made by an investment committee that comprises 12 members, each of whom has an average of 16 years with the firm and has been with the private equity team for at least ten years. Direct income investments have their own set of investment professionals and committee to make investment decisions into underlying portfolio companies.

Overall, the Neuberger Berman private equity business has managed approximately $80bn of commitments and has a very deep team of c.200 dedicated private equity professionals across offices in New York, Dallas, Boston, San Francisco, London, Milan, Zurich, Hong Kong and Bogota. The team makes around $10bn of investments for clients annually (on average over the last three years) in private equity transactions.

The team claims to have over 500 active fund relationships and reviews over 270 funds each year. Neuberger Berman Private Equity has invested approximately $5.3bn in equity co-investments and $3bn in debt investments over the last three years, with over 800 equity and over 900 debt opportunities reviewed during this period. The team conducts detailed in-house due diligence on co-investments in equity and debt, and leverages separate teams, which specialise in income and equity investments. In the manager's view they see a very high proportion of deal-flow from their management relationships, and have positioned themselves as 'strategic' co-investors who are often brought in very early in the investment process to help cornerstone a deal. They achieve this because they are not seen as a competitor to sponsors, and because of their large size ($10bn deployed annually over the last three years) and the speed with which decisions can be made given their specialist teams. Last year, the team only executed on around 12% of the 367 deals originated across the platform, and NBPE only participated in 22 of these.

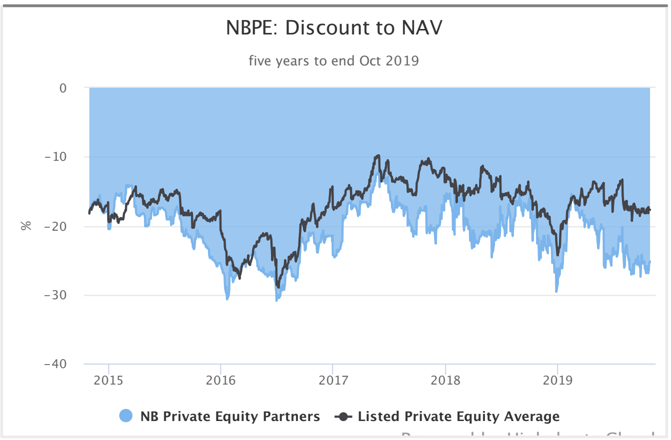
Discount

There have been a number of board-led initiatives over the past years, all designed to reduce the discount at which the shares trade. Less than a year ago, to consolidate liquidity and reduce costs, the board delisted the company's shares from Euronext (in December 2018) and listed a new US dollar denominated share (ticker: NBPU), which joined the existing sterling denominated share (ticker: NBPE) on the London Stock Exchange.

At the same time, the board entered into a new share buyback agreement with Jefferies International, with re-purchases made on the board's behalf within the confines of "multiple factors… including the absolute level of discount, NBPE's discount compared with peers and broader equity market movements, among other factors". As the graph below shows, these changes had an immediate and positive effect on the discount. However, since then the share price discount has widened back out again, and NBPE has been actively buying back shares – for example in September it bought back shares to a value of $1.1m at an average discount to NAV of 23.6%.

As at the current time of writing, NBPE trades at a 22.4% discount to JPMorgan Cazenove's 30 September 2019 estimated NAV per share of £14.26 (having adjusted for changes in the exchange rate), which is wider than its peers. The new chairman of NBPE reflected at the time of the interims that that the discount remains too wide. The performance of the company has been good, it is a clearly differentiated trust within its sector and, as we discuss in the Charges section, it has some fee advantages over both direct and fund of fund peers. Certainly, there doesn't seem be an obvious reason why it should not at least trade in line with peers. Yet, as the graph below shows, the discount to the peer group (representing the LPE peer group, excluding 3i and companies in wind-up or realisation mode) is at its widest point in five years.

Fig.4: Discount



Source: Morningstar

Charges

One of the unique selling points of NBPE is that it offers a very actively managed but diversified exposure to the private equity asset class at a lower fee rate than one might expect. This is chiefly because NBPE typically does not pay management and performance fees on the direct investments it makes. Ordinarily private equity fund investments charge c.1.5-2% p.a. (on commitments) and a performance fee of 20% over a hurdle of 8% realised total returns. Then a fund of funds would charge a management fee on top of this.

One of the main advantages of NBPE's approach is that third party fees are only being paid on c.2% of the direct investment portfolio. As a result, on 98% of the direct portfolio, investors in NBPE pay a single layer of fees of 1.5% p.a. on 'private equity fair value' (i.e. investments, excluding commitments and cash) and a 7.5% performance fee over a 7.5% NAV hurdle. As such, NBPE's management fee is in line with most direct investing LPE funds, but the performance fee is lower than other direct focused funds. Investing in a limited partnership typically attracts a management fee of 1.5%-2% of committed capital and a carried interest of 20%, so NBPE's fee structure is significantly lower than accessing these funds directly. The trust's AIC annualised OCF for the last financial year (to end June 2019) was 2.07%, of which management fees represented 1.69%.

The KID RIY figure as of May 2019 was 3.65%, of which 0.58% was carried interest (performance fees). We understand that as the legacy third party funds portfolio runs off further, this number is expected to reduce further. It is worth noting that calculation methodologies between companies do differ.

ESG

NBPE invests primarily in deals that are arranged and managed by third parties. As such, aside from the initial investment, it is not responsible for the ongoing performance or activities of the business, except as a shareholder/investor. That said, Neuberger Berman believes that mitigating ESG-related risks can reduce overall portfolio risk and that integrating ESG factors into investment due diligence may lead to a more consistent investment outcome.

Since 2012, Neuberger Berman has coordinated its efforts through an ESG committee, which is now chaired by the head of ESG investing, Jonathan Bailey. This committee includes senior representatives from across the firm, including private equity. It has been a signatory to the United Nations Principles of Responsible Investment (UN PRI) since then, and reports that Neuberger Berman and the PE group were awarded A+ scores for ESG in the most recent UN PRI assessment report.

The ESG committee is responsible for overseeing the ESG integration efforts, setting goals, and reporting on the firm's performance. As such, it is fair to say that ESG factors are an integral part of the NB Private Equity team's due diligence process. As a co-investor, NB performs due-diligence on each prospective investment and aims to ensure that the company and sponsor are appropriately managing ESG risks. The NB Private Equity investment team works closely with Neuberger Berman's dedicated ESG team to ensure implementation of industry best practices.

Find out why we believe the trust's unique investment model makes it a compelling prospect

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