NB Private Equity Partners

NBPE's discount has widened dramatically, but its managers have already taken decisive steps to protect the trust...

Update
13 May 2020

Summary

NB Private Equity Partners (NBPE) is a London-listed private equity investment fund. It is unique in this sector, in that the underlying portfolio largely consists of equity co-investments made with a broad range of different private equity managers.

The managers and their approach differentiate NBPE from all of the other LPE funds. However, as we discuss in the **Performance section**, the recent sell-off negatively affected NBPE's share price – both relative to wider equity markets and to the LPE sector (as represented by the Morningstar LPE ex 3i Index).

NBPE's board and manager took decisive steps as a reaction to the unprecedented events of this year. The trust has drawn down an additional $160m of the credit facility so that at the end of April 2020, it had liquidity of $205m. Alongside this cash, Neuberger Berman (NB) has provided information that as at 30 April 2020, the 'adjusted' commitments (i.e. net of those unlikely to be called) amount to c. $126m. As such, the commitment cover ratio is 163%.

As we discuss in the **Portfolio section**, NBPE is largely exposed to North America (74% of the portfolio), with Europe at 22% and RoW at 4%. By sector, the portfolio is relatively well diversified, with exposure to areas which might be more resilient to the economic slowdown. These include healthcare, financials and TMT, together adding up to c. 50% of the portfolio. On the other hand, companies in the consumer, industrials, energy and business-services sectors together account for 46%.

Based on the most recently published NAV (31 March 2020), and adjusting for quoted holdings movements, NBPE trades on a discount of 42% (Source: Numis).

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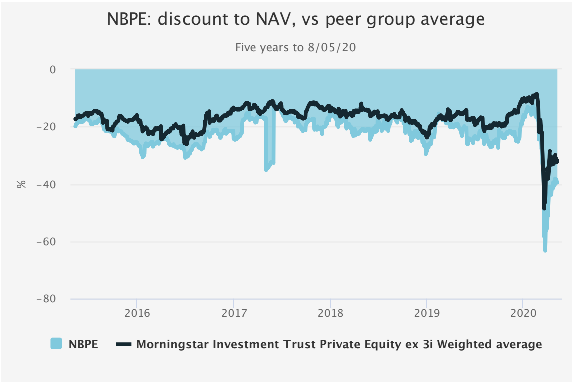
Key Information:

Price (p)	880
Discount (%)	-39.5
OCF (%)	2.13
Yield (%)	1.5
Gearing (%)	16
Ticker	NBPE
Market cap (£)	411,497,064



Kepler View

NBPE's portfolio is invested in high-quality businesses, alongside a range of top private-equity managers. All companies will be affected by the pandemic, and we'd expect the NAV to fall once the impact becomes clearer. However, in drawing down $250m of the $300m credit facility, NBPE has taken steps to ensure it does not face a financing squeeze. This, alongside publishing the updated commitment cover, sends a strong statement that this is unlikely to be a financial crisis for NBPE.

Given the emphasis on strengthening the balance sheet of the trust, it seems unlikely dividends will continue. NB has stated that private-equity managers are relatively well placed to nimbly react to business issues. While NBPE will publish monthly NAV estimates, the impact from COVID-19 may take until June's quarterly report to be better reflected in the NAV.

Whilst NBPE's ordinary shares are the most highly geared in its peer group, the fact NB is more in control of its investing activities than peers means that the higher gearing doesn't necessarily mean the trust is the most risky. NBPE's performance has been good historically, and it is a clearly differentiated trust within its sector. As we discuss in the **Charges section**, it has some fee-related advantages. However, the shares have significantly underperformed the market and trade on a discount of 42% (source: Numis). Likely catalysts for a re-rating will be updated valuations and the consequent potential for a resumption of buybacks.

BULL

- **Unique investment strategy, historically having delivered sector-leading returns**
- **Low-cost access to direct private-equity deals**
- **Wide discount to historical NAV**

BEAR

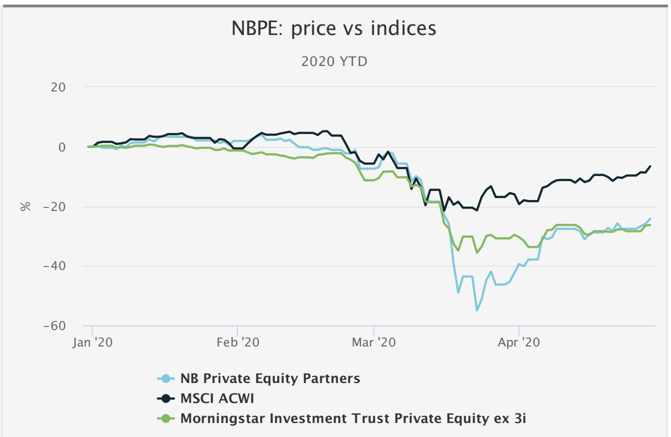
- **Geared exposure to companies which are themselves often geared**
- **Illiquid underlying investments mean liquidity needs to be managed**
- **Valuations on portfolio companies are performed relatively infrequently**

Portfolio

NB Private Equity Partners (NBPE) is a London-listed private equity investment fund. It is unique in this sector, in that the underlying portfolio largely consists of equity co-investments made with a broad range of different private equity managers. 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. The direct equity portfolio constitutes 87% of the total portfolio (as of 31 March 2020).

These investments are mostly done without management and carried interest fees, as we discuss later in this section. This gives investors a very broad and diversified exposure to what the managers believe to be the very top tier of US and global private equity deals from their deal flow. Around 10% of the portfolio is invested in income investments – typically fixed-interest instruments – and 3% is invested in a legacy portfolio of third-party funds which are in realisation mode. The managers and their approach differentiate NBPE from all of the other LPE funds. However, as the graph below shows, the recent sell-off negatively affected NBPE's share price relative to wider equity markets, and initially also relative to the LPE sector (as represented by the Morningstar LPE ex 3i Index). The share price has recovered some of the lost ground, but NBPE's shares have still lagged the wider equity market significantly.

Fig.1: Share-Price Returns Year To Date



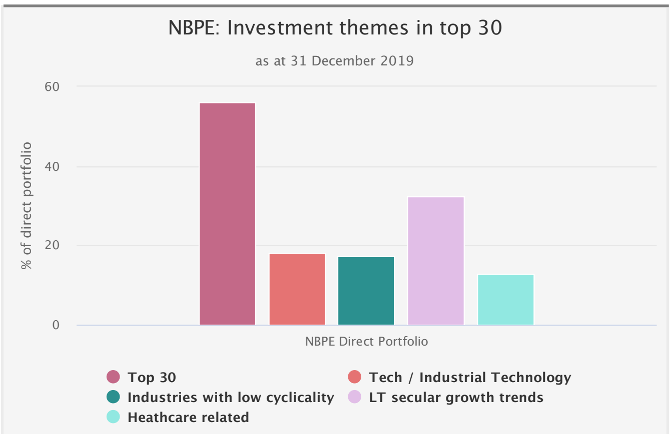
Source: Morningstar

The managers have clearly communicated with the market on the steps they and the board have taken as a reaction to the unprecedented events of this year, and in particular on the actions they have taken as a reaction to the looming economic slowdown. During the Global Financial Crisis of 2008 (GFC), listed private equity trusts encapsulated the nature of the crisis – they were mostly (but not all) over-levered and over-committed to a contractual obligation to invest in private equity managers' funds when required in the future. The board and managers of NBPE have taken prompt and decisive steps to ensure that the trust does not face a financing squeeze in the near term.

As we discuss in the **Gearing section**, back in December 2019 NBPE arranged a new ten-year credit facility of a total of $250m (inclusive of an accordion feature which was exercised in March 2020), with a ten-year availability. In May 2020, NBPE announced it had increased the size of the facility by an additional $50m, providing a total credit facility of $300m. Out of an abundance of caution, the trust has drawn down $250m so that at the end of April 2020 it had cash on the balance sheet of $123m. Following the increase of the facility in May 2020, the trust has an additional $50m of borrowing capacity under the facility which is undrawn. This, together with other realisations signed but not completed, means NBPE has total liquidity of $205.4m. Alongside this NB has provided information that as at 30 April 2020, the 'adjusted' commitments (i.e. net of those unlikely to be called, in the opinion of the manager) amount to c. $126m. As such, assuming no new realisations, the commitment cover ratio is 163%.

In our view this information, as well as drawing down a good proportion of the credit facility, sends a strong statement that current events will not cause a financial crisis for NBPE. The implication is that 2020 is more likely to be an economic crisis than a financial crisis for NBPE. The distinction being that the current crisis is not liquidity driven, but economically driven, and the negative effects of the pandemic are being felt by businesses to varying degrees, depending on their exposure to the sharply slowing economy. NBPE has a portfolio of c. 117 companies, accessed through over 55 different third-party private equity sponsors. Based on the estimated 31 March 2020 monthly NAV, the portfolio's top 30 equity holdings (on which NBPE provides visibility) represent 58% of the total portfolio – not dissimilar to the portfolio of a traditional (quoted) equity fund. The graph below provides an overview of common investment themes (which in some cases overlap) in these top 30 companies which should be more resilient to the economic slowdown.

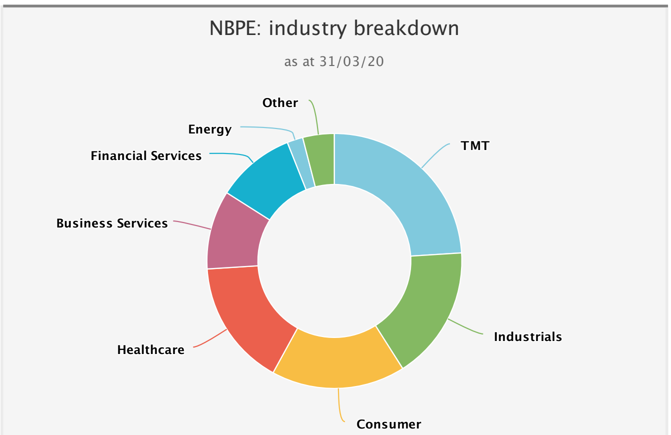
Fig.2: Investment Themes Less Exposed To Covid-19



Source: Neuberger Berman

Overall NBPE has a portfolio largely exposed (by headquarters) to North America (74% of the portfolio), with Europe at 22% and RoW at 4%. By sector, the portfolio is relatively well diversified, with exposure to areas that might be more resilient to the economic slowdown – such as healthcare, financials and TMT – together adding up to 50%. On the other hand, companies in the consumer, industrials, energy and business-services sectors (together accounting for 46% of the portfolio) are likely to be presented with plenty of challenges. NB has stated that it is still too early for the impact of the current pandemic to have been felt, but that private equity managers are relatively well placed to react to business issues in a nimble manner. NBPE reports NAVs every month, which at their most basic represent adjustments for quoted investments (7% as at 31 March 2020) and foreign-exchange movements. Quarterly financial statements are typically issued two months after the quarter end, which means that the next 'full' NAV calculation for NBPE – reflecting the initial COVID-19 impact and valuations – will be announced in early June. The second-quarter valuations, which will give a clearer reflection of the impact of the pandemic through the 'lockdown' period, will be issued in August. This leaves a long period of relative uncertainty for investors, although clearly a picture will start to emerge sooner than that.

Fig.3: Sector Breakdown



Source: Morningstar

One of the potential issues that commentators have highlighted regarding private equity-backed companies generally, is that on an underlying basis, they are more highly levered than they were during the GFC. We understand that NBPE's portfolio is 4.8x levered on a net debt-to-EBITDA basis. Whilst undoubtedly more highly geared than listed markets, the covenants on loans are significantly less onerous than they were in the 2008 downturn. NBPE reports that in the sample of the top 30 investments, 64% of companies have 'cov-lite' debt, and 10% have 'low leverage' (defined as 3x net debt/EBITDA or less).

NB doesn't deny that almost all businesses are, or will be, affected in the short term. However, it reports that it has been "generally pleased with the actions private equity managers are taking with companies". NB focusses first and foremost on partnering with high-quality sponsors because it looks for specialist and deep industry knowledge from its partners, as well as an ability to source differentiated investments and deliver operational 'value-add' to investments. We are optimistic that operationally, and from a valuation perspective, the effects of COVID-19 will have less of an impact on the NBPE portfolio than on wider markets generally. Time will tell, but we base this hope on the belief that private equity managers are typically more experienced and nimble than average quoted companies. We also believe that, gearing notwithstanding, the niche businesses which NBPE has exposure to might be less affected than many of the very large businesses that comprise the main equity indices.

Gearing

NBPE is one of the most fully invested LPE trusts in its peer group. NBPE has two forms of gearing – a traditional credit facility of up to $300m that expires in December 2029, and two zero-dividend preference (ZDP) share issues that are due to be repaid in September 2022 (with a final liability of £63.4m) and October 2024 (with a final liability of £65.3m). The ZDP shares effectively provide structural leverage for the trust, allowing it to remain fully invested, while the credit facility provides short-term cash management and flexibility.

In March 2020 NBPE drew down the credit facility in full, and at the end of April 2020 it had cash on the balance sheet of $123m. Net gearing as a percentage of NAV is around 30% (adjusting for cash, and allowing for the current entitlement – which is not final – of the ZDPs). This makes NBPE amongst the most geared of the LPE constituents. However, it is also worth remembering that around 10% of the portfolio is invested in 'income' (i.e. fixed interest) instruments which should hold up better to short-term market-induced moves in valuations.

The credit facility ranks first (in front of the ZDPs), and has an overall LTV covenant of 45%. NB has provided a table

LTV Ratio Analysis

DECLINE IN VALUE %	LTV RATIO %
0	19.8
10	21.6
20	23.7
30	26.2
40	29.4
50	33.5

Source: Neuberger Berman

which, based on a number of assumptions, shows the LTV covenant depending on a range of valuation changes in the direct-equity investment portfolio. It is notable that the portfolio could fall by in excess of 50%, but the LTV covenant would not have been breached (assuming $250 million of borrowings drawn, and based on known valuations at the time of the 29 February 2020 March monthly NAV estimate).

Most listed private-equity funds have to make contractually binding commitments well before actual investments are made. This is the reason that they arrange flexible gearing facilities, given the uncertainty of when investments will be made (cash out), or when other investments will be realised (cash in). As we have pointed out before, NBPE is able to manage cash and exposure more tightly than most peers because the managers have discretion in most cases to invest on a deal-by-deal basis. As such, should realisations start to slow or dry up, the managers would simply stop investing.

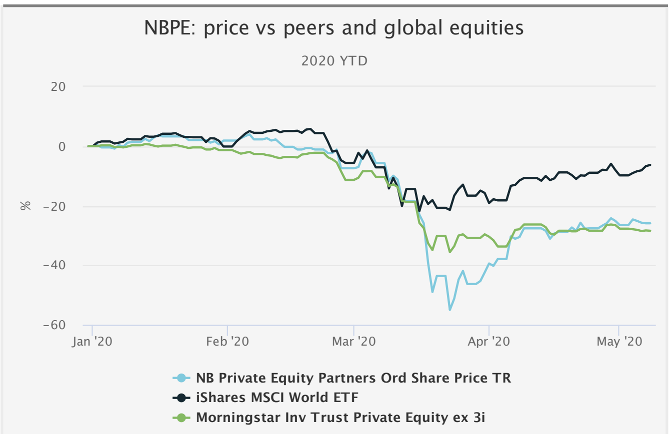
So whilst NBPE's ordinary shares are the most fully invested in the peer group, the fact that NB is more in control of its investing activities than peers means that the higher gearing doesn't necessarily mean that the trust is the most risky. Within private equity, gearing needs to be measured in two ways – in the traditional sense (net liabilities divided by net assets), but also by commitment cover (which measures the ability of the trust to fund its commitments through cash or a credit facility). NB has provided information that, as at 30 April 2020, the 'adjusted' commitments (i.e. net of those unlikely to be called, in the opinion of the manager) amount to c. $126m. As such, assuming no new realisations, the commitment cover ratio is 163%. In our view this information, as well as drawing down a good proportion of the credit facility and holding it as cash on the balance sheet, sends a strong statement that this will not be a financial crisis for NBPE.

Performance

Given the illiquidity of the underlying investments, private equity investing is a longer-term strategy. Private equity managers normally formally revalue their investments every three months, based on the trading performance of each company and listed market comparators. Clearly, the impact of COVID-19 will be material – both to the trading of each company, but also to comparable market valuations. Most of NBPE's companies are comprehensively revalued at every quarter end, which means the full effect of the market falls will not be felt in the official NAV until perhaps the June quarterly report (to allow for managers to calculate and report valuations). Indeed, of the most recent NAV (as at 31 March 2020), 77% of the portfolio is derived from the valuations of 31 December 2019, the delay being an issue across all LPE trusts. As we discuss in the **Discount section**, uncertainty on this point provides part of the explanation for why discounts have blown out for LPE trusts across the board. However, it also makes shorter-term performance numbers fairly meaningless – at least until all the data has been collected. We anticipate that the first time that the pandemic will be incorporated fully into NBPE's portfolio valuations will likely be from mid-August, when the 30 June valuations will be represented in the NAV.

In price terms, as the graph below shows, the sell-off negatively affected NBPE relative to wider equity markets, and also initially relative to the LPE sector (as represented by the Morningstar LPE ex 3i Index). The share price has recovered some of the lost ground, but NBPE's shares have still lagged the wider equity market significantly.

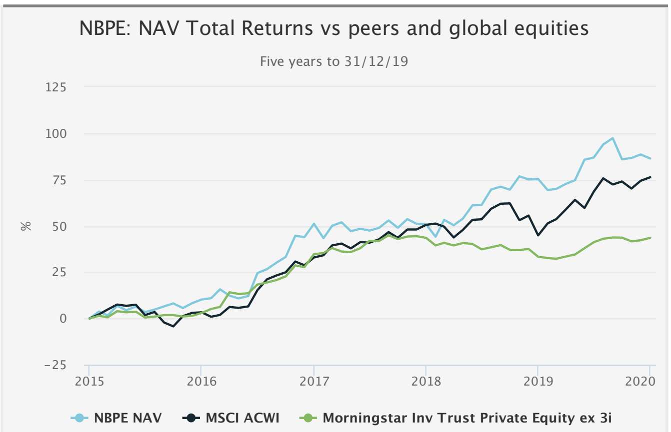
Fig.4: Share-Price Returns Year To Date



Source: Morningstar

Over the longer term NBPE has a strong track record of outperformance relative to its peers and the wider market. According to Morningstar, over the five years to 31 December 2019 (the last time we have a reasonably up-to-date valuation for the portfolio), 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 trusts which are in wind-up or realisation). NBPE has also outperformed the 81.5% total

Fig.5: NAV Performance

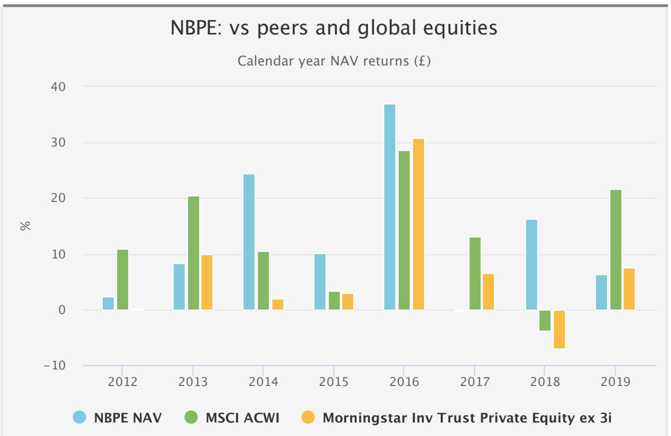


Source: Morningstar, Kepler Partners

return over this period for the MSCI ACWI Index in sterling. Over this period to 31 December 2019, as we discuss in the **Discount section**, shareholder returns have been higher than this thanks to the discount having narrowed (although this has since reversed).

The graph below shows historical 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.6: Calendar-Year Returns



Source: Morningstar

Dividend

NBPE has a long-term dividend policy of targeting an annualised dividend yield of 3% or greater on NAV. It is paid semi-annually, but now that the income investments represent a relatively small proportion of the portfolio, it largely constitutes a payment from capital. Given the discount to NAV at which the shares currently trade, the historical dividend yields 5.1%.

In a recent announcement (with further details included in a recent presentation), NBPE suspended share buybacks. Given the emphasis on strengthening the balance sheet of the trust, it seems reasonable to question whether the trust will continue to pay dividends whilst the full impact of COVID-19 is still unknown. We understand that the board doesn't need to make a decision on the second semi-annual dividend until July. By then, there may be more clarity on the longevity of the current lockdowns and the shape and speed of any economic recovery.

Management

The board is ultimately responsible for the overall strategy and performance of the trust, 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 trust and, with respect to NBPE, management is led by Peter Von Lehe (who is also a director of the trust) and Paul Daggett.

They are part of the private-equity division of Neuberger Berman Group, a very large global investment business. This private equity platform has managed commitments of approximately $85bn (as of January 2020, including commitments in the process of documentation). These commitments continue to grow, and this gives the team a greater level of access than many of their 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 $85bn of commitments and has a very deep team of c. 145 dedicated private-equity professionals focussed on co-investing and primary-fund investing. These professionals are based across offices in New York, Dallas, Boston, San Francisco, London, Milan, Zurich, Hong Kong, Tokyo and Bogota. Based on the average over the last three years, the team annually make around $10bn of investments in private equity transactions for clients.

The team claim to have over 500 active fund relationships and review over 270 funds each year. They conduct detailed in-house due diligence on co-investments in equity and debt, and leverage separate teams which respectively specialise in income and equity investments. In the managers' view they see a very high proportion of deal flow from their private equity relationships, and have positioned themselves as 'strategic' co-investors who are often brought in very early on in the investment process to help cornerstone a deal. They achieve this because they are not seen as a competitor to sponsors, due to both their large size (with $10bn deployed annually over the last three years) and the speed with which decisions can be made, given their specialist teams. During 2018, the team only executed on around 12% of the 367 deals originated across the platform, and NBPE only participated in 22 of these.

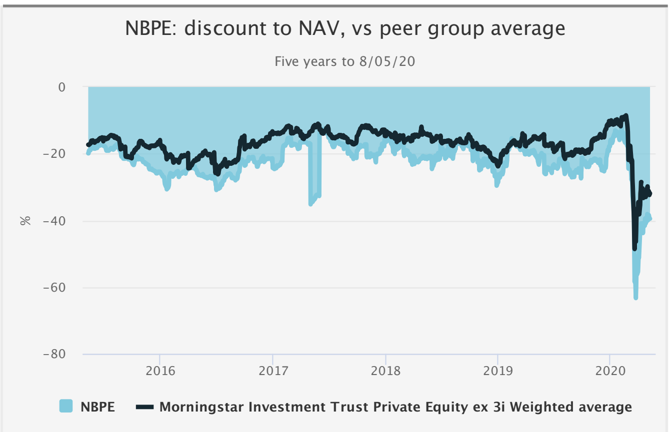
Discount

The graph below shows the severe effect that the COVID-19 crisis has had on NBPE's share price, and on that of its peers. Based on the most recently published

NAV (31 March 2020), and adjusting for quoted holdings movements, NBPE trades on a discount of 42% (Source: Numis, having adjusted for quoted investments). However, given the fact that most private equity-backed companies and funds are only revalued quarterly, the share-price falls are based on an expectation – rather than the reality – of NAV declines. The 'discounts' are illusory, and the reality of the discount of today's share prices is likely only to be found out at a later point in time. Uncertainty on this point provides part of the explanation for why discounts have blown out for LPE trusts across the board.

As we discuss in the **Portfolio** and **Gearing sections**, the board of NBPE has taken decisive steps to ensure that the market understands that the trust's liquidity is not under question. However, as we also discuss in the **Performance section**, there is a degree of uncertainty as to the economic effect that the crisis will have on NBPE's underlying companies. Certainly, they are likely to be more highly geared than their quoted counterparts, and NBPE is itself geared (we estimate current net gearing at 30%). As such, any downturn in operating performance or valuation multiples will have a geared effect for NBPE shareholders, and will only be quantifiable from mid-August. (NBPE's portfolio companies are comprehensively revalued every quarter, but Q2 valuations are likely to be more reflective of the impact of this crisis on their performance and value when the 30 June valuations are represented in the NAV.) At the same time, the performance of the trust has been good historically, and NBPE is a clearly differentiated trust within its sector. **As we discuss in the Charges section**, it has some fee-related advantages over both direct and fund-of-fund peers. Certainly, we see no reason why it should not at least trade in line with peers. As such, the current discount to the peer-group weighted average of nearly 12 percentage points seems unjustified. In absolute terms, having made progress towards a narrower discount, NBPE's shares remain at historically wide discount levels.

Fig.7: Discount To NAV



Source: Morningstar

Over the short term the discount widening so dramatically may have been compounded by the trust announcing the cessation of buybacks. However, depending on the market environment and the impact on portfolio companies, NBPE has announced that the board will be making decisions for the best uses of capital, which include:

- supporting existing portfolio companies
- making new investments
- paying down debt
- returning capital to shareholders

NBPE has a long-term track record of strong performance. Also, 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' (the private-equity managers behind each deal), it is unlikely that investors are exposed to any significant key-man or other specific risks. However, the recent discount history suggests that the market is focussing very much on nearer-term issues. We believe that the NAV will inevitably fall as valuations catch up with reality, and that this will take care of some of the discount narrowing. However, other likely catalysts will be updated valuations and an indication of how much of the current liquidity that NBPE has recently drawn down from the credit facility is likely to be needed, and therefore the potential for accretive buybacks.

Charges

One of the unique selling points of NBPE is that the way it invests offers significant fee-related advantages over a fund-of-fund approach. At the same time, the portfolio benefits from having a diversified exposure to the private-equity asset class. 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. 3% of the direct-investment portfolio, as reported in the May 2020 investor presentation (and based on the 31 March 2020 monthly NAV estimates). As a result, on 97% 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 that of most direct-investing LPE funds, but the performance fee is lower than that of other direct-focussed 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 OCF for the year to the end of December 2019 was 2.13%, of which management fees represented 1.71%.

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 do differ between companies.

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 businesses it holds, 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 co-ordinated 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 those involved with private equity. It has been a signatory to the United Nations' Principles of Responsible Investment (UNPRI) since then, and reports that Neuberger Berman and the private equity team were awarded A+ scores for ESG in the most recent UNPRI 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 work closely with Neuberger Berman's dedicated ESG team to ensure the implementation of industry best practices.

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