More than meets the eye with private company investing

The case for having an allocation to private companies has become compelling in recent years – yet not all ways of making unquoted investments are made alike...

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Privately-owned companies offer a compelling opportunity for investors of all types. For many years large institutions have invested alongside more traditional, listed equities in unquoted businesses. These investments are usually made through private fund offerings. Large institutions often have dedicated teams and specialised knowledge to analyse these types of investments and they often deploy meaningful amounts of capital to achieve appropriate scale and diversification. Over recent years, the amounts of capital available for unquoted companies has risen, and as a result, companies of all types have the option of relying less on equity markets to provide capital. Increasingly, retail investors have also sought to get access to unquoted investments. The attractions are there: a wider range of companies, a differentiated returns profile and the opportunity to benefit from ownership by high quality private equity firms and management teams incentivised to deliver long term growth (as opposed to hitting quarterly earnings targets). The benefits to company management teams and the resulting attractiveness to investors of private company ownership has been demonstrated, and so for investors, the opportunity set offered by listed funds exposed to private companies has widened considerably.

Listed private equity (LPE) investment companies have offered access to a more traditional approach to private equity investing for quite some time. Despite this, we have seen many investors instead opt to access private companies as part of a broader portfolio, notably in several well-known growth-oriented global equity investment trusts. Alongside these, other trusts have sprung up, offering exposure to private high growth opportunities, often specialising in technology or fintech. In contrast to LPE trusts, which generally invest in structures where Private Equity is ultimately a control investor, these trusts invest in situations where Private Equity is a minority investor.

A bit-part player

It is important to note that there are big differences between investing in private companies as a minority investor, and owning the entire (or majority) of a business (which we define as Private Equity).

Whilst being a minority investor in private businesses does offer potentially explosive growth at a relatively low management cost, we believe it does present extra risks over and above those of traditional private equity investing. Crucially, many general equity trusts that are investing in private companies have little-to-no track record of investing in these sorts of companies over a full business cycle. Simultaneously, they have little experience of managing the fluctuating successes of a limited number of private investments and the impact this can have on the profile of their portfolio as a whole.

Linked to this, another major potential issue is in the lack of control. Minority investors may have no control in how a company is run, what the strategy is and whether to accept an offer for the company (ie a sale). There are plenty of examples in the investment trust universe where trusts have continued to own unquoted minority stakes for far longer than originally envisaged. Certainly, if the trust is a forced seller, then there is usually only one buyer – which rarely means the most attractive price is achieved, and means that potentially minority investors can remain trapped for a prolonged period.

Centre stage

Nearly all of the London listed LPEs are reliant on a single manager or take a fund of funds approach to invest in private equity opportunities on their behalf. This approach has generally delivered good returns historically. However, one drawback of the way private equity investments are traditionally made in these listed formats (by committing capital to a fund, well in advance of when it is invested) is the difficulty of getting capital invested in a timely manner and this produces a need to overcommit the fund to underlying fund commitments in order to be close to fully invested.

A different approach, which offers the benefits of private equity investing, but with less of a deployment issue, is that employed by NB Private Equity Partners. Under this model, private equity sponsors (or managers) buying a private company may invite a small group of other investors (such as Neuberger Berman) into some of their deals. NB have relationships with a very large number of private equity managers, and as such have sight of a large number of deals occurring at any one time. This puts them in a good position to see a wide range of opportunities and hopefully select the best ones, as well as manage the trust's cash balances effectively to remain fully invested. As a result, NB is directly in control of the decision-making process for each and every investment at the time the investment is made. It also means that they can tap into a range of deals, with lots of different sponsors, bringing diversification to the table. Further, the managers have very granular detail on their underlying investments, which is vital to success given that a key challenge in private company investing is information flow.

Adapting the portfolio

This approach to private equity investing has garnered results for NBPE, in particular during the tumult of 2020. In the last three years, the management team recognised that the economic cycle seemed to be reaching its latter stages, and so tilted the portfolio toward what they saw as more resilient businesses in sectors and in investment themes they believed would be able to weather a downturn.

For example, NBPE's portfolio has a meaningful exposure to Technology, Healthcare and certain areas of consumer goods (20% of the equity portfolio), however the largest positions are in areas of the consumer sector that were viewed as less cyclical investments. Examples of this strategy include Action (the European discount retailer) and PetSmart/Chewy (online and offline pet supplies retailer), both of which have been very resilient in the last year and have delivered strong performances to date. The resilience of NBPE's model was also demonstrated in terms of realisations in 2020 – which exceeded that of 2019.

While private companies genuinely can offer exciting opportunities for investors, not all funds offering exposure to them are built the same. In fact, different approaches to investing in private companies can result in very different opportunity sets – and outcomes. Crucially, as with public equity investing, diversification and information remain vital components of a private equity investing strategy, all of which are components offered by NBPE's unique co-investment strategy.

The strength of this approach is demonstrated by the trust's performance. As of 28 February 2021, over the last year the trust has delivered a NAV return of 20.9%, fuelled by a strong IRR on its direct equity investments alongside healthy exit activity.

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