NB Private Equity Partners

NBPE is well positioned to take advantage of the changing dynamics in private equity...

Update
13 November 2023

Overview

NB Private Equity Partners (NBPE) is differentiated from its peers in the sector because of the sole focus on co-investments, made on a deal-by-deal basis alongside third-party private equity managers, often free of underlying management fees (see **Charges**).

NBPE's portfolio of 88 private companies benefit from two core themes – long-term secular growth and/or lower expected cyclicality. The portfolio is predominantly US focused (74%) and is well diversified; key sectors are technology, consumer and e-commerce, industrial technology and financial / business services.

NBPE's portfolio represents exposure that traditional equity investors cannot otherwise access. As majority owners of businesses, private equity managers are in control of the strategy, and focus on improving the operating performance of businesses, generally taking a longer-term view than publicly owned companies. As we highlight in the **Performance section**, this is showing up in the underlying operating metrics of the portfolio, with double-digit revenue and earnings growth despite the significantly changed economic landscape.

Over the last five financial years, NBPE has been a strong performer relative to the MSCI World Index. The private company portfolio continues to perform, increasing by 3.8% on a constant-currency basis in H1 2023. In our view, this is a result of the strong deal origination and company selection of the team at Neuberger Berman (NB). Long-term NAV outperformance has been driven by the direct private equity investments, which have achieved a gross IRR of 16.2% (five years to 30/09/2023).

As at 30/08/2023, NBPE is 8% geared. As we discuss in the **Gearing section**, this is relatively low compared to its history and the target range. It reflects not just an element of caution from the managers, but also a desire to be in a position to take advantage of opportunities as they arise. NBPE has plenty of firepower to take advantage of opportunities.

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Analyst's View

NBPE held a capital-markets event recently, discussing the changes that the higher interest rate environment brought, and what this means for the private equity market and portfolio. One important aspect is underlying companies are increasingly performing add-on M&A transactions. When achieved, these sorts of transactions can be transformational in gaining scale or efficiencies, and therefore in helping to drive value. In NBPE's Top 30 companies, 70% have completed M&A during ownership. NB believe that M&A transactions allow NBPE to put capital to work in companies that are performing and well known to the private equity sponsors.

For a number of reasons that we discuss in the **Portfolio section**, private capital is currently more constrained. As a result, the managers are seeing a significantly higher level of potential co-investment deal activity this year. NB note that sponsors are generally not lowering their expected IRR's for new investment, nor expecting valuation increases to drive holding-period returns. Instead, earnings growth and M&A are the main drivers underwritten for value growth.

Elsewhere NBPE's long-term capital allows it to participate in reinvestment opportunities, allowing shareholders to continue to benefit from backing proven winners. Private equity managers, such as those whom NBPE co-invests with, have historically proved adept at driving value creation within their investments. Whilst the economic backdrop remains challenging, investors who are taking a long-term view may see the current discount (see **Discount section**) to NAV as a potentially attractive entry point.

BULL
Unique investment strategy, with returns driven by direct equity co-investments
Manager has a high degree of control over the timing of new investments and, therefore, also over the balance sheet
Wide discount in absolute terms

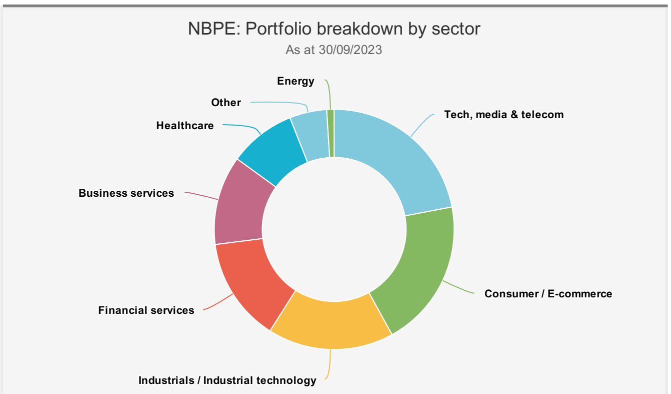
BEAR
Geared exposure to companies, which are themselves often geared
Underlying investments are illiquid, and deal activity in private equity markets generally appears to have slowed
Valuations of portfolio companies are performed quarterly

Portfolio

NB Private Equity Partners (NBPE) represents a carefully chosen portfolio of 88 private companies. The portfolio is built investment by investment and diversified across sector and vintage. The team are sector agnostic, but focus on businesses that benefit from two core themes – long-term secular growth and/or lower expected cyclicality. Currently, the four largest sectors of technology, consumer and e-commerce, industrial technology and financial / business services represent 85% of the portfolio, as we show below. These companies have been chosen by the private markets team at Neuberger Berman for their attractive investment characteristics. NBPE is differentiated from its peers in the sector because of the sole focus on co-investments, investments made on a deal-by-deal basis alongside third-party private equity managers, often free of underlying management and carried interest fees. This approach means that NB are able to manage the balance sheet much more precisely, and has enabled NBPE's gearing to remain within or below the target range that the board and manager deem as optimal (see **Gearing section**).

NBPE's portfolio represents holdings in companies that traditional equity investors cannot easily otherwise access. Bain's Global Private Equity Report 2023 highlighted that fewer than 15% of companies with revenue over $100m are publicly listed. Additionally, as majority owners of businesses, private equity managers are in control of the strategy, and focus on improving the operating performance of businesses, without having to focus on quarterly earnings targets like publicly owned companies. As we highlight in the **Performance section**, this is showing up in the underlying operating metrics of the portfolio, with NBPE's private companies so far continuing to deliver double-digit revenue and earnings growth despite the significantly changed economic landscape. By design, the portfolio is comprised of companies exposed to long-term secular growth trends and/or lower expected cyclicality. These companies tend to exhibit characteristics such as high barriers to entry, strong market share, recurring revenue streams and other attractive financial characteristics .

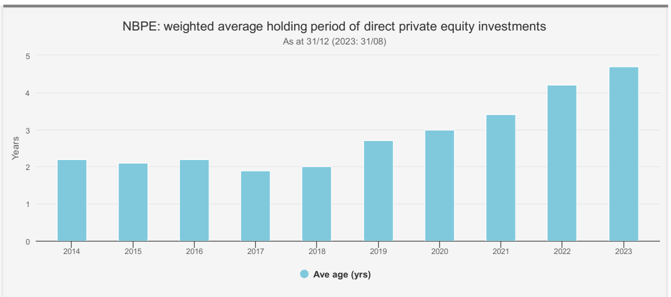
Fig.1: Sector Breakdown



Source: NB

Being a private equity portfolio, the underlying holdings do not change to a great degree over short periods of time, and we examine the underlying holdings in the portfolio in our **previous note**. NBPE held a capital-markets event recently, discussing the changes that the current higher-interest-rate environment brought, and what this means for the private equity market and portfolio. Realisation activity is down on historic rates, which is part of the reason that the average age of investments within the portfolio continues to rise (see graph below). An important dynamic within the portfolio is that underlying companies are increasingly performing add-on M&A transactions. In some cases, M&A transactions are part of a roll-up strategy, attempting to consolidate a niche or sector, but in others M&A has been opportunistic. When achieved, these sorts of transactions can be transformational in gaining scale or efficiencies, and therefore helping to drive value. In NBPE's Top 30 companies, 70% have completed M&A during ownership. This echoes industry-wide activity, which according to PitchBook market data has seen 80% of all deals in the US private equity market in H1 2023 consist of add-ons. NB believe that M&A transactions are often attractive for a number of reasons, sometimes also allowing NBPE to put additional capital to work in companies that are performing and well known to the private equity sponsors and NB.

Fig.2: Age Of Portfolio



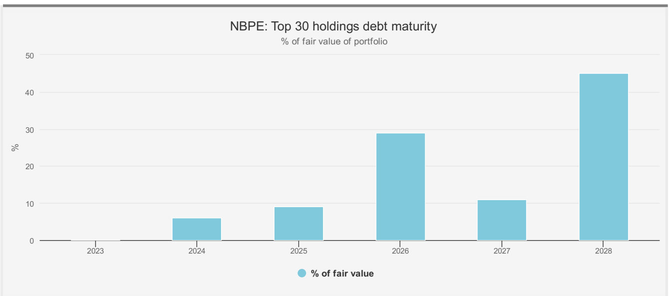
Source: NB

NB note that a defining characteristic of the current economic landscape in private equity is that capital is more constrained. The reasons behind this are various, but clearly one of them is that higher interest rates mean that less debt is being used in capital structures, and more equity is therefore required. Other industry dynamics are also contributing. Over the years, co-investing has become less niche and more 'casual' industry players started to invest in this way. Now that the outlook is less certain, many have stepped back. Another big factor contributing to fewer co-investors is the 'denominator effect'. Many institutional investors have targets for private equity exposure, and a combination of strong performance from private equity and poor performance from public equity holdings has meant that they have limited ability to raise their private equity exposure. As an allocator in this position, one way to rebalance portfolios is to halt 'discretionary' allocations such as co-investments.

These factors are the reason that seasoned investors such as NB are seeing a significantly higher level of potential co-investment deals offered to them. NB tell us that during 2023 so far, they have seen 11.3 co-investment opportunities per week, against 8 per week in 2021. NB note that sponsors are not lowering their expected IRRs for new investment, nor expecting valuation increases to drive holding period returns. Instead, earnings growth and M&A are the main drivers underwritten for value growth. This strong dealflow puts NB in a position to be highly selective in the investments it chooses to participate in, both across its wider private equity platform and for NBPE's portfolio.

In an environment of higher interest rates, as well as constraining the availability of capital, there is a potential risk for underlying portfolio companies that may need to refinance debt at significantly higher rates, thereby significantly constraining earnings growth. NB have provided this snapshot of the top 30 holdings (representing 67% of the portfolio at 31/08/2023), which shows that the majority of debt in this subset of holdings is due in 2027 or later. The team note that the interest coverage ratio of 2.6x of NBPE's top 30 holdings is significantly higher than the private equity industry average of 1.3x. The team also observe that 81% of debt of the top 30 holdings is covenant-lite. On a look-through basis, NBPE's portfolio has a weighted average net debt-to-EBITDA ratio of 5.2x, meaning that, with the weighted average valuation multiple of 15.5x on an EV/EBITDA basis, borrowings make up roughly one-third of the capital structure. All of these things mean that refinancing risk for the portfolio as a whole is unlikely to be an issue for the time being.

Fig.3: Underlying Debt Maturity

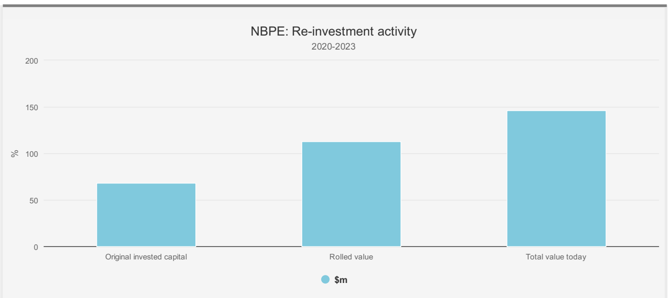


Source: NB, note: 2028 includes debt maturing after 2028

As we note above, realisation activity across the private equity industry has slowed since 2021, but NBPE continues to see realisation activity. Over the past five years, NBPE has achieved liquidity proceeds of 17% of portfolio value each year on average. The current rate of realisations is running ahead of last year but, depending on the last few months of the year, remains below the five-year average. Of note, NBPE has so far seen realisations from public stocks held within the portfolio (total proceeds of $33m, representing a multiple on investment of 2.3x, achieved on an average holding period of 6.2 years), boosted by four full or partial exits from private holdings (a total of $54m). NB report that there are six additional pending realisations due to complete in H2 2023.

One of the features of the private equity industry currently has been reinvestment opportunities, where private equity sponsors provide a liquidity option for existing investors, whilst at the same time welcoming new investors into the deal. Some commentators see this practice as controversial, given that it could enable private equity managers to crystalise carry or performance fees (in practice, very often carried interest is partially or fully rolled into the new transaction). However, it is worth noting that any exit requires investors to commit to roll their investment and/or new investors to come in at the valuation. NB highlight five reinvestments since 2020, with a value of over $100m in total, where liquidity or partial liquidity was offered and NBPE reinvested or chose not to sell. We show below the five reinvestments NB have made since 2020, illustrating that having generated a 31% IRR on their original investment, the good performance on these top-performing investments has continued post-reinvestment with an unrealised 29% IRR achieved subsequently. In our view, this serves to illustrate that reinvesting is not in itself worthy of criticism; in NBPE's case choosing to remain in these investments has allowed shareholders to continue to benefit from backing proven winners such as engineering and action.

Fig.4: Reinvestment Activity



Source: NB

In terms of outlook, realisations continue to be achieved at a premium to holding value on average, with total transactions so far this year (to 30/09/23) being made at a 13% uplift to the prior valuation. In our view, this serves to illustrate the conservatism built into the NAV. In the current market environment, it seems fair to assume that investors' focus will continue to fall on earnings progression from the underlying portfolio. As we discuss above, there seems no current reason to predict a derailment of the portfolio companies' strong and resilient revenue and earnings growth they have achieved in the 12 months to 30/06/2023. Private equity managers, such as those whom NBPE co-invests with, have historically proved adept at driving value gains within their investments and, whilst the economic backdrop remains challenging, investors who are taking a long-term view may see the current discount (see **Discount section**) to NAV as a potentially attractive entry point.

Gearing

NBPE's board and managers have historically employed structural gearing to enhance long-term returns. NBPE has one remaining zero-dividend preference share, which is due to be repaid in 2024 with a capital entitlement of £65m, but also has a flexible credit facility which extends to 2029. NBPE's manager aims for NBPE to be fully invested at all times, and has a long-term target of being 10% geared.

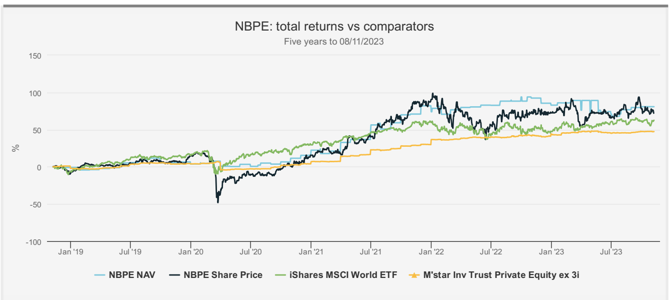
The credit facility allows the managers plenty of flexibility in being able to keep NBPE fully invested, and historically, NBPE has been amongst the most fully invested over time of all the listed private equity trusts. That said, given that NBPE invests through co-investments on a deal-by-deal basis, it is easier for NB to manage the balance sheet and gearing level more precisely than other private equity trusts, which typically commit to funds and have no control over when capital is deployed.

As at 30/08/2023, NBPE is 8% geared. This is relatively low compared to its longer-term history and the target range. It reflects not just an element of caution from the managers, but also a desire to be in a position to take advantage of opportunities as they arise. At the same date, according to NB, total available pro-forma liquidity, including undrawn credit facilities, cash and announced realisations that have not yet closed, is $345m, representing 27% of NAV, meaning plenty of firepower is at the manager's disposal.

Performance

Over the last five financial years, NBPE has been a strong performer relative to the MSCI World Index and its private company portfolio continues to perform well, increasing by 3.8% on a constant currency basis in the first half of 2023. In our view, this a result of strong deal origination and company selection of the team at NB. As the graph below shows, NBPE has outperformed world equities and Morningstar's weighted average of the peer group by some margin over five years. According to NBPE's statistics, this outperformance has been driven by a gross IRR achieved on the direct private equity investments of 16.2% (five years to 30/09/2023), and a realised return gross multiple over cost over the same period of 2.4x. We show below the experience for sterling investors, who in addition to the strong underlying NAV performance, have benefitted from the strength of the US dollar.

Fig.5: Five-Year Performance



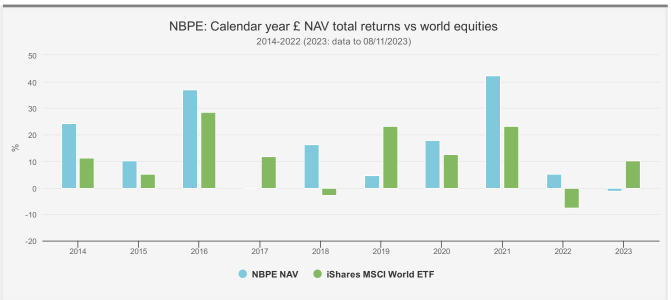
Source: Morningstar
Past performance is not a reliable indicator of future results.

The graph below shows that NBPE's strong performance in 2020 and 2021 has been an important driver of these index-beating returns over the past five years. However, it also shows that with private equity exit activity more muted, as well as falls in the valuations of NBPE public holdings, performance over 2022 and so far in 2023 has been more challenging in absolute terms. In fact, in USD terms, NAV performance over 2022 was -7.5%, with the 4.4% growth in the private companies on a constant-currency basis outweighed by movements in quoted and foreign exchange. Holding publicly traded investments is not part of NBPE's core strategy, rather a result of private equity managers partially exiting investments through IPOs. The decision on when to sell down remaining holdings is exclusively that of the sponsor rather than NB in almost all cases.

Following a rash of IPOs and strong subsequent performance in their share prices, NBPE's public stock exposure peaked in December 2021 at c. 20% of the direct equity portfolio. Through sales and falls in value, this has now fallen back to c. 13% (as at end August 2023). Underlying private company performance has been resilient over this period, driven by earnings growth. For example, as noted above, during 2022 the private portfolio value increased by 4.4% over the year on a constant-currency basis. And during the first half of 2023, the value of the private portfolio further increased by 3.8%, driven by a strong operating performance of 14.9% revenue growth on a trailing 12 months to 30/06/2023, whilst EBITDA growth was 15.4%.

Private company valuations tend to be less volatile than those of public companies and, we would argue, conservative. Evidence for conservatism can be found by looking at uplifts to values on achieving a realisation. Even this year, in a difficult economic backdrop, NBPE's realisation activity so far has shown c. $148m (to 30/08/2023) of realisations announced at an average uplift of 13%. Given the increasing maturity of the portfolio that we show in the **Portfolio section**, we believe this should provide a degree of reassurance to investors.

Fig.6: Calendar Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Private equity investments should always be considered with a long-term time frame in mind, and this applies to investments in listed private equity trusts as well. Clearly, an extra risk for investors in investment trusts is that the discount widens further (see **Discount section**). However, if sentiment improves, then the discount could narrow. Fundamentally, we think NBPE's long-term returns should mainly be driven by the underlying operational resilience of the companies in the portfolio. However, as we discuss in the **Portfolio section**, companies are increasingly helping to drive revenue and earnings growth through accretive bolt-on acquisitions made by portfolio companies. For companies that are able to consolidate fragmented markets, this is an important driver of gaining scale and efficiencies, and therefore value growth. Whilst it is hard to identify a near-term catalyst for exit activity to pick up, the portfolio's underlying performance continues to give grounds for optimism in our view.

Dividend

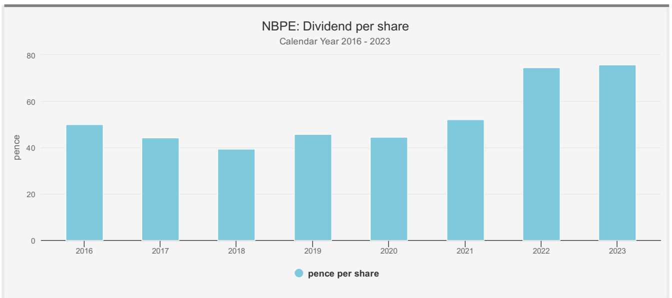
NBPE has a ten-year track record of maintaining or increasing the annual dividend. The board's policy is to pay a dividend that represents 3% of NAV or greater.

We show below the sterling dividends received by investors, which are converted from dollars by the company at the time of the payment, so the actual amount received by shareholders varies with currency movements. In 2022, when the NAV declined over the year as a whole, the board chose to maintain the dividend level. The board also decided to maintain the dollar dividend amount paid in 2023. Because of the strength in the dollar this year, the payout in pence has risen.

The board has stated that it recognises "the importance of paying a reliable dividend to our shareholders and we remain committed to the company's policy". Like most listed private equity trusts, NBPE's dividend can be viewed as a payment from capital. In many ways, dividends paid from capital can be viewed as more resilient than traditional income sources. Because the dividend is paid in dollars, the sterling amount paid depends on foreign exchange rates; therefore the dividend could vary and is not guaranteed.

Dividends paid from capital can also be seen as a return of capital at NAV, akin to a buyback. With the discount to NAV remaining wide (see **Discount section**), the board has stated that, in its view, dividends will remain the primary route for returning capital to shareholders. Over the last ten years, NBPE has returned c. $375m of capital, of which the majority has been through dividends that add to $316m over the period.

Fig.7: Sterling Dividends



Source: NBPE

Management

The board sets the overall strategy and is ultimately responsible for the performance of NBPE, but the board has delegated to NB to act as investment manager to execute day-to-day management and the investment 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 and Paul Daggett, both managing directors at Neuberger Berman.

Peter and Paul are part of the private equity division of Neuberger Berman, a very large global investment business that manages over $120 billion of assets in private equity strategies. The commitments made through the private equity platform give the team a greater level of access than many of their peers. NB aims to be a capital solutions provider for GP partners and not competition, able to leverage the significant resources of the team and wider asset management business.

Investment decisions are made by an investment committee that comprises 13 members, with an average tenure of 19 years with the firm. Neuberger Berman has more than 300 private market professionals, located across 14 global locations. The team claim to have more than 650 active private equity fund relationships. In the managers' view, they see a very high proportion of dealflow 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. Their large size and the speed with which decisions can be made, given their specialist teams, can be competitive advantages when sourcing and executing these co-investments.

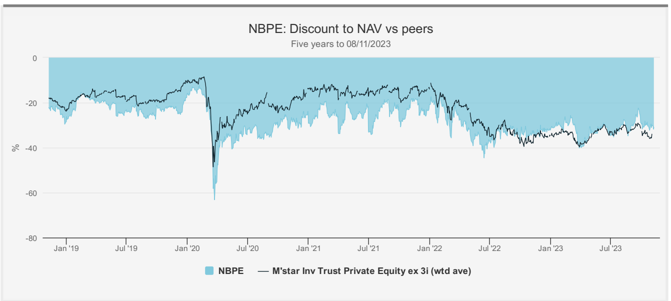
Discount

The graph below shows that NBPE has consistently traded at a relatively wide discount to NAV, and broadly in line with that of the wider peer group. At the recent capital-markets day, the board directly addressed its actions to combat the discount. In summary, it believes that its approach, resting on three pillars, will over time lead to the discount narrowing. Firstly, it believes that continued strong relative NAV performance is a key determinant of attracting investors. Secondly, it continues to invest in its investor relations (IR) offering, with a new UK based individual recently recruited to lead IR activities (Luke Mason). Finally, it believes that NBPE's governance - with a fully independent board – should also be attractive, and over time lead to a narrower discount to NAV.

Buybacks remain one of the tools at the board's disposal to manage the discount. At the current level of the discount, buybacks would be highly accretive. The company has an agreement with Jefferies, the company's broker, to repurchase NBPE shares based on certain criteria, and during June and July, a number of buybacks were completed. Over 2023, $5m of shares have been bought back at a weighted average discount of 32%. As we discuss in the **Dividend section**, the board sees the dividend, which is paid from capital, as the main way in which capital is returned to shareholders. Indeed, over the past ten years, $316m of capital has been returned to shareholders in this way, which compares against $59m of buybacks since inception. At the recent capital-markets day, the Chairman explained that buying shares back at a 30% discount would produce a 1.4x return on capital. This needed to be weighed against the historic return on capital invested that has been achieved by NBPE of 2.2x, albeit with returns generated over a longer-term time frame. In his view, therefore, it is in shareholders' best long-term interests to invest in new investments, rather than pursue buybacks.

We think the board's three pillars make sense over the longer term, but it is hard to identify a catalyst for the discount to narrow in the short term. In reality, we think that to long-term shareholders, what really counts is the NAV performance, and that at the same time the discount does not widen too much. Given that private equity is a long-term investment asset class, for those investors who also take a long-term view, the current discount to NAV may prove an attractive entry point in time to come.

Fig.8: Discount To NAV



Source: Morningstar

Charges

NBPE's sole focus on co-investments offers several advantages, including real-time deployment of capital, enabling control over the balance sheet and cash deployment (see **Gearing section**), as well as an ability to achieve optimal diversification (see **Portfolio section**). However, co-investing also enables NBPE to achieve a significant fee advantage over many peers. By co-investing alongside third parties, NBPE can invest in deals largely free of management and performance fees payable to the underlying private equity sponsors. Fund-of-funds peers often pay two layers of management and performance fees on a proportion of their investments, typically 1.5% to 2% of committed capital and typically a carried interest fee of 20% of gains over an 8% hurdle. As at 31/08/2023, NBPE paid no management fees or carried interest to third parties on 97% of the direct equity portfolio.

NBPE's management fee is 1.5% p.a. on 'private equity fair value', i.e. investments, excluding cash, and is in line with that of most direct-investing LPE funds. Neuberger Berman is also entitled to a 7.5% performance fee on NAV gains over a 7.5% per annum hurdle, subject to a high-water mark. We note that this performance fee is lower than that of other direct-focused funds, although it is charged on unrealised gains. Directly investing managers typically only receive carry on realised gains. The trust's OCF for the year to the end of December 2022 was 1.9%, of which management fees represented 1.57%, since it is calculated based on private equity fair value but presented in this ratio as a percentage of NAV.

The KID RIY figure, as at 21/08/2023, was 3.63%. Of this, 0.94% was carried interest, i.e. performance fees, which are averaged over five years in the KID. It is worth noting that calculation methodologies can differ between companies and versus the OCF.

ESG

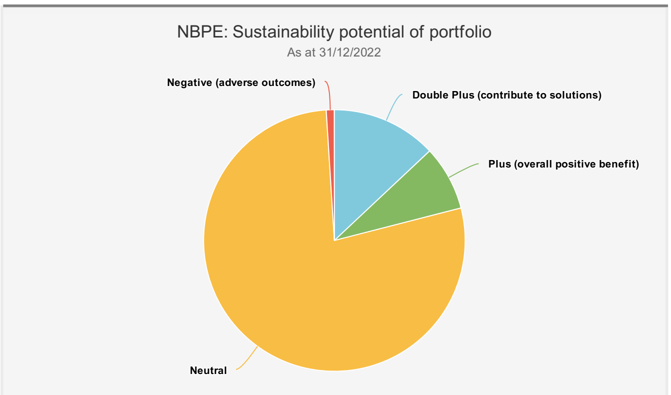
The team at NB believe that ESG is a fundamental part of investment risk and opportunity assesment. In August 2020, and updated in September 2023, NBPE's board implemented a responsible investment policy, which can be **found here**.

ESG factors are an integral part of the NB private equity team's due diligence process. As a co-investor, NB perform due diligence on each prospective investment and aim to ensure that the company and sponsor are managing ESG risks appropriately. The team also aim to monitor ESG risks during the time of any investment. The NB Private Equity investment team work closely with the firm's dedicated ESG team to support the implementation of industry best practices.

As a mark of the success of the team for their ESG efforts, in 2021 for the third year in a row, Neuberger Berman was awarded top scores of five stars across all categories by the UN PRI. Alongside this, NB Private Markets received the British Private Equity & Venture Capital Association's Excellence in ESG Award (LP Category) for its commitment to fostering innovation of ESG objectives, engagement with private equity managers and efforts related to ESG data and climate initiatives. Now in its third year, this award seeks to recognise outstanding contributions to ESG and impact investing across the private capital ecosystem.

The team provide a breakdown of the directly invested portfolio as they currently see it, showing that most of the portfolio is either positive or neutral, which illustrates their point that the ESG process has been used for quite some time and is working. The one company in the chart below represented as having an adverse potential outcome reflects investments made prior to NBPE adopting its Responsible & Sustainable Investment Policy in 2020.

Fig.9: Portfolio Through A Sustainability Lens



Source: NB

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