

SLEPET – Citywire article

Accessing operational alpha in private equity

Roger Pim, Managing Partner of SL Capital [the private equity arm of Standard Life Investments], provides insights into why he believes the private equity asset class can continue to outperform listed markets over the medium to long term through 'operational alpha'. Roger also highlights how investors can access this additional alpha generation through the Standard Life European Private Equity Trust Plc ("SLEPET"), a listed investment trust fund-of-funds.

The term private equity has created a number of negative headlines recently, partly because of high leverage and increasing purchase price multiples. However, we contend that the headlines do not consider the whole picture and miss the real core value generation of the strategies deployed by leading private equity fund managers. These experienced teams, who source and invest in private businesses, have developed unique capabilities to create what we refer to as operational alpha. This additional return is not available through listed markets and can lead to long-term outperformance from investment in private equity.

The private equity fund managers we back are highly focused financial and industrial investors and they deliver profit growth through a number of discrete elements. The core of their return comes from:

- a deeper set of available opportunities accessed through private markets compared to listed markets, offering enhanced stock selection in high quality businesses
- a demonstrated ability to invest in industry sub-sectors that have the potential to achieve faster growth
- the use of leverage to enhance value with a low level of risk.

Working in combination with these sources of return, private equity fund managers can deliver operational alpha from the work they undertake to make a company more commercially efficient. The standard investment period in a private equity-backed business of 4-5 years allows shareholders and management time to focus on driving operational excellence. This includes long-term strategic change, organic growth from new products or markets, mergers and acquisitions, margin enhancement through efficiencies and a focus on cash and working capital management. Private equity fund managers have dedicated internal teams to drive these projects - all targeted to deliver above-average profit growth.

In terms of leverage, default rates in private equity-backed businesses are comparable to corporate rates. The leading private equity fund managers we invest with have demonstrated that additional leverage [when compared to listed markets] in their companies is an asymmetric risk – they benefit from the upside of increased returns with limited downside. A core skill of a private equity fund manager is to operate a company under a leveraged structure. As a result, they can mobilise resources to negotiate with lenders or bondholders should an issue arise.

SL Capital is a conviction investor in these leading European private equity funds through SLEPET.

This allows us to capture the operational alpha in a European market that is demonstrating steady growth. We target funds that focus on private corporates at the smaller end, investing in businesses with enterprise values in the €100 million - €2 billion range. We maintain a key group of trusted relationships, with 11 private equity managers representing over 80% of the £453 million net asset value*. These are selected following detailed origination and a rigorous due diligence selection process that can take many months. Recent performance has been strong with SLEPET's net asset value total return outperforming its European peers in the LPX Europe index over one, three, five and 10 years*. We established SLEPT in 2001, so the mature portfolio continues to generate significant exit proceeds, representing £128.3 million in 2015*.

We believe that SLEPET has many attractive characteristics. Underlying profit growth of the circa 330 companies within the portfolio exceeded 8% last year*, well ahead of listed markets. Increased M&A activity meant that we continued to see a steady flow of exits at higher-than-reported values. We are continually deploying capital and recycling the exit proceeds into the leading European private equity funds that we believe are best placed to deliver market outperformance. We remain confident that the Trust's performance can continue to benefit from our access to private equity operational alpha and believe that SLEPET is an attractive investment proposition over the typical 3-5 year cycle.

*as at 30 September 2015