



## Private Equity: Opaque or Hidden Value?

October 2007

Global capital markets have been somewhat volatile in the last few months. Within our own domestic equity markets we have seen significant upward and downward swings. In a time of investor scrutiny and sensitivity regarding future valuations in equity markets, it may be appropriate to assess the virtues of listed private equity investing, and the somewhat 'hidden value' of this asset class.

### How to value listed private equity

A listed private equity company (even though it is a listed entity) actually invests in unlisted companies. This means the market is seeking to rate a portfolio of unlisted companies in a listed environment. This creates a common anomaly of listed private equity vehicles, whereby the share price is rarely in alignment with the value of underlying investments (known as the net asset value or NAV). Not surprisingly, many investors may fail to see the true drivers of performance and focus purely on a private equity vehicle's share price. Investors need to dig deeper to find the fair value of a listed private equity stock.

#### Identifying Value

Discount Levels	The difference between share price and 'realised NAV'
Discount 1	Share price is often at a discount to 'Reported NAV'
Discount 2	Reported NAV is typically at a discount to realised NAV due to AVCAL guidelines (ie. conservative valuations).
Discount 3	
3 a)	The timing lag of private equity valuations understates reported NAV in a rising market (but can over state it in a falling market).
3 b)	In a young portfolio, valuation at cost in the first 12 months, in accordance with AVCAL guidelines can further understate reported NAV in a rising market.

*NAV ultimately converts to cash through investment realisations, so provides a better long term indication of value than share price.*

In summary, the impact of share price discounts and reported NAV discounts to the ultimate realised value can be quite considerable for the long term investor.

#### Share price compared to Reported NAV

For the longer term investor, the best indicator of the value of a private equity portfolio is the net asset value (NAV). Movement in NAV is generated by cash received from portfolio realisations or revaluation of companies within the portfolio. So it is a good indicator of portfolio value.

## Reported NAV compared to Realised NAV

Private equity managers in Australia follow valuation guidelines set down by the Australian Venture Capital Association (AVCAL), and tend to price investments conservatively. Consequently, not only is there a discount between the reported NAV and the share price, but also the reported NAV typically reflects a discount to the ultimately realised value. ING Investment Management, the manager of ING Private Equity Access Limited's (ING PEAL) investment portfolio have performed a review of the realised NAV of all their Australasian private equity investments realised since the introduction of the new AVCAL guidelines in 2001. These were compared to the reported value of these assets in the immediate quarter before realisation and the results are tabled below:

### ING Investment Management Private Equity Assets Uplift in Valuation on Realisation

Sample Size	Total Realised Value of Assets	Premium of realised value over previous quarter valuations
97	\$2.6 billion	39%

*Sample size includes assets realised from ING Private Capital Fund No.1, ING Private Capital Fund No.2, ING Private Capital Fund No.3 and ING Private Equity Access Limited.*

### The impact of timing lags in valuation

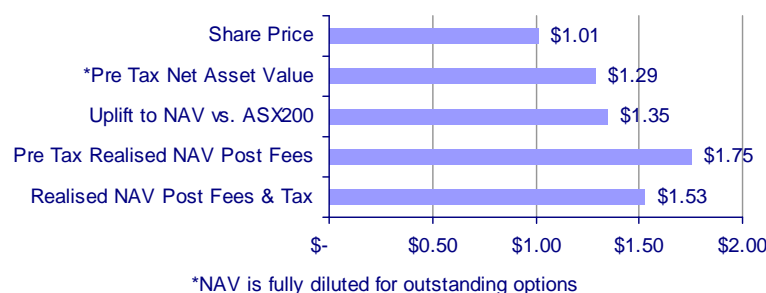
Another point of note is that the underlying assets of a private equity portfolio are usually only valued half yearly, quarterly or when a significant business event occurs. This means that a private equity valuation can lag a comparable daily market valuation by up to six months. Consequently, private equity valuations tend to be understated in rising markets and may be overstated in falling markets, though conservative valuations as per AVCAL guidelines tend to mitigate any overstatement. In addition to the above discounts, it is industry practice to value new investments at cost for a period of 12 months. This means that for a relatively immature investment portfolio there can be significant upside during the growth phase of the portfolio.

Taking ING PEAL as an example, 51% by value of the portfolio was less than 12 months old as at the end of June 2007 and will therefore typically be valued at cost. In that period the S&P/ASX 200 Index had risen by 23.7%, or 10.7% over 6 months taking an average life for the new portfolio. The impact of this valuation approach on the total portfolio is an effective discount of 4.4% relative to the movement in the S&P/ASX 200 Index.

## Discounting Analysis

Again using our example of ING PEAL and applying the indicative discounts mentioned in the earlier table we get the following results.

### ING PEAL as at 30 June 2007



In this example we have restructured the possible real value of ING PEAL taking into account the three levels of discounting.

- At 30 June 2007, the stated share price of IPE was \$1.01 and the pre tax NAV was \$1.29;
- Taking into account that some assets were still valued at cost at 30 June 2007 we have estimated the potential uplift in value (based on the S&P/ASX 200 Index). Based on ING PEAL's portfolio this would add a further 6 cents to the share price to \$1.35;
- A further premium is added to account for the historical uplift in value once an asset is realised. Applying ING Investment Management's experience of a 39% increase between the valuation and realised value, this adds another 40 cents to the value of the share price (on an after fee basis) bringing it to \$1.75.

In short the difference between the reported share price and the estimated share price represents a 74 cents premium.

As a reality check on this analysis a review of the UK market where listed private equity is more mature and better understood, reveals the share price discount has gradually eroded over recent years. Indeed share prices have recently traded at a premium to reported NAV (excepting the period of the recent market correction where reported data has yet to reflect the recent recovery). More information on the global experience of listed private equity can be found at [www.ipeit.com](http://www.ipeit.com). One note of caution - shares can be traded at a discount to NAV for long periods of time. This emphasises the point that listed private equity trusts are best suited to a long term holding and not frequent trading.

## Hidden aspects of private equity

---

The opaqueness of private equity can hide substantial unrecognised value, but there are some other misconceptions with regards to what private equity may also be hiding?

### Debt

**'The investment portfolio is likely to be highly leveraged and exposed to the currently uncertain debt markets.'**

ING PEAL conducted a review of its portfolio and debt exposure at the start of the year. The findings were that the private equity portfolio of 45 investments had an average gearing of only 52% at the time of investment (i.e. the proportion of the capital structure post investment that was debt funded). Further discussions with bankers and private equity managers reveal that in the heart of the industry lending practices have remained prudent with typically 75% of debt funding being fixed interest and debt facilities being term facilities initially for three years or more commonly five years. Gearing levels do vary from deal to deal, but on the whole private equity portfolios have sound capital structures.

### Share price discount

**'Once at a discount – always at a discount, so where is the benefit?'**

Private equity investments are held for a defined period of strategic change, typically around five years, and then realised. Private equity manager incentives are based on cash realised. Consequently, unrealised value is ultimately turned into cash and profits distributed. Taking our now standard example of ING PEAL, notwithstanding it being a young fund by private equity standards (i.e. less than 3 years old), its investment strategy has enabled a net dividend for 2006/07 of 7.4%. Going forward, dividends will vary from year to year as realisations can be unpredictable, but the intent is clear, the cashflow (which has no discount!) is expected to be strong over the long term. So the long term investor can reap the benefit without suffering the discount on selling shares.

### Management fees

**'A listed private equity fund-of-funds means fees are being paid to both the private equity manager and a fund of funds manager. This will produce significant return drag.'**

Accessing private equity through a fund-of-funds structure does mean extra cost, about 1% pa on NAV in the case of ING PEAL, or around 0.5% pa on the capital committed by the Company.

Private equity is administratively a complicated asset class with typically dozens of cash transactions within any one fund. There is also significant variability in performance, with the volatility between top and bottom quartile managers being significant. Even if an individual investor could gain access to private equity directly, a good fund-of-funds manager will be able to outperform the average more than offsetting the additional cost, as well as reducing the risk through manager diversification and saving on significant administrative hassle.

## Top of the Cycle

**'Currently we are at the top of the cycle, so now is not the time to invest'**

Picking where we are in the investment cycle is always difficult except with the benefit of hindsight. The attraction of private equity is that irrespective of where we are in the investment cycle, it has a history of outperforming comparable listed indices over the long term. The Australian market remains young in terms of its long term performance data, however, long term statistical information is available from the UK, which demonstrates consistent private equity out performance.

## UK Private Equity Performance against Listed Markets (FTSE)

Internal Rate of Return (IRR) % Annualised

Year	3 Years		5 Years		10 Years	
	Private Equity	FTSE	Private Equity	FTSE	Private Equity	FTSE
2000	28.9	10.0	26.4	13.9	20.4	15.4
2001	13.0	0.4	15.7	7.3	17.4	11.6
2002	4.2	-14.2	11.4	-2.3	16.2	6.8
2003	2.6	-6.8	10.2	-1.1	14.2	6.1
2004	11.5	1.8	9.4	-3.0	14.8	8.1
2005	21.1	18.5	11.9	2.2	16.4	7.9
2006	31.3	17.2	20.9	8.5	18.7	7.9

Source: British Venture Capital Association and Price WaterhouseCoopers

A particular attraction of an invested fund-of-funds vehicle, such as ING PEAL, is that it consists of investments made over many years compensating for the ebbs and flows of equity capital markets.

## Conclusion

---

We have discussed the merits of listed private equity investing. Whilst the immediate benefits are liquidity, limited capital constraints and instant access to private equity investments, listed private equity is subject to the volatility of the sharemarket, as is any other listed company. Pricing of these companies is often out of alignment with their true value, however an understanding of portfolio valuation and underlying investments will help an investor make the right choice.

The most important point to make about private equity investing is that it is a long term investment strategy. There are no short-cuts to extracting value. If we look at the profile of most private equity managers the majority of investments are sold within 4-7 years of the portfolio's life cycle. Therefore investors need to consider the reasons for investing in private equity in the first place. If it's for short-term capital gain, then this sort of vehicle is not for you. However, for those investors who are willing to take a patient approach to participating in the typical 'buy and build' private equity strategy, then this investment option can deliver substantial financial rewards.

---

### IMPORTANT INFORMATION

The information contained in this document has been prepared by ING Private Equity Access Limited (ING PEAL). Information has been derived from sources believed to be accurate at the time, but no warranty of accuracy or reliability is given and no responsibility arising in any other way by reason of negligence for errors, omissions or misstatements is accepted. It is provided as general information only and is not in any way intended to constitute a securities investment recommendation or financial advice. Before acting on any information, the appropriateness of it should be assessed having regard to each individual's investment objectives, financial circumstances and independent financial advice should be obtained prior to the acquiring a financial product. Investments in ING PEAL are not deposits with, or other liabilities of, nor guaranteed by any entity of the ING Group.