ICG Enterprise Trust

Summary

ICG Enterprise aims to deliver better than equity market growth over the cycle, through investing in private unlisted companies. They prefer more defensive and less volatile businesses, and have no venture capital exposure.

The trust appointed ICG as manager two years ago, and the team report that the move has had a beneficial impact on their ability to deploy capital and better manage the balance between risk and reward. Almost a third of all capital deployed or committed in the last two years has been to ICG managed strategies or investments.

ICG Enterprise's portfolio balances concentration with diversification. Its flexible mandate allow the team to enhance returns through proactive taking overweight positions in compelling investment opportunities. The top 15 companies make up 32% of the portfolio – which is a similar degree of concentration that one might find in a typical equity fund.

2017 has been a record period for realisations, as well as selective investments. The recent past has been very strong for the trust, with NAV performance bettering the FTSE All Share Index in each of the last four years. Over the past year performance has been driven by a record level of distributions from the portfolio, with sales completed at an aggregate 35% uplift to the most recent valuation and 2.4x original cost.

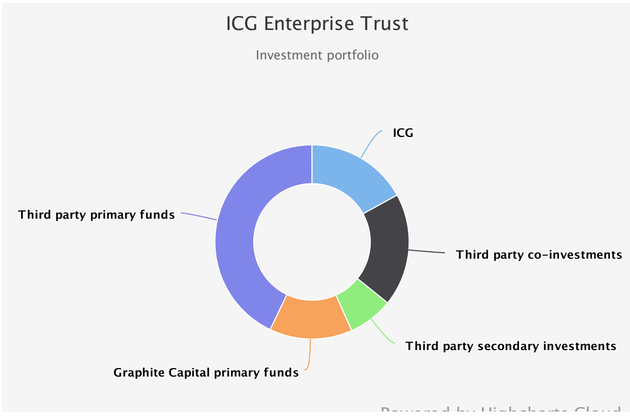
The team believe that in the current environment, a selective approach is key, and are focussing on high quality defensive business. The move to ICG has helped deploy capital, but such has been the strength of realisations that cash at the end of December stood at 11% of NAV. Over the cycle, the team aim to be fully invested.

The board made an explicit target to pay a dividend of 20p per share this year, or a 2.5% yield based on the current share price. In January, the board announced the intention to grow the annual dividend progressively. In addition the trust will move to quarterly dividend payments.

ICG Enterprise currently trades at a discount of c 14%, having narrowed by c. three percentage points since we last wrote on the trust around six months ago.

Portfolio

ICG Enterprise aims to deliver consistently better growth than the equity market (FTSE All Share) over the cycle. In seeking to achieve this, the managers invest in private, unlisted companies. The trust's flexible mandate allows the team to try to enhance returns through proactively taking overweight positions in attractive investment opportunities in its high conviction portfolio of ICG directly controlled investments, third-party co-investments and secondary investments (see our Glossary for more information on these terms). Overall, the high conviction investments make up 43% of the portfolio, although over time the managers anticipate this reaching 50-60%. The full breakdown can be seen in the graph below.

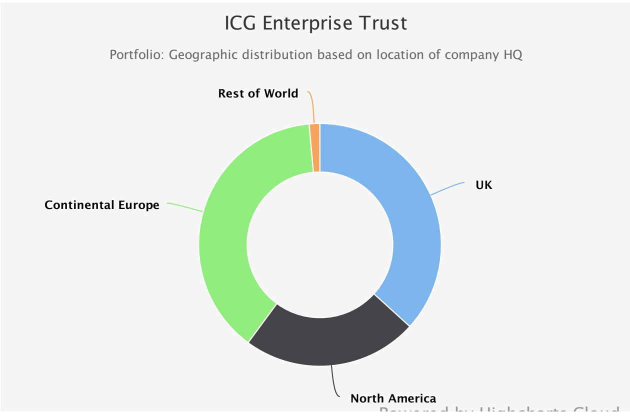


Source: ICG Enterprise, as at 31st October 2017

Outside of the "high-conviction" investments, the rest of the portfolio (57%) comprises holdings in funds managed by 38 different managers (of which c 27 are "active relationships"). This part of the portfolio provides a diversified base of strong returns and generates opportunities for the high conviction portfolio (such as co-investments).

The move to ICG two years ago has, according to the team, had a beneficial impact on their ability to deploy capital. Aside from having a significantly wider network of colleagues to source and discuss potential investments with, it has also enabled the team to access a wider range of investment strategies and co-investment opportunities, which in turn helps them to better manage the balance between risk and reward. Within the ICG managed funds, the team are focussed on those that are targeting equity type returns of 15-20% IRRs. Recently, they have been investing in companies with defensive growth characteristics, many of which should have an element of structural downside protection, investing across the capital structure. In addition, management has also invested in several deep value opportunities which are attractively priced due to transaction dynamics. A measure of the success of the move to ICG has been the fact that almost a third of all capital deployed or committed in the last two years has been to ICG managed strategies or investments.

In terms of asset allocation, ICG Enterprise has historically been relatively European (incl UK) centric. However, over the past two years, the managers have been increasing the trust's exposure to the US, which has risen from 14% to 23%, and is expected to reach 30-40% over time. Most of this has come from a gently reduced exposure to the UK. Shareholders in ICG Enterprise should expect the managers to continue to invest in "buyouts" of profitable (ie not venture capital) growth companies in the developed world, without too prescriptive an approach to geography. The managers tend to avoid small companies, and back businesses and managers with experience and track records.



Source: ICG Enterprise, as at 31st October 2017

ICG Enterprise's managers attempt to balance concentration and diversification. In other words, they aim to have enough high conviction investments to make a difference to NAV growth when a successful investment is realised, but not too concentrated that any one position will very negatively impact shareholder capital if the investment doesn't work out as well. The company has c 400 individual holdings on an underlying basis, but the top 15 companies make up 32% of the portfolio – which is a similar degree of concentration that one might find in a typical equity fund. The managers achieve this concentration either by investing directly in deals (resulting in a stake which is 5-10x the size of what they would get through investing in a fund) or by buying more of the investment indirectly through funds purchased in the secondary market.

Currently, the top 30 investments represent c 46% of the portfolio, over which the managers provide look-through earnings growth and underlying valuations data on a half yearly basis. Underlining their objective to deliver sustainable growth through the cycle, these top 30 companies grew profits (in aggregate) by 15% in the 12 months to June 2017, building on the 12% pa five year growth previously achieved.

Gearing / Cash Management

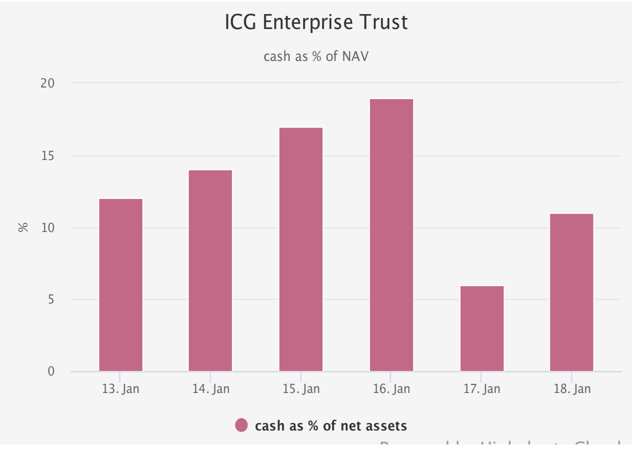
Cash management is a key part of the board and management's role – aiming to be as fully invested as possible, but careful not to find themselves over-extended if conditions deteriorate. It is worth noting that historically ICG Enterprise (Graphite as was) has been managed on a conservative basis and the company avoided any form of rights issue or dilutive action on shareholders in 2008/9 down to the careful management of the balance sheet in the run-up to the crisis.

In the eleven months to the end of December 2017, the company has received total proceeds of £215.5m from investments sold. As a measure of how exceptional this has been, realisations have outweighed the total proceeds received in the previous two years. Against this, the team have invested a total of £124.5m. In addition, £44.4m of new commitments were made to third party managers (although not yet deployed), including a £7.5m commitment to a new manager relationship, Leeds Equity Partners VI, a US based mid-market private equity firm. Alongside the commitment to Leeds Equity Partners, ICG Enterprise has signed a £7.5m co-investment with them.

The team believe that in the current environment, a selective approach is key, and are focussing on high-quality defensive business. They are increasing allocations to the US, having recently invested in and alongside two US firms Oak Hill and Leed Equity. They are focused on the mid-market rather than the larger end of the market (KKR, Blackstone etc.) and both have outstanding track records. The team are also investing alongside colleagues at ICG in some deep value opportunities, or transactions that have structural downside protection.

As the graph below shows, the company has historically had higher levels of cash on the balance sheet than the managers would have liked, given that it has "cost" the company – in terms of lost opportunity – 2.2% pa over the last five years (Source: ICG Enterprise). The team feel that part of the benefit of being at ICG has been access to deal-flow, which has meant that they have made strong progress in getting to their key strategic objective of being fully invested over time. Cash at the end of December stood at 11% of NAV– a significant improvement on the average cash level over the past ten years of 20%.

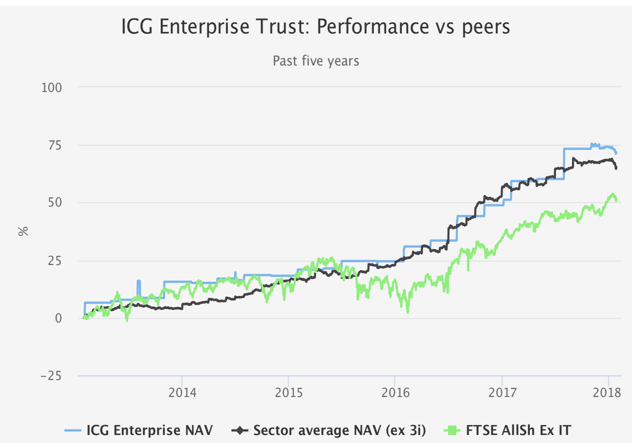
The trust has a gearing facility of c £100m, which assuming it is fully utilised would enable the trust to be c 16% geared. We understand that the board have given the team prior authority to be modestly geared, with the aim of giving them enough headroom to get fully invested. However, the board and manager have stated that over the medium term, the intention is to be fully invested but ungeared. JPMorgan Cazenove estimate that the company has a commitment cover of 0.6x, meaning that total cash and borrowing facilities make up 60% of total commitments. This is broadly in line with the average for the other fund of fund peers.



Source: ICG Enterprise

Returns

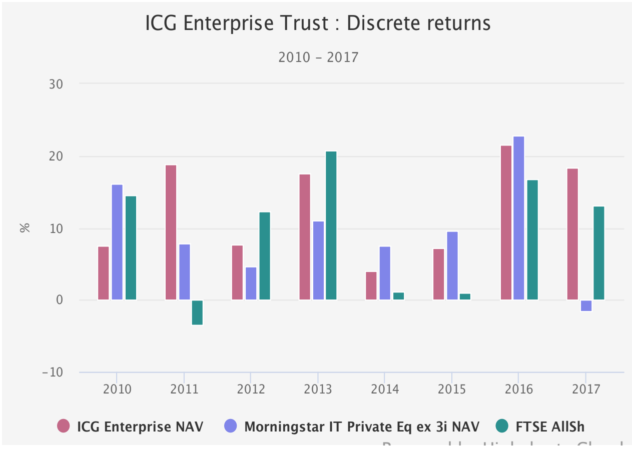
Over the short term, comparing LPE trust's share price performance relative to equity indices is of limited use. This is because of the time that valuations take to do and their infrequency (usually backward looking, and half yearly on an underlying fund basis). Over the longer term however, share price and NAV statistics can help illustrate the sort of returns that can be generated against more liquid / public market investments. Over the last 20 years for example, ICG Enterprise has outperformed the FTSE All-Share by 4% pa, a very impressive level of outperformance (source: ICG Enterprise) despite having the negative effect of not being fully invested over this time. The trust has had an average of 20% cash on the balance sheet over the past ten years. As we refer to in the gearing / cash management section below, cash drag has the effect of muting performance. In the environment that we have had over the past five years, ICG estimate that cash drag has "cost" the company – in terms of lost opportunity – 2.2% pa over the last five years.



Source: Morningstar, Kepler Partners

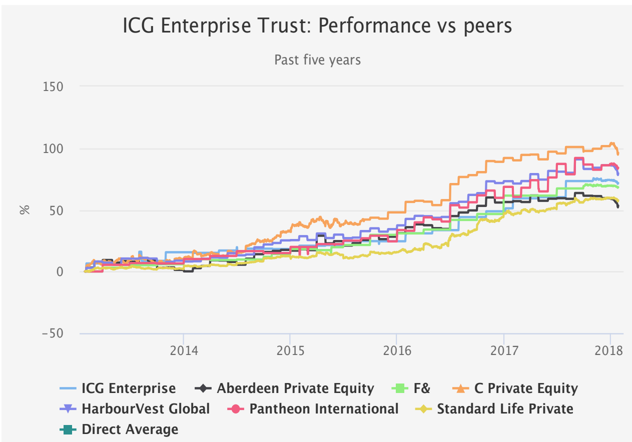
Despite this, and thanks to the strong performance of the invested assets, ICG Enterprise has been a good performer both relative to equity benchmarks and peers. On a five-year view to the end of Jan 2018, as the graph below shows, ICG is ahead of the FTSE All Share, as well as the listed private equity peer group (ex 3i).

The recent past has been very strong for the trust - as the graph below showing calendar year performance illustrates, NAV performance has bettered the FTSE ALL Share in each of the last four years. The impact of sterling weakness relative to the euro and dollar will also have helped vs the FTSE All share during 2016. More recently performance has been driven by a record level of distributions from the portfolio during 2017, with sales completed at an aggregate 35% uplift to the most recent valuation and 2.4x cost.



Source: Morningstar

In the graph below, we compare performance to what we consider to be ICG Enterprise's fund of fund peer group. We think it is worth noting that Pantheon and HarbourVest have had considerably higher exposure to the US dollar, which was a very strong following wind for performance over the majority of the period in question. The past few months has seen them give some relative outperformance back with the dollar weakening. In other respects, the trust has performed in line with its more

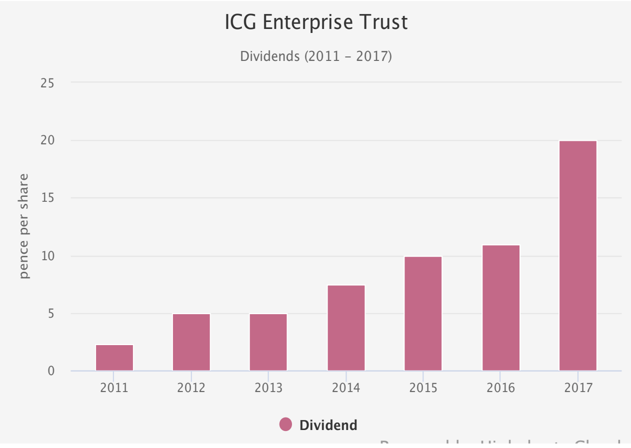


Source: Kepler Partners, Morningstar

comparable peers. We think it notable, that ICG Enterprise has significantly outperformed the average of the directly invested LPE trusts.

Dividend

The board have been paying an increased dividend and supplementing a proportion from capital. In the current year, the board have made an explicit target to pay a minimum dividend of 20p per share, and more recently have committed to growing the annual dividend progressively and move to quarterly payments. This means that at the current share price, the trust yields c 2.5%.



Source: ICG Enterprise

Management

This year marks the two-year anniversary of the team moving across to ICG Asset Management. Emma Osborne continues to lead the private equity fund investment team at ICG which consists of seven investment professionals. Emma has been managing the trust (previously at Graphite) for 13 years, and before that worked on private equity fund investment at Merrill Lynch. Kane Bayliss is also an important member of the management team, and brings valuable direct PE experience having worked previously at Terra Firma and latterly on the direct-side at Graphite Capital. Since they arrived at ICG, Emma added one person to the team but also reports significant synergies with the rest of the ICG group who have 136 investment professionals in 13 countries.

ICG has significant reach around the world and is a specialist manager of private debt, credit and equity with €27bn under management. As such, they have a significant deal flow of potential fund investments, as well as secondary and co-investment opportunities, which Emma and her team get to review for inclusion in ICG Enterprise trust which is their only "client". Emma reports this has been particularly useful for the stated aim of becoming more fully invested (reducing cash-drag), but also with regard to increasing the US exposure. Emma reports that ICG's office in New York has helped her identify very exciting opportunities for the trust, ones which she would have been unaware of at Graphite.

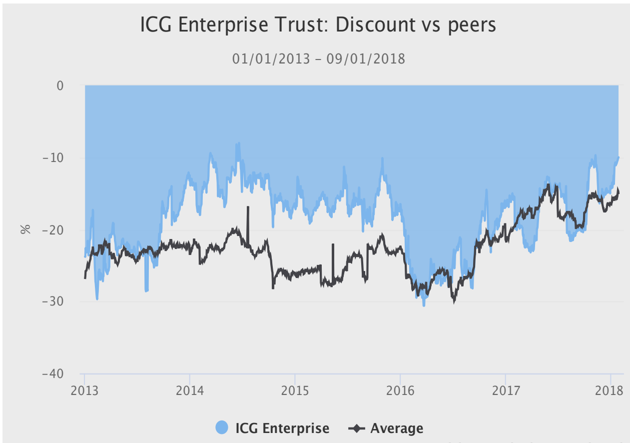
The board is chaired by the highly experienced Jeremy Tigue, who was the long-term manager of Foreign and Colonial Investment Trust from 1997 to 2014, and includes Sandra Pajarola, who was former head of PE fund investments at Partners Group.

Discount

ICG Enterprise currently trades at a discount of c 14%, having narrowed by c. three percentage points since we last wrote on the trust around six months ago.

We think it noteworthy that whilst historically fund of funds traded at significantly wider discounts to "direct" investing peers, they have outperformed the average of the single manager funds. In our view, having generated a superior performance with lower volatility, it is perhaps not surprising that they now trade at narrower discounts on average.

The trust buys shares back opportunistically. Since January 2017, the company has bought back 992,437 shares (representing a capital return of c £7.5m) at an average discount of 17%, adding 0.3% to net asset value per share. Whilst there are risks to the downside at the current level of discount, the environment remains supportive for realisations and the trust has a conservative balance sheet position.



Source: Morningstar, Kepler Partners

Charges

When the company transferred to ICG from Graphite over a year ago, the board took the opportunity to negotiate down the management fees payable to ICG from 1.5% to 1.4% of invested capital, and 0.5% of committed but un-invested capital. ICG charge this fee only on qualifying assets – being investments outside the funds managed by Graphite and ICG directly. This means an effective management fee of c.1.1% of net assets of the trust. In addition, the mangers are entitled to participate in an incentive scheme, which requires an investment of 0.5% of investments made and they receive 10% of any returns ahead of an 8% hurdle. This creates long-term alignment of interests with shareholders by ensuring the managers invest in every underlying investment along the trust. We understand cash pay-outs over the last 10 years have been less than 5% of total gains.

Private Equity is an active asset class and investing requires considerable skill and direct engagement, and so “direct” PE managers usually charge in the order of 1.5% pa (on commitments in the first five years, on invested cost thereafter) and a performance fee of 20% over a hurdle of 8% realised returns, once the fund has returned 100% of committed capital.

The recent PRIIPs regulations have required investment trusts to publish a new KID on 1st January 2018, detailing all charges incurred in the management of the portfolio, including fees paid to third party fund managers. Whilst theoretically all trusts should employ the same methodology, we believe that there is some inconsistency across peer groups. Listed private equity, with an average KID fee of 4.36% looks optically expensive, but must be seen in the context of the degree of active management employed in the private equity industry, in which the managers actually help run investee businesses, rather than just own shares and vote at AGM’s!

ICG Enterprise has one of the higher figures at 6.03%. Whilst seemingly high, we believe investors must remember that a significant proportion of these charges come from performance fees (44%), which is a direct corollary of superior performance. It is worth noting that ICG Enterprise NAV has outperformed the FTSE-All Share index after all fees by 4% p.a over the last 20 years.

ICG Enterprise Trust is a client of Kepler Trust Intelligence. Research produced by Kepler Trust Intelligence covering ICG Enterprise Trust should be considered a marketing communication, and is not independent research. Please see the important information by following this link or at the bottom of the page.

Important Information

Kepler