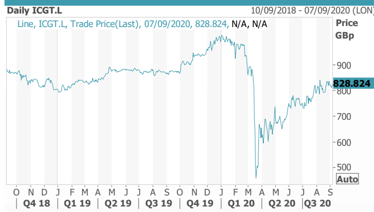
8 September 2020

Closed-Ended Investment Funds



Source: Refinitiv

Market data

EPIC/TKR	**ICGT**
Price (p)	**820**
12m High (p)	1,015.0
12m Low (p)	460.0
Shares (m)	68.88
Mkt Cap (£m)	564
Disc. to NAV	25%
NAV p/sh (p) (Jan)	1,114
Market	Premium equity closed-ended investment fund:

Description

ICG Enterprise Trust (ICGT) is a listed private equity investor providing shareholders with access to a portfolio of European and US investments in profitable, cash-generative unquoted companies. It invests in companies managed by ICG and other leading private equity managers, directly and through funds. It strikes a balance between concentration and diversification, risk and reward.

Company information

Chair	Jane Tufnell
Aud. Cte. Chr.	Alastair Bruce
NED.	Lucinda Riches, Sandra Pajarola, Gerhard Fusenig
Inv. Mgrs.	Oliver Gardey, Colm Walsh
Contact	Tom Burkinshaw (ICGT Financial Controller) +44 203 201 7700
	www.icg-enterprise.co.uk

Key shareholders

None over 3%

Diary

Early Oct	Interim results

Analyst

Mark Thomas	020 7194 7622
	mt@hardmanandco.com

THE MATERIALS CONTAINED HEREIN ARE NOT FOR RELEASE, PUBLICATION OR DISTRIBUTION, DIRECTLY OR INDIRECTLY, IN WHOLE OR IN PART, TO U.S. PERSONS OR IN OR INTO THE UNITED STATES, AUSTRALIA, CANADA, JAPAN, THE REPUBLIC OF SOUTH AFRICA OR ANY OTHER JURISDICTION WHERE TO DO SO WOULD CONSTITUTE A VIOLATION OF THE RELEVANT LAWS OR REGULATIONS OF SUCH JURISDICTION. SEE PAGE 2 FOR FURTHER DETAILS.

ICG ENTERPRISE TRUST PLC

Defensive growth: explaining downside resilience

We called our 6 July initiation *Outperformance through every stage of cycle*. In this note, we explore ICGT's resilience to a downturn in more detail. We first explain why private equity (PE) is so resilient, and then we deep dive into what ICGT has done to further reduce risk. Its performance through the initial stages of COVID-19, earlier NAV returns through downturns and academic research all confirm our view of PE's and ICGT's market-beating resilience. For ESG investors, this aspect of ICGT shows good "S" (jobs are preserved) and "G" (better governance, especially managing for the long term, is key to this performance).

- **Why PE outperforms in downturns:** The critical factors are i) access to committed capital, ii) strategic optionality, iii) operational, financial and market expertise and iv) for managers to earn performance fees, or launch new funds, they must manage through the cycle. Recent sector changes enhance resilience.

- **ICGT incremental risk reduction measures:** ICGT's stated policy is "defensive growth". In practice, this means focusing on well-established businesses with strong competitive positions in a structural growth market, recurring revenues, high margins, strong cashflows and low customer concentration.

- **Valuation:** Valuations are conservative (uplifts on realisations averaging 33% to latest book value over medium term). The ratings are undemanding and the carry value against cost modest. The discount to NAV is 25% (ca.2.5x recent levels), and is anomalous with defensive long-term market-beating returns.

- **Risks:** PE is an above-average cost model, but post-expense returns are market-beating. Even though actual experience has been continued NAV outperformance in economic downturns, sentiment is likely to be adverse. ICGT's permanent capital structure is right for unquoted and illiquid assets.

- **Investment summary:** ICGT has consistently generated superior returns, by adding value in an attractive market, having a defensive growth investment policy and exploiting synergies from being part of the ICG family. The valuations and governance appear conservative. It has an appropriate balance between risks and opportunities. The risks are primarily sentiment-driven on costs and cyclicality, as well as the underlying assets' liquidity. It seems anomalous to have a consistent record of outperformance and trade at a 25% discount to NAV.

Financial summary and valuation

Year-end Jan (£000)	2017	2018	2019	2020	2021E	2022E
Total income	10,151	22,386	5,969	7,441	12,057	12,283
Realised gains	844	-31,257	9,329	14,686	15,568	15,869
Unrealised gains	104,350	91,381	76,440	70,974	0	95,213
Investment mgr. fees	-6,209	-7,165	-7,984	-9,572	-8,691	-9,431
Other expenses	-2,783	-2,734	-2,903	-3,232	-3,319	-3,428
Rtn. on ord. act pre-tax	109,346	73,437	81,789	80,505	16,116	110,505
NAV per share (p)	871	959	1,057	1,152	1,152	1,288
S/P discount to NAV	-6%	-15%	-22%	-29%	-29%	-36%
Investments (£m)	572	576	670	778	793	880
Dividend per share (p)	20	21	22	23	24	25

Source: Hardman & Co Research

Disclaimer: Attention of readers is drawn to important disclaimers printed at the end of this document

Disclaimer

The information contained herein and on the pages that follow does not constitute an offer to sell, or the solicitation of an offer to acquire or subscribe for, any securities in any jurisdiction where such an offer or solicitation is unlawful or would impose any unfulfilled registration, qualification, publication or approval requirements on Hardman and Co (the "Company") or its affiliates or agents. Equity securities in the ICG Enterprise Trust have not been and will not be registered under the applicable securities laws of the United States, Australia, Canada, Japan or South Africa (each an "Excluded Jurisdiction"). The equity securities in ICG Enterprise Trust referred to herein and on the pages that follow may not be offered or sold within an Excluded Jurisdiction, or to any U.S. person ("U.S. Person") as defined in Regulation S under the U.S. Securities Act of 1933, as amended (the "U.S. Securities Act"), or to any national, resident or citizen of an Excluded Jurisdiction.

The promotion of ICG Enterprise Trust and the distribution of the materials contained in the report in the United Kingdom are restricted by law. Accordingly, it should only be accessed by, and are directed only at:

- persons outside the United Kingdom to whom it is lawful to communicate to; or
- persons having professional experience in matters relating to investments who fall within the definition of "investment professionals" in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended) (the "Order"); or
- high net worth companies, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) of the Order, provided that in each case the report and any materials in it are only directed at persons who are "qualified investors" as defined in article 2(1)(e) of Directive 2003/71/EC (as amended) (the "Prospectus Directive") ("Relevant Persons"). Accordingly, this report does not constitute, and does not contain the information required to be contained in, a prospectus as required under the Prospectus Directive.

The information on the pages that follow may contain forward-looking statements. Any statement other than a statement of historical fact is a forward-looking statement. Actual results may differ materially from those expressed or implied by any forward-looking statement. The Company does not undertake any obligation to update or revise any forward-looking statements. You should not place undue reliance on any forward-looking statement, which speaks only as of the date of its issuance.

Your reading of this report is governed by the above terms. The Company may change these terms. The changes will be posted on the website. Your access to our website is governed by the version of these terms then in force.

Should you continue reading this report, you represent, warrant and agree that you (1) have read and understood these terms and the other information set out above, (2) agree to be bound by the terms, (3) do not have a registered address in, and are not resident or located in, an Excluded Jurisdiction (or, if you do, you will not seek to make any investment in the securities of the ICG Enterprise Trust), (4) are not a U.S. Person or a national, resident or citizen of an Excluded Jurisdiction (or, if you are, you will not seek to make any investment in the securities of ICG Enterprise Trust, (5) are permitted under applicable laws and regulations to receive the information contained in the pages that follow, and (6) agree that you will not transmit or otherwise send any information contained in this website to any person in the United States or to any U.S. Person for the purpose of that person considering an investment in the securities of ICG Enterprise Trust, or to any publication with a general circulation in the United States.

Why is PE resilient in downturn?

PE's outperformance in downturns does not come about by accident but reflects core aspects of the model

We explored how PE delivers through-cycle operational and strategic advantages on pages 17-18 of our *ICGT* initiation. Looking at a downturn scenario, these advantages are arguably even greater. The critical factors are i) access to committed capital, ii) strategic optionality, iii) operational, financial and strategic expertise and iv) PE funds last at least 10 years. If managers want to earn performance fees or launch new funds, they have to manage through the cycle. Recent changes (including cov-lite documentation, diversity in funding, committed capital, communication and management information and defensive positioning) mean the sector should also be more resilient than it has been in the past.

Access to committed capital and creditors' knowledge of this support important factors

PE-backed companies have greater, and faster, access to committed capital than non-PE backed ones. "Dry powder" (committed funding to PE that has not been drawn down) is at record nominal levels, reinforcing this advantage (see page 12 of the Bain Global PE report 2020 for more details). Knowledge of this support means that suppliers and other finance providers feel they are less at risk and so can be less aggressive in managing their cashflows with PE-backed companies. Confidence can be critical in uncertain times and PE backing gives a competitive advantage in this respect in downturns.

Strategic optionality both acquisitive and organic

Access to capital gives more strategic optionality for PE-backed companies. This may fund acquisitions, which in a downturn are likely to be less expensive and also more readily available (weaker competitors may see exit as an option/look for a stronger parent or larger firms may dispose of non-core businesses to strengthen the group balance sheets). Importantly, the optionality from committed capital also allows investment for greater organic growth, which can be even more important in challenging conditions. This complements PE's operational support. By way of example, we note the Popov and Roosenboom (2009) study cited in the May 2013 report, Exploring the impact of private equity on economic growth in Europe, that €1 of private equity finance can be up to nine times more effective than €1 of non-private equity finance in delivering innovations, as measured by patents granted.

PE backers may provide expertise in downturn to help investee companies operationally, manage their finances and strategically

In downturns, General Partners (GPs, the PE managers) can assist their investee companies with expertise that may not be available to the standalone entity. *Inter alia*, PE backers may provide:

- operational expertise, which may include: i) advice on managing supply chains; ii) human resource management including redundancies; and iii) best practices;
- financial expertise, which may include: i) treasury skills in managing greater volatility in currencies, input prices, etc.; ii) relationships and "buying-power" with banks, for whom a PE backer with skills in structuring debt is an attractive partner; and iii) planning and stress scenario testing;
- strategic expertise, which may include: i) wider awareness of market opportunities including acquisitions; or ii) leveraging experience in one area/geography across others – particularly relevant in COVID-19.

We believe these support structures are real, not theoretical. On p16 of our recent initiation note on Oakley Capital, we gave practical examples of how these measures benefitted its investee companies throughout COVID-19. For that company, its support included structuring and managing a public equity for one of its companies.

Manager alignment

As PE funds last at least 10 years, if managers want to earn performance fees or launch new funds, they have to manage through the cycle. The Kinsey study referred to earlier noted that those GPs with value-creation teams not only outperformed but they also raised more capital afterwards. We believe this alignment results in i) adopting a long-term focus for investments, ii) having resource in place so they are never forced sellers at distressed prices but rather can manage the time of sale to optimise returns and iii) building expertise to manage through downturns. The long-term focus of PE investors may be in marked contrast to public businesses for whom meeting the next quarter's results is important to the share price and therefore managers' stock and option holdings. The agency cost from listed businesses looking to the short term may include deferred investment, incentivising short-term revenue production or chasing the latest "hot" sector theme. This analyst saw how banks, which had been out of favour for "bullet-proofing" their balances sheets by restricting lending in 2005-06, were under such pressure that they started to chase lending volumes, just going into the GFC. A PE-backed business would not be under such short-term pressure.

Recent changes support resilience

In addition to these structural factors, there are several market developments, which should enhance the PE market's resilience to a downturn. These include:

Expertise has been built at GP level

- Expertise can not only be provided to investee companies but also important at the GP level: One recent feature of PE has been an investment by GPs in their own resources. The Ernst and Young March 2020 report *Why private equity can endure the next economic downturn* noted PE firms have 30% more operating partners than they had just five years ago. Pantheon International highlighted in its recent results that GP expertise had materially increased in advance of COVID-19 as managers prepared for a downturn. The April 2020 McKinsey & Company *Lessons for private equity from the last downturn* highlighted the scale of outperformance by those firms with "value-creation" teams against those without.

Cov-lite documentation

- Cov-lite documentation should reduce the probability of default: Cov-lite documentation may allow weak companies to trade through to a recovery, when, in the past, they would not. A bank contact of Hardman & Co recently reported that the enforceability of documentation was currently lower than in the GFC. We explored this in some detail in our *12 May 2020 note on Volta Finance*. Where gearing has been increased in a PE deal, cov-lite impacts are especially important.

Diverse and sophisticated funding sources

- Diversity in funding: The growth in private debt capital markets, as well as public ones, has meant the support to investee companies from sophisticated PE treasury teams is even more valuable. These teams have established relationships with financers, which can be invaluable in managing liquidity in a downturn. We do not see a potential debt refinancing cliff as was the perception in the GFC[1].

Better communication and management information

- Communication and management information: One consistent theme from every PE-listed vehicle is the speed and depth with which they are communicating, not only with investee companies but also with a range of other stakeholders including shareholders. Technology has facilitated a quantum league improvement in management information allowing the rapid transfer of experience from one geographical region, which experienced COVID-19 early, to countries that experienced it later.

- Committed capital: As noted above, the dry powder is at record nominal levels.

[1] Ernst and Young note refers to €570bn of PE loans perceived as needing re-financing in GFC

- Investor sophistication: We believe the experience of GPs, LPs and financers is very important in terms of managing in a downside. It is noticeable that the discount to NAV this time around widened significantly less than in the GFC.

Defensive positioning by sectors

- Defensive positioning: Every quoted PE company, in recent times, has been emphasising the defensiveness of its portfolio and the importance of sectors such as technology and healthcare. Since the beginning of 2018, for example, PE firms have invested US$181bn into tech – more than double the amount invested into retail and energy combined[2]. This investment has also been more focused on the defensive elements of technology, especially enterprise software[3]. A Boston Consulting Group report noted 84% of the top 10 PE house average share of deal value in 2016-18 was in defensive sectors (against 75% in 2005-07).

Evidence our assertion is correct

In looking for supporting evidence that the whole PE sector is more resilient than PE-backed companies, we cite a number of research pieces from academics.

Stanford report noted resilience

In a piece called *Private equity firms show resilience in a downturn*, Stanford scholar Shai Bernstein noted, in September 2017, "the decline in investment for private equity-backed firms was significantly smaller than the comparable firms. Specifically, we found that in the years leading to the crisis, both the private equity-backed firms and the control group followed a very similar trend in terms of investments. But this trend diverged in 2008, at the onset of the financial crisis, when the decline in investment among private equity-backed firms was much smaller. Moreover, we found that private equity-backed firms increased their assets more rapidly relative to the control group, and also enhanced their market share during the crisis."

Reasons given include long-term horizon and "dry powder" capital built ahead of downturn

The explanations given were "I think there were a couple of reasons that allowed private equity-backed companies to gain better access to financing resources and, as a consequence, invest more and grow more rapidly relative to their peers. First, the longer time horizon of the private equity firms' funds (average fund life is 10 years) allowed the private equity investors to support their portfolio companies during the crisis. Moreover, the private equity firms themselves still had capital available to deploy – capital they had raised before the crisis. Consistent with this notion, we indeed found that private equity firms with more "dry powder," or non-deployed capital, at the onset of the crisis were more able to alleviate financing constraints of their portfolio companies during the crisis."

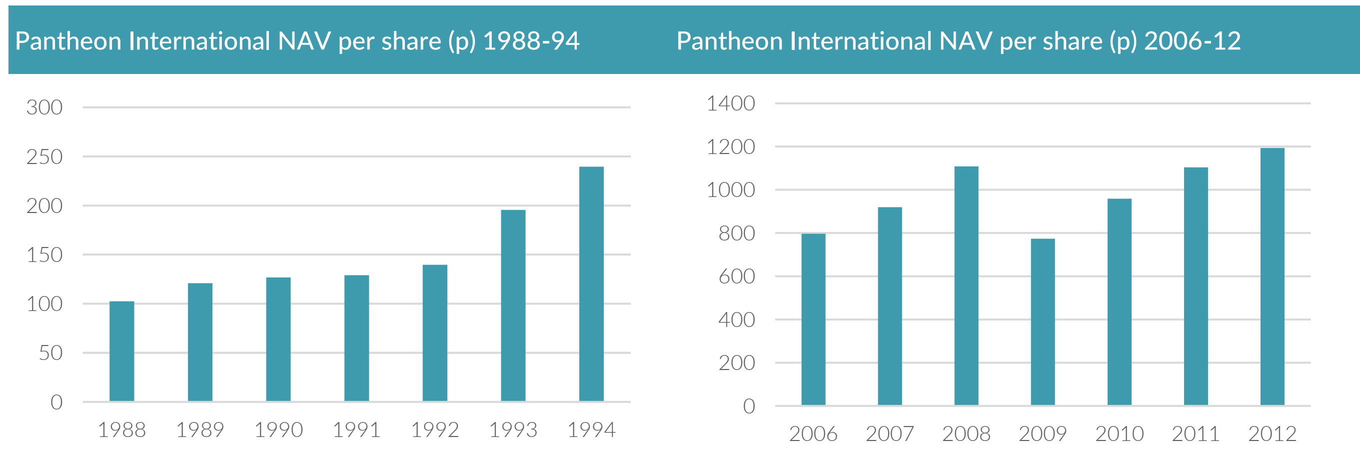
Academics from Leeds/Nottingham universities reached similar conclusion, with PE-backed companies showing stronger performance than quoted companies

Similarly, in a 2011 piece called *Private Equity Portfolio Company Performance Through The Recession*, academics from Leeds and Nottingham universities noted "Private equity-backed buyouts show a stronger economic performance in the period before and during the recent recession than a matched sample of private companies and listed companies. Private equity-backed buyouts show a higher return on assets, sufficient ability to cover the interest payments on their debt and higher gross margin in the recession period than before it. Growth in value added and profit is stronger than for listed companies during the recession period. Growth in turnover and employment remains positive for the PE-backed buyout sample. ..... The results imply almost 14% higher productivity and 5% higher return on assets (ROA) during the recession than matched private companies and listed companies."

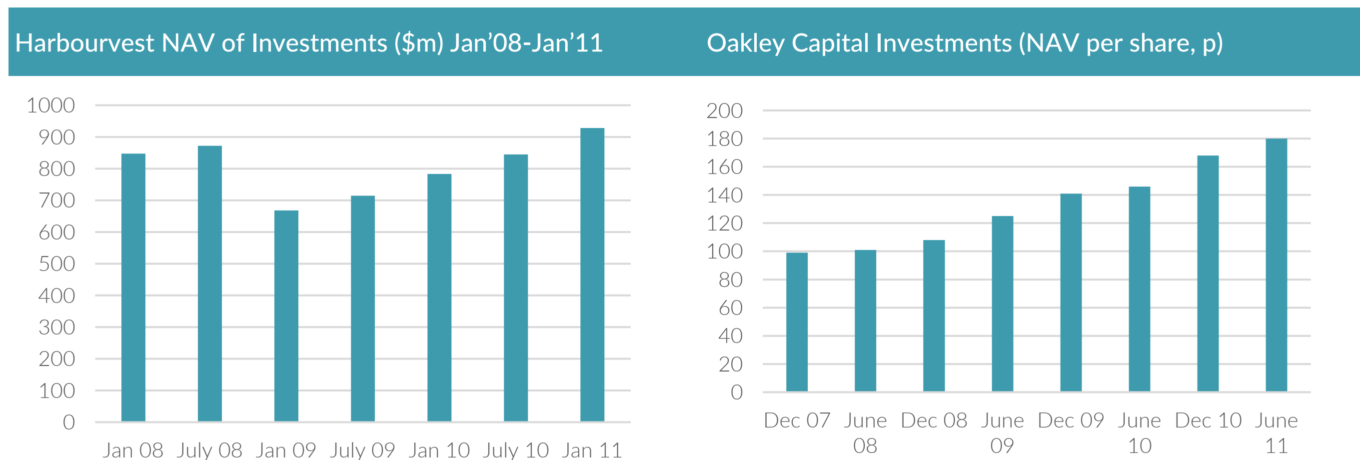
[2] p14 https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/private-equity/private-equity-pdfs/ey-why-private-equity-can-endure-the-next-economic-downturn.pdf?download
[3] p30: www.bain.com/globalassets/noindex/2020/bain_report_private_equity_report_2020.pdf

Peer NAV performances

The charts below show the performances of a number of peers through different downturns. The overall key message is relatively limited NAV downside combined with rapid recoveries to pre-downturn levels.



Source: PIP Report and Accounts, Hardman & Co Research



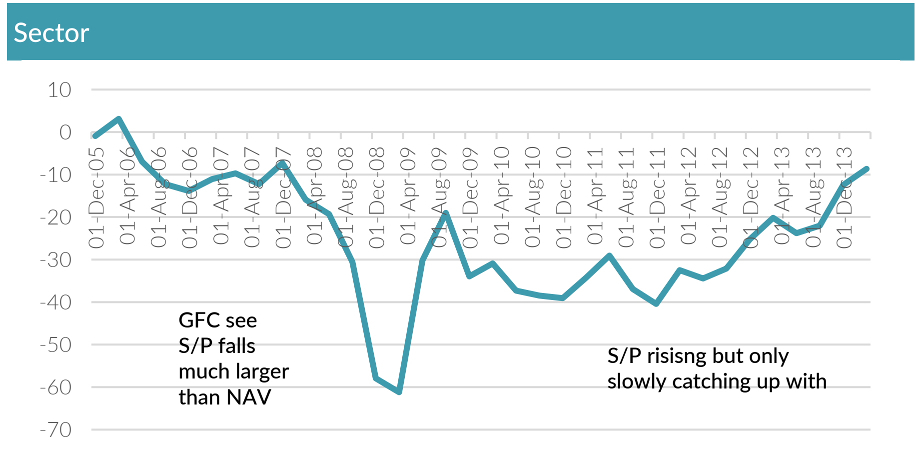
Source: HVPE and OCI Report and Accounts, Hardman & Co Research

Share prices and discount to NAV

Share price over-reacts with higher discount. This time much less widening and rapid recovery.

Historically, as shown in the chart below covering the GFC period, the share price has reacted more than the NAV going into the downturn. Coming out of the downturn, while the share price rose strongly, it took some time to catch up with the then accelerating NAV. We saw going into COVID-19 a widening of discounts (typically by 15%-20%) and around a third of that has already been recovered.

Sector



Source: ICGT Report and Accounts, Hardman & Co Research

Operational impacts

A downturn has several potential impacts on PE businesses beyond the underlying companies. The realisation rate is likely to fall (ICGT's fell by seven-eighths in 2009 compared with 2007), as will investment drawdowns and the valuation rating applied to underlying companies is likely to fall with market declines.

Upside opportunities

Re-investment opportunities likely to be material

ICGT is a long-term investor. The dislocation associated with an economic downturn is likely, over time, to see more opportunities for new investments at more attractive pricing multiples. This is likely to reflect i) lower acquisition multiples given market contractions in ratings and ii) a greater number of opportunities as weaker companies seek an exit/support and weak conglomerates sell down non-core assets to strengthen the group balance sheets.

ICGT incremental risk reduction

ICGT NAV outperformed quoted markets in the past and during first few months of COVID-19

We note that, in the early 1990s' recession, ICGT reported just a 3% fall in NAV for one year and a rapid accretion every year thereafter. Even in the financial crisis, the only annual fall in NAV was 14% (FY'08), which was well below stock market falls. Including intra-year numbers, the peak-to-trough drop was closer to 25%, again still below the market. The outperformance in 1Q'FY21 reinforces the point that PE and ICGT outperform overall markets in a downturn. Looking forward, ICGT has a defensive growth strategy, which should enhance its defensive resilience.

Defensive growth philosophy

Investments chosen for defensive growth characteristics, which should assist through current crisis

When picking investments and managers, ICGT has an overall philosophy of "defensive growth", which it outlines in detail on p12-13 of its 2020 Report and Accounts. It adopts a bottom-up approach, looking for key business model characteristics that should help an investee company be resilient through the cycle, rather than adopting a top-down approach through sector or geographical allocation. The type of characteristic it is looking for includes a strong competitive position in a structural growth market, a high level of recurring revenues, high margins, strong cashflows and low customer concentration.

Looks to established businesses with robust capital structure; helped by manager having debt background

This leads to a focus on well-established businesses, rather than early-stage companies, enabling them to analyse performance through the last downturn as an indication of future defensiveness. The greatest element of control is in co-investments (around a quarter of the portfolio). ICGT focuses on the capital structure of its investments looking at debt terms and covenants to ensure the company can maintain flexibility through a cycle. ICG, as an organisation, has a debt background that culturally gives a high consideration of downside scenarios, and ICG's funds account for just over a tenth of the book.

Applies to own investments and choice of manager

When making fund investments, ICGT looks for these characteristics in its other managers too. Again, it wants those with experience and a track record through a downturn to add to its comfort in downside scenarios.

Resulting portfolio characteristics

We see delivery of this strategy evidenced by:

- In its 17 June 2020 1Q (to end-April) update presentation, ICGT revealed it had done a detailed assessment, covering 84% of the portfolio, based on discussions with the underlying managers, and a review of recent financial performance and liquidity of the underlying companies. Many are performing well, including share price rises in several quoted holdings.
- The portfolio was balanced across a range of developed markets and has large exposures to more resilient sectors, such as healthcare and education (24%), business services (14%) and technology (15%).
- Exposure to industrials (15%) and consumer (16%), sectors with a higher potential impact of COVID-19, was concentrated in high-conviction investments with defensive characteristics and that saw limited falls in value in 1Q. In a number of cases, there is additional structural downside protection, reflecting ICG's expertise in this area.
- There was limited exposure to energy and financials.

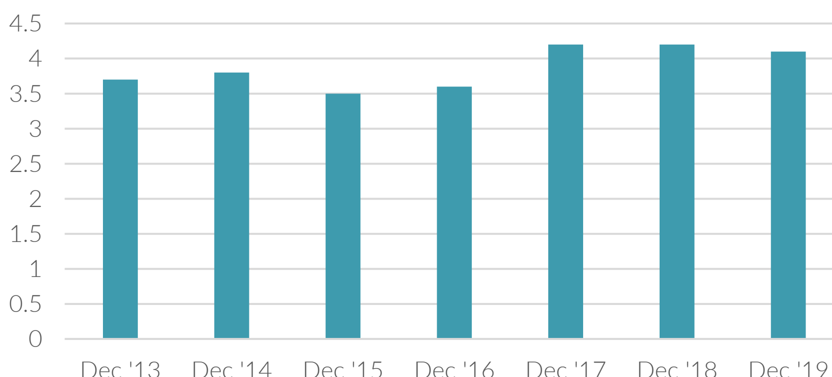
The update presentation also gave several investment-company-specific examples of how the policy feeds through in practice. By way of examples:

- the largest industrials investment (third-largest in portfolio overall) is in Minimax, which is both a manufacturer and service provider in the highly resilient fire protection sector;
- the largest leisure exposure (sixth overall) was to Roompot where an agreement to sell was announced on 22 June at a significant uplift to the carrying value (adding 1.3% to ICGHT NAV);
- in consumer, almost half of the exposure is concentrated in four top 30 investments where ICGT has strong visibility with all the businesses fully operational; and
- similarly, in healthcare, ca.40% of the exposure is concentrated in the three top 30 investments: all are fully operational and have a sound financial position.

Leverage stable since end of 2017. Many companies reduced gearing, with some mix effects keeping average at 4.1x EBITDA (Dec'19).

We note that ICGT's top 30 companies' debt to EBITDA has been broadly stable, at 4.1x (December 2019), since 2017 (with some underlying company deleveraging offset by mix effects). This compares with the latest disclosures of 4.8x at SLPE and 4.7x at HVPE, while, at PIP, the ratios are 5.9x for large/mega buyouts (26% of book) and 4.1xfor small/mid-sized buyouts (40% of book). *Prima facie*, it does not appear that ICGT has been taking incremental risk going into any potential downturn. As noted above, a prevalence of cov-lite documentation should reduce the probability of default. We also note that having a parent manager with a historical focus on debt and downside management should be considered a positive.

Net debt to EBITDA multiples



Source: ICGT Report and Accounts, Hardman & Co Research

Book fundamentally better positioned than going into GFC

Since the financial crisis, we note i) lower over-commitment (uncovered commitments were 51% of the NAV at the end of 2008 – against the current 38%), ii) increased diversification of the book (especially geographically), iii) stable leverage, at 4.1x EBITDA, but lower equity gearing – see below, iv) a relatively defensive stance in the book and v) that the managers have experienced a severe downturn, and this experience is reflected in how they position the book. Even in like-for-like economic conditions, we would not expect such a sharp increase in the discount.

Evidence our assertion is correct

Lower risk than market falls delivered in 2020

ICGT has massively outperformed indices throughout COVID-19 crisis

Defensive growth is the approach to each investment, and ICGT is not driven by sector/geographical allocations. Management believes the majority of the portfolio falls into a low to moderate risk range to the COVID-19 crisis. We concur, noting that: between the January to April valuations, the investment portfolio return was -3.8% (-7% local currency), with the high-conviction portfolio (where the "defensive growth" investment decision characteristics are most evident) falling less than 3%, and the third-party funds were down 10% (both movements in local currency). The funds' drop is around half the FTSE All share index and a sixth of the high-conviction portfolio.

Recent performance proves value of defensive growth, with NAV declines well below those of indices

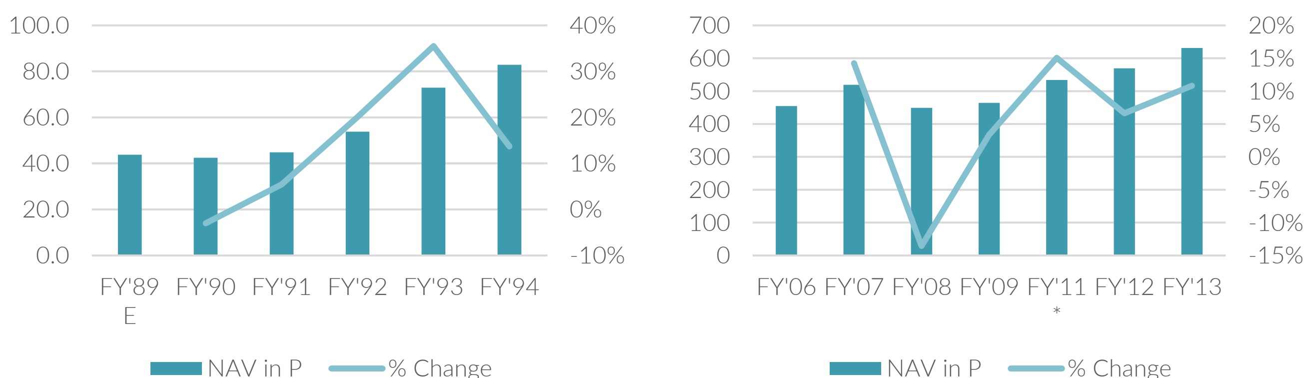
NAV performance during shock periods

Annual NAV only fell one year in each of i) early 1990s, by 3% and ii) financial crisis, by 14%. The peak-to-trough falls, including intra-year numbers, were somewhat higher, but still market-beating.

The charts below detail the performance of ICGT though the 1990s' recession and in the financial crisis. We note:

- in the early 1990s' recession, ICGT's annual reported NAV was broadly stable, before rising sharply in the subsequent years; and
- in the financial crisis, annual net assets decreased by 14% in the first year, but grew steadily thereafter. This is a materially better performance than that of some of ICGT's peers and the overall market/share price levels. The intra-year peak-to-trough was a slightly higher number but, again, still better than the market.

Annual NAV (p) and annual change in NAV (%) in early 1990s' recession (LHS) and financial crisis (RHS)



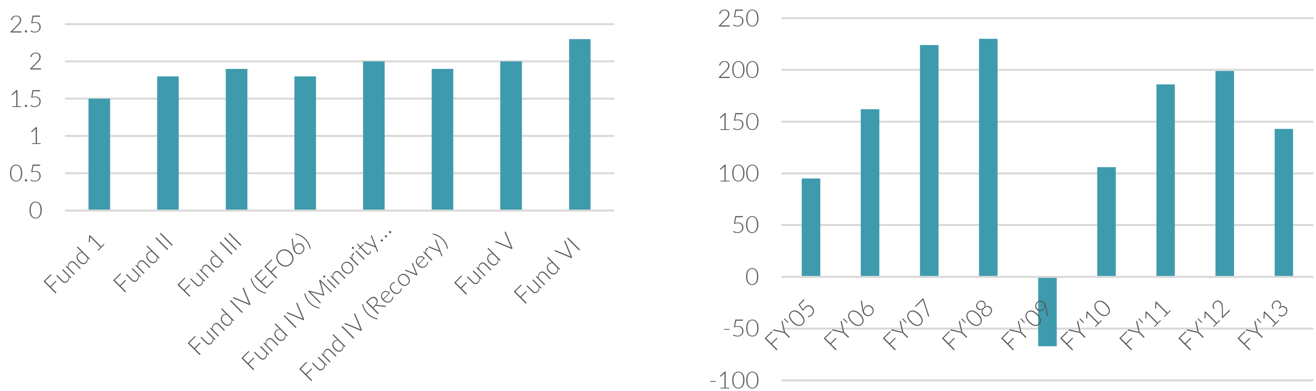
Source: ICGT Report and Accounts (1989 estimated following re-statement of 1990 accounts), Hardman & Co Research

ICG performance

Over long term, ICG funds proved resilient

Given the increasing weighting to ICG strategies, we also think it appropriate to consider a measure of how ICG itself performed over this period. The charts below show the money multiple (i.e. proceeds versus costs) for a range of the core European strategies. The funds had a range of launch dates from well before the crisis through to 2016. Fundamentally, there has been a remarkable stability in returns (1.5x to 2x) across this huge range of dates. The right-hand chart shows the profits of ICG, which saw a temporary dip in 2009, and sharp recovery thereafter. There was no long-term impact on its business.

Money multiple returns by the various ICG European funds (x, LHS) and ICG reported pre-tax profit (£m, RHS)



Source: ICG capital markets day presentation, 30 January 2020 (LHS), ICG Report and Accounts (RHS), Hardman & Co Research

ICGT financial report commentary

We note ICGT's comment, in its 2009 Report and Accounts, that, for its top 30 holdings, "despite the hostile economic environment the EBITDA of these companies increased materially in 2009".

What it means for (ESG) investors

Current discount anomalous with NAV resilience. If investors value downside protection in future, potential increases in discount will be less than in past.

We believe the widening discounts seen across PE investments through the early stages of the COVID-19 crisis reflect investor concerns that PE represents an above-average risk class into uncertain times. We believe that at the peak of COVID-19 market reaction, the discount increased by over ca.20%, of which more than a quarter has subsequently been recovered. For the reasons outlined above, and supported by academic research into PE performance in historical outturns, we believe the increasing discount is anomalous with the underlying NAV performance. Assuming we are right, the discount anomaly could unwind further.

The most likely driver to the investor sentiment is a view around gearing and that PE companies have higher debt and gearing than they did as standalone entities and as such are more exposed to a downturn. We believe there are nuances to this, which some investors may not fully appreciate, and in particular how much the support PE can provide, and operational improvements under PE management. We noted above the importance of cov-lite debt covenants on current debt. Looking further forward, as investors gain more confidence that PE as an asset class outperforms in downturns, we would expect future increases in discount to be less than those seen in the past.

Environmental, Social, and Governance

Private equity, like any other investment, has ESG implications. Looking specifically at the resilience in a downturn, we believe there are two key considerations in this regard.

Social – jobs retained in downturn as more business likely to survive

The key social aspect from PE resilience is the fact that companies with strong backing are more likely to survive a recession and so employees will still be employed and taxes paid. While somewhat dated, the May 2013 report *Exploring the impact of private equity on economic growth in Europe* prepared for the EVCA on p41-42 cited a number of academic pieces, which indicate the potential survival rates were between 5% and 50% better under PE ownership. The research on employment levels (p43) does not explicitly look at downturns.

Improving investee company governance with long-term focus allowing cross-cycle management of business

A core part of PE delivering outperformance is improving the governance within the investee companies to ensure optimal returns. A PE shareholder is likely to be much more actively engaged with the investee company management than most public shareholders are. There should be less room for pet projects and less tolerance of extended under-performance with such active engagement. The communication is also likely to be more open as there are not the same formulaic requirements seen between private and public shareholders. Perhaps, most importantly, for considering a downturn scenario, PE businesses are managed for the long term, matching the long duration of their mandates. Investee companies can thus be run for the long term, including cross-economic cycles, rather than just for the purpose of meeting short-term performance goals.

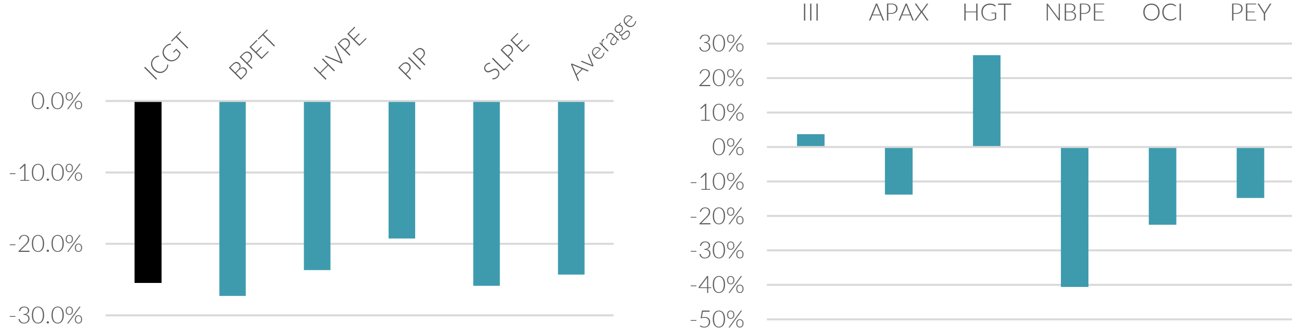
Valuation and financials

Most fund-of-fund peers at similar discounts, despite differing risk/reward profiles. Given factors outlined throughout this report, ICGT's discount, in both absolute and relative terms, while shrinking, still appears anomalous.

One of the more noticeable features of the discounts for fund-of-fund PE investment companies is the remarkable consistency between most of the companies investing in funds and the huge variability in funds investing directly. *Prima facie*, it appears that the market has a broad concern with the whole sector (as evidenced by the fund discount). The most obvious factors would be i) sensitivity to the cycle (ICGT's NAV fell just 3% in one year in the early 1990s' hard recession), ii) lack of confidence in illiquid and unquoted assets (ICGT is structured to avoid being a forced seller, and has lower over-commitments than its peers), iii) lack of confidence that the NAV is a realistic reflection of the underlying companies – discussed in detail above, including timing issues re COVID-19 market falls and iv) fees (ICGT's three-year return is above peers after all costs). Taking an absolute, rather than relative, rating perspective, it appears anomalous that a company with such a long track record of consistent outperformance would trade at a discount to NAV.

Since our initiation in on 6 July, ICGT's share price has increased by 9% against the peers' average 3%. Consequently, its discount to NAV is now only marginally above the peers' average.

Current share price discount to January NAV (ICGT's last reported NAV) for immediate peers (LHS) & wider peers (RHS)



Source: Company websites, factsheets and presentations, Hardman & Co Research; priced at 2 July 2020

Disclaimer

Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.

This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.

Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.

Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.

The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.

Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.

This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).

No part of this document may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission from Hardman & Co. By accepting this document, the recipient agrees to be bound by the limitations set out in this notice. This notice shall be governed and construed in accordance with English law. Hardman Research Ltd, trading as Hardman & Co, is an appointed representative of Capital Markets Strategy Ltd and is authorised and regulated by the FCA under registration number 600843. Hardman Research Ltd is registered at Companies House with number 8256259.

(Disclaimer Version 8 – Effective from August 2018)

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January 2018, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com