ICG Enterprise

ICGT continues to differentiate itself from the peer group...

Update
17 November 2022

Overview

ICG Enterprise (ICGT) is a leading listed private equity investor, focussed on generating consistent and resilient returns across economic cycles. ICGT is well-positioned to generate long-term value, benefitting from the experience and expertise to source attractive opportunities in primary, secondary and direct investments.

The **Portfolio** composition reflects the team's focus on three strategic objectives designed to further enhance risk-adjusted returns. These objectives are: being more fully invested over time, thereby reducing cash drag; to allocate a higher proportion to discretionary investments, which, historically, have delivered higher returns than fund investments; and to have a greater proportion of the trust's assets invested in the US, the largest, most mature and best performing PE market globally.

As discussed in the **Performance section**, ICGT's NAV growth has been steady and consistent over time. NAV total returns over the past five years have been impressive, outpacing the FTSE All-Share Index by 12.9% per year (to 31/07/2022, Source: ICG). In our view, a key contributor to this is ICGT's focus on 'defensive growth' companies, as evidenced in the resilient earnings' growth of underlying companies.

The current discount to NAV of 45% is 1.8 standard deviations from the long-term average of 26%. Of course, some investors perhaps expect the NAV to fall over the short term: a NAV decrease of 30% would put the shares back on their long-term average discount. Whilst we do not believe ICGT's portfolio will be immune from declines in public market multiples, the discount gap, which is c.20 percentage points wider than ICGT's long-run average, implies an EV/EBITDA multiple reduction from 14.5x to c.10x, assuming no EBITDA growth.

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Analyst's View

ICGT's managers have demonstrated their ability to capitalise on opportunities in the evolving private equity market. One example of this is ICGT's increased exposure to the secondary market, with a target allocation of 15-25% of the portfolio in secondary investments announced in FY22. Increased secondary investments should accelerate the portfolio's cash flow profile, since secondary investments generally reflect more mature assets, the distributions being typically received faster than from primary investments. Moreover, structural supply/demand dynamics are generating secondary investment opportunities priced at attractive discounts. In our view, all of these developments are to be welcomed, and NAV returns should be enhanced as a result.

As illustrated in the **Discount section**, ICGT's shares have suffered a significant de-rating over 2022. Indeed, the listed PE sector has significantly underperformed UK equity markets over the short term by quite a considerable margin. However, as illustrated in the **Portfolio section**, we show that the earnings' growth of ICGT's underlying companies has been strong and consistent, as well as being considerably less volatile than that of UK equities. This should put the trust in good stead in the currently uncertain environment but, in our view, the ability of ICGT to outperform over the long term has improved as a result of the board's and managers' strategic initiatives.

As such, the short-term move in the share price seems unjustified. Relative to the peer group, we believe ICGT is differentiated enough to justify a premium rating relative to peers. ICGT's current discount level could, therefore, be viewed as an attractive entry point for investors on an absolute and relative basis.

BULL
Portfolio's earnings' resilience should position ICGT to withstand current macroeconomic headwinds
Strong progress being made on board's and managers' strategic objectives, which should result in improved portfolio returns over long term
As ICGT increasingly differentiates itself, the higher the potential for a sustained discount narrowing relative to peers

BEAR
Private equity valuations lag markets, so it can be hard to determine current underlying value
ICGT's overcommitment strategy and gearing, including that in underlying companies, will magnify valuation movements
No guarantee that the discount will narrow

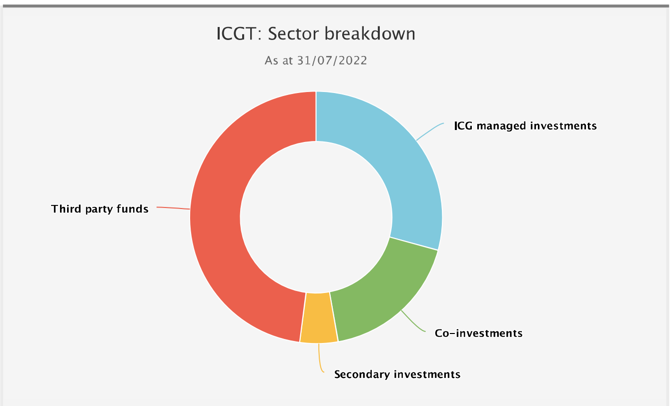
Portfolio

ICG Enterprise (ICGT) is a leading listed private equity investor, focussed on generating consistent and resilient returns across economic cycles. ICGT is well-positioned to generate long-term value, benefitting from the experience and expertise of a dedicated investment team with a clear investment strategy and a flexible mandate, which enables it to source attractive opportunities in primary, secondary and direct investments.

Oliver Gardey, Head of Private Equity Fund Investments and Portfolio Manager for ICGT, has over 25 years' private equity experience, with a specialism in secondaries, which is of particular relevance in the current market. The so-called 'denominator effect', driven by resilient performance of private equity against weakness in public equity markets, means some institutions are being compelled to dispose of mature private equity interests to rebalance their weighting to the asset class. In Oliver's view, this creates compelling opportunities for ICGT. With deep expertise and a network in the private equity fund sector, the dedicated investment team are able to originate and evaluate attractive investments. As a result, ICGT has completed successfully several secondary portfolio acquisitions over the past 12 months, often at an attractive discount, making them immediately accretive to NAV. We discuss the characteristics and different approaches to secondary investment taken by the ICG team in our **previous note**.

Increased allocation to secondaries has also been a contributory factor toward the increase in the discretionary or 'high conviction' investments, which ICGT targets, representing c.60% of the portfolio in the long term. ICGT proactively increases exposure to those companies for which it has a high conviction that there will be outperformance through the cycle, enhancing returns and increasing visibility and control of underlying drivers of performance. ICGT's direct investments and secondary investments sit alongside investments into ICG-managed funds to form the high-conviction portfolio. As at 31 July 2022, 27 out of the top 30 underlying holdings were high-conviction investments. In total, high-conviction investments now represent 52% of the portfolio, as can be inferred from the graph below.

Fig.1: Portfolio Breakdown



Source: ICG

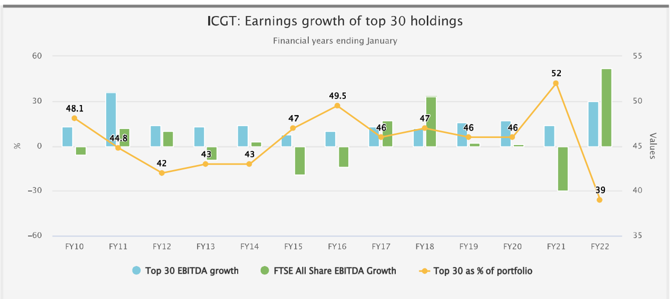
Increasing the exposure of ICGT to high-conviction investments has been one of three key strategic objectives since the move to ICG, which the team and the board believe will result in higher returns going forward: firstly, to be more fully-invested over time, thereby reducing cash drag; secondly, to allocate a higher proportion to discretionary high-conviction investments, which have historically delivered higher returns than fund investments; and, finally, to have a greater proportion of the trust's assets invested in the US, the largest and best-performing PE market, globally.

The team are clearly making good progress in terms of exposure to high-conviction investments. As discussed in the **Gearing section**, the team have also been successful in ICGT being more fully invested and, more recently, notionally geared. Part of the reason this has been achieved, and also why the team are confident on the team's gearing and overcommitment position, is that in ICG's view, secondary investments represent considerably less risk than committing to new funds and acquired portfolios tend to be very cash-generative. Secondary investments are expected to accelerate the cash returns' profile, as the assets are more mature and so distributions are likely to be received more quickly.

As discussed in the **Performance section**, ICG's NAV growth has been steady and consistent over time. This consistency drives powerful compounding growth. As a result, ICGT has generated impressive long-term NAV total returns, outpacing the FTSE All-Share Index by 12.9% per year on a five-year basis and 7.3% per year on a ten-year basis, respectively, to 31/07/2022 (Source: ICG). In our view, a key contributor to this is the managers' preference for defensive growth companies. The managers define these as being profitable, cash-generative businesses that they believe will deliver strong and resilient returns across economic cycles. In practical terms, these will have characteristics, among others, of attractive market positioning, providing mission-critical services to their clients and customers, an ability to pass on price increases and structurally high margins.

To some extent, the success of their selection process is reflected in the chart below, which shows the earnings' growth (EBITDA) of the top 30 holdings in the portfolio over each financial year. This illustrates that the engine for ICGT's NAV growth has been consistently positive since 2010, in stark contrast to the FTSE All-Share Index which has seen considerably more volatility. Given that this is based on the top 30 holdings, there is an element of survivorship bias in these numbers, but we also include the percentage of the portfolio that the top 30 represents at each point. This indicates that the top 30 have, on average, represented 45% of the portfolio, a very meaningful proportion of shareholder exposure. In our view, this supports the managers' notion that the portfolio is made up of companies whose earnings have been considerably more defensive than those of listed indices, but which have also outgrown them. Strength in earnings' growth and margins has continued into the first half of the current year, with the top 30 companies delivering impressive operational performance, reporting 27.5% LTM revenue growth and EBITDA growth of 26.3%, along with some EBITDA margin expansion, as at 31/07/2022. The net leverage of the portfolio companies has remained broadly in line with levels at year end.

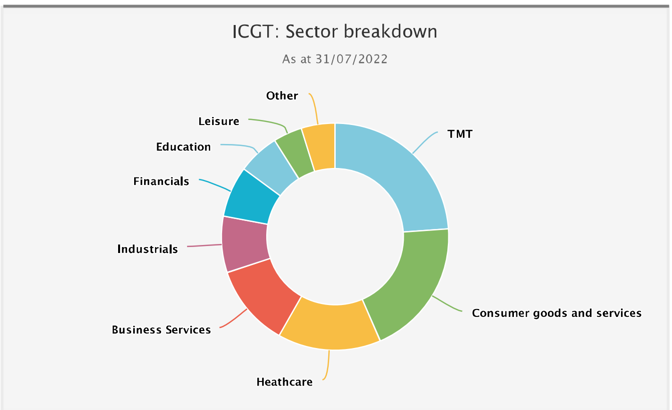
Fig.2: Top 30 Holdings' Earnings' Growth



Source: ICG

Clearly, economic conditions are challenging and we would not expect ICGT's portfolio to be entirely insulated. According to the team, they remain alert to the evolving inflationary pressures and macroeconomic challenges that companies must navigate. The team report that they have a high bar for executing transactions in today's environment and are focussed on assessing risks around GDP-linked revenue, such as discretionary spending and inflation, and identifying differentiated investments that can reduce the risk of unknown variables. It is worth bearing in mind that many of the companies that ICG is invested in occupy niches within these sectors and so represent a very different underlying exposure to much larger companies that represent the bulk of listed equity indices. Of relevance to performance comparisons with the FTSE All-Share Index is ICGT's largely zero exposure to key sectors, such as energy, mining and financials. It is worth noting that whilst ICGT does not actively invest in publicly-quoted companies, IPOs are used as a route to exit an investment. In these cases, exit timing typically lies with the third party manager alongside whom the trust has invested. As at 31 July 2022, ICGT's exposure to quoted companies was valued at £119.1m, equivalent to 8.8% of the portfolio.

Fig.3: Sector Breakdown Of Portfolio



Source: ICG

Complementing the high-conviction portfolio, ICGT has a diversified exposure to top-quartile private equity funds run by experienced teams with proven track records, investing in larger, more mature and more resilient buyouts. The portfolio of fund investments not only increases the diversification of the ICGT's portfolio, but is also a key source of deal flow for ICGT's co-investments. Historically, high-conviction investments have generated significantly higher returns than the fund portfolio but have higher idiosyncratic risk. The team describe their 'secret sauce' as blending the benefits of each and constructing a portfolio to maximise risk-adjusted returns. The managers aim to ensure that the top holdings in the portfolio are significant enough to create meaningful growth when they are successful, yet the trust is diversified enough to have little specific, company risk. More detail is available in the recently-published factsheet **available here**. As a result, ICGT represents a very active exposure to private equity, which has the potential to deliver higher returns than highly-diversified or passive exposures to private equity.

Gearing

The board and managers of ICGT have stated that they do not intend for the trust to be geared other than for short-term working capital purposes. Given the illiquidity of the underlying investments and the difficulty of predicting when investments or realisations will be made, managing cash actively is a critical element of the management of ICGT. When ICG was appointed in 2016, one of the strategic goals was to reduce cash drag by trying to remain more fully invested over time. This has been achieved, with the portfolio as a percentage of net assets increasing over time and, as at 31/07/2022, ICGT was 6.7% net geared. The team have a total c. €240m borrowing facility, which is effectively used as an overdraft to fund commitments and short-term working capital. As at 31/07/2022, £39.1m of debt had been drawn down.

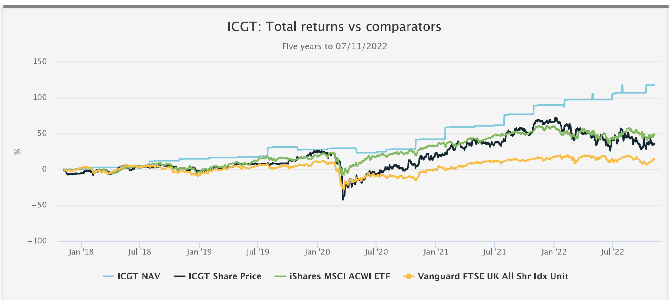
ICGT's managers employ an overcommitment strategy to minimise cash drag. Commitments to funds stand at £528m, as at 31/07/2022, of which c. £95m is to funds that are outside their investment period, meaning an effective commitment of £433m. Cash balances stood at £13m, as at 31/07/2022, meaning that cash and unused borrowing facilities make up 40% of likely commitments. Being 'overcommitted' in this way represents a form of gearing. However, given that ICGT's capital is likely to be drawn over four to five years, cash and the borrowing facility represents approximately two years' worth of funding, without accounting for any cash proceeds from realisations or distributions from the portfolio.

Performance

The first half of 2022 has seen a strong performance from ICGT, building on what was a very robust year in 2021 which saw a NAV total return of 24.4%. This brings the last five years' NAV total returns to 16.9% per annum, representing considerable outperformance of broad equity markets (see below). 2021 saw ICGT deliver its 13th consecutive year of double-digit underlying portfolio growth, i.e. including third party management fees, but not including the effects of cash drag or FX changes.

Total returns for ICGT's NAV and share price over the past five years are shown in the graph below. We note that despite considerable share price volatility during the early stages of the pandemic and this year (see **Discount section**), ICGT's shares have outperformed UK and Global equity markets, on both NAV and share price bases, over the same period.

Fig.4: Total Returns

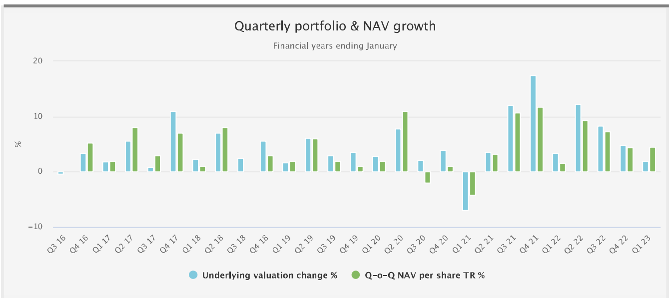


Source: Morningstar
Past performance is not a reliable indicator of future results.

We believe that underpinning the strong and consistent long-term track record is the earnings' growth of the underlying companies in the portfolio, in our view the 'engine' which drives ICGT's portfolio growth. As discussed in the **Portfolio section**, ICGT's top 30 holdings have delivered strong earnings over time. Fundamentally, private equity managers control each company, set the strategy and, at times, roll up their sleeves to effect change to generate long-term growth, largely through achieving earnings' growth. We believe that private equity investing is a repeatable process in which active management can drive value creation, irrespective of short-term equity market movements and the impact this can have, potentially, on valuations. Given private equity's active approach to managing companies, in our view there is good reason to be optimistic that the portfolio can continue to deliver earnings' growth – at the very least ahead of listed markets - into the future.

Certainly, short-term headwinds to positive NAV growth in the immediate term could be valuations, but also the earnings' risks presented by inflation and rising interest rates, not to mention a potential global recession. The table below shows that in portfolio valuation and NAV terms, the trust has achieved positive absolute returns on a quarterly basis nearly every quarter since 2016. We note that the portfolio return doesn't necessarily translate into the same NAV growth, thanks to the effect of cash drag, ICG's management fees, currencies, etc. In our view, part of the reason for this consistency and resilience in the face of what has been a relatively eventful period, including Brexit, Covid, etc., has been because ICGT's managers, both direct and indirect, tend to favour companies and sectors with relatively resilient business models. This should put them in a good position for the current economic uncertainties we face.

Fig.5: Quarterly Growth



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

Aside from consistency, since the move to ICG, the team have been focussing on three key objectives which they and the board believe will result in higher returns going forward: that is to be more fully invested, i.e. reducing cash drag; to have more high-conviction investments, that have, historically, delivered higher returns than fund investments; and a greater proportion of the portfolio to be invested in the US, the largest and best performing PE market, globally. As the table below shows, the long-term track record is very strong, but by bringing more high-conviction investments into the portfolio, the board expects that returns will improve yet further. Evidence for this expectation can be found in the recently-published interim results, which highlighted that, over the six months to 31/07/2022, high-conviction investments generated a 9.2% total return on a local currency basis, with secondaries and co-investments being particular drivers of returns, which compares to the 5.7% portfolio return on a local currency basis for fund investments over the same period. If this trend continues, the ability of ICGT to outperform in the future has improved. As such, the wide discount seems unjustified and could be seen as an opportunity for long-term investors.

Total Returns (%)

	6 MONTHS	1 YEAR	3 YEARS	5 YEARS	10 YEARS
NAV per share total return	10.9	24.2	18.6	16.9	14.5
Share price total return	-1.6	10.0	12.8	12.2	14.4
FTSE All-Share Index Total Return	-0.1	5.5	3.2	4.0	7.2

Source: ICG

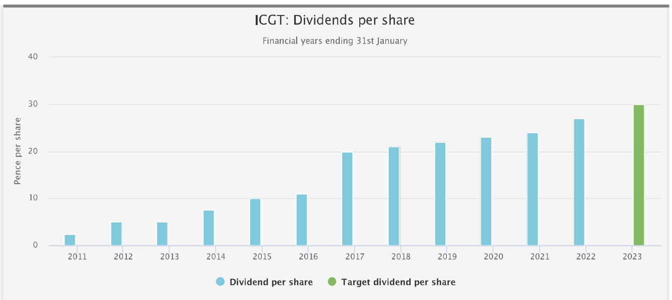
Past performance is not a reliable indicator of future results

Dividend

ICGT's primary aim is to deliver long-term capital growth through investment in unquoted companies. However, ICGT also pays a dividend, effectively funded from capital. As highlighted by the graph below, over the last six years, shareholders have seen a substantial increase in the level of dividends being paid. In 2017, ICGT's board stated an explicit target of paying a dividend of at least 20p per share per annum, in addition to increasing it progressively. For the last financial year, ending 31/01/2022, the board paid a full-year dividend of 27p per share, representing a 12.5% year-on-year increase. Based on the target dividend for the current year of 30p, at the 1020p share price on 08/11/2022, this is equivalent to a c. 2.9% yield.

In addition, as discussed in the **Discount section**, the board's announcement of a long-term buyback programme at the time of the interim results can be seen as another form of return of capital. Share buybacks can be completed at any discount to NAV, meaning that any share buyback will be accretive to NAV per share, further enhancing shareholder returns.

Fig.6: Dividends



Source: ICG Enterprise

Past performance is not a reliable indicator of future results.

Management

ICGT's lead managers are Oliver Gardey and Colm Walsh. Oliver joined the team in Autumn 2019 and has more than 25 years of experience within the private equity industry. During the last decade, Oliver has been a partner at Pomona Capital, where he was part of the global investment committee. Previously, Oliver was a partner and investment committee member at Adams Street and Rothschild/Five Arrows Capital.

Colm Walsh joined the team in 2010 and is a member of the investment committee (IC). Colm has more than 15 years of experience within private equity. Crucially, ICGT's investment team have sight of Intermediate Capital Group's significant deal flow of potential fund investments in addition to secondary and co-investment opportunities, which is of significant benefit to the trust and part of their original rationale to move to Intermediate Capital Group in 2016.

Discount

ICGT has traded on a consistently wide discount to NAV over the years, as has much of the listed private equity (LPE) sector. That said, other than at times of market stress, LPE discounts has rarely been wider, as shown in the graph below in which we compare ICGT to the averages for the Fund of Fund and directly-investing peer groups, as well as +/- one standard deviation of ICGT's long-term average, since May 2008. The current discount to NAV of 45% is 1.8 standard deviations from the long-term average of 26%. Of course, it is possible that one reason for the current wide discount is that investors expect the NAV to fall over the short term. However, a NAV fall of 30%, with no change in the share price, would put the shares back on their long-term average discount of c. 25%.

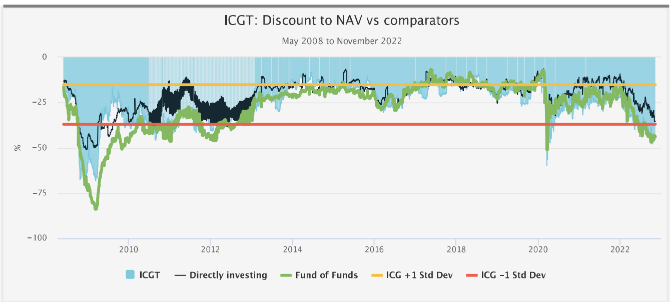
Given the illiquidity of the underlying investments and the peer group's discounts, in our view there is unlikely to be an immediate catalyst that will help the discount to narrow. As such, we believe it is crucial that investors consider the anticipated long-term growth in the NAV of a trust, as opposed to investing on the basis that the discount will narrow. That said, at a discount of 45%, the long-term average suggests that the discount may be narrower in the future, rather than wider.

Supporting this thesis, ICGT's board announced a buyback programme in the recently-announced interim results, representing an extension of the historic policy of returning capital to shareholders by repurchasing shares opportunistically. In our view, the introduction of this latest buyback programme should give investors confidence, given the board always evaluates carefully the balance sheet strength, the opportunities to deploy capital into new investments and the potential for accretive buybacks. Since the announcement of the buyback program in October, ICGT has bought back 60,000 shares at an average price of 1,008.77 pence per share.

As illustrated in the **Portfolio section**, ICGT's portfolio has demonstrated resilient earnings' growth over time, so we have some confidence that earnings' growth will not be especially challenged in the short term. On the other hand, valuations across the portfolio have been moving up over time, with the average of the top 30 holdings having increased from c.11x EV/EBITDA in 2017 to the current level of 14.5x, as at 31/07/2022. Some of this is a result of multiples expanding generally, but part of it is also a function of the change in portfolio mix. We note that TMT has been increasing over time, now constituting c. 24% of the portfolio, but these companies typically constitute mature businesses that provide mission critical services, and with high customer retention. Whilst we do not believe that ICGT's portfolio will be immune from valuations in public markets falling, the discount, now at a level 20% wider than the historic average of 26%, suggests that the market expects earnings to stay the same and for valuations to retrench from c. 14.4x to 10x.

Over the long term, relative to the peer group we believe ICGT's differentiated and actively-managed exposure to private equity, as well as the managers' expertise in sourcing primary, secondary and co-investment opportunities, could justify a premium rating relative to peers. As such, ICGT's current discount level could be viewed as an attractive entry point for investors on absolute and relative bases. Nonetheless, over the short term, we caution that the discount has been wider at recent points and the same could happen again, although the buyback programme could provide support.

Fig.7: Discount History



Source: Morningstar

Charges

As manager, ICG is paid a 1.4% per annum management fee from ICGT and 0.5% of uncalled commitments. It should be noted that ICGT only charges this fee on qualifying assets, i.e. investments managed outside the funds managed by Graphite and ICG directly. As such, given the current portfolio, the effective management fee is c.1.3% of the net assets of the trust. ICGT's ongoing charges ratio was 1.4% for the last financial year, ending Jan 2022.

ICGT's managers have an incentive scheme that requires a co-investment of 0.5% of investments made. Afterwards, they are entitled to 10% of any NAV returns above an 8% hurdle, excluding ICG and Graphite funds. This differs from conventional LTIP schemes, which are common across publicly-listed companies. The co-investment scheme requires that the team invest their post-tax earnings in each deal and leads to a long-term alignment of interests with shareholders by ensuring that the managers invest in every underlying investment along with ICGT. However, this arrangement excludes post-2016 ICG and Graphite funds.

ICGT's most recently-published KID RIY cost is 6.94%, which included 4.12% of performance fees across the underlying funds and at the trust level. These performance fees are non-recurring and are fully dependent on strong performance, net of all costs and incentives. Whilst the absolute fees appear high, in our view, they reflect the active management approach within a complex asset class. In addition, we caution that calculation methodologies vary significantly across listed private equity trusts, with not all disclosing their cost breakdowns fully and consistently.

ESG

Responsible investing remains a key focus for ICG's investment team, with ESG considerations embedded across the business. The investment team work closely with ICG's ESG team to ensure that the investment programme is compatible with the wider business's ESG framework. ICGT's board has stated that it believes that the long-term success of the trust requires the effective management of both financial and non-financial measures and fully endorses the increasing emphasis on responsible investment. It believes that companies that are successful in managing ESG risks, while embracing opportunities, will outperform over the long term.

In some ways, private equity managers are in a stronger position to be responsible investors than listed company-investors, given the control that they have over strategy and other matters. At the same time, private equity managers and the management of the companies they back are heavily incentivised through financial performance, which could at times create a potential conflict. ICG seeks to manage and mitigate these conflicts through active and detailed due diligence on all high-conviction and third-party fund commitments.

ICG, as a business, has been a signatory to the UN's Principles for Responsible Investment (PRI) since 2013 and we understand that almost all of the underlying managers, through which ICGT accesses its investments, are either signatories to PRI or have an ESG-policy framework.

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