Market reaction is overdone

TOM TREANOR

Head of Research at AVI

Tom Treanor, AVI's Head of Research, considers **the opportunities in the Private Equity/Venture Capital (PE/VC) sector**, where valuations are cheap and discounts to Net Asset Value (NAV) are extraordinarily wide. Higher rates and tighter credit markets may have seen a slowdown in the sector, but Tom explains why that hasn't had a direct impact on AVI's portfolio, 21.4%* of which is made up of PE/VC names.

Q Why is AVI looking at PE/VC now?

A Valuations – that's the key driver for us. We've been active in the sector for 15 years and it's responsible for some of the best returns across our portfolio, but our exposure has waxed and waned in line with opportunities. In the wake of the Global Financial Crisis (GFC), a lot of companies got themselves in trouble in the PE sector and were trading on extraordinarily cheap valuations and a very wide discount to NAV. That's when we were most active: we tend to be contrarian investors, so buying things when they're cheap and a little bit out of favour. Our exposure came down over the following five years and then ramped back up as discounts to NAV have widened, and the opportunity set has broadened for us.

* Based on net assets.

Q Why is PE/VC specifically attractive to investment trusts versus open-ended funds?

A It comes down to a huge liquidity mismatch. If you manage an open-ended fund investing in AstraZeneca or Glaxo etc., and your investors want their money back, all you have to do is sell your shares and hand their money back. But not all assets are quite so liquid, such as open-ended property-focused funds. Every time there's some sort of crisis – be it the GFC, the Eurozone crisis or Covid, for example – these property funds put up their gates and prevent investors from redeeming their shares. That's because investors all run for the exit at the same time and the underlying assets aren't liquid enough to allow the managers to raise cash quickly and fund those redemption requests.

A privately owned company is also a very illiquid asset. That means the closed-ended structure (such as an investment trust) is the only structure that could possibly work for privately held companies because investors don't redeem their shares. If an investor wants to sell out of a closed-ended fund, they sell out their shares in a stock exchange to another investor and no money goes in or out of the fund.

Q How does the current economic environment affect your PE/VC exposure at AVI?

A We invest in PE and VC through publicly quoted investment companies, so we don't have any direct private asset exposure at all. There are about a dozen listed PE companies on the London market and those range from uberdiversified fund-of-funds to concentrated single-manager funds. Diversified fund-of-funds are good proxies for the broader PE market because there aren't any idiosyncratic factors present driving their share price or discount.

Going into mid to late 2021, those funds were trading at between 15% to 20% discount to Net Asset Value (NAV). If you look at them today, they're trading anywhere between 15% to 40% discount to NAV. That change could be the market saying valuations are stale and they're going to have to come down to meet share prices, which means it isn't a real discount. But we happily take the other side of that argument and think private valuations do lag public markets, but that they lag on the way up, too.

> The main difference between PE/VC is the maturity of the companies in which they invest.
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> **Tom Treanor**
> Head of Research, AVI

Q How does the current economic environment affect your PE/VC exposure at AVI? continued

A Private NAVs didn't creep up the same way public markets did but there was an essence of in-built equity valuation buffer. The real damage we saw in public markets was in the unprofitable tech sector, to which PE isn't particularly exposed. Companies that have high free cash flow and are in defensive sectors have held up much better than public markets, and those tend to be overrepresented in PE portfolios. As we only invest in quoted investment companies, the financing market drying up hasn't really had much of a direct impact on our portfolio companies because their portfolios were all fully formed by late 2021.

But we have seen a dramatic slowdown in both the pace of these companies' new investments and in the pace of their exits. That means we need to scrutinise the balance sheets of our investee companies, making sure they can withstand periods where exits dry up, making sure they have enough cash on the balance sheet to cope with that sort of environment, and making sure they have prudent banking facilities in place. In an environment like this, the metrics we use to analyse companies change, so as the backdrop worsens, we're focusing on the balance sheet much more than we were previously. The sell-off in public markets and fears around PE and VC has meant listed companies across the board have become very cheap. So, starting in early 2022, we ramped up our PE and VC exposure; some of the discounts to NAV are at extraordinarily wide levels. Overall, while there are genuine concerns out there and there are reasons to be fearful, we think the market reaction has been overdone.

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