MARTEN & CO

Initiation | Investment Trusts

10 May 2016

Standard Life European Private Equity

Sitting in a sweet spot

In recent years Standard Life European Private Equity Trust is one of the best performing private equity funds of funds listed in London. SL Capital, managers of the fund, believe it its discount of 26.9% is too wide for the quality of its NAV and that, as a European (mid-market) specialist, it sits in a relative sweet spot within the global private equity market. If the managers are right, there is scope for its share price to benefit from both continued NAV outperformance and an improvement in its rating.

European private equity fund of funds

Objective: Standard Life European Private Equity Trust (SEP) aims to achieve long-term capital gains through holding a diversified portfolio of private equity funds investing predominantly in Europe.

SEP occupies a unique position within the UK listed private equity sector as the only fund of funds focused solely on Europe. Its portfolio is also more concentrated than most funds in its peer group with around half the portfolio accounted for by the top ten holdings of leading private equity funds.

Like many private equity funds, SEP has no formal benchmark. The normal size of the underlying companies is between €100m and €2bn and therefore its portfolio is most closely correlated to European small cap. indices; we have used the MSCI Europe Small Cap. Index in this report.

Year Ended	Share Price TR (%)	NAV TR (%)	MSCI Europe Sm Cap. TR (%)	MSCI Europe TR. (%)	LPX Europe TR (%)
31/03/12	(5.5)	6.0	(9.5)	(6.6)	(14.4)
31/03/13	28.4	4.6	21.1	17.1	25.3
31/03/14	12.9	6.8	28.4	14.0	17.3
31/03/15	11.4	7.8	3.9	7.3	7.9
31/03/16	(5.8)	16.5	8.5	(4.9)	7.8

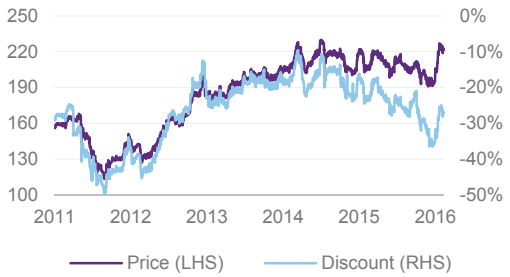
Source: Morningstar, Marten & Co

Sector	Private equity
Ticker	SEP LN
Base currency	GBP
Price	222.50
NAV	304.42*
Premium/(discount)	(26.9%)
Yield	2.4%

* Morningstar estimate, last published 304.9p at 31 March 16

Share price and discount

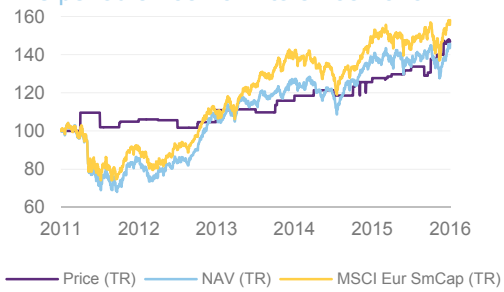
Time period 31/03/2011 to 09/05/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 31/03/2011 to 31/03/2016



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	May 2001
Manager	SL Capital Ptnrs.
Market cap (GBP)	344.4m
Shares outstanding	154.8m
Daily vol (1 yr avg)	126k shares
Net gearing	Nil

Contents

Contents - continued

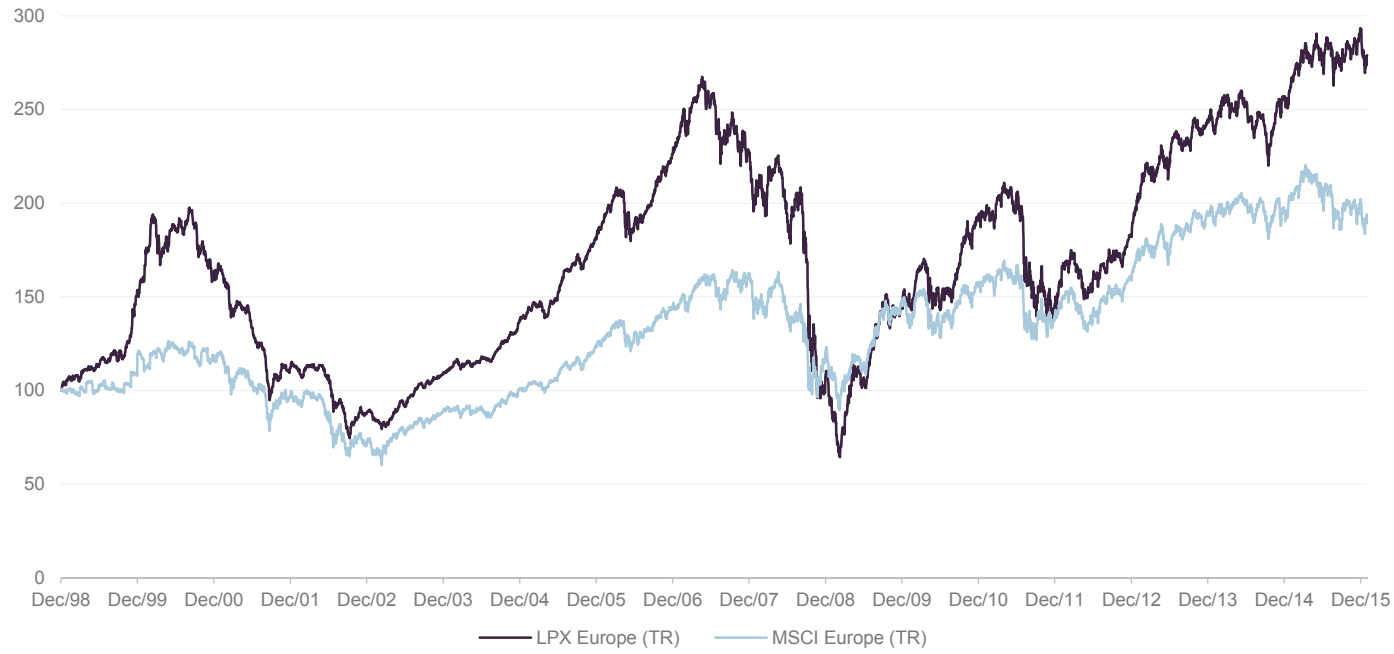
Why is European private equity attractive?

Over the long term, private equity outperforms listed stocks

The managers believe investing in private equity brings some tangible advantages over investing in listed equities and that, over the longer term, private equity should offer superior returns than traditional listed equity markets. The ability to take a long-term view is one of component of this. Unlisted companies can take hard strategic and M&A decisions and make investments for the future without worrying about the impact on short-term profitability – listed companies might be more wary of doing this. Predominantly, private equity managers are growth investors; they want to be invested in companies capable of growing earnings faster than the market and tend to favour those niche sectors that are offering above-average growth. In addition private equity managers seek to add value through operational improvements that aim to accelerate the growth of the businesses that they invest in.

Over a 16 year time horizon (as long as we could go back on this comparison as December 1998 marked the start of MSCI Europe Index), European private equity has outperformed listed stocks (see Figure 1). Leverage has had a part to play in this. The manager believes that private equity managers are better at operating companies under leverage and point to the default rates in private equity companies being similar to the overall defaults rate for corporates, despite higher leverage multiples.

Figure 1: Long-term performance of listed private equity (LPX Europe) vs. wider market (MSCI Europe)



Source: Morningstar, Marten & Co.

Another factor at play in Figure 1 is the shift in discounts across the sector. These reached excessive levels at the nadir early in 2009 and narrowed afterwards as investors' worst fears on NAV values were not realised. Discounts are widening again now and the discount section (see page 19) shows how average discounts have been moving for SEP and its immediate peer group.

There is a macro argument to support favouring European private equity as well. As the manager outlines on page 9, Europe is much earlier on in its economic recovery

than the US, is supported by accommodative monetary policies and, relative to sterling, is benefiting from a strengthening currency. The manager emphasises that SEP's performance has been held back by the weakening Euro in recent years and welcomes this current reversal of fortune.

Private equity discounts are still too wide

As illustrated in Figure 17 on page 17, which provides a comparison of SEP vs its private equity fund of funds peer group, SEP trades at a significant discount. This is despite it having one of the lowest ongoing charges ratio, offering a moderate yield and having provided attractive absolute NAV total returns that compare favourably against its peers (SEP's NAV total return performance ranks second, fourth and fifth over one, three and five years respectively).

SEP's managers believe and we agree, that the sector is trading on too wide a discount. In their view, investors currently lack confidence in the NAVs of private equity funds given market volatility. However, in the case of SEP, they believe that investors can have greater confidence in the stability of its NAV for the following reasons:

- The underlying managers that SL Capital selects tend to value their portfolios conservatively, in their view. For example, for the year ended 30 September 2015, there was an average uplift of 14% of NAV, from the last valuation, achieved when SEP's underlying funds have made disposals.
- Historically, SEP's NAV has been more correlated with European small caps and so has been inherently less volatile than the broader market and large caps. This is contrast to SEP's share price which, in volatile periods, has been more correlated with large caps and therefore more volatile than the NAV.
- SEP's managers advise that the secondary market is pricing private equity funds at sub 10% discounts, which is significantly below SEP's own discount (we discuss this in further detail on page 11). The managers believe that, partly as a result of a quality bias in SEPs portfolio, this mismatch is unsustainable. For example, the trust sold their holding in an Apax fund, to another institution, at a premium to NAV.
- Private equity funds represent a distinctly different investment to the broader listed equity market. As a reflection of this, SEP is not significantly exposed to the "problem sectors" of oil & gas, mining and chemicals.
- The current buoyant market for disposals is benefiting SEP, given its mature portfolio (around 50% of the fund is in investments more than five years old). The managers expect that SEP will continue to see cash being returned as a result of realisations (since the year end the trust has received £80m from exits) and, reflecting the above, they expect realisations to continue to be at a premium to the underlying funds NAVs.

Fund profile – European private equity

A more focused underlying portfolio than most funds of funds with c330 underlying companies

SEP is a pure fund of private equity limited partnerships ("LPs" or "funds") that are focused on (western) Europe. It acquires its investments through both primary and secondary transactions but, unlike some of its peers, does not make direct co-investments (see below). SEP operates in this way as its managers believe that the fund of fund approach is optimal to achieve adequate diversification. The manager believes it is important not to be over diversified either and dilute returns

unnecessarily. Therefore SEP operates with a fairly tight number of funds compared to peers (between 35 to 40 active positions), which equates to about 330 underlying companies. The funds that SEP invests in are focused on making equity investments; there is no allocation to funds focused on mezzanine debt, for example.

Focused purely on primary and secondary transactions

Mix of primary commitments and secondary purchases

SEP has adopted a two-pronged approach that involves both making primary commitments to new funds managed by firms and teams that the manager rates highly and purchasing private equity funds in the secondary market at attractive values. It does not make direct co-investments. This is not because its managers lack the necessary skills (this an activity that SL Capital engages in for other mandates) but it is not considered to be appropriate for SEP. The managers say that, given the size of a typical co-investment opportunity, including this strategy within SEP has the potential to increase volatility and losses.

History

Further information can be found on SEP's website: www.slcapital.com/slepet/index.html

SEP was listed in May 2001. The trust's portfolio was seeded with a portfolio of 19 private equity funds from Standard Life's balance sheet and Standard Life remains a significant supportive shareholder in the company. The manager is SL Capital Partners (SL Capital) which is part of the Standard Life group.

Investment process

Oversight from Board

The Board has oversight of strategy, gives guidance to the manager and challenges investment strategy annually. Day-to-day management of the fund is delegated to SL Capital.

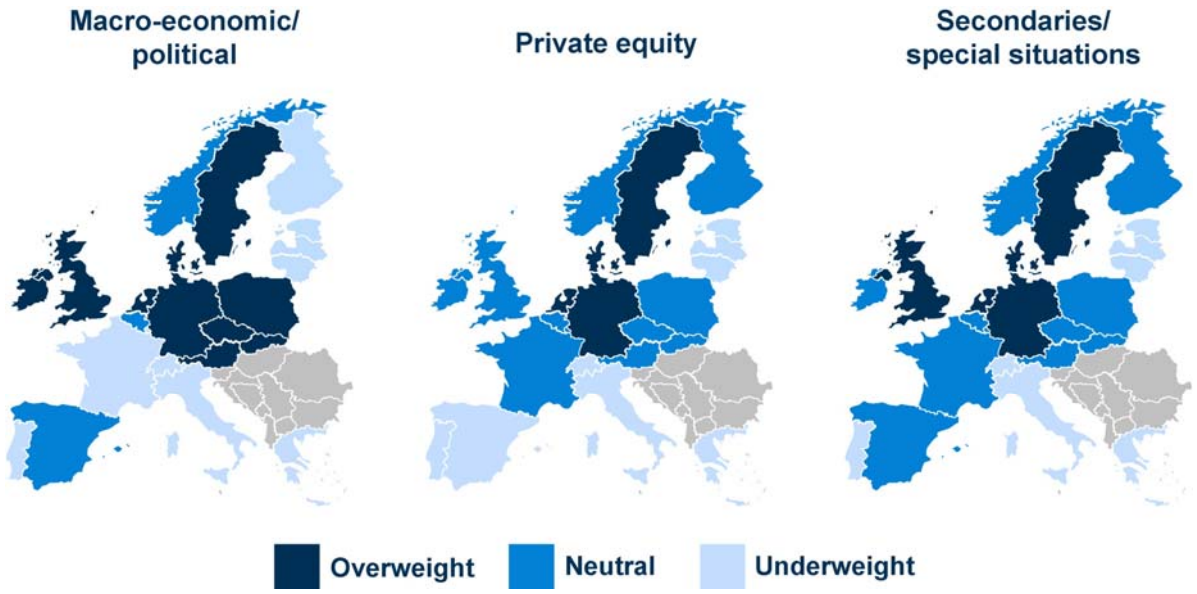
SL Capital has a staff of 57 (including 28 investment professionals) working in offices in Edinburgh, London, Munich and Boston. They have raised over €10bn for private equity deals and are one of the most influential investors in private equity funds in Europe having been established in the 1980s. The team of investment professionals source opportunities along geographic responsibilities. They spend a considerable amount of time visiting managers in their home markets and often meet underlying portfolio companies as well. They typically deploy teams of four on both primary and secondary transactions.

A mix of top down and bottom up

Portfolio construction committee taking top down view

The top down overlay comprises the quarterly Portfolio Construction Committee (PCC) that considers the European macro environment. Its views inform asset allocation decisions. In practice, asset allocation evolves slowly. The PCC directs both geographic focus and the emphasis on the mix of primary versus secondary investments. The committee generates views on each country within the remit creating a "heat map" of Europe that shows where they think the best opportunities are in the primary and secondary market regionally. An illustration is provided in Figure 2 overleaf.

Figure 2: SL Capital European investment opportunity heat map (as at 31 December 2015)



Source: SL Capital

SEP's European remit includes the UK. The manager estimates there are about 1,500 funds in their European universe and they reckon about 800 of these are "institutional grade" and would fit their strategy. Through both their origination efforts and their regional experts, SL Capital aim to track and maintain a deep understanding of all of these funds. Private equity funds in Europe raise capital, on average, every three to five years, so they consider about 150 funds a year. In practice the filter is tight and few managers make it through to the final buy list.

They identify their favourite funds in each market (between five and ten) and typically the best two of these will form a forward buy list. They have a predisposition towards funds specialising in Northern Europe, the most developed private equity markets.

Each week, after desk-top due diligence and manager visits, they will review a list of about 20 funds, which are discussed at a committee meeting. If a fund is deemed worthy of more detailed due diligence, the team will spend three to six months in due diligence for a potential primary fund investment, and anything from two weeks to a couple of months, for a potential secondary fund investment.

Searching for "operational alpha"

The most important differentiator they are looking for is "operational alpha" from a fund – the added value generated by the LP managers in their underlying portfolio companies. They partner with firms that get stuck into improving the businesses they invest in rather than simply being passive financial investors. Most of their favoured managers have considerable in-house industrial expertise that they can make available to portfolio companies. SL Capital cited the example of Advent International which has over 170 investment professionals complemented by a team of around 70 Operating Partners, industrial experts who they embed within the companies they invest in to drive top-line growth and profitability.

Beyond that, SEP's managers are looking at factors, such as, does a fund have a unique strategy or unique resources for originating deals as well as the strength and depth of their investment team. Managers that focus on sectors where they have proven expertise are preferred and any sign of drift in strategy will trigger a review of the investment. SEP's managers do not like concentration risk within a fund portfolio.

Looking for motivated and stable underlying managers

SL Capital want to invest in funds run by motivated, stable teams so they look at issues such as team growth, development and succession planning. This means that SEP's managers will typically avoid firms, with an *investment bank* model, where there is usually a higher turnover of personnel. As such, SL Capital always include "key man" clauses, in their agreements with LPs, so that they can press "pause" on the investments in the event that key team members leave.

SL Capital looks at a broad range of fund managers and fund sizes but is focused on funds investing in companies with enterprise values between €100m and €2bn.

Looking at past performance, a fund with a high ratio of loss-making investments is not a good sign. SL Capital comment that it is unrealistic to expect zero losses – like all investment strategies, private equity investing is a trade-off between risk and reward. In fact they prefer managers who have learned from their mistakes.

Fees on the underlying funds

Focus on potential returns net of fees

SL Capital spend significant time analysing fund structures and ensuring they are acceptable. Part of this includes establishing that the fees they are being asked to pay are in-line with European market norms, incentivise the underlying managers appropriately and that the LP managers' interests are aligned with investors'. However, when they are weighing up one potential investment against another, they will opt for the one that offers the best risk-adjusted net return (after fees). This might not necessarily be the one with the lowest headline fees.

Managing commitment levels

Policy of carefully managed over commitments to minimise cash drag

One issue that dogged some funds of funds in the credit crisis was a problem of over commitments – a surfeit of obligations to stump up for new investments and a lack of cash distributions coming off the portfolio, exacerbated by a sharp reduction in available credit. However, being over cautious in this regard can hamper a portfolio leading to a considerable cash drag on returns. SL Capital manage SEP's portfolio with the aim of ensuring it has a spread of maturities. They use a detailed cash flow model to forecast the timing of potential drawdowns and distributions. This has been made a little more predictable now that many LPs are using acquisition facilities to fund investments over the short-term, drawing down and distributing cash at more regular intervals – usually quarter ends.

We talk about the fund's borrowing facilities on page 20. In practice they will rarely dip into this. The managers do not hedge currency in the portfolio. They consider that the cost of doing this would likely outweigh any potential benefit. Uninvested cash is held in euros, sterling or US dollars, in line with the trust's underlying exposure, with excess cash invested in ETFs tracking UK and European large cap. indices. The ETFs are the first source of cash used to finance drawdowns and secondary transactions.

Portfolio construction

Targeting 1.8x cost and 15% IRR on primary transactions and 1.4x cost and 20% IRR on secondaries (but in practice have often done better than this)

All of this activity boils down to four or five new primary fund commitments of €30m to €50m each year. Their target net return on these investments is 1.8x cost over the life of the investment and a 15% IRR.

The second element of the investment focus is secondary transactions, an area that SL Capital have been placing increasing emphasis on in recent years as they seek to minimise cash drag. This is particularly pertinent at present as SEP has been benefitting from a high level of distributions. As discussed on page 10, this is because LPs have been focused more towards realising investments and are aggressively distributing capital as they exit companies. Funds are purchased in the secondary market, at discounts, generating an instant uplift to SEP's NAV as these are revalued at full asset value. The manager's target return for secondary investments is 1.4x cost and a 20% IRR. The blended return on the primary and secondary investments is intended to target NAV growth of 15% per annum.

The managers monitor the portfolio closely. Members of SL Capital' team sit on advisory boards of funds (not interfering in day-today decision making but providing strategic oversight and other ad-hoc advice) and they have quarterly meetings with the underlying managers.

SEP's managers get a high level of transparency on the underlying portfolio. They cannot share all of this information with shareholders unfortunately but aggregate useful information such as earnings growth and debt levels within the portfolio and publish this.

SL Capital usually hold funds to maturity but will occasionally sell funds in the secondary market if they believe the returns on these funds will not meet their minimum target future returns.

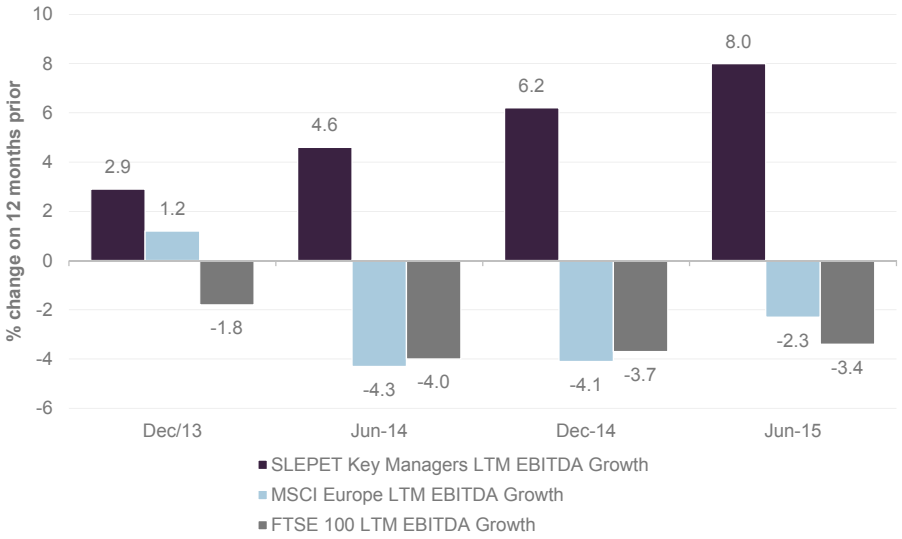
Managers' view

SEP's managers estimate that Europe potentially offers the opportunity for superior growth, over the US, in the next few years. Europe is benefiting from QE and is earlier in its recovery cycle than the US. The Euro had been weak, which has been a headwind to SEP's performance, but this trend is reversing as investors become more nervous about the prospects of Britain voting to leave the EU. The manager believes that global private equity money is shifting its focus towards Europe.

The managers think that a key attribute of the trust is the visibility it gives to the profit growth within its underlying portfolio. In our view, this is particularly reassuring for investors given that private equity, by definition, is less visible than that in public markets and can appear to be opaque.

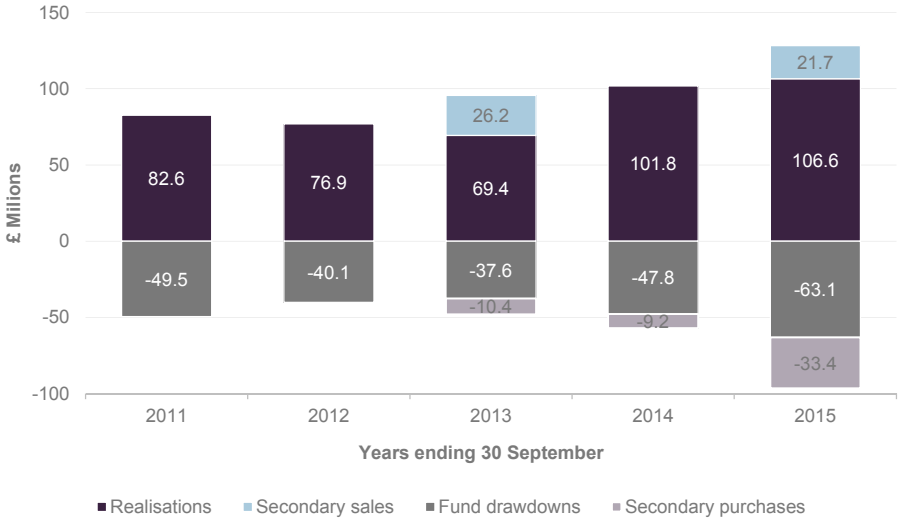
SL Capital regularly analyse the underlying holdings of the 12 largest fund positions. As illustrated in Figure 3, the underlying portfolio saw 8% EBITDA growth last year, which contrasts with the average 2.3% reduction in the earnings of the constituents of the MSCI Europe Index and a fall of 3.4% for FTSE All-Share constituents.

Figure 3: EBITDA Growth comparison



Source: SL Capital

Figure 4: Portfolio cash flows over the last five years



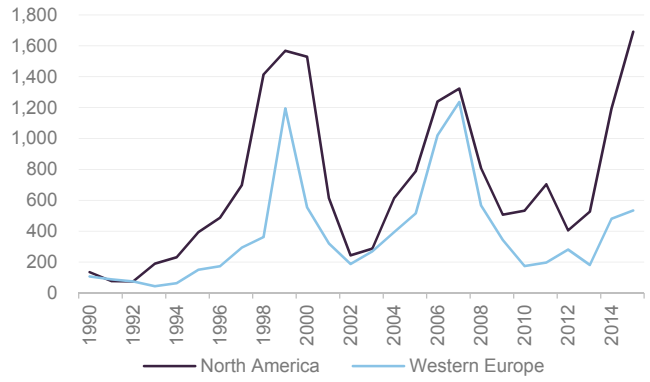
Source: SL Capital

As Figure 4 illustrates, SEP's underlying managers have been and continue to focus more towards realising investments, versus making new investments, and are aggressively distributing capital as they exit companies. There has been a high level of realisations from the portfolio over the past three years (and the managers say this continued after September 2015 with significant realisations in December 2015 in particular). Whilst an increase in market volatility could serve to depress the current pace of realisations, this does not appear to have been an issue so far during 2016. Despite notable listed market difficulties in January, the first quarter of 2016 saw SEP receive £36.3m of distributions whilst drawdowns saw investments of £17.5m made.

M&A activity has been high. Private equity funds have been selling businesses but have more recently found it harder to find high quality acquisition targets at sensible valuations. However, the manager believes that we might be approaching an inflexion point. In recent times, trade buyers have been competing with private equity houses

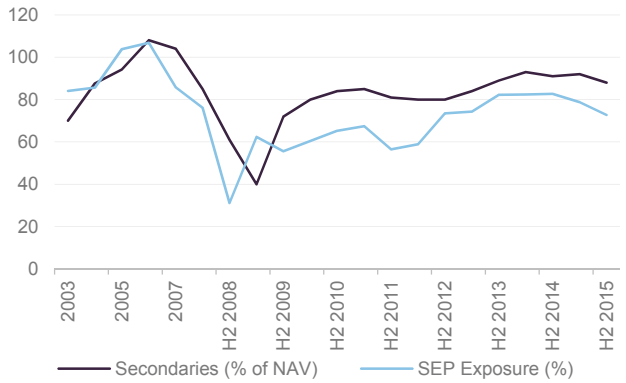
for deals and they have often been the buyers of assets sold by private equity firms. The manager feels that funding for these corporate acquirers may not be so readily available going forward and this should make it easier for private equity funds to step up the pace of investments.

Figure 5: M&A deal value ($bn)



Source: SL Capital (from Datastream)

Figure 6: Secondary market pricing



Source: SL Capital (from Cogent)

Looking at Figure 6, secondary market pricing has been on a rising trend for a while and so SL Capital believe there is a need to be selective. The managers comment that, to a certain extent they have paused on secondary purchases, post the year end. They do not think that prices properly reflect current market uncertainty and are waiting for the markets to adjust. However they believe it is possible to pay up for a secondary fund investment, and achieve strong performance, provided you can identify attractive deals. A good example of this is a purchase they made of 3i Eurofund V (a 2013 vintage fund). The managers paid a 2.5% discount to historic valuation and, to 30 September 2015, this achieved a 1.8x multiple of cost and a 47% IRR, which the managers say was much better than the investment case.

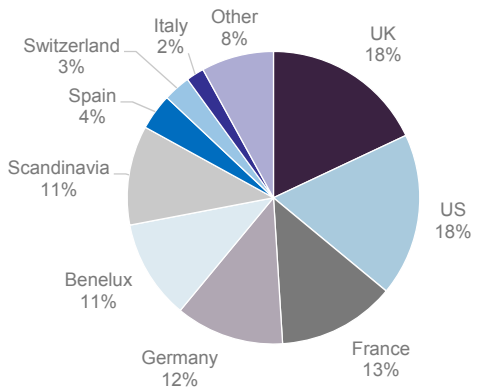
Note SEP's own discount is much wider than the prevailing discount on secondary transactions and was moving in the opposite direction. The manager thinks, and we agree, that this is counter intuitive. Specialist investors in secondary private equity investments ought to have a much better idea of the true value of these positions than the market in general.

Asset allocation

Figures 7 to 10 show the split of the portfolio by geography, industrial sector, maturity and manager as at 30 September 2015.

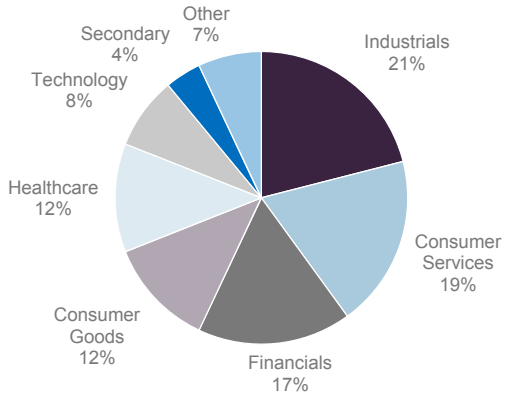
SL Capital are deliberately underweight the UK private equity market as they note that this market is the most competitive in Europe. Nevertheless the UK remains the largest exposure within the portfolio, reflecting the significance of this market within European private equity. SEP has some US exposure but this is just a by-product of deals done by their European based managers – CVC, Cinven, and Advent all have offices in the US and Towerbrook is a transatlantic firm. SEP's managers have been adding to their exposure to France, believing that there are many good companies that can prosper despite France's well-rehearsed economic problems. Additionally, they are focused on increasing allocations to Germany, Benelux and the Nordic markets.

Figure 7: Geographic split at 30 September 2015



Source: SL Capital

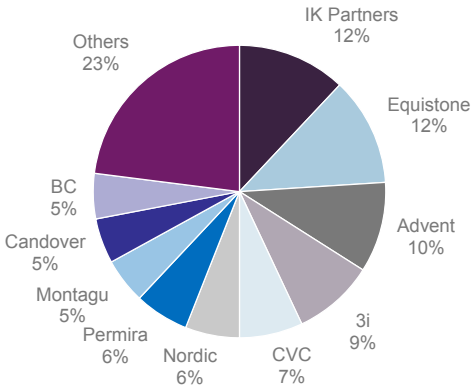
Figure 8: Sector split at 30 September 2015



Source: SL Capital

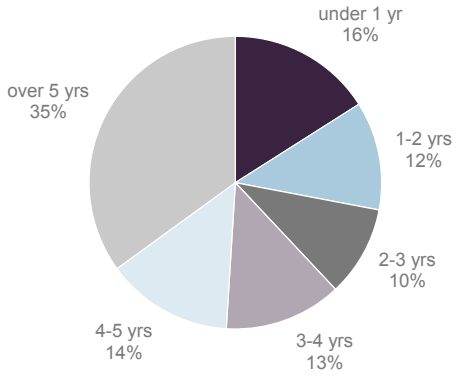
There are 46 funds in the portfolio with a focus on the best in class, "blue chip" buyout managers in Europe. Figure 8 provides an illustration of the sector split within the portfolio. It illustrates that private equity represents is distinctly different investment opportunity when compared to listed markets. Private equity tends not to be focused on capital intensive sectors. This naturally leads SEP to have limited exposures to oil & gas, mining and the chemicals sector, and so they have managed to avoid much of the current malaise. However, the quid pro quo is that private equity would likely to have limited participation in any cyclical bounce, should this occur.

Figure 9: Split by manager at 30 September 2015



Source: SL Capital

Figure 10: Maturity profile at 30 September 2015



Source: SL Capital

IK Investment Partners (Industri Kapital) are a Northern European focused private equity advisory group with investment offices in the UK, Germany, France and Sweden. They have invested over €6.3bn since 1989 in more than 85 companies. The last fund, IK VII closed in October 2013 with €1.4bn.

Equistone Partners emerged from Barclays Private Equity. They specialise in investment in the lower end of mid-market private equity – businesses with enterprise values between €50m and €300m.

Advent International we mentioned on page 7 and 3i will be well known to most readers – today it focuses on mid-market companies with enterprise values between €100m and €500m. CVC is a global firm. Its last two European funds exceeded €10bn in size. Its minimum investment size for a European deal is $150m.

SL Capital use secondary transactions to rebalance portfolios where necessary. Looking at Figure 10, SEP's managers say the fund is currently slightly underweight the three to four year old tranche and this has been a focus of buying activity. A recent secondary purchase was Towerbrook III – they already held Towerbrook II and IV so knew the manager well and the asset mix was positive for the maturity profile.

The over five year segment includes a tail of older companies which are in realisation mode.

As illustrated in Figure 10, approximately 50% of the fund has a maturity of four years or older. Anecdotally, most private equity positions will be held for four to seven years, with LP's frequently looking towards exits beyond the fifth year. In the manager's view, the proportion of the portfolio with maturity five years and above offers a good indication of the proportion of the portfolio likely to be realised as cash in the short to medium term. Realisations, particularly when these occur sooner than expected, can leave gaps in a funds maturity profile. However, a fund such as SEP, which has the ability to make secondary investments, can use these to back fill the maturities with the aim of generating a smoother path to future returns. Looking at the maturity profile of SEP's portfolio in Figure 10, the managers appear to have been successful in achieving this as the allocation between the individual maturities, up to five years, looks to be relatively even.

Commitments

Figure 11 shows SEP's ten most recent primary deals.

Figure 11: SEP's ten most recent private equity deals

Fund	Year	Commitment	Fund size	Focus
Advent International GPE VII	2016	€45.0m	€12bn	Business and financial services, healthcare, industrial, retail, consumer and leisure; and TMT.
Equistone V	2015	€30.0m	€2bn	Consumer & travel, financial services, specialist engineering and support services
Bridgepoint V	2015	€35.0m	€4bn	Mid-market buyouts with EV of €150m to €600m
Exponent III	2015	€38.0m	£1bn	UK businesses with EV of £75m to £350m
PAI Europe VI	2014	€35.0m	€3.3bn	Mid to large size European companies
Altor IV	2014	€55.0m	€2bn	Developing mid-market companies in the Nordic region
Permira V	2014	€30.0m	€5.3bn	Consumer, financial services, healthcare, industrials and TMT
CVC Cap. Ptnr VI	2013	€30.0m	€10.9bn	€150m investments
Nordic Capital VIII	2013	€30.0m	€3.5bn	Nordic region and Europe. Healthcare
Towerbrook IV	2013	€35.0m	$3.5bn	Mid and large companies, special situations

Source: SL Capital, Marten & Co.

Cash is partly invested in ETFs to reduce drag – this is the first source of cash for investments

SEP currently has £76m in cash and cash equivalents (£38.4m in cash and £37.6m in ETFs) and also have an £80m multi-currency facility. SEP's outstanding commitments totalled £238.6m, as at 31 January 2016, and the managers reckon that about £55m of these will not be called. This leaves a balance of £184m to be drawn down, by the funds, over the next four years or so. Funds acquired in the secondary market do not have much in the way of outstanding commitments.

The practice of holding cash in ETFs has divided opinion among investors. The ETFs are based on large-cap UK and European companies. They act as a liquid proxy for the portfolio and are another way of minimising the effects of cash drag.

The underlying portfolio

SL Capital reckon that, on a look-through basis, SEP's portfolio has exposure to around 330 companies through its underlying funds. The top ten underlying investments are listed in Figure 12.

Figure 12: Ten largest underlying holdings

Company	Business	Fund	Value 30 September 2015 £m	% of net assets	Current multiple
Action	Non-food discount retailer	3i Eurofund V	14.8	3.4%	9.7x cost
Parques Reunidos	55 leisure parks in Europe and Americas	Candover '05	7.5	1.7%	1.4x cost
Vistra	Trust, fiduciary, fund and corporate services	IK 2007	7.1	1.6%	2.2x cost
Not disclosed		Advent VI	5.7	1.3%	5.3x cost
Scandlines	Ferries between Sweden and Denmark	3i Eurofund V	5.4	1.2%	2.7x cost
Guardian Financial Services	Life Assurance funds in run-off	Cinven IV	5.3	1.2%	3.5x cost
AWAS / Pegasus	Aircraft leasing	Terra Firma III	5.2	1.2%	1.5x cost
Schenck Process	measuring and process technologies	IK 2007	5.1	1.2%	1.6x cost
Not disclosed		BC Euro. IX	4.9	1.1%	2.3x cost
Stork	Dutch industrial services focused on oil & gas, chemical and power sectors	Candover '05	4.7	1.1%	0.6x cost

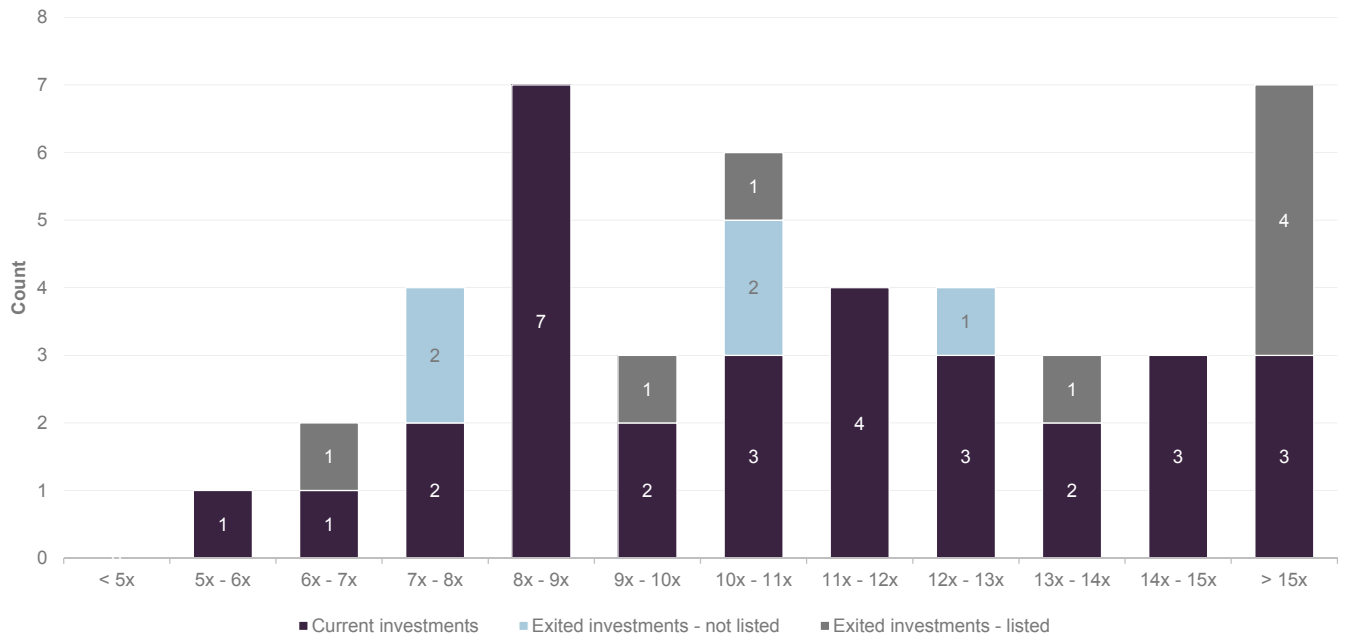
Source: SL Capital, Marten & Co

Action has recently (11 February 2016) completed a €1.2bn refinancing and its value has been written up. This should result in a capital return to the fund in March 2016. Guardian Financial Services was sold by Cinven to Admin Re (part of Swiss Re) in January 2016 at a value of 4.3x cost. Stork was sold to Fluor Corporation by Candover in December 2015 at a discount to holding value.

Figure 13 gives the current enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) across the top 50 companies in the portfolio. The manager notes that the average of 8-11x is comparable to the general averages for European private equity.

Figure 14 shows the indebtedness of the top 50 underlying companies relative to their EBITDA. SL Capital say these ratios are broadly in line with the European market for size and sector of deals. They also observe that leverage in the portfolio has decreased over time.

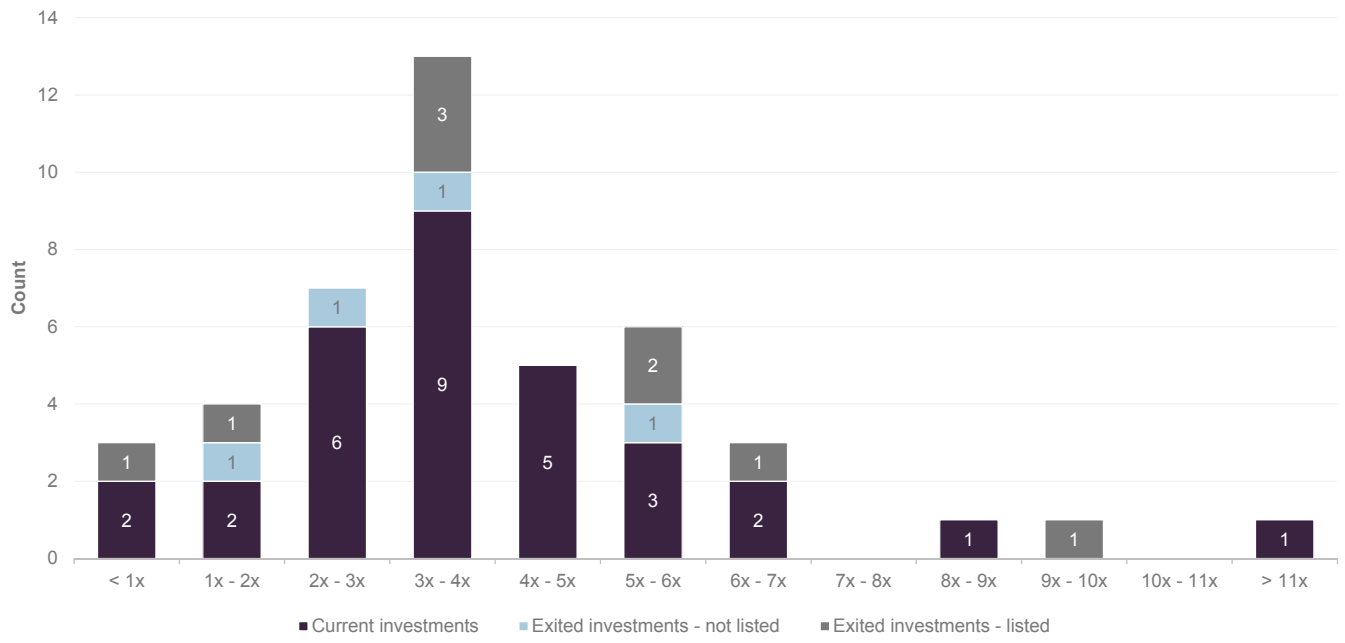
Figure 13: EV / EBITDA of top 50 underlying companies at 30 June 2015



Source: SL Capital

The experience during the credit crunch was that levels of defaults predicted by the market turned out to be way too high and the default experience of the past few years has been relatively benign. The low interest rate environment has undoubtedly helped with this.

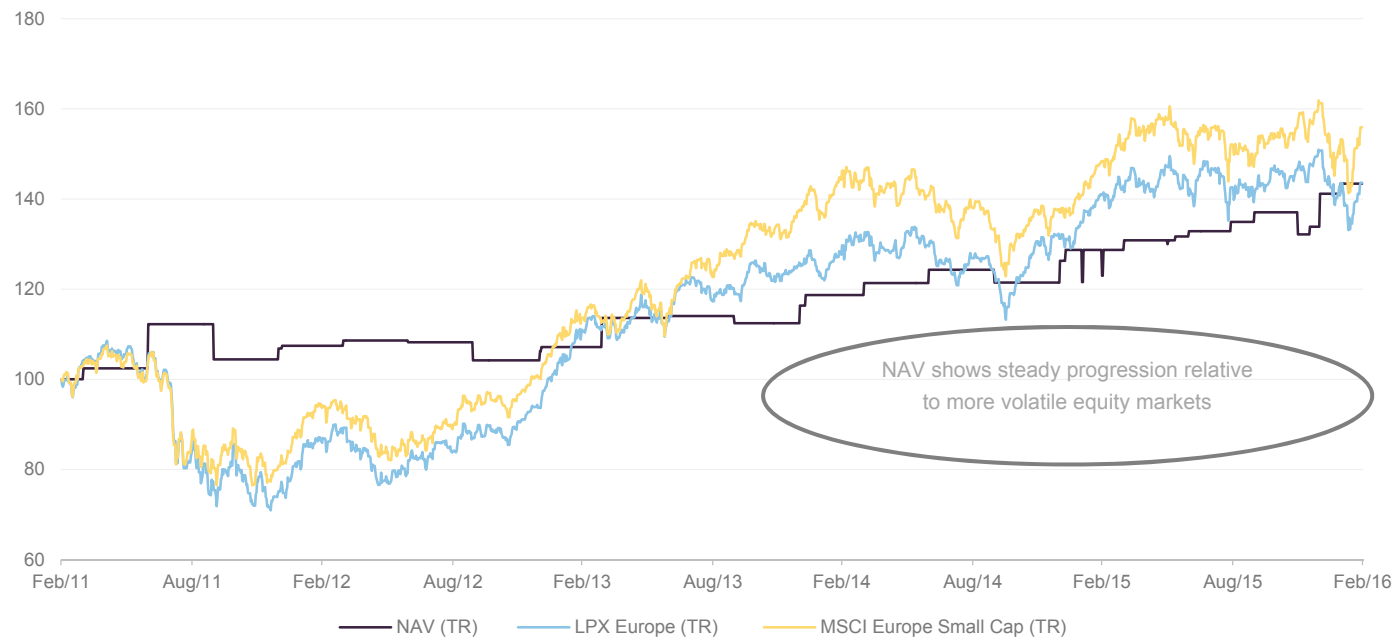
Figure 14: Net Debt / EBITDA of top 50 underlying companies at 30 June 2015



Source: SL Capital

Performance

Figure 15: NAV performance compared with the LPX Europe and MSCI Europe Small Cap. indices



Source: Morningstar, Marten & Co

As illustrated in Figure 15, which plots the progression of SEP's net asset value over the past five years alongside those of the LPX Europe and the MSCI Europe Small Cap, SEP's NAV has followed a path of steady progression in contrast to the much higher volatility witnessed in these listed equity indices, whilst providing performance that is comparable. Looking at Figure 16, it can be seen that SEP'S NAV total return has been superior to the share price total return of the broader listed equity market, as represented by the FTSE All-Share, for all of the time periods provided. The outperformance over the longer term horizons are particularly notable.

The last published NAVs are based on valuations as at 31 December 2015. These values were received from all of their managers and were based on a bottom-up valuation of the fund portfolio. The managers believe investors should have greater confidence in SEP's NAV and further discussion is provided on page 5.

Figure 16: Cumulative total return performance to 31 March 2016

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
NAV TR	1.1	8.0	11.2	16.5	34.2	48.9	112.8
Price TR	3.0	(3.3)	(3.1)	(5.8)	18.4	43.7	34.9
LPX Europe TR GBP	7.0	0.2	8.1	7.8	36.4	46.3	44.6
MSCI Europe TR EUR	3.1	0.1	5.5	(4.9)	16.4	27.2	56.8
FTSE All Share TR	1.9	(0.4)	3.5	(3.9)	11.4	31.9	58.3
MSCI Europe Sm Cap TR	5.1	1.5	9.9	8.5	44.8	58.7	111.9

Source: Morningstar, Marten & Co

Strengthening Euro benefiting recent performance

SEP had faced a currency headwind to performance in the form of a weakening Euro but, of late, this trend has reversed and is one factor that has recently been driving an uplift in SEP's NAV (NB SEP do not hedge fx exposure – see page 8).

Relative to broad equity indices, SEP has benefited by having limited exposure to mining, chemicals and basic materials. The managers say the real key to the fund's outperformance has been focusing on the right sectors and avoiding capital intensive segments. SEP has some oil & gas exposure but this is primarily in services companies.

Uptick in realisations

The recent increase in realisations by the underlying funds is feeding through to the NAV. During 2015, they have been seeing uplifts on exits of, on average, 14% over the last relevant valuation. The underlying businesses are achieving average exit multiples of 1.9x cost, which the manager notes has been consistent for the past four years.

Recent realisations include Solina Group, a food ingredients company, sold by IK Partners to Ardian Mid Cap Buyout. This had been held in the portfolio at a valuation of 1.9x cost and was sold at 2.4x cost. The sale of Stork by Candover was a disappointment. It was sold at a discount to the last valuation. This is a reflection of the stress this business has been put under by the collapse of activity in the oil & gas market. Advent sold WorldPay Group through an IPO in London, one of the largest flotations achieved last year. At 31 December 2015, the company was valued at 8.0x cost and the shares remain well above the IPO price.

Peer group comparison

Please click here to visit QuotedData.com for a live comparison of SEP versus its private equity peer group.

We have put together a peer group for SEP based on a subset of investment companies in the AIC's Private Equity sector that are predominantly funds of funds. SEP is the only fund in the sector that focuses exclusively on European LPs however and so none of these offer a perfect comparison.

Figure 17: Fund of fund sub-sector comparison table (data as at 9 May 2016)

	Market Cap GBPm	Discount (%)	Yield (%)	Ongoing charge (%)	NAV total return performance to 29/03/16			
					1 year (%)	3 years (%)	5 years (%)	10 years (%)
Standard Life Euro Pvt Eq	344.4	(26.9)	2.4	0.97	16.3	34.0	48.6	112.5
Princess Private Equity	417.9	(20.9)	7.1	2.02	28.2	28.3	33.4	
Aberdeen Private Equity	95.2	(33.5)	2.5	2.01	10.9	26.9	57.2	
HarbourVest Global Pvt Eq	522.0	(19.2)	Nil	0.49	10.9	43.1	80.4	
F&C Private Equity	188.3	(14.2)	4.5	1.30	12.8	28.4	47.9	122.3
Pantheon International	1,546.1	(28.5)	Nil	1.18	14.7	38.2	67.1	119.3
Mithras	31.0	(9.0)	0.6	2.16	12.1	21.9	22.8	138.5
NB Private Equity Partners	349.0	(25.7)	4.6	2.37	6.9	43.5	66.2	
JPMorgan Private Equity	221.0	(25.1)	Nil	2.43	6.2	23.0	7.2	45.4
Private Equity Investor	19.7	(22.8)	Nil	1.88	(6.2)	(4.6)	(3.0)	31.9

Source: Morningstar, Marten & Co

Second best performing fund over one year

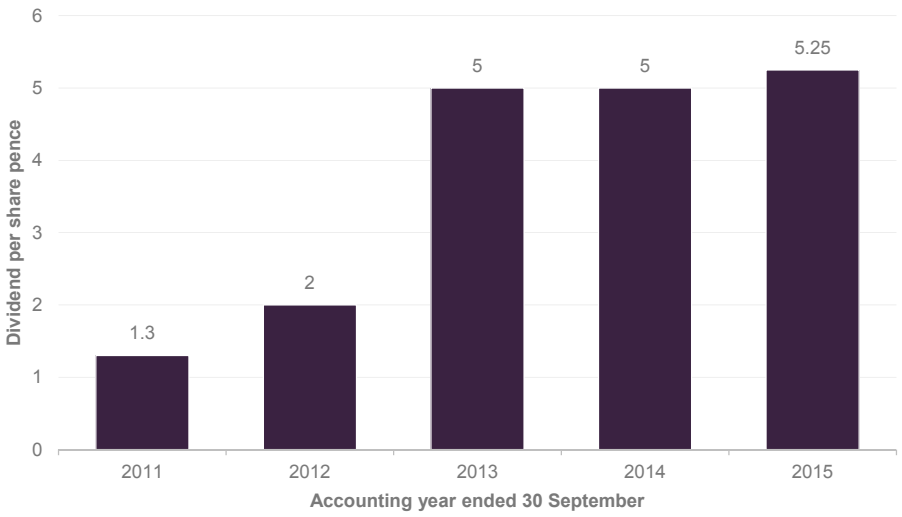
We ranked the funds in Figure 17 by NAV performance over the past year and SEP comes in second, although it is more middle of the pack over longer time periods. SEP's European exposure will most likely account for much of the difference in performance between it and the rest of the peer group over the medium term. SEP's managers believe that its current discount, of approximately 27%, is too wide for the

quality of its NAV. Comparing the yield and discount figure, there is no obvious benefit, in terms of discount, to providing a higher yield within the private equity sector. Investors generally look to private equity to generate capital growth. SEP's ongoing charges ratio is the second lowest of its peer group. You can access up to date information on the wider private equity sector on our website. Please click here.

Dividend

SEP's policy is to pay covered dividends out of income and its current yield (on share price) is 2.4% (or 1.7% of NAV). Prior to its last financial year, SEP paid one dividend per annum in January. However, beginning with the year ended 30 September 2015, SEP now pays its dividends in two tranches. These comprise a smaller interim dividend in July and a larger final dividend in January. The recent history of these is shown in Figure 18. The dividend for the 2015 year was 5.25p (2014: 5.0p), which was more than covered by income return during the year of 5.69p (2014:5.69p). SEP had a revenue reserve of £15.4m at the end of September 2015, equivalent to 9.9p per share.

Figure 18: SEP's five year dividend history



Source: Standard Life European Private Equity

Board intends to maintain real value of dividend

Although SEP has the flexibility to pay dividends from capital, this is not trust policy and, as discussed above, SEP has been generating enough income annually to fully cover its dividend payments. The last statement made by the Board on this topic (in 2015's annual report) said – "It remains the Board's intention, subject to unforeseen circumstances, to maintain, at least, the real value of the Company's dividends going forward." Shareholders can take advantage of a dividend reinvestment plan introduced in 2015 if they wish.

Discount

Figure 19 shows how SEP's discount has moved over the past five years. The discount traded within an acceptable range for much of 2013 and 2014 (narrowing on occasion to c 10%). It has widened over the last couple of years but, in recent weeks, has been on a narrowing trend. Over the past year the discount has moved within a range of 16.1% and 33.3%.

Discount widest it has been over the past three years

Looking at Figure 19, the discount is not far off of its three year high. The investment trust sector has generally widened this year, and private equity trusts have not been an exception to this. However, as we discuss on 4, discounts on many private equity look to be unduly wide and, in the case of SEP, it appears somewhat anomalous with the trust's longer term performance record, relatively low charges, yield, etc. It may in part reflect concerns over global macro volatility and the general outlook for Europe although this appears to be one of the brighter spots within the global macro economy. As with many private equity funds, there may be some uncertainty around the quality of the trust's NAV but, as also discussed on page 5, there is evidence to suggest that this warrants greater confidence than the market is currently attributing to it.

The board and manager regularly discuss options for narrowing the discount. Different approaches have been examined and rejected, for example, paying a higher dividend from capital or adopting a realisation structure, but, looking at examples of other funds in SEP's peer group that have adopted this approach, they are not convinced that these approaches add much value.

SEP has the authority to repurchase up to 14.99% of it issued share capital, which is renewed annually. Given the importance maintaining adequate cash flow, the Board works closely with SL Capital in managing the buyback process. Over the year to the end of September 2015 SEP bought back 3.1m shares at a cost of £6.9m. Given a backdrop of volatile markets, no share repurchases were authorised in Q1 2016. However, 1.0m shares were acquired in April.

At 25.7%, we feel that SEP's discount does not reflect the company's recent strong performance relative to its peer group. It also seems anomalous that secondary market pricing for the underlying funds is much closer to NAV (see Figure 6 page 11).

Figure 19: Premium/(discount) over the past five years

Source: Morningstar, Marten & Co

Fees and costs

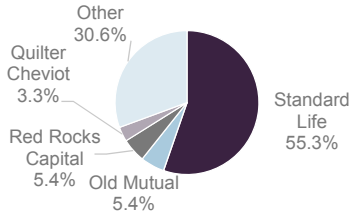
Ongoing charges ratio 0.98% - second lowest in peer group

SEP's manager charges a base annual management fee of 0.8% of net assets and is also entitled to a performance fee. This is calculated as 10% of returns, in excess of an annualised 8% hurdle, measured over five year periods. The current performance fee measurement period finishes on 30 September 2016. The ongoing charge ratio for the year ended 30 September 2015 was 0.98%.

The managers of the underlying funds also charge fees – both annual charges and performance related fees. The method of calculating these varies from fund to fund. We discussed the managers' attitude to fees in the section on page 8. It is always worth bearing in mind when thinking about funds of funds that performance figures are quoted net of all fees. In relation to fees, the managers comment that the fee structures, in private equity, are the costs that have to be borne to access the strong performance of these funds.

Capital structure and life

Figure 20: SEP Shareholderbase



Source: SL Capital, RDIR

SEP's capital structure is relatively straightforward. There are 155,776,294 ordinary shares in issue and no other classes of share capital. Standard Life holds 55.3% of these by virtue of the initial transaction that launched the fund where Standard Life injected part of its private equity portfolio into the fund in exchange for shares. SL Capital tell us Standard Life is a long-term supportive shareholder. Standard Life has agreed that it will not seek to nominate a director to the Board or take any action which would be detrimental to the SEP's shareholders as a whole. Other large shareholders are Old Mutual (5.4%) and Red Rocks Capital LLC (a US based private equity investor – 5.4%).

Cash is held by BNP Paribas Securities Services S.A.

SEP has an £80m committed, multi-currency syndicated revolving credit facility provided by Citi and Societe Generale. The facility matures in 2020, has an interest rate of LIBOR plus 1.50%, rising to 1.70% depending on utilisation, and the commitment fee payable on non-utilisation is 0.7% per annum. SEP is not using the facility at the moment and is ungeared.

SEP has an unlimited life and there is no specific mechanism, such as a continuation vote, to wind up the company.

SEP's year end is 30 September and its Annual General Meetings are normally held in January.

Board

SEP has five directors all of whom are non-executive and independent of the manager. The annual limit on directors' fees in SEP's articles of association is £250,000. The three longest-serving directors have an average of 2.6x their annual fee invested in the company.

All directors stand for re-election annually.

Figure 21: Board member - length of service and shareholdings

Director	Position	Appointed	Length of service (yrs)	Annual Fee (GBP)	Share-holding
Edmond Warner OBE	Chairman	27/11/08	7.2	£50,000	25,000
Alastair Barbour	Chairman Audit Committee.	01/04/11	4.9	£35,000	66,658
Alan Devine	Director	28/05/14	1.7	£31,000	Nil
Christina McComb	Senior Independent Director	29/01/13	3.1	£35,000	4,386
David Warnock	Director	26/01/09	7.1	£31,000	50,000

Source: Standard Life European Private Equity, Marten & Co

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