

TRANSCRIPT: EPISODE 300

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Today's guest emphasises the uniqueness and interesting opportunities available in the UK small and mid cap market.

I'm Staci West and today I'm joined by Rosemary Banyard, manager of the VT Downing Unique Opportunities fund. Rosemary, thank you very much for joining me today.

Rosemary Banyard (RB): Pleasure.

[INTERVIEW]

SW: Now, this is a multi-cap UK equity fund, but I believe about two thirds of the portfolio sit in the mid and small caps at the moment. Now, it's been a difficult time for those types of companies recently, so where do we sit today? Are those companies still out of favour? Is sentiment improving? Maybe give us a little update.

RB: Yeah, so actually I think probably the proportions are even higher than you've said. I mean, obviously it depends a bit which index you single out, whatever, but actually only 5% of the fund is invested in companies over market capitalisation of £5bn. And that actually equates to only 5% being in FTSE 100. And so everything else is either in the mid 250 [FTSE 250], the small cap, the fledgling [FTSE Fledgling Index] or on AIM. And just a further clarification, so there is about 37% of the fund in companies between £1bn and £5bn, which we might loosely call mid caps. So, that's the fund.

It's been a very rough 18 months or more actually really, really from the beginning of 2022 when there was a sudden expectation that interest rates and inflation were going up a lot, right through to this last autumn when actually I guess the reverses starting to emerge; some sort of sense that interest rates are going to fall because inflation is coming more under control. And so, we've seen really sentiment moving in favour of these companies really in the last three or four months I'd say.

SW: You mentioned your position to smaller companies for the fund, and we didn't really see the recovery of smaller companies that maybe many thought would happen last year. So, why didn't this maybe come through then? And then also do you think that it will improve in 2024?

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RB: Yeah, so by inference, something over 50% of this fund is in companies of less than a billion market value. And actually, most of that is below half a billion, but it includes about 30% of the fund being listed on AIM.

So I think yes, there was a difficult period for small companies and for the AIM market in 2023. And I think a lot of the year, we still saw people selling. So maybe private investors, but also funds in this space responding to redemption requests. And I think that some of that was people deciding that interest rates were a lot higher, and so moving money into cash to earn that more predictable rate. We also saw investors continuing to switch maybe into the US, global funds and maybe tracker funds, et cetera. And all these things resulted in - for a lot of the year - funds selling out of small companies and AIM companies. And so it didn't seem to matter for ages; a company would announce good results or a good update or an attractive acquisition, and the shares would typically go up for a bit and then you'd see selling coming in and the shares often would end up the day the same as where they started. And this was going on for months and months. This is just the sort of pressure of fund flows that we all saw. And I'd say this sort of started to dry up in the autumn as the valuations got so low that I think so people started to maybe stop selling. Also you know, there's been a steady stream of bids. And so I think, there's now maybe just a trickle of selling going on. No more than that. I think that's a big factor.

And the other thing which is possibly a bit unresolved still is the future of the AIM market in the sense that there's potential for political interference here. So, we've had the Conservative party saying they might abolish or reduce inheritance tax, and then we've had the potential Labour government saying that they might reduce the tax breaks for investing on AIM. And so both of those things in their own way have have unsettled people.

And obviously we don't know what's going to happen, but one thing I do know, not least because my boss, Judith Mackenzie, is chair of the QCA, the Quoted Companies Alliance, is that there's been a lot of lobbying going on to the political parties to explain that AIM companies are very important to the UK economy; they're big employers; they're the growth engine of the economy. And that if you tinker with it too suddenly and too aggressively in terms of the tax situation, you may well force funds that exist purely for these benefits to actually start selling, and we don't want that. So, I guess that's still unresolved, but it has affected prices.

SW: Maybe just for the listeners, can you just explain a bit more about AIM companies? What type of companies do they tend to be on AIM and why are they kind of so important?

RB: So AIM is the Alternative Investment Market. It has less onerous listing requirements than for the main stock exchange list. And in particular, it has lower disclosure requirements for companies that are already on the market but then want to raise capital for expansion or for acquisitions. They've just got less disclosure requirements, and so it's cheaper for them, it's less onerous. It's just easier to raise money. So, it tends to attract smaller businesses, but also perhaps companies that are sort of minded to grow using capital. And it also attracts newer companies where the entrepreneur that may be the founder or the founding team might want to stay in for quite a while and, and they will then get tax breaks potentially. So, there's lots of reasons

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why people use the AIM market. And it's important as a source of investable businesses that are intent on growing.

SW: It's hard to talk about smaller companies without talking about M&A, so how prevalent has M&A activity maybe been in the portfolio? Have you received, you know, or have your companies received takeover offers? Are you expecting more or less in the year ahead?

RB: Hmm, so there have been takeover bids. Actually, if you look at the wider UK, there's been something around 40 to 50 takeovers a year since 2014. And so, there's been a large exit of often excellent businesses from the market. And these takeovers have ... some of them have come from other companies I'd say particularly from the US, and quite a lot have come from private equity. And yes, my fund has benefitted.

So, last year, out of a total of around 30 holdings, we had two that were taken over. Actually they were both in the healthcare area. One was called EMIS and EMIS is the leading supplier of software that runs GP practice systems, and it also runs pharmacy systems, both community and hospital pharmacy systems. So, it's an important business and it was taken over by a huge American business called UnitedHealth. And they paid a 50% premium to the undisturbed share price to get control of the business. So, we owned EMIS, because it's a crucial piece of software for the community health system, the bid was referred to the competition authorities and it had I think it's called a level two reference - it's a sort of higher level of reference. And so the share price then fell back to the level it was at before the bid.

So I should explain, we'd sold out on the bid approach at the premium and then it fell back, so, I bought back in. And then the bid was cleared. And so the bidder came back and so, I actually - unusually, perhaps - had two bites at the cherry and made two lots of profit in this investment, one in 2022, and then one in 2023. But I'm sad to see it go because it's a unique business, and there isn't another one on the London market like it.

The other company was also in healthcare is called Ergomed. And that company provides clinical trials services. So, this is for pharmaceutical companies who are running trials before they apply to get a drug approved. And Ergomed was running some of these trials throughout the world. And it specialised in cancer trials and what are called orphan drug trials, where the drug has a very limited, very specialist use. And they were taken over by a private equity house. And again a decent premium, but sad to see it go.

And yes, I do expect more bids in the future. The UK market is still cheaper than the US and so that will probably lead to more US companies bidding for UK counterparts. And I think that private equity still have plenty of cash and they have the tendency to sort of gear up these businesses and that means that they don't tend to pay much corporation tax because, after they've paid the interest, they don't have much profit initially. So, I still see them coming back to take more companies private as well. So, it's a double-edged sword. There'll be benefits for investors from the premium that they pay, but then we've got to find new investments in a shrinking pool.

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SW: Yeah, I was going to ask how the kind of M&A activity impacts the construction of the fund, because it's already fairly concentrated - I think you mentioned 30, but I think you can have up to 40 in the fund or thereabouts, so it's fairly concentrated. And with the turnover activity - with the M&A activity, sorry - do you see a lot of turnover in the fund or is the turnover quite low in the funds?

RB: So, the turnover is quite low. Last year in the second half of last year, we had three exits and three new purchases in the fund. And I've already mentioned that two of the exits were takeovers. So, there was one other disposal that we decided to make of a company where they'd had quite a lot of debt, interest rates had shot up, they then had a problem with demand in their market, and we decided to sell. So we bought three new names.

But I think I'm correct, that turnover last year was approximately 10%, which is quite low. A lot of funds will turnover their assets much more aggressively than that. But we are very much long-term investors, so we're quite reluctant to trade a lot. We think it's not necessary if you have good quality investments. And it's also costly, not so much the amount you pay the dealer, but the spread between the bid and offer price that market makers will quote, that can be quite costly if you trade a lot. So, yeah, so we tend to avoid it.

SW: I mean, it's probably unsurprising that the turnover is so low, given that one of the key parts of your philosophy is this long-term compounding. So I was going to ask you to elaborate, but you kind of have already done that. So, I don't know if you want to give more into this philosophy of holding long term and what your time horizon you're looking at for companies is?

RB: Yeah. So, the prospectus says that we are investing for the long term and it defines that as over five years. And that's definitely the case, the sort of horizon on which we invest and there's some good reasons for that. So you know, if companies are investing, say they're recruiting more people, they're perhaps taking more office space, they're building a factor, they're buying some other businesses; we all, as investors, we get impatient for the rewards from that, but actually in real life - and if you work, you only have to think about that in your own circle - it can take a while, it can take two or three years for these things to bear fruit. So, we want to sit there and give companies time to actually deliver on those investments.

So yeah, the long-term compounding concept is very much one where a business which already earns very good returns on capital, reinvests some of that capital into the business. And if it can continue to earn high returns, it will compound up in value over time, if you just let the company just get on with it.

And there are numerous examples in the fund, but one that I'd share with you today is a company called Softcat. So, Softcat is one of three companies listed in London that are, broadly speaking, known as resellers of computer equipment and software. What this means is that they procure hardware - it could be laptops, computers, network equipment, they also procure software, they provide services around sort of cybersecurity, how to set up your IT systems - and they do all this for, in Softcat's case, medium sized UK businesses. And they sell them the hardware and the software and they take a turn.

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They're nice businesses because they're quite capital light. So, the suppliers, which could be Dell or Microsoft or any of these sort of technology names, tend to supply them on very good terms because these big tech companies don't necessarily want to deal, they're not geared up to deal with medium-sized businesses all over the world. And so, Softcat are providing a useful service for them. Softcat will tend, for example, to only own a few days of stock, and then it's passed on to the client. So they have good returns and they don't really need extra capital, their growth is organic, and so they're just growing through selling more to existing customers - having a greater share of their wallet - and also adding new customers. They're just searching and calling and you know, emailing and just finding new people who want this service.

So, what's the result of that? Well, in Softcat's case, they floated on the stock market at the end of 2015, and the share price then was £2.40, and the market value was £470m. So, in the time since then, sort of eight years, they've only added 1% to their share capital, which is a few incentive schemes for management, so, they've not issued really any shares. The share price has gone up six-fold and they've had some dividends on top of that. So, as I say, they floated at £2.40. The total amount of dividends that you would've received since they floated is £2.13. So 88% of your initial value you've had back already in dividends.

That's pretty amazing, isn't it? You've had almost all your money back and it's gone up six times, so why is that?

So, as I say, they didn't need to issue shares. Their profits have gone up three times. And I guess they've also re-rated as well. But, while they may not rerate as greatly in the future, as people now realise it's a really good business, I don't see any reason why they won't continue to grow their market share and their share of wallet in the future. So, that's an absolutely perfect example of a company compounding, and you could hold it for years and you just don't need to worry about it.

SW: You're certainly not complaining about that, are you? [**RB:** No.] Well, that brings me on to my next question actually, because another part of your process is looking for companies with sustainable and competitive moats. So, first off, can you just explain what this means, what kind of characteristics that you're looking for in companies? And then also again, if you maybe have an example of that in the portfolio?

RB: Yeah, so the concept of a moat was first coined by Warren Buffett, a famous US investor and it's quite a long while ago now. He talked about it in one of his annual letters to shareholders. And the concept is that a company is like a castle and you want lots of things to protect that company from competition. And the things that protect it from competition are the moat. And he waxed lyrical, actually, he talked about having piranhas in the moat, you know, he was really labouring it!

So, what kind of things protect companies from competition? Well, it can be that they've got patents. It can be that they've got other intellectual property. They may have rights, licenses, regulatory approvals which other people don't possess. They may have other slightly more complex things, such as they may have a service or a product that's so embedded in their customers' workflow that switching out is really tough. And software is a key example of this. And so, wrong geography and the wrong size, but Microsoft people can understand: if you use Microsoft for email or whatever, it's very difficult to switch to something else. You

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probably wouldn't even switch if it was free, actually, it's just too difficult, right? [SW: Yeah] So, you know, high switching costs-type businesses are very interesting.

And another one is networks. So, if you're the leader in a network, it's very hard for people to come along and take that from you. It could be something like an internet network where you've got the most eyeballs on your site and therefore you've got the most suppliers of information and it's mutually beneficial. Or it could be a distribution network - a physical one - where you've just got a very extensive network.

So, if I was to give an illustration of one of my holdings, which probably contains a couple of those, it'd be a business that many people would know in some way or other, which is called A.G. Barr, and it's a Scottish-based manufacturer of mainly soft drinks. So, it's got quite a lot of well-known brands. Irn-Bru is probably the most famous, but they also own the Rio brand Tropical Drinks, the Rubicon brand of passion fruit and other fruit drinks. And so what are their moats?

So, I would say a couple - and I wouldn't rush to say the brands actually - maybe - but the two that I would identify are firstly distribution network. They actually distribute themselves, certainly in Scotland, and they've got their own fleet of trucks and their own drivers, and they distribute to corner shops throughout Scotland. And that's a real asset. So, they do buy up brands of drinks. So, they recently bought Rio and they recently bought something called Boost. And then they can add that to the lorry and when they go to the shop, they'll say, right, here's your Irn-Bru, would you care to stock some Rio as well? And it's not much extra cost to them at all. [SW: They're upselling] They're upselling, and other individual brands or actually, the previous owner of Rio doesn't have that network actually.

The other thing they've got specifically with Irn-Bru is they have a secret recipe which has been handed down to the family generations. And there is no own-label alternative to Irn-Bru because it literally is a unique secret recipe. So, while you may see own-label lemonade or you know, ginger beer or even dare I say a tropical drink, there is no own-brand version of Irn-Bru, so it's a big thing,

SW: As we've said throughout, this is a concentrated fund and you've given us examples throughout really. But just to finish, I thought if you wanted to just give us another example of a holding in the funds and the portfolio that you kind of encompasses what is available in this space for this fund, just to wrap up.

RB: Thank you. So I could pick any of them really, couldn't I <laugh>?

SW: I won't make you choose favourites! <laugh>

RB: One of the new investments in the second half of last year perhaps to talk about is a company called GlobalData, which is on the AIM market. It's still approximately 60% owned by the founder, which is actually an attraction too because I like skin in the game. GlobalData has lots of databases, something about over 300, most of which are proprietary and behind firewalls so that ChatGPT can't trawl for that information, right, which is important. And the data is on businesses globally as the name suggests, and

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they've got, I think, 20 different industry verticals that they have in information on. And they have information that ranges from patent data on drugs, they have obviously sort of financial data, they have market share data, and they bring all this together on a platform which is very easy to use. And the users are sometimes very big, bigger companies who are maybe looking at their strategy, looking at the competition, trying to understand trends in their industry. And obviously they've got their in-house data, but they want to see the data about everybody else. And so the model is one where people usually pay an annual recurring subscription. So that's nice and predictable.

But one thing that's interesting about GlobalData is they were getting a bit frustrated because they felt that companies in the American market were valued much more highly than they were. And so, in December, they announced that they had sold 40% of one division, which was the healthcare division to a private equity house for 88% of the market value of the whole group. Wow!

And this division in its entirety accounted for something like 35 - 36% of the group revenues. They sold it for well over 80% of the entire group's valuation. So the shares have popped up a bit on that, but actually not as much as I think they're capable of in the fullness of time. So, we will see.

But I think if it had been a company where the management didn't own many shares, maybe they'd have just succumbed and sold the whole group to somebody, right? But because the founder is sitting there with 60%, he didn't want to give it all away at once. So he just did this deal on one bit to illustrate to people what the whole thing is worth, which I think is unusual and interesting.

SW: Unusual and interesting is a great way to summarise that. I was also going to say that this has been an excellent overview of truly as the name suggest, the Unique Opportunities that are available. Thank you very much for joining us today, it's very much appreciated.

RB: It was a pleasure, Staci.

SW: Launched in 2020, the VT Downing Unique Opportunities fund seeks companies with sustained competitive advantages, low debt, and strong management. We discussed in this interview the portfolio is highly concentrated with names primarily from the UK, although some overseas names can be added if the opportunity arises. For more information on the VT Downing Unique Opportunities fund visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.