MARKET INSIGHT

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Redmayne Bentley

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A Changing Marketplace

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A CHANGING MARKETPLACE

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After a quiet summer period, activity is now returning to financial markets. Recent news, suggesting that central banks are coming to the end of their interest rate hiking cycles, financial market participants will be reassessing current opportunities with greater levels of certainty. This looks to be feeding through with both companies and investors returning to participation in both public and private transactions, following an extended period of muted activity.

One unexpected consequence of interest rate rises has been an increase in commentary around one of the UK's oldest investment vehicles which dates back to 1868, the investment trust. Having ballooned in assets through the zero-interest rate environment, attention regarding the sector has turned to costing disclosures following a piece of European regulation dating back to 2018. Some argue the costing guidance creates an artificially expensive disclosure which has the potential to take the wind out of the sales of a sector that has a significant part to play in the provision of permanent capital to infrastructure projects and the achievement of net zero targets in the UK.

Following a period of depressed activity in the primary markets, hot Initial Public Offerings (IPOs) look to be returning in the US. Arm Holdings, the UK chip designer, enjoyed a strong start to public market trading with the shares jumping more than 25% on the first day. More debuts are set to follow, with news of Instacart, the grocery delivery app, targeting a healthy US$10bn valuation, but still well below the peak US$39bn valuation seen in 2021. The famous German footwear company, Birkenstock, also announced its intention for a US public listing with another healthy valuation in the US$8bn range. With big valuations on offer across the pond, London continues to struggle to generate primary market activity.

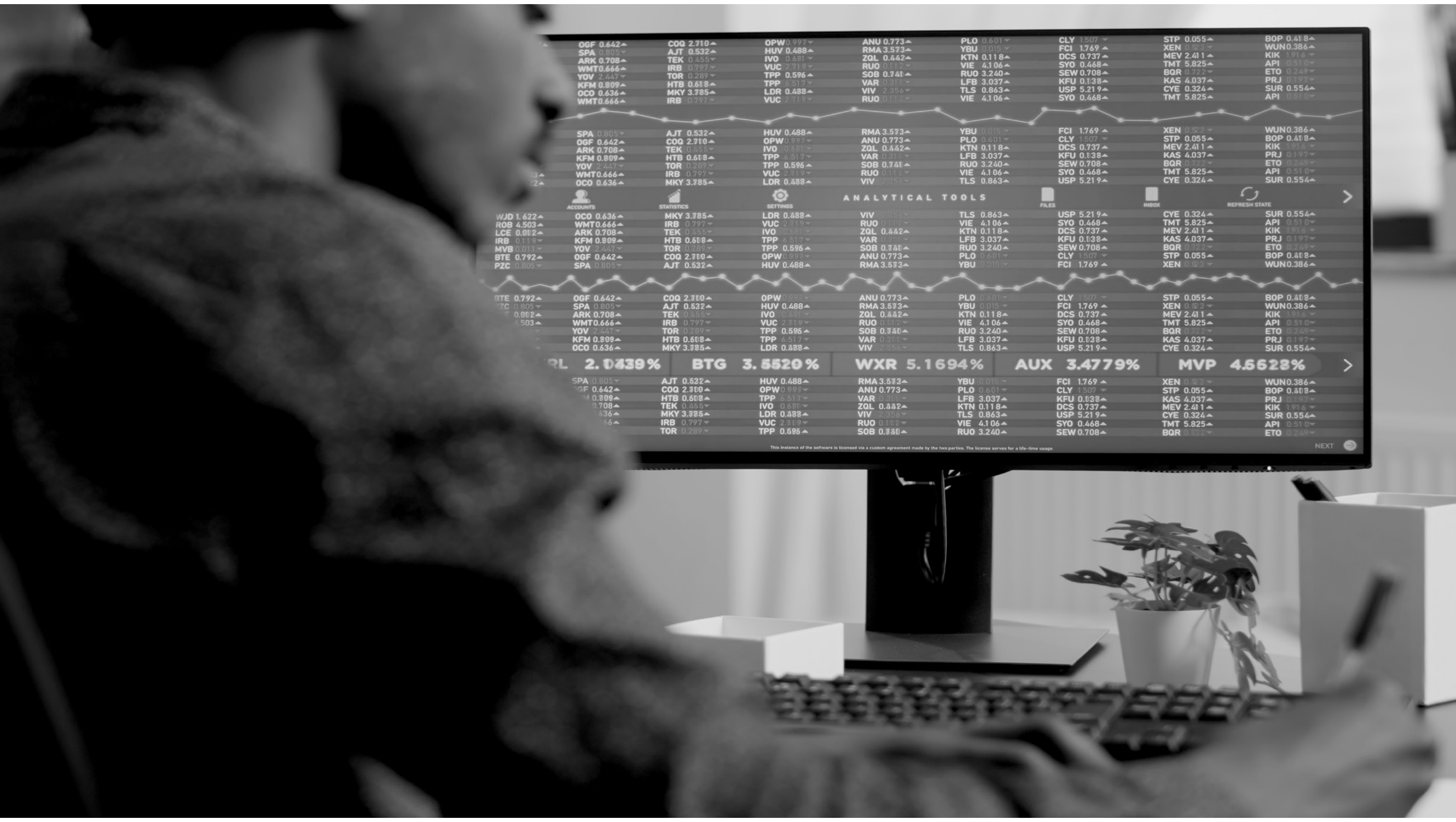
Alongside activity in the IPO market, we have seen some uptick in relevant activity in private market transactions. Listed private equity trusts have always experienced some scrutiny around the carrying value of their assets, leading many to trade on wide discounts to their reported net asset values (NAV). In this edition of *Market Insight*, we look at Hg Capital Trust, a technology focused private equity investment trust, which has seen several sales at healthy premiums to the carrying values, providing both validity and uplifts to the reported NAV. As a trust with a history of trading in a tight range around its NAV, further price discovery through exit events could result in the current 12% discount as more than just an optically attractive entry opportunity.

One area where activity remained muted was UK offshore wind farm auctions, an area of great importance in respect of achieving net zero by 2050. Recent reports highlighted a failed auction with no bids for wind farms as inflated construction cost charges made new projects economically unviable at the underlying power prices. News of Vattenfall ceasing development of its Norfolk Boreas offshore wind site has the potential to impact future asset construction and thus government target achievement. The three UK-listed, wind focused investment trusts look to have shrugged off the news, with mostly operational assets and little exposure to those in the pre-construction phase of development.

STOCK FOCUS

HG CAPITAL

OSCAR SHEEHAN | INVESTMENT EXECUTIVE



Private equity (PE) has had a rough ride recently. Gone are the halcyon days of 2021 when investors were clamouring to gain access to both established and new funds across the market. Private equity limited partnerships have seen three straight quarters of declining investment amidst fears of persistently high interest rates and their knock-on effects on the growth prospects of smaller companies. While many of these closed-end funds remain inaccessible to retail investors due to their high minimum investment thresholds, private equity investment trusts have been hit equally hard by this collapse in confidence. Trusts such as Harbour Vest Private Equity and Hg Capital are trading at discounts of 39.4% and 15.5%, respectively. There are, however, signs of life within the sector. We recently explored the opportunities and threats presented by these discounts. Today, we will draw attention to the recent activity of one trust in particular, Hg Capital, and how its increasing trade activity paints a slightly rosier picture than public sentiment might be accounting for.

Hg Capital Trust (HGT) is a publicly traded private equity firm that invests in tech and software companies in Europe and North America, with target annual growth rates around the 20% mark. The trust has a long history of success and has outperformed global equity markets over the last five years, however it is yet to recover to the lofty heights it reached in April 2022. With IPO's tailing off and secondary market activity seriously declining as companies become unwilling to reprice themselves to lower valuations, the sector seemed to have stagnated. We are beginning to see a turnaround here with IPO's and trading activity starting to pick up. Hg Capital has itself had a recent flutter of activity. One notable partial sale has been that of TeamSystem, an Italian cloud software company, which HGT was able to move for around £33.3m. This represents an uplift of 68% from the carrying value of £19.8m in the trust's net asset value (NAV). This is a positive sign as it indicates that other assets held by the trust may be seriously undervalued. Assets in private markets are notoriously difficult to value and, as such, it is important that we don't jump to conclusions or extrapolate single pieces of data into long-term trends. Having said that, this is certainly good news.

This theory is backed up by the growth figures for the trust's top twenty holdings. The average revenue growth generated by these companies is around 30% per annum, and when we consider that the top twenty make up 77% of the trust's total value, it starts to look like perhaps HGT has been undervalued. Market perception of private equity has long been that valuations have to come down across the board as companies can no longer finance long-term growth by permanently borrowing money with exceptionally low interest rates. The trust has also undertaken in £1.4m worth of buybacks over the past year, indicating that its management believes its own portfolio is undervalued by the market, and this should help narrow the existing discount. What is particularly impressive is that it has managed to execute these buybacks without tapping into its revolving credit facility, meaning it still has a total of £689m of dry powder to invest into the market.

The counter argument to this is that unpredictable valuations are hardly reassuring, especially at a time when even public markets have been exceptionally volatile. This is a valid concern as private equity is an opaque market at the best of times and when valuations are this out of sync and discounts are this wide the market can start to feel chaotic. It may seem an obvious statement, but assets are only ever worth what someone will pay for them, and people will generally pay less for assets that are shrouded in uncertainty. Some uplift at the point of sale is also expected with private equity investments, so while the scale here does warrant some optimism, this is far from unheard of.

"It may seem an obvious statement, but assets are only ever worth what someone will pay for them."

Private equity investments such as this are inherently risky. A lack of reporting requirements and significantly decreased transparency when compared to listed equities make them unpredictable. That said, the increased activity we are seeing in the space from trusts such as HGT is indeed promising. It shows us that quality companies, even in private markets, are finding ways to adapt to high interest rates and generate growth. There is a light at a the end of the tunnel. ■

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INSIGHT

A SEA CHANGE FOR OFFSHORE WIND PROJECTS

GREG LODGE | PERFORMANCE & RISK ANALYST

If you've flown or sailed across the North Sea in recent years, your attention may have been drawn to the perfectly straight rows of wind turbines steadily rotating across the water. The true scale of these wind farms is perhaps best appreciated by air, but the size of the individual turbines is difficult to comprehend – they are gigantic. The 277 turbines currently under construction at SSE's Dogger Bank Wind Farm, off the coast of East Yorkshire, are 260 metres tall and each blade is 107 metres. A single rotation generates sufficient electricity to power the average UK house for two days. The North Sea is also uniquely positioned to provide wind power with its high wind speed and shallow depth. The efficiency and economy of scale from increasingly large turbines has also helped reduce the cost of offshore wind power by two-thirds since 2000.

While recent announcements by the Prime Minister, Rishi Sunak, have amended some of the UK's climate targets, the ultimate aim is still for the country to be net zero by 2050, and the Government is bound by its own legislation to be so. Part of the plan includes tripling the UK's offshore wind capacity by 2030. As it stands, offshore wind contributes around 11% of the UK's energy mix. The UK is something of a global leader in offshore wind, with four of the world's largest wind farms located within its waters.

During a decade-long period of near-zero interest rates, funding for offshore wind installations was straightforward and the costs fell as investment in new technologies and competition increased. Now that this era seems to be over, wind farm developers have seen their costs increase substantially. The Swedish developer Vattenfall suspended work on its Norfolk Boreas site in July after development costs rose by 40%. 140 turbines had been planned, which would have provided power to more than four million households. Compounding the issue is the method by which wind farm projects are funded, which bears exploring. The UK Government holds an annual auction where companies are invited to bid on renewable energy developments and contracts. Successful bidders will receive a guaranteed price for the electricity they generate for the next 15 years. If prices are above this guarantee, the company returns the excess. Conversely, if prices fall below this threshold, energy supplies, and ultimately the consumers, will make up the difference. The idea of the scheme is that developers with large upfront costs have some assurance over their future revenue. The Norfolk Boreas development had been guaranteed last year at £37.35 per megawatt hour with an inflation link. One year on and so keen to now exit the contract, Vattenfall is willing to swallow an impairment of US$537m. Explaining the firm's decision in a press release, President and CEO Anna Borg said, "Higher inflation and capital costs are affecting the entire energy sector, but the geopolitical situation has made offshore wind and its supply chain particularly vulnerable."

At the time, the 2022 auction had been regarded as successful, with five offshore wind farm contracts awarded. Now only two projects are going ahead, and these were already at an advanced stage by the time the auction got underway. This represents a significant setback for the UK's offshore wind strategy, which plans to increase capacity from 14 gigawatts (GW) to 50 by 2030.

The UK's green energy aspirations took a further hit this month when the results of the most recent auction revealed there had been no bids for offshore wind contracts whatsoever. This shouldn't have come as a total surprise to the Government, as the would-be bidders had been warning for months that the £44 per megawatt hour maximum price was too low and that they had failed to take into account the substantial rise in costs they faced.

"Higher inflation and capital costs are affecting the entire energy sector, but the geopolitical situation has made offshore wind and its supply chain particularly vulnerable."

The auction wasn't a complete failure, however, as solar power and onshore wind won contracts priced at £47 per megawatt hour and £52, respectively. For the first time, geothermal energy projects also won contracts. Nevertheless, the winning contracts represent just one third of the capacity awarded last year. In a press release, Energy and Climate Change Minister Graham Stuart said: "offshore wind is central to our ambitions to decarbonise our electricity supply and our ambition to build 50GW of offshore wind capacity by 2030, including up to 5GW of floating wind, remains firm. The UK installed 300 new turbines last year and we will work with industry to make sure we retain our global leadership in this vital technology." The Government has also hinted that the next round of bidding, which commences in March 2024, may offer a higher maximum price to revive interest.

As the UK seeks to end its energy dependence on fossil fuels, offshore wind is a vital part of the renewable energy strategy. A gradual, albeit slightly more drawn out, shift to electric cars and domestic heat pumps will further increase demand on the grid. The setbacks offshore wind has seen this year are not intractable, and the UK's capacity will keep growing. The cold and windy North Sea, which formerly provided the UK with much of its oil and gas, will continue to keep our homes warm and bright. ■

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TOPIC OF THE MONTH

THE COST DISCLOSURE DEBATE

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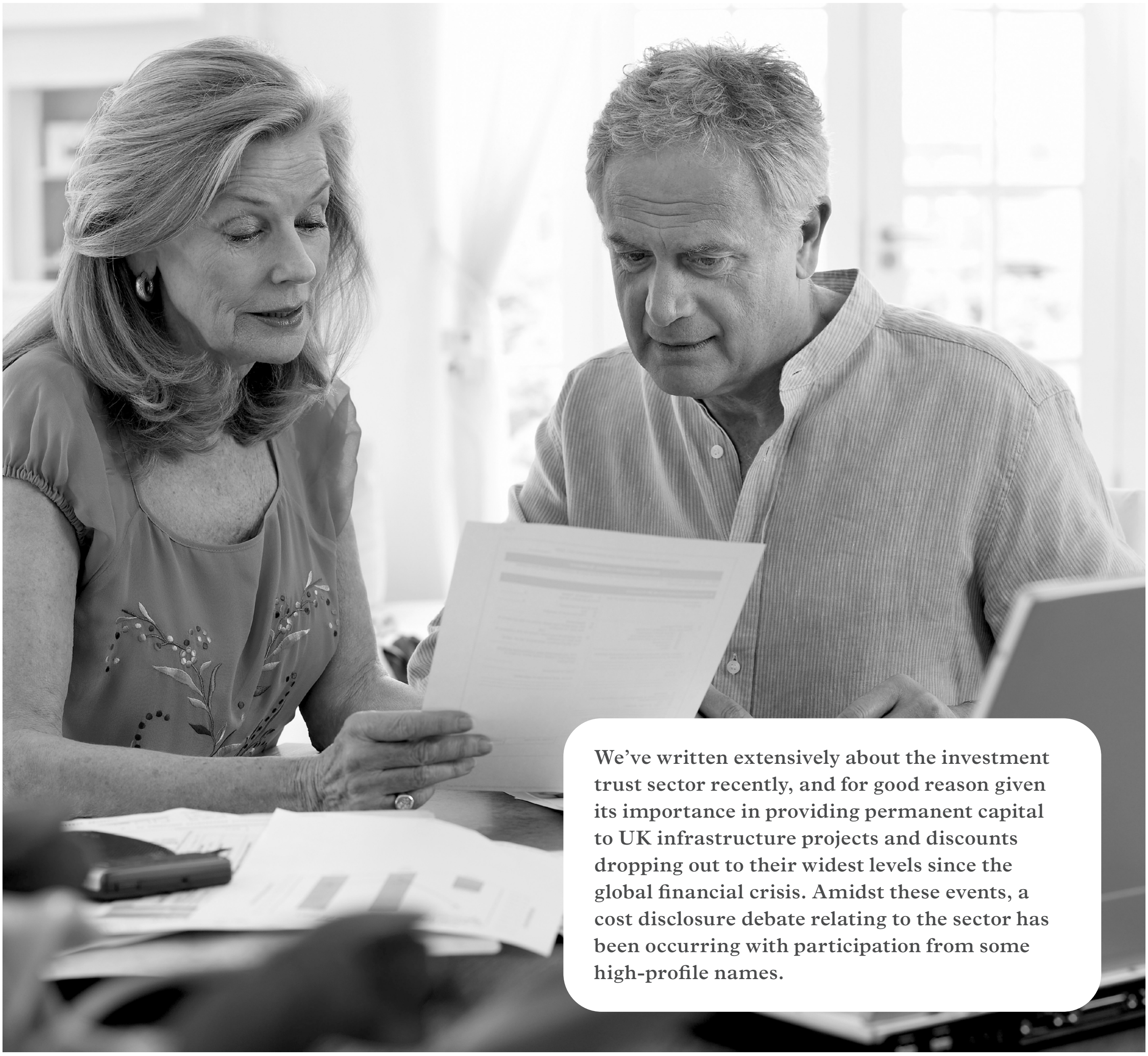

We’ve written extensively about the investment trust sector recently, and for good reason given its importance in providing permanent capital to UK infrastructure projects and discounts dropping out to their widest levels since the global financial crisis. Amidst these events, a cost disclosure debate relating to the sector has been occurring with participation from some high-profile names.

Improvements to cost transparency within financial markets are a resounding positive and formed an important aspect of a key piece of 2018 European legislation. Part of this included requirements for listed investment trusts to produce a Key Investor Document (KID) outlining ongoing charges figures (OCFs) and potential risks. Designed to crossover with the open-end fund requirements, the result looks to be increased confusion, rather than clarity. The voice at the forefront of concerns is House of Lords member Baroness Bowles who argues that rules around investment trust fee presentation is causing investors to turn away from sectors such as renewable energy where the investment trust sector is a significant provider of permanent capital in the transition to net zero.

When looking at a KID for an investment trust, potential investors will see a quoted OCF in percentage terms which includes costs such as manager fees, interest cost, performance charges and other operational costs. Add all these up and there are points where the total can be a little alarming, reaching the 5% range in some cases. Above this figure sits a table outlining the costs associated with investment over multiple time periods. Of all the comments around the costing disclosures of investment trusts, this is an area highlighted most frequently as one that causes confusion, mainly due to the structure of the investment trust vehicles.

Structure-wise, investment trusts are commercial companies listed on a publicly recognised stock exchange, like Marks & Spencer. Assets of the business are invested to generate returns, generally by external asset managers via an arrangement decided by the board of directors. Operational costs, such as listing fees and manager fees, are recognised in the accounting process and bear out in net asset value and earnings per share releases. The share price will fluctuate around the net asset value through time and trend in the same direction over longer time periods, with the risk of a divergence ever present in the shorter time horizons.

Many of the arguments put forward surrounding the cost disclosure rules being confusing center on the fact that investors buy the share price while fees are charged to the net asset value. Therefore, investors are not directly paying a fee and any cost charged is reflected in the fluctuations of the share price around the net asset value. This makes for the confusion around that previously mentioned costs table found in the regulatory KID. This could outline a potential, and sometimes alarmingly large, fee that investors never actually pay.

One of the most impacted areas of the market in relation to investment trust cost disclosures are the fund-of-funds managers, who invest client assets within their own funds into portfolios of other funds. Last year saw guidance from the Investment Association (IA) to report the fees of funds invested in on top of the fund's own fees, leading to a jump in the OCF figure. For those fund firms launching their own funds or domiciling them offshore, guidance can be ignored and investment trust costs removed from the OCF. For those asset managers who use an outsourced platform the decision is out of their hands, with reported OCFs increasing together with confusion over what charges are being paid.

"Improvements to cost transparency within financial markets are a resounding positive and formed an important aspect of a key piece of 2018 European legislation."

In the first quarter of this year, consultations with market participants as part of UK Chancellor Jeremy Hunt's Edinburgh Reforms noted the levels of confusion around cost disclosures, agreeing to amend current disclosure rules to improve the transparency of the associated costs of investment products. With new guidance anticipated in the coming year, simplification and improvements to transparency will be welcomed. ■

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RETURNING IPO ACTIVITY

KONRAD PIETKA AND SAMANTHA CORY | INVESTMENT RESEARCH TEAM

The market is currently experiencing a wave of hefty Initial Public Offerings (IPO) with US$60.9bn raised in the first half of 2023. The trend is expected to continue into the third quarter of 2023, with the online grocery deliver app, Instacart, and German sandal maker, Birkenstock, set to list later this year. Both firms are attempting to replicate the success of Arm Holdings, which has been experiencing a rally following its IPO in the US this September.

Arm Holdings specialises in central processing unit (CPU) designs, with a virtual monopoly on smartphone chip blueprints due to high barriers to entry in the market. Questions were raised regarding the firm's future profit projections on the back of a global phone sales slump, causing Arm's net profits to fall. The idiosyncratic management structure of Arm China and heavy reliance on a handful of customers caused additional concern. Yet this did not deter investors who expressed confidence in the growth prospects of the company as it seeks to expand its chip provision to Artificial Intelligence (AI) systems and data centres. Arm's IPO, valued at US$52.3bn on the day of the listing, has been the largest since November 2021 with the company's shares soaring by a quarter on the first day of trading. Arm's IPO performance could embolden other technology firms to follow suit and become public as investors have demonstrated a noticeable appetite for AI-linked businesses.

"It should be noted that it is not just tech firms that are going public. Birkenstock, the German footwear producer, is also throwing its hat into the ring. The sandal maker is hoping to obtain a valuation that exceeds US$8bn which appears attainable if the firm manages to convince investors of its growth potential. Indeed, the company had a compounded revenue growth rate of 20% between 2014-2022, driven by a reorientation towards the American market and a loyal consumer base..."

Instacart, a fellow technology business in the US grocery delivery sector, has experienced an uplift in its pre-listing valuation range after Arm's IPO success, from US$9.3bn to US$10bn, as investors demonstrate a willingness to put money into new technology IPOs. Instacart achieved admirable growth during the pandemic with the total value of transactions on its platform increasing from US$5.1 bn in 2019 to US$28.8bn in 2022. Growth has stagnated this year, though, due to high inflation and tough competition from rivals. These headwinds, in conjunction with the rising costs of customer acquisition, have resulted in a considerable devaluation of the company, from a peak of US$39bn in 2021 to US$10bn in September 2023.

Similar to Arm Holdings, Instacart has persuaded key stakeholders to become cornerstone investors for its IPO, as it has admirable future growth prospects. Although orders plateaued in the first half of this year, the company still has space to expand its market share, as only 12% of US grocery shopping occurs online. PepsiCo has already agreed to purchase US$175m of Instacart convertible stock, expressing a vote of confidence in the company and its future growth prospects.

It should be noted that it is not just tech firms that are going public. Birkenstock, the German footwear producer, is also throwing its hat into the ring. The shoe maker is hoping to obtain a valuation that exceeds US$8bn which appears attainable if the firm manages to convince investors of its growth potential. Indeed, the company had a compounded revenue growth rate of 20% between 2014-2022, driven by a reorientation towards the American market and a loyal consumer base, with the average US customer owning 3.6 pairs of Birkenstock sandals. Since 2021, the firm has been owned by private equity house L Catterton, itself backed by European luxury goods giant LVMH. L Catterton will be hoping that Birkenstock can replicate the IPO success of its other portfolio company, Oddity Tech, an Israel based beauty business which went public this July.

However, a halving of net profits in the six months to March 31st has brought Birkenstock's performance into question. The company attributes this to its endeavour to sell more products directly to consumers, rather than via third party retailers, as a means of vertically integrating its business. Birkenstock will hope that this growth focus, marked by the ongoing construction of a €120m factory in Pasewalk, Germany, will highlight to investors the firm's expectation that its market share will continue to expand.

It will be interesting to see whether Instacart and Birkenstock can benefit from the recent momentum. Its performance will provide greater clarity regarding investor preferences and appetite for IPOs in the post-pandemic era as well as the information to judge if the success of Arm was just a one-off occurrence or the mark of a sustained increase in public offerings. ■

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