Q&A

R.C.B Primary Opportunities

MARKET TURBULENCE POSES THE PERFECT BACKDROP FOR PRIMARY MARKET INVESTING. JENNIFER HILL SPEAKS TO **OLIVER BROWN**, LEAD MANAGER OF THE MFM UK PRIMARY OPPORTUNITIES FUND – THE ONLY FUND DEDICATED TO INVESTING AT THE POINT A COMPANY IS RAISING MONEY

MARKET VOLATILITY MADE A COMEBACK IN 2018. WHAT DOES THIS MEAN FOR PRIMARY MARKET INVESTORS LIKE R.C. BROWN INVESTMENT MANAGEMENT?

First and foremost, we are not afraid of market volatility. In fact, we see it as an opportunity. The reality is that we make some of our best investments during periods when markets are volatile because the discounts available at the time of the placing are greater. It is during times of market stress that we can not only expect a greater discount at the point of purchase, but shares in listed companies raising fresh capital are likely to have been weak already in line with the market sell-off – effectively netting us a double discount.

DOES MARKET VOLATILITY NOT DISSUADE COMPANIES FROM RAISING MONEY?

We still see companies wanting to push ahead and raise money even during market volatility. They raise money for a variety of reasons – expansion, acquisition, further research and development, working capital. Perhaps even more so at times when there are fears over an economic downturn, companies may look to shore up their balance sheets to put them in a more secure position. It is also a truism that only really high quality companies are able to pass the rigours and scrutiny of raising money during market turmoil, when the average investor is running for the hills or is minded to sit on their hands. The natural policing of the market at a time of economic nervousness means only better quality companies will be successful in raising new money – just the way we like it.

WHAT KIND OF DISCOUNTS CAN YOU ACHIEVE?

If a company wants to go ahead and raise money during market volatility they have to be pragmatic. They know there will be less buyers prepared to ignore the market noise so primary placings – existing listed companies raising new money and very much our bread and butter – are typically priced at discounts toward the upper end of a range of 2-10%.

ARE THERE OTHER ADVANTAGES OF PRIMARY MARKET INVESTING?

Buying at a discount to the prevailing market price is a definite advantage, but there are certainly others. Purchases are free of stamp duty and dealing commission – charges that act as a drag on performance. We are also not buying blind; when raising money, companies need to make us and other investors aware of all available information, so we can be as certain as possible that a company is in the state it says it is. It is also worth mentioning that the companies we hold in the Fund now have more cash than they did before they raised capital. All of these factors give us an element of downside protection from punishing market falls.

CAN YOU GIVE ME SOME FIGURES TO SUPPORT THIS?

Absolutely. Our performance analysis points to new issues in 2018 falling less than the market as a whole. Looking at the main market, IPOs [initial public offerings] that took place last year averaged a capital return of 2.4% to the year end, while further issues, such as placings for cash and rights issues, returned 5.3%. In comparison, the FTSE 100 lost 12.5% in capital terms and the FTSE All-Share dropped 13%. On the Alternative Investment Market, IPOs lost an average of 2% and further issues lost 8.3%, while AIM overall lost 18.2%. Of course, these are not like-for-like comparisons because transactions happen throughout the year, but the data serves to illustrate the discount and cost benefits, and proves our process.

WHAT ABOUT YOUR FUND – HOW HAS IT PERFORMED?

The MFM UK Primary Opportunities fund ranks in the top quartile of funds in the IA UK All Companies sector over three and five years. Creo Medical was the undoubted star of the portfolio in 2018, rising 186% as the market started to appreciate the huge potential for its medical device products focused on the non-invasive endoscopy area. Sumo Digital, the video games developer, as well as long-term holdings Fever-Tree and the London Stock Exchange also contributed positively to performance.

HOW BIG IS THE PRIMARY MARKET?

Primary placings raised £11 billion in new money last year, and IPOs raised a further £9.5 billion, so it's a market that was worth more than £20 billion. The large arena in which we participate gives us plenty to choose from and enables us to be selective with our investments. We participated in only 15% of companies that floated last year and 50% of primary placings, where at least £5 million was raised by the company.

HOW IS THE FUND DIFFERENT FROM OTHER UK EQUITY FUNDS?

The main difference is that our focus is on newly issued shares – companies that float for the first time (IPOs) or companies that are already listed and are coming back to the market to raise more money (primary placings). This is what R.C. Brown and our Fund was set up to do. It's what we spend our entire working lives looking at. Everything we invest in is a listed business either on the main market or AIM, so this is absolutely not a private equity fund.

YOUR PROCESS DEPENDS UPON HAVING CLOSE RELATIONSHIPS WITH INVESTMENT BANKS, WHY IS THIS IMPORTANT?

Our investment team has almost 100 years' experience, so when we hear about an opportunity, we will almost certainly have some knowledge of that company. Our focus on the primary opportunities market, and the close working relationships we have forged with investment banks over the past 30 years, means we are often made an insider on a deal. At this point, we are privy to information not yet in the public domain, enabling us to better form and share our views on the value of the company and the price we are prepared to pay.

WHAT HAVE YOU BOUGHT RECENTLY?

In February, we participated in a £100 million fundraising to further develop Blue Prism Group, a multi-national high growth artificial intelligence software business, buying the shares at a 5% discount to the prevailing market price. In January, we bought Savannah Petroleum as it raised $23 million for working capital purposes at a 9% discount to the previous night's closing price. Savannah is an oil and gas company with assets in Niger that is close to completing the purchase of assets in Nigeria, which we believe offer compelling value alongside the hope of further finds in Niger. The company is shortly to commence dividend payments – a rarity amongst smaller oil and gas companies.

WHAT ABOUT THE UK DOMESTIC MARKET – DO YOU HAVE MUCH EXPOSURE HERE?

We recently increased our UK domestic exposure with the purchases of Kier and Grainger in December. These perfectly illustrate the opportunity to acquire stock at particularly attractive levels during market sell-offs. Kier, a construction and support services company, had a rights issue to reduce its debt levels that were causing customers concern following the collapse of Carillion earlier in the year. We consider Kier to be a hugely superior business to Carillion and one of the best in its sector. The shares were very weak on a perfect storm of an expected rights issue, market weakness over growing trade tensions and Brexit-related uncertainty. In January, the company said it was trading in line with market expectations, had a strong order book and a strengthened balance sheet – the shares have risen 25% since we bought them. Grainger, the largest UK listed private market landlord, had a rights issue to buy out the 75% of a private landlord vehicle it did not own. Much like Kier, its shares had been weak over trade tensions and Brexit uncertainty, resulting in extreme UK asset aversion. We purchased shares in Grainger at a 30% discount to NAV and the shares are currently showing a healthy 15% profit. Despite these purchases increasing our UK domestic exposure, we remain cautious over the political backdrop and await a more certain outlook before adding more.

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> Oliver Brown, Lead Manager, MFM UK Primary Opportunities fund

WHAT IS THE OUTLOOK FOR YOUR FUND IN 2019?

Market volatility is likely to remain elevated as political noise continues to overhang markets, but we anticipate a continued recovery in share prices as and when the risk aversion dissipates. Against this backdrop, many of the companies we acquired throughout 2018 ought to outperform as the market appreciates the growth potential and quality of these businesses.

AND FOR THE OPPORTUNITIES IN THE PRIMARY MARKET?

Companies will always be looking to raise money and good quality ones should still be able to. While the year is still young, there is a clear indication of good quality companies wanting funding for further growth. We anticipate a steady flow of opportunities in the first half of the year, as there is a pent-up demand from the back end of 2018, when some fundraisings were postponed due to market conditions. In times of market turbulence and a slowing economy, we also anticipate an increase in companies refinancing as they look to shore up their balance sheets, not dissimilar to 2009. We expect the IPO market to pick up in the second half of the year assuming global growth fears turn out to be fears rather than an advancing recession – the former being our base case. Companies that are able to grow, even in times of uncertainty, are likely to prove fruitful long-term investments.

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