Chelverton European Select Fund

Webinar Transcript - June 2024

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Gareth Rudd: Good afternoon, everyone. I have two parts to this update, the first one is a very brief recount of how we do things which will be which will be for the first few minutes, as I'm not sure what the level of knowledge is here, but a refresher on our philosophy and processes will be no harm. Then I really want to get into the bulk of the presentation, which is how we're seeing markets at the moment, how the fund is positioned, and we are very excited about the current opportunity, so I'd like to get to that.

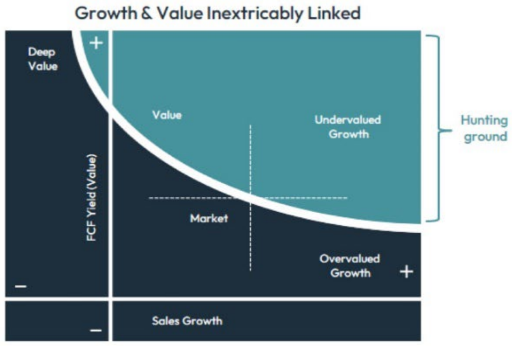
Investment Philosophy

We have four pillars of our investment philosophy. Free cash flow which is front and centre of our process and it's very much our DNA. We feel it's done poorly by markets; markets are still very much focused on single point forecasting, PE's and EV/EBITDA and we are very much of the opinion that you learn much more from the cash flow dynamics of a business, as an investor in public equities you have two sources of return, you've got income from dividends, and you've got capital appreciation from growth. You need to be able to deliver, sustain and grow in order to really deliver value as an investor, so very much focused on free cash flow. Outperformance without excessive risk, that is our firmly held belief that you do not have to have significant financial leverage in public equities in order to make good returns and we think that's especially the case in smaller companies. You don't want to be beholden to a higher-ranking stakeholder in times of financial stress. We think that's important, and we have a portfolio rule that we will always have less debt than the market. Inefficient markets really relate to the opportunity that we find in smaller companies in Europe. When we launched the fund over six years ago now, Dale and I knew that we had to do something different, our main differentiator is our focus on the small and mid-cap area. Coverage has been affected by things like MiFID ii, there are fewer analysts that cover small companies, which is great for us, but also the qualitative angle as well, when you go down the market cap spectrum, the number of analysts that produce materials like cash flow forecasts falls away quite sharply. So long may that continue. It's a very fertile hunting ground for us and the final point, growth and value inextricably linked, this has been paraphrased from a Warren Buffett quote where he said that you cannot compute the value of a company without inputting the growth that you expect that company to be able to deliver and we completely concur with that. We don't want to be stylistically handcuffed into being growth managers or value managers, we think you can get the best of both worlds with a sensible process, which is what we think we have.

I am going to talk through the below as it is something that we always come back to during our presentations, and it is how we view our investment world and our investable universe. We try to plot all our investments on this free cash flow yield, which is the y axis, and sales growth, which is the x axis, and see what sort of trade off we're getting between the free cash flow yield, which is our valuation measure, and the growth that the company is expected to achieve. For the free cash flow yield, we use a blend of two years of historic free cash flow and two years of forecast free cash flow, we want to be investing in businesses that are cash generative now. Sales growth simply takes the next three years of forecast growth for a business. Obviously, when we get down into the individual company analysis, we become much more granular, and we'll look at operating cash flow growth and so on. In the first instance, we're just wanting a loose proxy for growth and valuation, we plot all our investments on this curve. Anything that is above in the blue shaded area is investable to us. We're always trying to be invested in the undervalued growth quadrant, which is the top right, and think intuitively that's where most investors would want to be invested, where you're investing in companies that got better growth prospects than the market, but they've got a higher free cash flow yield as well, i.e. they're cheaper. The fund, since we launched, has always resided in that quartile because of the opportunity in small companies, predominantly. We're prepared to take pragmatic approaches, so we might pay up a bit if the growth opportunities are exceptional. We might buy some companies that have got a slightly lower free cash flow yield than the market and we also might buy some companies where perhaps the growth is a little bit slower than the market and what I've termed value in the upper left quadrant, but we're being compensated by a higher free cash flow yield. It is important to mention that these are still good companies. They're still growing. They've still got good growth prospects. They might just be a little bit slower than the market. We're not involved in deep value areas where companies have perhaps gone ex-growth, they're very capital intensive and returns are coming back. They might superficially look cheap on a PE basis, but we want to avoid these, we also want to avoid overpaying for companies being sucked into the overvalued growth area.

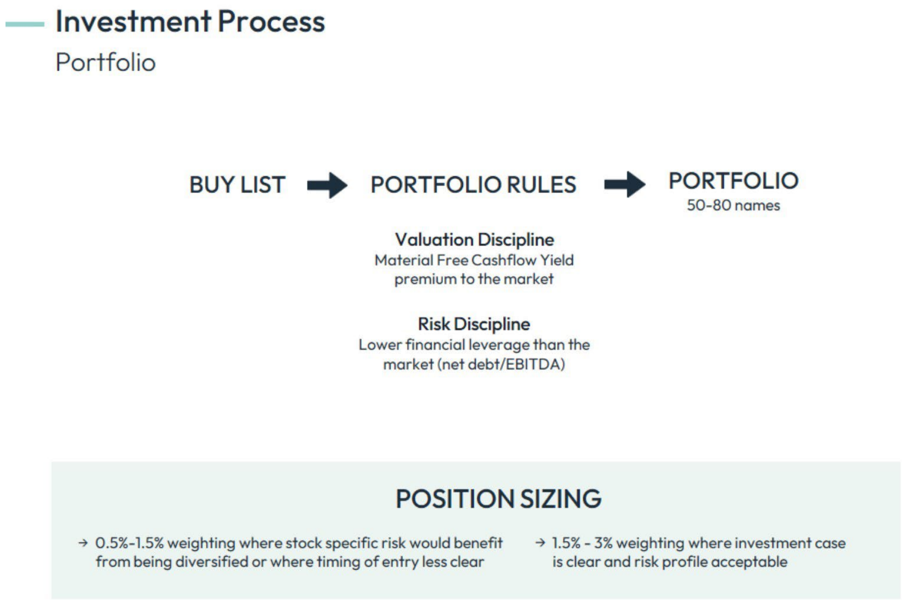
Investment Philosophy

Valuation discipline



Investment Process

When we look at the portfolio itself, we have two rules that investors need to know they get with us. The first one is our valuation discipline, which is that we will always have a material free cash flow yield at the portfolio level to the market, so that stops us from overpaying. The risk discipline, which I've mentioned before, is that we will always have less financial leverage than the market, as measured by Net Debt/EBITDA. The portfolio currently has 60 names, 50 to 80 is a kind of bracket, we tend to be closer to 50 than 80.



Portfolio

This is how the portfolio looks, you can see where the portfolio clearly resides in that upper right quadrant, where we've got a 6.1% free cash flow yield versus the market of 4.1%, that is our valuation discipline and our commitment to investors. The growth prospects are excellent, 11.9% versus the market on 6.5% for the next few years, you can also see our risk discipline there as well. Net Debt/ EBITDA at the portfolio level is neutral, i.e. our companies have got no debt at the aggregate level versus the market of 1.3X. I want to come to the main part of the presentation, which is an update on where we are with markets. I thought I'd start with another Warren Buffett quote. Interestingly, written in 1987 but it's incredible how many of his quotations from the past and history still have huge relevance today. What he's basically saying is you that you will get de-coupling between what the market thinks our companies worth and what it is worth. The whole point is about being invested in companies that are increasing in intrinsic value and they're becoming better businesses, they're growing, they're becoming more profitable. His point is, if you can afford to take a longer-term view, then that's really the secret to making money. In over 30 years of market experience my view is that the biggest opportunity in markets is or the biggest arbitrage in markets is time. I think that the average holding period in the New York Stock Exchange now is down well below a year and Europe's not that far behind it. If you can take a long-term view, that's how you get this compounding return. The three elements I want to focus on are: the intrinsic value of the portfolio and demonstrate that it is increasing in intrinsic value and has been, the second that I want to talk to you and triangulate how you might think about the value opportunity in the portfolio and just how cheap it might be seen as and I want to use three separate measures to do that. Finally, I just want to touch on the asset class itself, small and mid-cap companies which are very out-of-favour at the moment, we think that they are a huge opportunity.

Portfolio

	PORTFOLIO	MARKET
FREE CASH FLOW YIELD	6.1%	4.1%
SALES GROWTH 3-YEAR CAGR	11.9%	6.5%
NET DEBT/EBITDA	-0.1x	1.3x

Source: Chelverton Asset Management, Factset 31 March 2024
For full FCF Yield and Sales Growth definitions please see the appendix

Intrinsic Value

The first point on intrinsic value. The unit price last year was up just over 5%. This is what the companies did at the aggregate level. Sales were up 10%, EPS up 15%, operating cash flow up 31% and free cash flow up 14%. I think we can comfortably say that these companies grew and became better businesses last year and they added intrinsic value.

1 Our portfolio continues to build its intrinsic value

2023 Operating Performance

	2023 growth
Sales	10%
Earnings Per Share	15%
Operating Cash Flow	31%
Free Cash Flow	14%

Source: Chelverton Asset Management, 30 April 2024
*Current portfolio holdings, with historic performance analysis

How are they looking for the next three years? Well, this is what we're expecting at the portfolio level, an average of around 12% growth at the top line, and an average of about 15% free cash flow growth as well. So, we think that these companies will continue to add intrinsic value. The market will sit up and take notice at some point, we've just got to be patient.

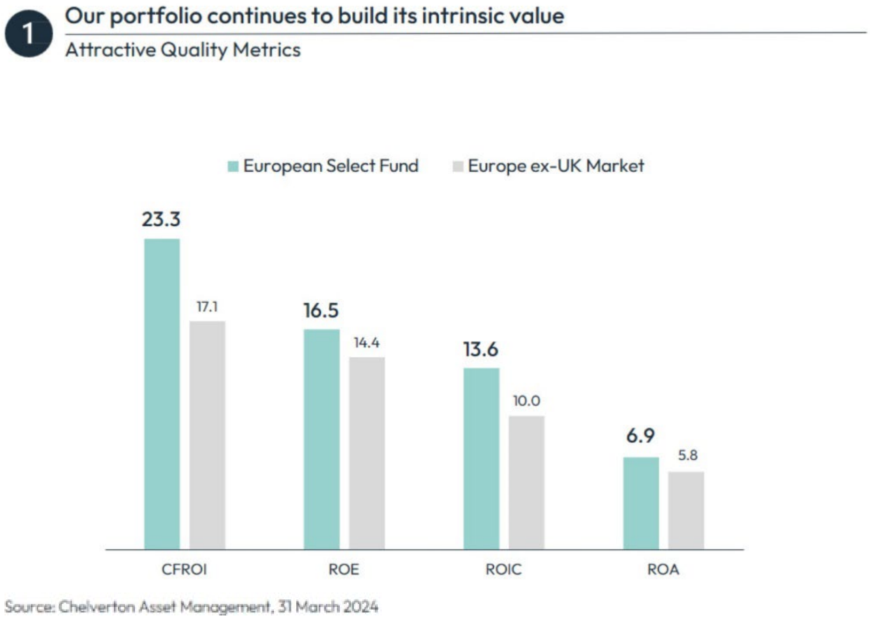
1 Our portfolio continues to build its intrinsic value

Our portfolio companies are expected to deliver good growth

	2023	2024 (e)	2025 (e)	2026 (e)	Average (e)
Portfolio Sales Growth	+10.1%	12.7%	12.9%	10.4%	12.0%
Portfolio FCF Growth	+14.0%	16.0%	17.0%	12.0%	15.0%

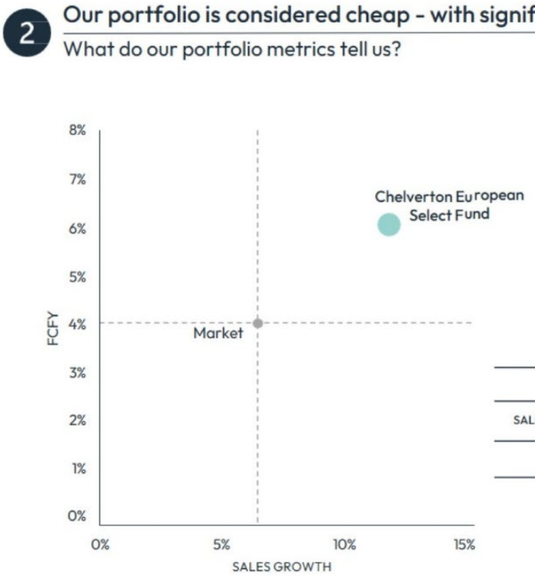
Source: Chelverton Asset Management, 31 March 2024

What about the quality of the companies we're investing in? One criticism that could be levelled is, are we just investing in poor companies that are becoming a little bit better from a low base? That also isn't the case. These four measures of quality: cash flow return on investment, return on equity, return on invested capital and return on assets. This is the average of these four over the last decade versus the market and you can see that on all metrics, the portfolio companies have better quality metrics. It's not the case that we're investing in poor quality businesses.



Significant Potential

Having proven that the portfolio is increasing in intrinsic value. We come on to the question: have we paid the right price for it? As people like Charlie Munger are fond of saying, have we paid a fair price for good businesses?



	PORTFOLIO	MARKET
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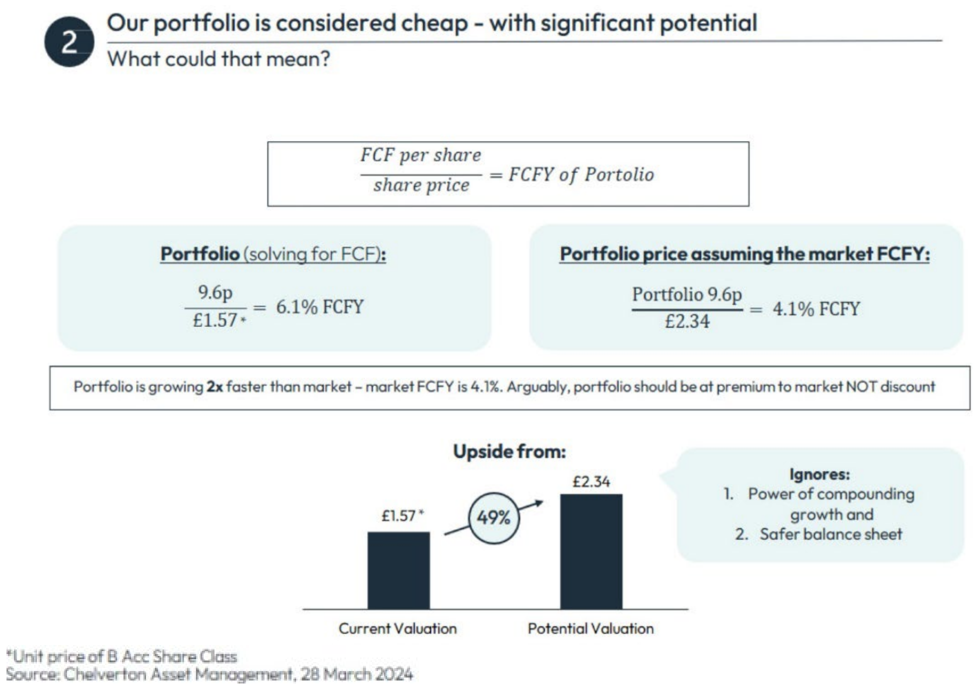
NET DEBT/EBITDA	-0.1x	1.3x

Source: Chelverton Asset Management, Factset 31 March 2024
For full FCF Yield and Sales Growth definitions please see the appendix

The below is the portfolio at the aggregate metrics. 6.1% free cash flow yield versus the market of 4.1%, 11.9% growth versus 6.5% and ungeared balance sheets. How cheap could that be? Before I get on to this analysis, I want to make it clear that there is no precision in this. It's simply having a look at it and trying to ascertain that there's a good margin of safety or there's very good upside in the portfolio. I don't want anyone hung up on the exact valuation. But one exercise that you could do at the portfolio level is that you could calculate a free cash flow per unit, or per share, you know the free cash flow yield and you know the unit price. It's a little bit higher than that now, but not much, and the analysis is still the same. We've got 6.1% free cash flow yield and the unit price of £1.57 gives you 9.6 pence per unit of free cash flow. In the first instance, all we do is put that on a free cash flow yield equal to the market, i.e. 4.1%, and find out what the unit price would be and the unit price in order to solve for that, would be £2.34 versus the current price, so it's about 50% upside. Now we're going to argue that holding a portfolio that has much better growth prospects than the market and safer balance sheets should give us a premium to that market, which is why I don't want anyone to write down 49% and then at £2.34 the fund is a sell. We're going to argue that it should be a lot more. It doesn't take account of compounding and it doesn't take account of these balance sheets. That's what the valuation at the portfolio level is telling us. So, that's the first point of the triangle.



The second element for valuation would be to look at the individual companies themselves and see how we value them. Now on a webinar like this, I don't have time, and I don't think anyone's got the appetite for me to go through all 60 holdings. What I've done is I've taken the top ten, and you can see, that across a range of sectors we've got recruitment companies, we've got software as service businesses, we've got semiconductor equipment manufacturers, we've got environmental consultants.

It's a real broad spread of interesting businesses and I've shown the free cash flow yield of each company, the average for the top ten is 5.9%, which is a little bit lower than the average for the whole fund at 6.1%, but we're getting 13% growth so we're getting slightly better growth for a slightly lower free cash flow yield. We think that the trade-off is really attractive and what we've got on the potential upside column, this is the result of our extensive modelling on each individual company. Those of you that have had presentations from us before will know that Dale and I are firm believers in the futility of forecasting, we think it can't be done with any sort of precision. All you're doing is you're looking for a direction of travel when you're examining companies, we tend to use scenario models where you've got a best, a central and a worst-case scenario, all you're looking to answer is, is it in your favour that you're holding a cheap company? The average upside for the top ten is 61%. You're triangulating that with the 49% that I showed with the portfolio. At the portfolio level, there's very decent upside, at the individual company level, we think there's very decent upside as well. But then the criticism now could be, are Dale and I just sitting in our little office in Edinburgh popping happy pills and believing the hype that we've generated about our companies

2 Our portfolio is considered cheap - with significant potential

What do our stocks tell us?

COMPANY	DESCRIPTION	PORTFOLIO WEIGHT	FCFY	SALES CAGR	POTENTIAL UPSIDE
Amadeus Fire	German specialist recruitment and training - high quality compounder	2.6%	10.6%	7.2%	73%
Fabasoft	Software business providing document management solutions.	2.6%	4.2%	10.3%	80%
GTT	World leading provider of membrane technology for LNG storage and transportation	2.6%	5.2%	21.9%	59%
ASM International	Leading front end semiconductor equipment supplier	2.5%	2.8%	17.0%	27%
DEME	Offshore infrastructure service provider renewables and dredging	2.5%	4.7%	9.3%	70%
ARCADIS	Design & engineering consultancy, focussing on urbanisation, sustainability & digitalisation	2.5%	5.1%	7.6%	48%
Technogym	Leading manufacturer of exercise equipment	2.5%	4.8%	8.0%	45%
Besi	Leading manufacturer of semiconductor assembly equipment.	2.4%	3.0%	32.0%	25%
Esker	B to B order to invoice management software	2.4%	3.9%	14.0%	100%
vallourec	Steel tubing manufacturer, supplying energy sector	2.4%	14.9%	3.1%	83%
	TOP 10 AVERAGE		5.9%	13.0%	61%

Source: Chelverton Asset Management; all data as at 31/05/24

'Potential Upside' is based on the DCF valuation work which forms a core part of the research process. Should be considered a 3-5-year potential upside to fair value.

The third leg that I want to use in defence against that is what external buyers are saying, what corporate buyers and what private equity buyers are saying. We get a lot of bid activity in the portfolio which is not surprising. We like companies with strong balance sheets, good cash generation and decent growth prospects and they're an attractive combination for potential buyers. These are the last 5 deals that we've had in the last nine months or so and you can see the premium varies, but they average 58%. We often get asked how we feel about bids in the market, are we disappointed? Do we feel that companies are being taken out in the cheap? I think our experience has been a bit more nuanced than that, if you take a company like Pagero, which is software as a service company with very high recurring revenues which is a fantastic business, that ended up in a three-way bid war with a 138% premium to the undisturbed share price value.

That's a pretty good deal for us and again, trying to take our five year plus time horizon. We think we would have made more money than the bid. But do you know what, we got handed 3 or 4 years worth of performance up front and I think that's pretty fair. When you get down to something like Visiativ or Alkemy, we're more disappointed there, Visiativ was frustrating, we made much better money than the undisturbed price because our endpoint was a lot lower but we held Visiativ for a number of years, it was a mainstream IT service business, and we ended up having an argument with the analysts that covered it because he said that it is a really good price that they've achieved and we said it's a terrible price. He then said, yeah, but you've got a year's performance handed to you. We said, yeah, but we're not investing for a year, we're trying to find a compounding long term business that will potentially be a multi-bagger and we certainly felt if we could have held it for three, five, ten years, we would have made a lot more money than that. But on average, the third point of the triangle, is that corporate buyers agree with us that these businesses are significantly too cheap.

What do I think going forward will happen in terms of corporate and private equity bids? I think they will continue to be supportive for the market. I think interest rates have now settled down in Europe and people are less worried about the funding or the magnitude of the rises in funding. I think this will continue to be a feature. We have well over 2000 companies to choose from, and it's a case of just continuing to roll our sleeves up and find more. It comes with investing in smaller companies, sometimes you get the criticism of, well, if they're not covered by anyone and they're not widely owned because most people are in large companies, don't they just stay cheap forever? This is your answer as to why that doesn't happen.

2 Our portfolio is considered cheap - with significant potential

What do corporate/PE buyers tell us?

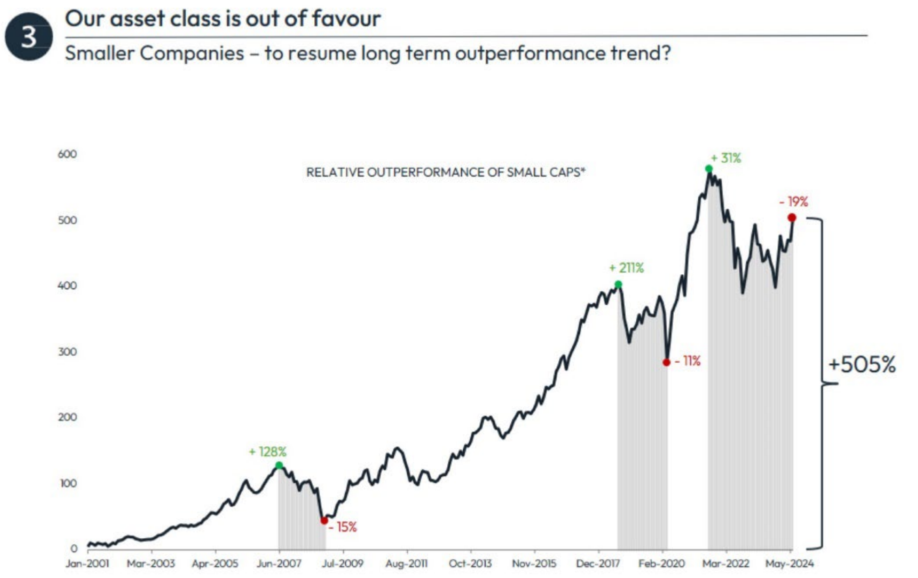
M&A ACTIVITY LAST 9 MONTHS:

COMPANY	COMMENT	PREMIUM
EQS GROUP	German regulatory software – private equity bid	50%
PAGERO	Swedish e-document company – 3-way corporate bidding war	138%
visiativ	French IT services/software – French corporate bid	36%
OX2	Renewable energy project developer - private equity bid	44%
Alkemy	Marketing Technology Company – corporate bid	24%
	AVERAGE	58%

Source: Chelverton Asset Management

Our Asset Class is out of Favour

I'm going to move on to the final part of the webinar, which is to talk a little bit about small and mid-cap as an asset class, which is very out of favour at the moment. This graph shows the outperformance of European small caps versus the broader sector. So long term compounding outperformance 505% to date.

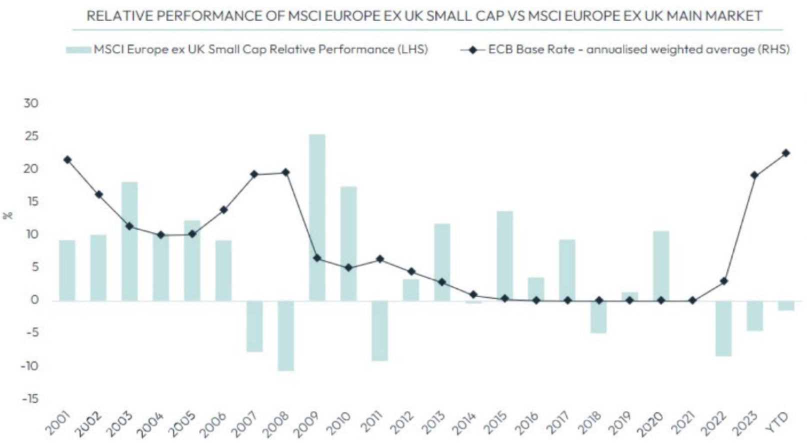


Source: MorningstarDirect, data 01/01/2001 to 31 /03/2024 (01/01/2001 being the start date of the MSCI Europe Ex UK Small Cap Index) in GBP.
*MSCI Europe ex UK Small Cap vs the main index.

We've had three significant drawdowns in this period. We had a 15% drawdown in the global financial crisis, 2007/ 2008. We had an 11% drawdown, which culminated in Covid, and we're currently 19% drawdown, May was a better month for small companies, but blink and you would have missed it on the graph, it's very significant drawdown historically. What did I think about that? I cannot see any reason why this trend is broken; small companies have had to contend with a lot in the last couple of years. We've had to contend with supply chain issues. We've had to contend with inflation and certain territories going into recession, but really, this period is about interest rates. The graph below shows you the outperformance and underperformance of smaller companies since 2001 versus the broader market and it overlays it with interest rates. What you can see is that when interest rates fall it's good for small companies and when interest rates rise it's poor for small companies if interest rates are stable, it's fine for smaller companies as well. We've just had very aggressive turnaround and rises, but we've had our first interest rate cut in Europe. We're certainly not experts on things like interest rates but I've been saying for a while, the market just needs confidence that we're nearer to the top than the bottom and I think we've got that now. I don't think that an interest rate of around 4% is particularly egregious for businesses to borrow and finance and I think that's why this is so interesting.

3 **Our asset class is out of favour**

MSCI Europe ex UK Small Cap vs MSCI Europe ex UK



Source: Morningstar and European Central Bank 31st May 2024

The below shows you what sort of outperformance you get from smaller companies. 2001 to 2007 there was 128% outperformance, then there was a 15% pullback with the global financial crisis, 211% outperformance up to 2018. Then you got your 11% pullback, then 31% outperformance we're now 19% down. To me, this is really interesting and I think there's a lot of things starting to align that suggest it could be a really interesting time for the fund.

3 **Our asset class is out of favour**

Historical patterns suggest strong recovery potential

TIME PERIOD	MSCI EUROPE EX UK SMALL CAP	MSCI EUROPE EX UK	RELATIVE PERFORMANCE OF SMALL CAPS
01/01/01 - 31/05/07	+ 167%	+ 38%	**+ 128%**
31/05/07 - 30/11/08	- 49%	- 34%	**- 15%**
30/11/08 - 31/08/18	+ 372%	+ 161%	**+ 211%**
31/08/18 - 31/03/20	- 23%	- 12%	**- 11%**
31/03/20 - 31/08/21	+ 81%	+ 50%	**+ 31%**
31/08/21 - 31/05/24	- 3%	+ 16%	**- 19%**
CUMULATIVE PERFORMANCE	**+ 768%**	**+ 263%**	**+ 505%**

Source: MorningstarDirect, data 01/01/2001 to 31 /05/2024
(01/01/2001 being the start date of the MSCI Europe Ex UK Small Cap Index) in GBP.