During the half year to 31 March 2018, the Fund (VT Cape Wrath Focus Fund A-shares, GBP) delivered a 17.4% loss, while our Benchmark (MSCI UK IMI net dividends reinvested, GBP), delivered a 2.3% loss. A reduced appetite for risk that affected UK equity markets from mid-January meant that companies that announced bad news suffered large share price reactions, and there were a number of negative updates within our portfolio. As there were no meaningful outperformers in the portfolio during the period, this review will focus on the main sources of underperformance.

Our worst performer during the period was the outsourcing business, Capita, which delivered a 74% loss. On 31 January 2018, Capita announced a profit warning, rights issue and new strategic plan, causing a 48% share price decline on the day. While we believed that Capita's acquisitive past would lead to write-downs, the rights issue came as a surprise to us: Capita had recently sold the Capita Asset Services business for £888m in cash, and had always been a highly cash generative business. Reviewing our analyses, we realised that we had not given enough thought to the source of Capita's strong cashflow - negative working capital - and in turn had not considered the consequences of negative working capital when a company suffers a drop in sales. In the case of Capita, cash received in advance from customers (deferred income) had been used to fund acquisitions and dividends, which meant that delivery of long-term contracts was dependent on an ongoing pipeline of contracts with upfront cash payments. When the pipeline ran dry, a rights issue was required to plug the gap, as well cover catch-up investment in systems and technology. We added to our Capita position after announcement and, contrary to the headlines, believe that outsourcing will continue to be a growth market, even as the opportunity mix within the sector changes over time.

For a more detailed analysis of our investment in Capita, where we went wrong and what we learned from the experience, please see our recent Broadside, '[Capita, Carillion & Contract Accounting]', which is available on the Cape Wrath Capital website.

Other contributors to underperformance included the roadside assistance and motoring services business, AA Group, which delivered a 53% loss over the period. As with Capita, we made our initial investment in AA Group after the CEO had changed, but before the strategic review was concluded. We believed that AA Group's dividend would be cut, but saw this as being 'in the price' when we made our first purchase at 169.5p on 29 September 2017. We failed to appreciate the magnifying effect that AA Group's weak balance sheet (at around 7x net debt to EBITDA) would have on any negative news around cashflow. We were, perhaps, too focused on the return side of the risk-return equation.

As with Capita, the outcome of AA Group's strategic review, which was announced on 21 February 2018 had a material negative impact on the share price. The following day we spoke with management at a group lunch, and drew the following conclusion:

'AA's balance sheet gives a thin-ish margin of safety. Covenants may be tightened with future refinancings and the cost of debt will increase. AA's blended cost of debt is 4.5%, while the blended yield is currently 5.4%. To a large extent the future for equity holders lies in the hands of S&P. A downgrade to junk and resultant increase in the cost of debt could precipitate an equity issue at the next refinancing. If AA survives with an investment grade rating intact then the risk of equity issue is low and potential for re-rating is high… Following a 1.5% top-up this is now a 4.8% position, with further top-up around 60p... An S&P credit rating decision stands in the way of this being a very high conviction holding.' (Cape Wrath Capital internal research: AA_UPDATE_18-02-21_strategic review)

As with our investment in Capita, we continued to believe in the long-term prospects for the business, saw a significant value opportunity, and used the share price decline to top-up our holding at 90p. Subsequent to the period end, S&P affirmed the ratings on AA Group’s bonds, and the shares performed strongly, delivering an 87% return over the first three weeks of April, allowing us to reduce our position at a profit.

Mothercare was another source of underperformance, delivering a 64% loss over the period until our sale on 28 February 2018 at 31.5p. While we were, and remain, cautious about the retail sector, we believed that Mothercare had a credible operational turnaround plan. Ultimately, we placed too much faith in management’s cashflow forecasts for the business. While we continue to see value in the international franchise business, and in the Mothercare brand, we believe that the UK business can only be meaningfully profitable as an online business, perhaps with a handful of physical stores to support the brand. We sold out of Mothercare because it became clear that management remained committed to their strategy of investing in the physical store estate, despite growing evidence that this investment would never deliver a return.

In the 2017 annual review we outlined a few changes that we had recently implemented and a few that were in the pipeline. To provide a brief update on these:

Our broadened valuation approach, which includes 33 different metrics visualised through a Gaussian distribution has been extremely useful, and gives us confidence that we are not missing anything valuation-wise. This is now included in the major portion of our process that I believe requires no further ‘tinkering’ for the foreseeable future.

We continue to work with Essentia Analytics; their product is at an early stage, but we see great potential in what they are doing. We believe that over the next decade or two the best performing portfolios will be managed by firms who have found the optimal way to combine man and machine. In this vein our plan to develop a smart screen for new ideas is taking shape and we are excited about the opportunity to implement machine learning algorithms in this stage of our process.

In the 2017 annual review we also highlighted our commitment to ‘reach a fully invested position over the next few months’. We have subsequently made some changes to the research team and process that will allow us to cover more ground, however we no longer believe that targeting a fully invested position is the right way to manage the portfolio. In our enthusiasm to commit capital I believe that we made some bad timing decisions. AA Group and Capita are good examples of this. In future we commit to hold cash as our default position and to recognise that in investing, return is only half of the equation.

Adam Rackley

Investment Director

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