During the half year to 31 March 2020, the Fund (VT Cape Wrath Focus Fund A-shares, GBP) delivered a 38.0% loss, while our Benchmark (MSCI UK IMI net dividends reinvested, GBP) delivered a 22.5% loss. Our three largest holdings at the start of the period were Capita (CPI), Enquest (ENQ) and Premier Oil (PMO), which all underperformed, and are reviewed later in this report.

The Fund's best performer was The Restaurant Group (RTN). This was one of a number of investments that we made around the third week of March, just before the period end, when the risk-reward offered by many companies on our Watchlist became extremely attractive. RTN delivered a 74.9% return over our 7-day holding period, making a positive contribution to closing NAV of around 3%.

The biggest contribution to the Fund's underperformance was our position in CPI which incurred a 51.9% loss. As our largest position, the P&L impact was around 10% of the Fund's closing NAV. The majority of CPI's underperformance occurred during the week following the FY19 results on 5 March. CPI disappointed the market by reducing its underlying free-cash-flow guidance for 2020 to £160m from £200m, and dropping the previous 'double-digit' EBIT margin target. Year-end net debt also came in ahead of expectations due to a £229m contract working capital unwind with fewer new contracts being signed in the year (up-front cash received on new contracts means that CPI operates with negative working capital). Rising debt and falling EBITDA left leverage at the top end of management's 1-2x target. We cut our FY21 EPS forecasts by 24% and our approximate value by 22% to 151p. Over the last 2-years, CPI has raised £1,060m through disposals and an equity issue, and paid down £490m of debt, with a £410m working capital unwind. For companies with long-term contracts we typically include working capital in our adjusted net debt calculations. On this basis, CPI's balance sheet has improved by around £900m. With around 50% public sector exposure, and private sector exposure focused on non-discretionary activities (HR, customer service, ERP), we believe that CPI is as well placed as any in the support services sector to cope with the current environment. At the end of the period CPI traded on 2-3x normalised earnings.

The Fund has had a large exposure to the E&P sector since launch, predominantly through our investments in ENQ and PMO, which were our second and third largest investments respectively at the start of the period. The period started well for our E&P holdings and by mid-January, when we top-sliced the positions, they were each showing positive returns over the period of over 50%. In the $60-70/bbl oil environment both companies were delivering strong cashflows and debt reduction, and trading on 30%+ free-cash-flow yields. However, as concerns about the economic impact of COVID-19 pushed down the oil price, so E&P share prices followed, with the biggest share price declines on 9 March, following the failed OPEC meeting when Russia and Saudi Arabia launched a price war. We exited our ENQ position that morning at 13.3p (22.3% loss during the period) and PMO the following day at 28.7p (37.0% loss during the period). Brent continued to fall, hitting a low of $20/bbl on 20 April when prices on WTI forward contracts briefly fell negative.

At the time of our sale we saw limited equity value in these stocks with long-term Brent below $45/bbl. That hurdle will come down a little with cost-cutting, but we need to be confident of long-term oil prices above $60/bbl to see material upside in these stocks. Opex is now forecast to be below $20/bbl at both firms, however with their focus on mature fields with natural annual reservoir decline rates of 10-15%, significant capex is required simply to maintain flat production. There are also large debt service costs. These factors make up the difference between the company's sub-$20/bbl opex forecast, and our own analysis of $60/bbl for an appropriate risk-reward.

Cumulatively, the P&L impact of our ENQ and PMO positions over the half-year was a loss of around 4% of the Fund's closing NAV. If we look back over the total holding period (3½ years for ENQ, a little less for PMO), the P&L impact of our ENQ investment was a gain of around 0.1% of the Fund's closing NAV, while PMO was a loss of around 0.5%. A mitigating factor over the total holding period was that we used our valuation-based approach to trade around share price volatility.

The opportunities created by falling prices allowed us to increase the number of equity holdings in the portfolio to 20 from 15 while reducing our cash position. Changing economic conditions impacted on our assessment of fair values, but by significantly less than was reflected in share prices. As a result, the upside on our Watchlist increased over the period to 216% from 74% (with a low of 49% on 19 January). The Fund's absolute and relative underperformance has caused a great deal of pain for us and our other investors. Value as a style has done badly relative to growth during this bear market and we have always been at the 'deep' end of value. We don't know when value and price will converge, but we will be here and well prepared when they do.

Adam Rackley

Investment Director

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