Menhaden

Unique portfolio and good performance means discount looks anomalous...

Update

03 December 2020

Summary

Menhaden (MHN) is a highly concentrated global equity fund categorised in the AIC's Environmental sector. The management team took over nearly five years ago (April 2016), first transitioning the portfolio to suit the new investment philosophy, and then refining since – which has shown good results in terms of performance.

Portfolio of investments must fit two criteria, as we discuss in the **Portfolio section**. Firstly, they must have a dominant position in their market, with a very high competitive moat. The second is that companies need to deliver – or benefit from – the efficient use of energy and resources. As such, it fits a 'sustainability' definition in two ways.

With its closed-end structure, MHN can afford to be highly concentrated (only 17 holdings currently), with the top two holdings representing more than 20% of NAV each. With the trust holding both public (c. 80%) and private (c. 20%) investments, the team use the structure to its fullest extent.

Over the last three years, the team's approach has led to strong performance relative to global equities as well as the Global investment trust peer group as we illustrate in the **Performance section**. NAV total returns over three years to 30/10/2020 (MHN announces NAVs only monthly) was 32.8%, compared to the MSCI ACWI return of 21.6% and the average global investment trust return of 19.3%.

MHN's discount has historically been wide but, following the trust's good performance in 2018 and 2019, it regained ground to trade in the high teens. The discount then widened dramatically during March, to c. 50%, but still remains wide at 27% relative to JPMorgan Cazenove's estimated NAV.

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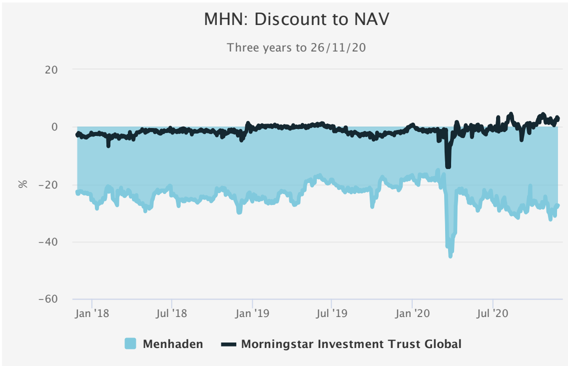
Key Information:

Price (p)	94
Discount (%)	-27.0
OCF (%)	1.99
Yield (%)	0.3
Gearing (%)	-2
Ticker	MHN
Market cap (£)	75,200,001



Kepler View

MHN is a highly differentiated and actively managed trust which seems to fit the sustainability theme in more ways than one. The portfolio is highly concentrated, which means that at times the NAV can be volatile. However, MHN's discount looks an aberration when one considers the overall proposition.

The underlying portfolio has evolved rapidly this year, with only c. 20% of the portfolio now in unlisted investments compared to around 50% at the beginning of the year. The team's actions during the Q1 selloff show that they are focusing squarely on fundamentals. Their willingness to take a long-term view, and back their convictions, has meant that MHN is on track to turn in another year of good relative performance, on the back of strong results in 2018 and 2019.

Now that the trust has a tiered management fee, and we have seen organic growth such that it is now paying a lower fee on any future growth, another potential reason for the wide discount (i.e. a high OCF) is eroding. The discount widening dramatically earlier this year serves to highlight the risk of the illiquidity in the shares, but at the same time offers a potential opportunity. Certainly, if the trust continues its current trajectory of improved liquidity, a reducing OCF and strong relative performance, the chances must be rising of the discount narrowing on a sustained basis.

BULL
Wide 27% discount to estimated NAV seems entirely a result of historic factors
Good performance track record continues to develop
Differentiated high conviction portfolio, with clear investment rationale behind it

BEAR
Concentrated portfolio means any stock picking mistakes will hurt NAV
Illiquidity and highly concentrated portfolio mean discount volatility likely to persist
OCF of 2.0% is relatively high

Portfolio

MHN is a highly concentrated global equity fund categorised in the AIC's Environmental sector. The management team took over nearly five years ago (April 2016), first transitioning the portfolio to suit the new investment philosophy and refining since then, which has shown good results in terms of performance. The team (headed by Luciano Suana) have an ultra-low turnover approach, aiming to take very long-term views on companies and hold them indefinitely (assuming the investment case doesn't change). The managers use the closed-ended structure to achieve their aims, which allows them to invest with high conviction (the top two holdings are over 20% of NAV each), as well as invest in private opportunities when they see fit.

Investments are selected based on them fitting two basic criteria, in addition to standard valuation and other financial metrics. Firstly, companies must demonstrate that they have a dominant position in their market, with a very high competitive moat which makes competing with them hard. With strong pricing power, this gives Menhaden Capital the confidence that margins will not be competed away over the long term and, assuming the underlying company management have good capital allocation skills, the business will be capable of sustained growth from reinvestment of a proportion of earnings. The other criteria, which also ties in with the managers' long-term investment perspective, is that companies need to deliver – or benefit from – the efficient use of energy and resources. The managers believe this is likely to be a long-lasting secular growth theme, and that companies exposed to it will be exposed to fewer risks and more likely to outperform over the long term.

Within this, the managers have found companies which fit within several broad themes. For example, long term holdings Safran and Airbus fit within a "high efficiency air travel' theme. Other themes include cloud computing (Microsoft, Alphabet), transportation (railway companies), broadband (Charter Communications), and renewables (X-Elio). As we discuss later in this section, a new theme that the managers are starting to invest in is enhanced demand for low energy semi-conductors that are required for applications like AI and electric vehicles.

At any point, the portfolio is only expected to comprise between 15 and 30 positions. At the time of writing the portfolio is made up of 17 holdings, with the top ten positions accounting for 90.9% of NAV (as at 31 October 2020). The table below illustrates the highly concentrated nature of the portfolio, which does present short term risks. On the other hand, it represents the manager's conviction and their belief that companies with very defendable moats are relatively few and far between. In the managers' view, all of their holdings should benefit from the secular growth offered by the transition to a low-carbon economy.

Top Ten Holdings

NAME	TYPE	%
Alphabet	Public	21.2
Charter Communications	Public	20.8
X-Elio	Private	12.3
Safran	Public	9.3
Canadian Pacific Railway	Public	7.5
Canadian National Railway	Public	5.1
Microsoft	Public	4.7
Calisen Group	Public (held via KKR)	4.0
Airbus	Public	3.2
Ocean Wilson	Public	2.5
TOTAL		**90.6**

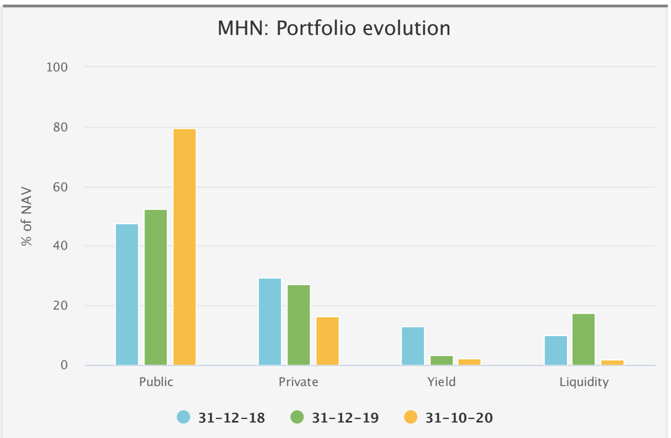
Source: Frostrow Capital, as of 31/10/2020

2020 has seen some interesting changes to the shape of the portfolio, despite the challenges presented in terms of extreme volatility in equity markets. 2020 has benefitted many of the companies that feature in the portfolio such as Charter Communications and Microsoft (both 2019 purchases) in which the managers increased their holdings during the market sell-off. The original thesis was that both companies are providing the large-scale infrastructure which could power the smart, more resource-efficient cities of the future. However both have also been key beneficiaries of the COVID-19 lockdowns and the increased prevalence of working from home. In particular the team believe that Charter Communications should be able to use its dominant position and scale to provide a better service to customers at a lower cost – thereby reinforcing its position in the market. This has led to the team increasing the concentration of the portfolio as witnessed by the 20%+ invested in the top two holdings.

Another significant change seen in 2020 has been a marked increase in the proportion of the portfolio invested in public equities. With fortuitous timing, many of MHN's private investments were realised at the end of 2019 with cash received in early 2020. This had two benefits – firstly, it has increased the underlying liquidity of the portfolio, which in our view means there is less reason for the discount to remain wide. Secondly, MHN found itself with 15% of cash on the balance sheet as markets started falling in Q1. The managers' philosophy is to focus squarely on fundamentals at all times, and try to ignore market noise. This approach helped them follow a structured approach to the sell-off, investing c. 2% of NAV per week from their cash as markets declined. This strategy meant that the trust has been able to bounce back strongly, as we discuss in the **Performance section**.

As the chart below shows, publicly traded investments now represent nearly 80% of the portfolio, compared to around 50% at the beginning of 2020. As we discuss in the **Discount section**, we think that over time this should help the discount narrow – our reasoning being that private investments are illiquid and often relatively hard to value, and therefore might justify a wider discount. Public market investments, on the other hand, are priced daily and usually very liquid; therefore a large discount is harder to justify.

Fig.1: Portfolio Breakdown



Source: Frostrow Capital

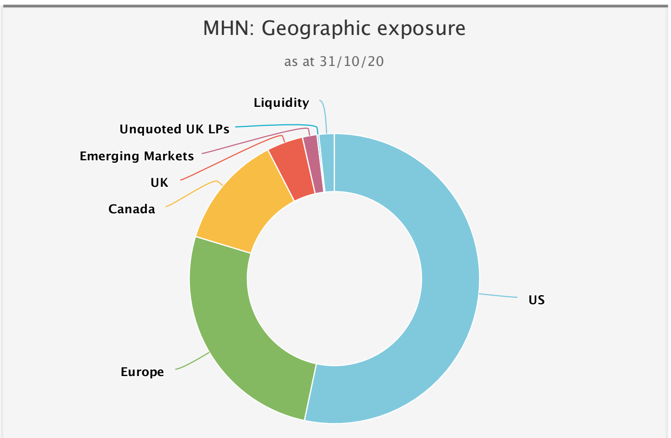
Other than investing cash, portfolio turnover this year has been muted – in line with the strategy. Cash was generally added to existing holdings rather than new positions, which has resulted in Alphabet and Charter Communications representing greater than 20% of NAV. The managers have latitude to invest in companies up to 20% of NAV, but are not able to add more. That they have grown to greater than 20% reflects market appreciation relative to the rest of the portfolio.

Since our last note in June 2020, the number of holdings in the portfolio has been increased from 14 to 17. We understand that this reflects new positions in three suppliers to semi-conductors. All of them dominate their niche, and have a critical place in the semi-conductor supply chain. The foundations of the managers' investment thesis for these holdings is that globally the number of applications requiring higher power computing capacity but with lower energy requirements will be increasing rapidly. Electric vehicles and AI are both examples of areas that will see hugely increased semi-conductor demand. MHN now has small (c. 1%) positions in ASML, LAM Research and KLA Corporation. Each occupies a different position in the semiconductor manufacturing process which the team believe are exposed to structural growth opportunities. These initial positions are the first step towards getting a better understanding of the dynamics within the industry and potentially building larger stakes as the team get more confident.

The private investments part of the portfolio now represents just under 20% of NAV, and the team remain open to opportunities on a selective basis. The largest private holding is X-Elio, a renewable energy developer that Brookfield has invested heavily into (MHN sold them one third of their original stake at a significant profit as part of the transaction). We understand that X-Elio now has significant cash on the balance sheet which will enable it to further develop its considerable pipeline of renewable energy projects. In terms of identifying private investments, the managers believe that their edge comes with their strong network of contacts through MHN founder Ben Goldsmith; which has resulted in investment collaboration with world class private equity firms such as Apollo, TPG, KKR and Brookfield.

Over time, the portfolio is expected to be mainly focussed on investments in developed markets. The current geographic allocation can be seen in the graph below. We think it is worth noting that the managers have the ability to hedge currencies. We understand that around two thirds of foreign exchange exposure is neutralised through these hedges. Consequently, MHN is likely to have a significantly higher GBP exposure than most other global funds, meaning that if sterling depreciates the trust's relative performance will struggle – and vice versa.

Fig.2: Portfolio Breakdown



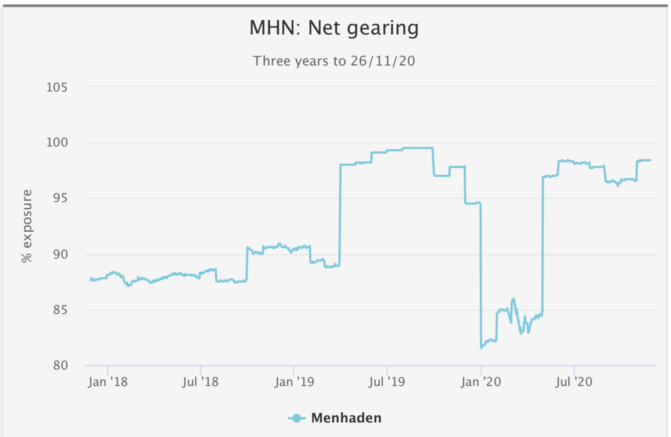
Source: Frostrow Capital

Gearing

Historically MHN has typically run with a higher cash level than most equity trusts, given the various private equity commitments that it has had. Having said that, MHN is currently in a different position. As we discuss in the **Portfolio section**, several of the private investments were realised at the end of 2019, with cash received in early 2020. This saw cash levels enhanced (fortuitously) as the market sold-off, which prompted the managers to take advantage of market falls to put cash to work by buying public equities – mostly topping up existing holdings. As a result, MHN became significantly more invested in Q2, as illustrated in the graph below.

In having fewer private investment commitments, the managers have more latitude to run the trust in a more fully invested position which now sees cash at only 1.7% of NAV. MHN has shareholder permission to employ gearing, but does not currently have a gearing facility in place. The trust has some outstanding commitments (which may not all be drawn) mainly to the TCI Real Estate Partners Fund. MHN's public equity portfolio remains highly liquid. So if these commitments are called, we do not envisage a problem for the managers in funding them.

Fig.3: Net Gearing



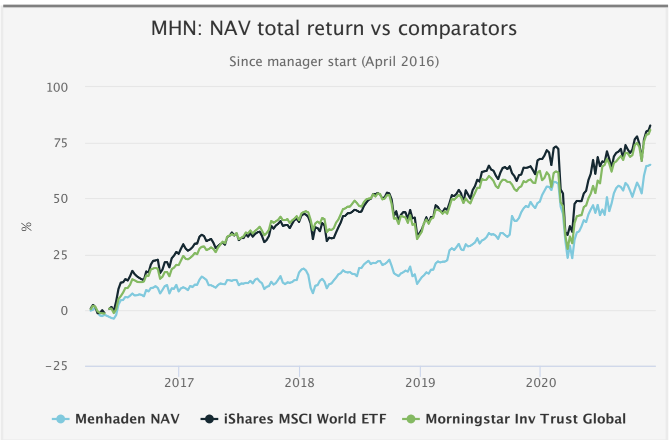
Source: Morningstar

Performance

Originally launched in 2015, MHN had a difficult start in life. A new management team, led by Luciano Suana, was recruited in March 2016 and the portfolio was repositioned. Reallocating the trust's exposure more evenly between public equities, private equity and yield investments took some time, but we understand was largely completed by Q1 2017. Below we illustrate the trust's NAV performance since the new team joined. This graph shows that the trust lagged during the period when the portfolio was being repositioned, but since then has been catching up with world equity markets and the average global investment trust.

The past three years have been strong against comparators. According to Morningstar the NAV total return to 30/10/2020 (MHN announces NAVs only monthly) was 32.8%, compared to the MSCI ACWI return of 21.6% and the average global investment trust return of 19.3%. It is worth noting that this performance has been achieved despite much of the trust's overseas currency exposure being hedged back into sterling since 2018. This likely means a higher GBP exposure than most peers, i.e. a headwind as GBP depreciated over most of this period.

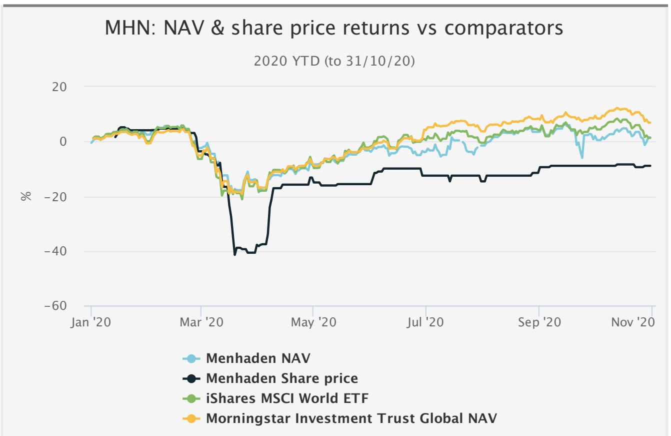
Fig.4: Performance



Source: Morningstar, to 31/10/2020

The graph below shows the experience of 2020 to date. As we note above, MHN announces NAVs only monthly, and the uncertainty caused by this factor may have contributed to the discount widening so dramatically during March and staying relatively wide since then. As the graph illustrates, the NAV recovered alongside equity markets and as at the end of October 2020, the NAV was just ahead of global equity markets.

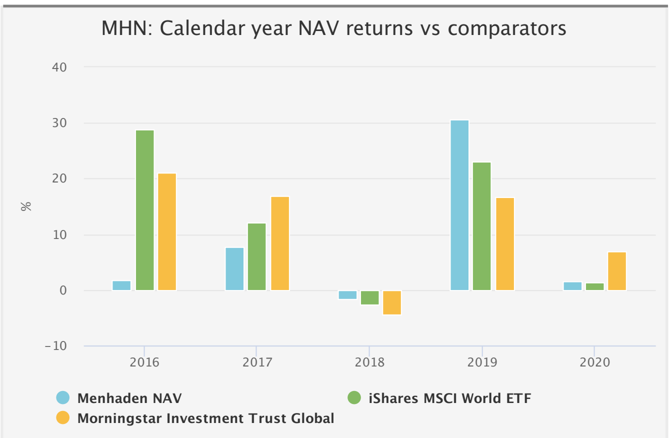
Fig.5: NAV Returns YTD



Source: Morningstar, to 31/10/2020

As we highlight above, MHN's performance has been strong on a relative basis over the past three years – including excellent performances during 2018 and 2019. The managers' rigid focus on fundamentals during the market panic, investing cash balances into a declining market during early 2020 shows the rigour behind the investment philosophy.

Fig.6: Calendar Year NAV Returns



Source: Morningstar, to 31/10/2020

Dividend

MHN currently has a pure capital growth objective, so the dividend is not an area of focus for the managers or the board. The directors are bound by the investment trust requirement to distribute at least 85% of net income, however. Consequently MHN paid a dividend of 0.4p per share on 12 June 2020. Over the longer term – assuming the managers can achieve their ambition of investing around a third of the portfolio in 'yield' investments – the hope is that the trust will pay a dividend which will yield c. 2%.

Management

MHN's portfolio is managed by Menhaden Capital Management LLP (MCM). The three partners of MCM – Ben Goldsmith, Luciano Suana and Graham Thomas – form the investment committee, which is responsible for all investment decisions.

Luciano manages the portfolio on a day-to-day basis, with a particular focus on the publicly traded and yield elements of the portfolio. He joined MCM in March 2016, having previously been a director at Barclays Capital where he ran credit operations for Brazil in Sao Paulo. Using this previous credit experience, Luciano helps the team look at the market through a 'value' lens – particularly when it comes to assessing potential downside risk in the portfolio.

The investment committee is chaired by Graham Thomas. Graham previously chaired RIT Capital's executive committee and was a member of its investment committee, with direct responsibility for its private investments. Ben Goldsmith co-founded WHEB group – one of Europe's leading energy and resource-focussed fund investment businesses – prior to setting up MCM. As well as managing the portfolio alongside Luciano and Graham, Ben focusses on originating new private investment ideas for the trust.

The managers are supported by an analyst, Edward Pybus. Edward previously worked at Exane BNP Paribas in the research division, specialising in oil and gas.

It is worth noting the experience of the trust's independent board. Chairman Sir Ian Cheshire was previously CEO at Kingfisher, during which time he was one of the leading lights in driving attitudes towards energy and resource efficiency at a corporate level. He also chaired the Ecosystem Markets Task Force, an independent business-led initiative aimed at helping UK businesses to find new opportunities to drive green economic growth and to profit from valuing and protecting nature.

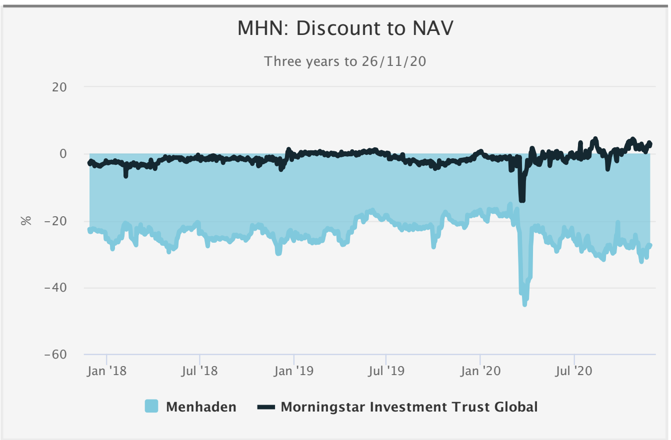
The other board members include: Emma Howard Boyd – who is the Chair of the Environment Agency, and was director of stewardship at Jupiter Asset Management; Duncan Budge – who was previously a director of J. Rothschild Capital Management and a director and chief operating officer of RIT Capital Partners; and Howard Pearce – founder of HowESG Ltd, which is a specialist environmental, asset stewardship and corporate governance consultancy business.

Discount

MHN trades on a persistent discount to NAV, amongst the widest in the entire sector. As the graph below shows, it trades on a significant discount to the AIC's Global investment trust peer group. Given the relatively small size of the trust and concentrated share register, the board do not regard buybacks as a suitable method of bringing the discount in. Certainly, there seems no dissatisfaction from shareholders, with MHN having achieved a resounding vote of confidence at the most recent AGM in June with 97.8% of investors voting in favour of continuation. The next continuation vote is in five years' time.

We believe that part of the reason for the wide discount can be attributed to the trust's poor start in life, which saw the NAV underperforming markets significantly after launch. Initially, in 2016, the discount widened out to more than 30%, but since then – following the trust's good performance in 2018 and 2019 – it did regain some ground, narrowing from around 34% in October 2016 to trade in the high teens during 2019. Latterly, however, as the graph below shows, the discount has widened once more following the COVID-19 market sell-off. The current discount of c. 27% to JPMorgan Cazenove's estimated NAV is wide in both absolute terms and relative to global investment trusts.

Fig.7: Discount



Source: Morningstar

One potential reason that the discount has been wide historically, could be the exposure to less liquid private investments which are harder to value. The listed private equity sector, for example, currently trades on an average discount of c. 23% (according to JPMorgan statistics). However, as we discuss in the **Portfolio section**, MHN's portfolio has evolved significantly over 2020, with only around 20% of the portfolio now unlisted. We continue to believe that a large discount on this basis is getting harder and harder to justify.

In reality, we think a large part of the reason for the discount is technical – a result of market illiquidity and the fact that it publishes NAVs only monthly. The trust is relatively tightly held and has a market capitalisation of £74m, which means turnover in the shares is not high. This presents both risks and potential opportunities, but as time goes on and assuming a fair wind then, as many trusts have proven in the past, these challenges can be overtaken. We continue to believe that MHN is an interesting trust, with a discount of c. 27% (to JPMorgan Cazenove's estimated NAV); both for the value opportunity, the differentiated investment portfolio, and the evolving track record of the management team.

Charges

MHN has a tiered management fee structure, which pays the manager a fee of 1.25% on net assets up to £100m, falling to 1% thereafter. As at 31/10/2020 (the NAV is only announced monthly), the trust's total net assets were £95.1m, which means that we are close to seeing any future growth positively impact the ongoing charges figure (OCF) of the trust. A reduction of the OCF is one of many catalysts that we believe together could lead to the discount to NAV reducing.

The most recently announced OCF for the last financial year (2019) was 2% (2018: 2.1%). While this may not be cheap, the trust's wide discount – if it moves in the right direction – should more than make up for the higher costs. The KIDRiY cost for the trust is 2.3%. The fact that this measure is only marginally higher than the OCF reflects the portfolio's lack of gearing and relatively low turnover.

The trust also pays a performance fee of 10% of the excess of NAV over a compounding 5% hurdle (since launch) which also applies. We calculate that the current hurdle of 130p is marginally above the NAV (119p as at 31/10/2020). It is worth noting that MHN pays no third-party fees on co-investments made in the private equity portfolio (such as X-Elio).

ESG

The managers take a pragmatic approach to investment and, as we discuss in more detail in the **Portfolio section**, one of the main criteria that they look for is that investee companies need to deliver – or benefit from – the efficient use of energy and resources. The managers believe that sustainability is likely to be a long-lasting secular growth theme, and that companies exposed to it will be exposed to fewer risks and outperform over the long term. Within this, and reflecting the pragmatic approach, MHN has two long standing investments that might not fit negatively screened investors' portfolios which are Airbus and Safran. The airline maker and engine manufacturer (respectively) might not seem obvious choices for investors aiming to invest in a low-carbon economy. However, the MHN team see these companies as industry champions, helping airlines to reduce their carbon emissions.

As such, the mandate and the investment philosophy behind MHN might be considered well aligned with many ESG investors. But it is worth noting that the team do not apply negative selection criteria to investments. As such, MHN might not suit a very strict interpretation of ESG, but it is clear that it may suit a more real-world view that sustainability cannot be achieved at the drop of a hat, and that every sector has its part to play. According to Morningstar's sustainability rating, MHN's portfolio has an 'above average' score, which corroborates the managers' aims and intentions.

Menhaden Capital believe that ESG processes, which are fully embedded in their investment process, helps them avoid companies which are badly managed – both from an 'impact' perspective and in a business sense. The MHN team say they plan to engage with their portfolio companies more proactively, and to ensure the companies understand the importance of taking action to reduce carbon emissions. In our view, the evidence that they will be able to provide as being committed long term investors (rather than short term 'renters' of stocks) will lend weight to their arguments.

In the trust's annual results, MHN review the 'impact' of the portfolio every year: estimating the impact that their stakes in the companies in the portfolio have had in reducing greenhouse gas emissions, renewable electricity generated, etc. **The most recent impact report can be found by following this link**. In summary, MHN's holdings helped generate 47,000 MWh of clean energy in 2019, contributed to 32,000 tonnes of avoided greenhouse gases and 61,000 m^3 of water saved.

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