Menhaden

MHN's portfolio has become significantly more liquid and is trading on a sector-wide discount...

Update
25 June 2020

Summary

Menhaden (MHN) invests in businesses that benefit from the efficient use of energy and resources. The managers see this as a long-lasting secular growth theme, which enables their companies to outperform.

With its closed-end structure, MHN can afford to be highly concentrated (only 14 holdings), and invests in both private and public markets. The team aim to identify companies which have the opposite characteristics of 'commoditised businesses', exhibiting strong pricing power and high barriers to entry. They invest for the long term and have high conviction: the top ten holdings account for 92.9% of NAV (as at 31 May 2020).

An important development is that many of the private investments have now been sold, as we discuss in the **Portfolio section**. Having received sales proceeds at the end of 2019, MHN had around 15% cash in January 2020, and this was invested in listed equities during March and April. As a result the trust has been able to bounce back, and is now only marginally behind world equity markets YTD; despite having low USD exposure as a result of currency hedging.

Performance has been strong against comparators in the past three years, with NAV total returns of 28.5% to 31/05/2020, versus the MSCI ACWI return of 20.5% and the average global investment trust return of 17.8%. MHN's YTD NAV has proved relatively defensive, as we illustrate in the **Performance section**.

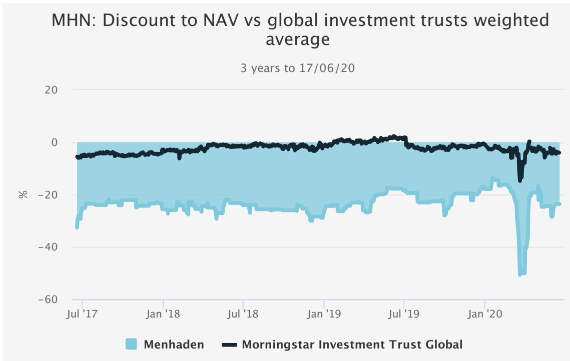
MHN's discount has historically been wide but, following the trust's good performance in 2018 and 2019, it regained ground to trade in the high teens. The discount then widened dramatically during March, to c. 50%, but has narrowed to c. 24% currently.

Analysts:

William Heathcoat
+44 (0)203 384 8795

Key Information:

Price (p)	86.5
Discount (%)	-23.6
OCF (%)	1.99
Yield (%)	0.4
Gearing (%)	-2.0
Ticker	MHN
Market cap (£)	69,200,001



Kepler View

MHN is a highly differentiated and actively managed trust which seems aligned with a long-term secular growth theme. The portfolio is highly concentrated, which means that at times the NAV is volatile. However MHN's underlying portfolio has evolved rapidly over the last six months, with only c. 20% of the portfolio now in unlisted investments – compared to around 50% at the beginning of the year.

We believe an attractive feature of the trust is that the managers aim to focus squarely on fundamentals. Their willingness to take a long-term view, and back their convictions, is illustrated by their approach to the recent equity market sell-off. The team followed a structured approach, investing c. 2% of NAV per week from cash holdings as markets declined; largely adding to their highest conviction positions and enabling the trust to bounce back. In our view this recovery gives grounds for optimism and is a further sign that the trust's clearly thought out investment rationale is now bearing fruit.

MHN's performance has been strong on a relative basis over the past three years, including excellent performances during 2018 and 2019. The more recent experience serves as a warning, however, that MHN's discount is volatile, which presents both risks and potential opportunities. We continue to believe that on a discount of c. 24% (to the 31/05/2020 NAV) MHN is interesting, both for the value opportunity but also given the evolving track record of the management team.

BULL
24% discount unwarrented given 80% of portfolio is now in listed equities
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

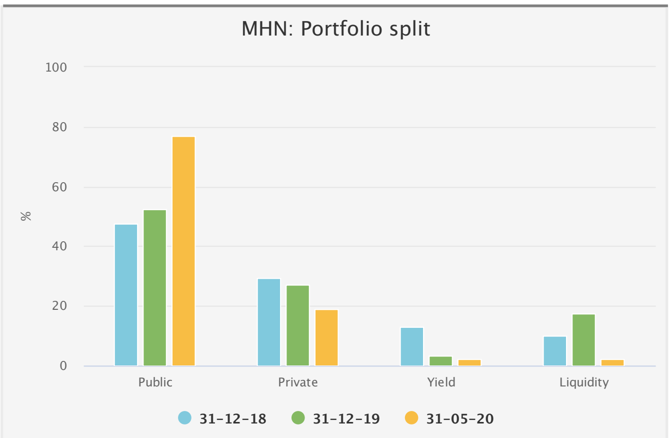
Portfolio

Menhaden (MHN) invests in a concentrated manner into unique businesses that 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 outperform over the long term. Menhaden Capital Management (MCM) aim to take a longer-term view than most investors when buying into a company; an approach that they believe gives them an advantage over the competition. As an investment trust, having a fixed pool of capital is helpful in this regard. It is worth noting that MHN achieved a resounding vote in favour of continuation at the most recent AGM, meaning that the next continuation vote is in five years' time.

MHN's structure – and its renewed shareholder mandate – allow it to invest in both private and public markets to achieve its aims. Originally the team aimed to balance the portfolio across three 'buckets', defined as public equities, private equities and 'yield' (which can be either public or private). Over the long term, each bucket is expected to constitute around 30% of the portfolio. But the team report that filling the 'yield' bucket has been increasingly hard to do with investments that meet their return targets.

One important development – which we believe means the current level of the discount is anomalous – is that over the last six months or so many of the private investments held by MHN have been successfully realised. This has left a much greater proportion of the portfolio invested in listed equities. As we discuss in the **Discount section**, our reasoning on the discount is 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. This marked transformation can be seen in the graph below, which shows the evolution of the portfolio over two and a half years. It is notable that publicly traded investments now represent nearly 80% of the portfolio, compared to around 50% at the beginning of 2020.

Fig.1: Portfolio Breakdown

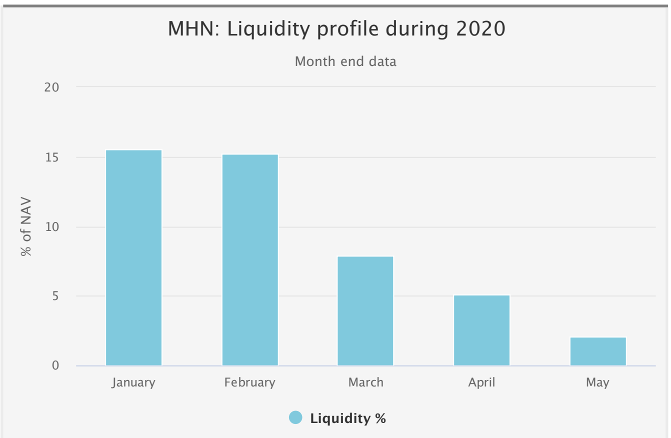


Source: Frostrow Capital

As we discuss in the **Performance section**, MHN had a poor start following its IPO in mid-2015. The current management team (led by Luciano Suana) took over in 2016 and since then have applied a consistent, valuation-led approach. They aim to identify companies which have the opposite characteristics of 'commoditised businesses'. Consequently the team aim to find durable companies, which exhibit strong pricing power and very high barriers to entry in the sectors they operate in. The team believe in having a concentrated portfolio and low turnover . They believe that there are relatively few companies on a global basis which exhibit the characteristics they look for at a price they are willing to pay. Accordingly the team aim to be invested for the long term, so that the trust can benefit from compounding of returns within investee businesses.

In both their public and private market investments, the managers try to focus squarely on fundamentals. Their willingness to take a long-term view is illustrated by their approach to the equity market sell-off which occurred in Q1 2020. As we illustrate in the **Gearing section**, MHN has historically run with reasonable cash weightings; reflecting the trust's commitments to private equity funds and investments. However in January – having received the proceeds from several private investments (discussed below) – the trust found itself with c. 15% of cash on its balance sheet. Aside from being fortuitous timing, the managers took the decision to invest this cash in a progressive way as the prices of their preferred investments fell. The team followed a structured approach, investing c. 2% of NAV per week as markets declined. This strategy meant that the trust has been able to bounce back strongly and is now only marginally behind world equity markets. This is despite having a significantly lower exposure to the US dollar – the trust currently hedges around two thirds of its foreign exchange exposure.

Fig.2: Cash Exposure During 2020



Source: Frostrow Capital

The portfolio is expected to comprise between 15 and 30 positions. At the time of writing the portfolio is made up of 14 holdings, with the top ten positions accounting for 92.9% of NAV (as at 31 May 2020). The table below illustrates the highly concentrated nature of the portfolio. In the manager's view, all holdings should benefit from the secular growth offered by transition to a low-carbon economy. Charter Communications and Microsoft were 2019 purchases, and the managers have increased their holdings in both stocks recently. 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 – as luck would have it – both have also been key beneficiaries of the COVID-19 lockdowns and the increased prevalence of working from home. So the team have added significantly to Charter, believing that it is in a dominant position and able to use its scale to provide a better service to customers at a lower cost – thereby reinforcing its position in the market.

Top Ten Holdings

NAME	TYPE	% OF NAV
Alphabet	Public	20.7
Charter Communications	Public	20.6
X-Elio	Private	13.5
Safran	Public	9.3
Canadian Pacific Railway	Public	7.1
Canadian National Railway	Public	5.9
Calisen Group	Public (held via KKR)	5
Microsoft	Public	4.7
Airbus	Public	3.2
Ocean Wilsons	Public	2.9
TOTAL		**92.9**

Source: Frostrow Capital

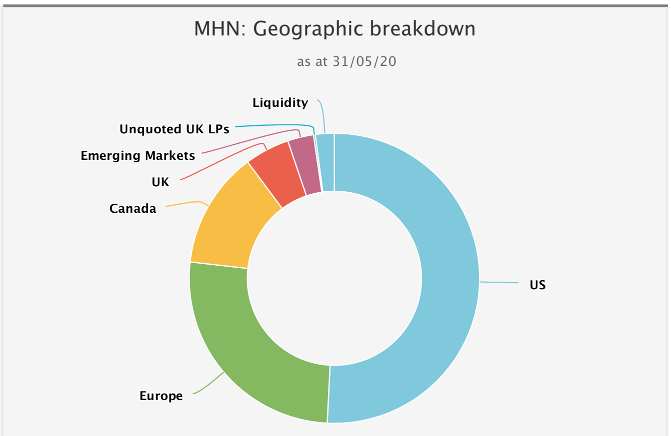
Alphabet is another holding added by the team as the market fell. Despite the immediate headwinds, Luciano and Edward believe that Alphabet's advertising business will continue to lead the market. They think it will inevitably recover to be the engine of earnings and growth for the company for many years to come. The new executive team will – the team believe – mean that capital allocation is more disciplined in the future, and the external investors in Waymo also provide some reassurance on the value of that business.

Within the private investments bucket, MHN has now received proceeds from a number of successful investments; meaning that the private bucket now comprises only c. 20% of the portfolio. Realisations include a partial disposal of one third of the holding in X-Elio – now the third largest holding in the portfolio, having previously been the largest; Ado Group – a German property play on which the team made a return of 25% over a period of less than a year; and Perfin Apollo 12 – a Brazilian infrastructure fund, which has made a return of c. 3x the original investment over three years. Calvin Capital was a co-investment deal alongside KKR, which has IPO'd and listed on the London Stock Exchange as Calisen PLC. The shares are still locked up and under the control of KKR, but the position has now transferred into the public equity portfolio.

In terms of identifying private investments, the managers believe that their edge comes with their strong network of contacts through Menhaden founder Ben Goldsmith; which has resulted in investment collaboration with world class private equity firms such as Apollo, TPG, KKR and Brookfield. The team remain alert for opportunities in this area, but also expect their commitments to the TCI Real Estate Partners Fund to be drawn down more fully in the current year.

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. But it is notable that following the deployment of the cash on the balance sheet over 2020 so far, the USA is now the trust's biggest geographic exposure. We think it is worth noting that the managers have the ability to hedge currencies. As such, at the start of 2018 around half of the portfolio's exposure to US dollars and euros was hedged. Since November 2019, however, hedging activity has increased, with around two thirds of foreign exchange exposure neutralised. 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.3: Portfolio Breakdown



Source: Frostrow Capital

Gearing

Historically Menhaden has typically run with a higher cash level than most equity trusts, given the various private equity commitments that it has. As we discuss in the **Portfolio section**, the last six months has seen a transformation in the overall exposure in the portfolio; with several private investments having been realised and cash redeployed into public market investments.

As a result the trust's cash position has significantly reduced over the year to date, with the managers taking advantage of equity market weakness to put their cash to work. The graph below shows MHN's investment exposure as a percentage of NAV over time. Currently the trust has net cash of around 2%, which – as we demonstrate – is towards the lower end of the historic range.

MHN has shareholder permission to employ gearing, but does not currently have a gearing facility in place. We also note that the trust has outstanding commitments (which may not all be drawn) of around £10m – 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.4: Net Gearing

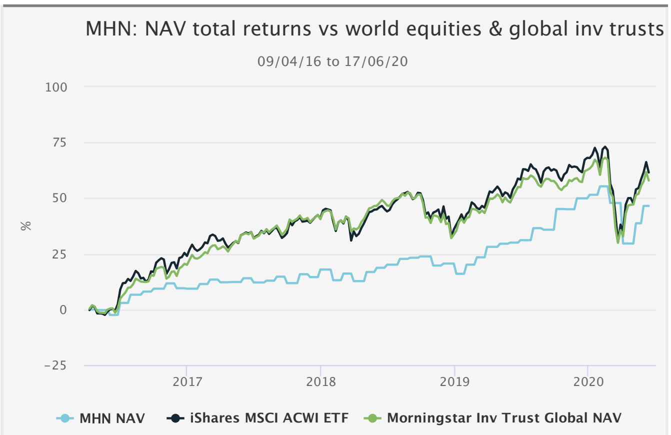
Source: Morningstar

Returns

Originally launched in 2015, Menhaden (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. Subsequently the managers reallocated the trust's overall exposure more evenly between public equities, private equity and yield investments; this process 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 30/05/2020 (MHN announces NAVs only monthly) was 28.5%, compared to the MSCI ACWI return of 20.5% and the average global investment trust return of 17.8%. 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 this period.

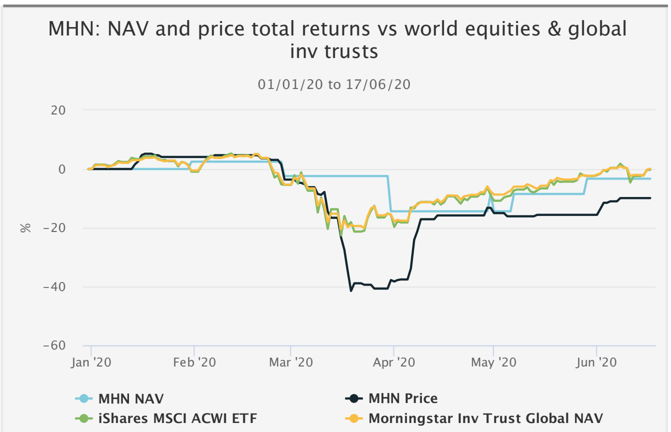
Fig.5: Performance



Source: Morningstar

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. However, as the graph illustrates, the NAV fell by less than the trust's comparators and has also largely recovered. As at the end of May 2020, the NAV was only 3% behind global equity markets.

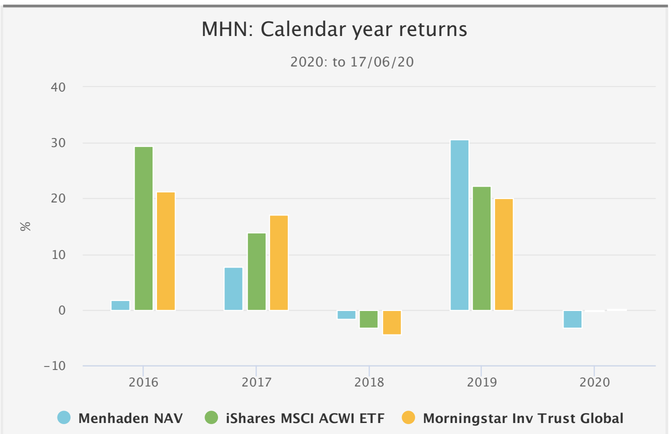
Fig.6: NAV Performance



Source: Morningstar

The graph below shows calendar year performance relative to world equities and global investment trust peers. As we have noted in the **Portfolio section**, MHN is highly concentrated and the managers pay no heed to any benchmarks when assembling the portfolio. As a result performance in any one year is likely to deviate considerably from the benchmark – which has certainly been the case historically. It is also worth bearing in mind that a proportion of the portfolio is invested in private market investments; where valuation changes are reflected only periodically, and sometimes in a lumpy fashion.

Fig.7: Calendar Year NAV Returns



Source: Morningstar

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 in 2020 gives grounds for optimism, and is a further sign that the clearly thought out investment rationale is now bearing fruit.

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

Menhaden 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 Menhaden Capital Management. 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.

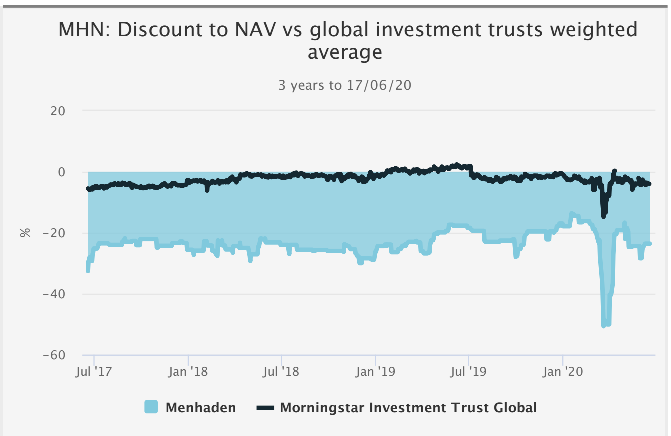
The other board members include: Emma Howard Boyd – who was director of stewardship at Jupiter Asset Management and a major driving force behind the group's environmental markets investment team; Duncan Budge – who was previously a director of J. Rothschild Capital Management and a director and chief 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 one of the widest discounts in the equity investment trust sector. In fact, according to the **AIC website**, it is in the top ten widest discounts for trusts which invest in liquid public equities. 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. 24% is wide in both absolute terms and relative to global investment trusts.

Fig.8: Discount



Source: Morningstar

Another possible reason why the discount has historically remained wide is that private investments – which hitherto have represented a good proportion of the trust's portfolio – are illiquid and often relatively hard to value. Conversely public market investments are priced daily and are usually very liquid. As a result, a trust with a significant proportion of its assets in unlisted investments might justify a wider discount than one with pure exposure to listed investments. As we discuss in the **Portfolio section**, MHN's underlying portfolio has evolved rapidly over the last six months, with only around 20% of the portfolio now unlisted. We believe that a large discount, on this basis, is getting harder and harder to justify.

The recent market sell-off saw MHN's discount widen to an almost incredible 50%. We believe that part of the cause of this extreme move could be the fact that MHN only publishes its NAV on a monthly basis. When markets are moving rapidly – combined with a certain amount of panic and illiquidity in the market – having a 'stale' NAV creates uncertainty. But, at the same time, the portfolio is concentrated and the managers have a low turnover approach. Consequently it should have been possible for market participants to model the likely NAV and take advantage of such a wide discount. After all the discount remained wider than 40% for over two weeks.

We think it likely, in fact, that a large part of the large discount widening was a result of market illiquidity; given the trust is relatively tightly held and has a market capitalisation of £69m. Whatever the cause, the recent experience serves as a warning that the MHN's discount is volatile – which presents both risks and potential opportunities. We continue to believe that Menhaden is an interesting trust, with a discount of c. 24% (to the 31/05/2020 NAV); both for the value opportunity, the differentiated investment portfolio, and the evolving track record of the management team.

Charges

When we last wrote about Menhaden, we understood that the board was undertaking a review of the ongoing costs and fees paid to third parties. In the trust's annual report the board announced that it had appointed a new auditor, presumably at a lower cost, but had also negotiated a revised fee tiering arrangement with the managers.

Consequently the fees remain the same, but the lower fee tier will apply from £100m rather than £150m previously. While the immediate impact of the board's cost review is therefore slight, it does mean that, as the trust grows, shareholders will benefit from lower charges. The revised fee terms are 1.25% on net assets up to £100m, falling to 1% thereafter. An AIFM fee of 0.225% of NAV up to £100m, 0.2% from £100 to £500m, and 0.175% thereafter also applies. A performance fee of 10% of the excess of NAV over a compounding 5% hurdle (since launch) also applies. We calculate that the NAV has to rise by a further 12.3% to reach the current hurdle of c. 127p.

It is worth noting that Menhaden pays no third-party fees on co-investments made in the private equity portfolio (such as X-Elio). The ongoing charges figure in 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.

ESG

The managers of MHN invest globally, which restricts their focus to companies which deliver – or benefit from – the efficient use of energy and resources. As a result the mandate and the investment philosophy behind the trust might be considered well aligned with many ESG investors. But at the same time the managers embrace engagement with their companies, and do not apply negative selection criteria to investments. An example of two investments that might not fit negatively screened investors' portfolios 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. Menhaden, however, takes a pragmatic approach and sees these two companies as industry champions, helping airlines to reduce their carbon emissions.

The managers believe that ESG processes are fully embedded in their investment process; in their view this helps them avoid companies which are badly managed – both from an 'impact' perspective and in a business sense. The managers aim to be invested in their companies for the long term. So they aim to ensure that each company they invest in has a sustainable business, in both senses of the word.

On a macro view, the team believe that all of their investee companies are playing their part in efforts to slow the pace of global warming. In the trust's annual results the Menhaden 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.

Menhaden 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, Menhaden's holdings helped generate 47,000 MWh of clean energy in 2019, contributed to 32,000 tonnes of avoided greenhouse gases and 61,000 m3 of water saved. We discuss specific holdings, and their contribution to a lower carbon economy (among other things), in the **Portfolio section**.

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