Rockwood Strategic

RKW's high conviction approach has led to sector-leading returns...

Update
18 September 2024

Overview

Manager of Rockwood Strategic (RKW), Richard Staveley, looks to take advantage of the lack of research and limited institutional interest at the lowest end of the UK's market-cap spectrum to find overlooked companies trading at significant valuation discounts to their intrinsic value and long-term potential. The manager often looks for companies that are going through challenging periods but have strong recovery potential or strategic initiatives that might unlock value. He will take large positions in these stocks, leading to a concentrated portfolio, which he manages with a highly active approach. This involves instigating change to unlock value for the benefit of all shareholders (see **Portfolio**).

This approach has delivered very strong **Performance**, with RKW one of the best performing trusts in the smaller companies sector over the long term. Richard has been manager since 2019, with the exception of a short period of corporate activity (see **Management**). Performance continues to be very strong, leading to excellent returns over both the near and longer term.

The strong performance has helped lead to the trust's **Discount** narrowing significantly, and the shares moving to a sustained premium from 2023 onwards. The board has been active in managing this through ongoing share issuance. Authority to continue this was renewed in July 2024 to allow for further issuance, allowing the trust to grow and to help keep the premium close to NAV.

The manager has been using this share issuance to buy several new holdings, as well as the proceeds of M&A activity, after a number of holdings were bid for in late 2023 (see **Performance**). This outcome is typical of the manager's process, which includes a full assessment of possible exit strategies when the initial investment is made. The portfolio now consists of 22 holdings.

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Analyst's View

RKW's sector-leading performance is the standout attraction of this trust in our opinion. Richard's approach of finding out-of-favour companies at the lowest end of the market-cap spectrum and benefitting from their turnaround has repeatedly provided positive returns over multiple time periods. He uses the liquidity risk in this part of the market to his advantage by taking large stakes, often alongside existing investors minded to change, and looking to instigate a catalyst to generate shareholder value. This has meant that not only has the trust delivered stellar performance, but also means the portfolio will look completely different to other trusts in the peer group (see **Portfolio**).

Whilst stock-specific factors will be the primary driver behind performance, the current market outlook could also be a positive for the trust. Despite a recent pickup, we believe that UK smaller companies remain an under-owned and undervalued asset class. This means it may offer an alternative to the crowded trades seen elsewhere in the market, with sentiment showing signs of improving as macro-conditions continue to improve and interest rates begin to fall. We believe Richard's high conviction portfolio would benefit well from an improvement in sentiment, as a positive share price move in just one or two holdings can have an outsized impact on NAV, as has been the case in 2024, leading to the exceptional relative and absolute **Performance**.

BULL
Performance over the near and long term has been exceptional
Portfolio is likely to be highly differentiated to peer group and index
Potential recovery in the sector could provide a tailwind to performance

BEAR
Trust levies a performance fee, which could be off-putting for some investors
Portfolio is highly concentrated and has holding liquidity risk
Shares trade at a premium rating, in contrast to most peers that are at a discount

Portfolio

Rockwood Strategic (RKW) owns a highly concentrated portfolio of some of the smallest listed companies on the UK stock market. Manager Richard Staveley looks for companies at a maximum £250m market cap, though typically lower, with a current average of c. £150m. When he identifies an idea, it is backed with conviction and allowed to run, meaning the portfolio will often have position sizes in excess of 10% of NAV.

Richard's philosophy is to take advantage of the illiquidity premium at the lowest end of the market-cap spectrum, by taking large stakes in companies and looking to influence change for the benefit of all shareholders. When Richard buys a stock, he will have an exit plan in mind, typically M&A, which accounts for around three-quarters of sales. To help implement this, Richard takes an active approach. This may come though pushing for change in the board or management in order to instigate a new strategy. In several cases, this has been done alongside other investors from within the Harwood Group (see **Management**). This applies to five of the current holdings. Overall, Harwood funds control over 5% of 15 of the 22 Rockwood holdings. We understand there are Chinese walls in place between different strategies, though the similar approaches within the group, and the overlap in their investable universes often means companies can appear in multiple portfolios and equate to large shareholdings of stocks.

Due to the work required with this active approach, Richard has a very concentrated portfolio. At present, there are only 22 holdings, of which eight have board representatives proposed by Harwood. These are split between 'core' and 'springboard' positions, which we discussed in **our previous note**. As a result of this concentration, the top ten holdings will make up a large portion of the portfolio, which will be a minimum of 50%, though is currently over 71% due to the strong performance in 2024 of Filtronic and Funding Circle (see **Performance**).

Despite being the largest holding in the portfolio, Funding Circle is a relatively new position, having been initiated in January 2024 at an average share price of 31.5p per share. The strong performance seen since, driven by a share buyback programme and the announcement of a return to profitability sooner than expected, has led to the position size increasing as the share price has climbed to c. 117.5p per share as at 11/09/2024.

Other new positions bought in the past year include Capita, which provides business services. This was previously a FTSE 100 company that fell back significantly following challenging trading conditions, pension issues and an over-leveraged balance sheet. However, Richard believes the new CEO has begun to execute on a maturing turnaround story. The debt and pension issues have been resolved, with a cost-saving programme now supporting an operational improvement. The stock was a 3.5% holding as at 30/08/2024 and has a market cap of c. £300m, though Richard believes the stock could treble from here should the turnaround plan continue.

Top Ten Holdings

COMPANY	SECTOR	INITIAL PURCHASE (YEAR)	RKW (%)
Funding Circle	Financials	2024	12.7
RM	Education	2022	10.9
Filtronic	Technology	2023	9.9
Trifast	Industrials	2023	7.7
M&C Saatchi	Media	2020	7.2
Flowtech Fluidpower	Industrials	2020	5.2
James Fisher & Sons	Industrials	2023	5.1
STV	Media	2023	4.7
Restore	Business services	2023	4.0
Galliford Try	Construction	2022	3.9
Total			**71.3**

Source: Harwood, as at 30/08/2024

Other new holdings include television broadcast and production company STV, and Restore, which provides data and informational services, particularly for the asset management industry. Richard also made his first repurchase of a stock in National World. This is a print and digital publishing company that owns titles such as The Yorkshire Post and The Scotsman. The manager first bought the stock in 2021, where he helped fund the purchase of Johnston Press assets out of administration and instigate a recovery plan focussed on digital transformation and cost cutting. This led to a return to profitability, allowing Richard to sell his stake at a sizeable profit. However, the share price has since fallen back. Part of this has been caused by technical factors, with another fund winding up and selling down their stake. Richard has therefore repurchased the stock at an average price of 13.5p per share.

These new holdings have been funded through a combination of the trust's M&A proceeds, of which there were many in late 2023 (see **Performance**) as well as the share issuance in 2024, as a result of the trust trading at a premium (see **Discount**). Outside of the M&A activity we understand that Richad has not sold any shares of his existing holdings, as he continues to back his stocks with conviction, and looks to grow the assets of the trust.

Gearing

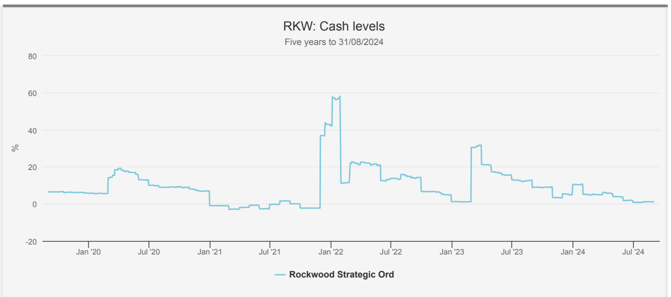
Gearing is unlikely to be a feature of RKW. Whilst the investment policy allows for gearing of up to 20% of gross assets (25% of net assets), there is currently no facility in place to allow this and we understand there are no plans begin one.

Richard believes that his highly concentrated portfolio of micro-cap companies means the portfolio is already taking enough risk to provide significant upside and therefore additional gearing is not required.

Richard has been running the trust at a net cash level for much of the past five years. However, this is currently fully deployed after Richard has been adding to a number of new ideas (see **Portfolio**). The cash level has been as high as 30% in the past following the takeover of a large portfolio holding, as we discussed in a **previous note**. This concentrated portfolio and the goal of using M&A as an exit route for holdings means that cash levels can move around notably.

The five-year chart below also covers a period where the trust began a wind-down period from December 2021 that was eventually reversed. We discussed this in detail in **our previous note**, and it is the reason behind the sharp rise in cash levels at the time. Due to a number of purchases recently (see **Portfolio**), RKW is effectively fully invested at present, as can be seen below.

Fig.1: Gearing



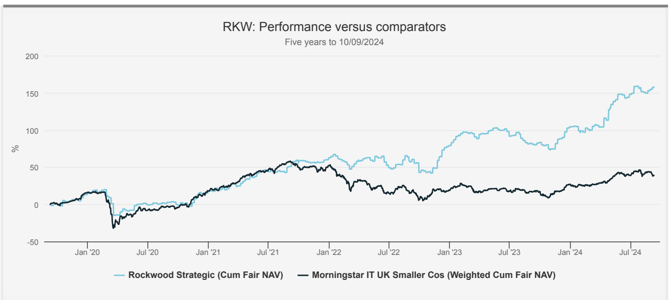
Source: Morningstar

Performance

RKW's long-term performance has been very strong, with the trust returning 157.6% in NAV terms over five years to 10/09/2024, versus the trust's formal benchmark, the FTSE Small Cap ex Investment Trust Index, which returned 56.8%. This performance is also considerably ahead of peers, with the AIC UK Smaller Companies sector average returning 38.9% over the same period.

Whilst Richard first took over management of the trust at the beginning of this five-year period, having been appointed in September 2019, there was a c. 12-month period from May 2021 where the trust was not under his direct management, during which no new holdings were purchased. The trust temporarily began a wind-up procedure in December 2021, which led to cash rising materially before being returned to investors. This would have been beneficial to relative performance. The wind-up procedure was subsequently reversed when the Harwood Group became majority shareholders in May 2022, which then saw Richard reinstated as manager. This period has been discussed further in **Management**. Since Richard returned to management, RKW has continued to perform well, leading to significant cumulative outperformance since Richard first assumed management responsibilities.

Fig.2: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

RKW's unique portfolio has led to a number of specific factors influencing performance. The portfolio is highly concentrated, typically at just c. 20 holdings, which are backed with conviction, meaning position sizes can be in excess of 10%. As such, stock selection will have a dominant effect on performance. This is true of micro-caps more generally, which are typically less affected by broader market movements, though this is especially impactful in RKW's circumstances due to the high concentration.

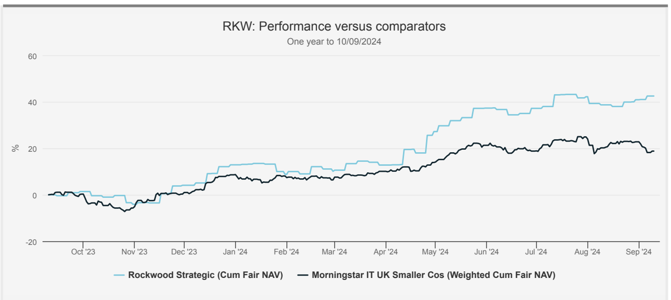
This is best demonstrated by the performance of two of the trust's largest holdings. One is Filtronic, which makes specialist radio frequency hardware, with applications in the space industry. The company was first purchased in May 2023, and in April 2024 announced a multi-year supply deal with SpaceX, which included the prospect of a future equity investment from the American firm. A further deal was announced in August 2024. These announcements led to impressive share price returns in 2024, from c. 21p per share at the beginning of the year to c. 77.8p as at 10/09/2024. This has had a material impact on RKW's NAV. Richard remains confident in the stock's future, which is now over 10% of the portfolio, as it could benefit from rival space companies also requiring their technology.

Another strong performer has been Funding Circle, which was first bought in early 2024, at an average price of 31.5p. Richard's thesis is that the business needed to buy back shares and cut costs, as the company had significant value on its balance sheet, with good cash levels and an attractive loan book, which could drive a recovery in the share price. Richard's successful early engagement with the board was positive, which was followed by a disposal of the loss-making US operation, a share buyback, board evolution and a cost-cutting programme. This has resulted in much faster recovery than anticipated, with the firm returning to profitability in the first half of 2024. This was ahead of schedule and when announced alongside the half-year results in September 2024 led to a one-day share jump of over 29% on 05/09/2024, which we estimate will have added over 3% to NAV.

The manager's focus on companies at the smallest end of the micro-caps will mean liquidity will be a factor in performance. Richard openly looks to take advantage of this, aiming to find overlooked opportunities and influence their turnaround. However, whilst this has been a positive to returns over Richard's tenure, it does create risk, especially should a holding's turnaround strategy not go to plan, as it would be challenging to sell the holding. One example is Pressure Technologies, an industrial holding that predates Richard's management. The holding has suffered from a tough trading year and share price performance has been weak, with a total return of c. -3% in the past year to 10/09/2024. Richard sits on the board of the company and is trying to instigate the sale of a division to streamline the business and pay down debt. However, the time taken to do this is a demonstration of the risks of the micro-cap space. That being said, the manager is very conscious of such risks, and looks to mitigate them through position sizing, which includes the core and springboard approach (see **previous note**).

Furthermore, before buying a stock Richard will consider practical exit strategies, which should mitigate the liquidity risk. The most likely exit route will be through a takeover, which Richard expects to make up as much as 75% of RKW's disposals. To help instigate this, Richard will often take large stakes in companies (see **Portfolio**). As such, M&A activity will have a significant impact on the portfolio. This has been the case in the past year, especially the final quarter of 2023 where RKW saw successful bids for three holdings. These consisted of Finsbury Food Group at a 34% gain, City Pub Group at a 43% gain and OnTheMarket for a 94% gain. These bids have come from a variety of sources, including from domestic rivals, US peers and private equity, which Richard believes demonstrates the breadth of value from across the portfolio. Due to the highly concentrated approach, when bids happen they can have a significant impact on performance. This has supported performance over the past 12 months, although 2024 to date has seen less activity, instead being supported by the strong operating performance of portfolio companies, as previously mentioned. Both of these factors have contributed to RKW's significant outperformance in the past year, with the trust returning 42.5% over one year to 10/09/2024 versus benchmark of 23.1% and peer group of 18.8%.

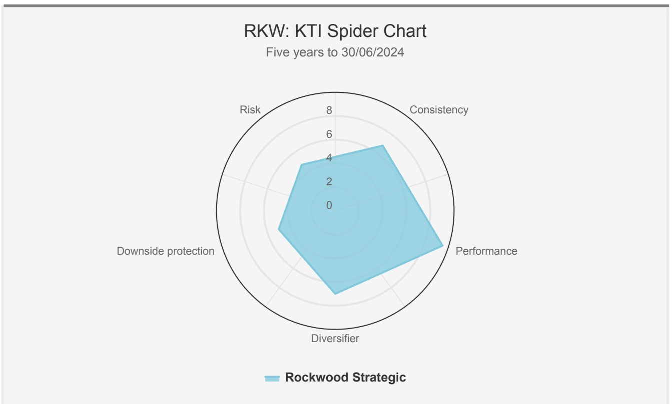
Fig.3: One-Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Our proprietary KTI Spider Chart is shown below. This shows how RKW has performed versus a wider peer group of 22 UK smaller companies investment trusts over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic. As a result of the sector-leading returns, RKW scores significantly above average for performance. The trust also has a much higher-than-average score as a diversifier due to its low correlation score versus the benchmark and a bond index. We would attribute this to the concentrated micro-cap portfolio, which will look and perform very differently to most comparators. RKW's score for consistency is also above average due to its high hit rate, meaning that the trust has outperformed more often than its peers. The score for downside protection is in line with the average of the peer group. This statistic constitutes of two parts; one is downside capture, for which RKW is one of the best in the peer group, though this is contrasted by a low score for its worst five-month period. The risk score is also slightly below average. This is as a result of a higher volatility score, which we would

Fig.4: KTI Spider Chart



Source: Morningstar
Past performance is not a reliable indicator of future results.

expect from a micro-cap trust, though this has provided exceptional returns, meaning the risk-adjusted score is one of the highest in the peer group, also meaning the higher risk has generated considerably better performance.

Dividend

A dividend is unlikely to be a feature of RKW for a number of reasons. Firstly, Richard targets companies at the smallest end of the market-cap spectrum, meaning they are likely to be using any excess cash to reinvest into the business for growth, rather than pay out as dividends. Furthermore, Richard's primary focus is identifying firms trading at valuations below their intrinsic level, and helping to unlock that value. This often means he identifies firms going through a tough period financially, which means they are unable to pay dividends. Also, Richard's preferred outcome for many of these firms is for them to be sold on, rather than increasing the total return prospects by encouraging a dividend payment. Finally, we understand that a portion of expenses will be allocated to the income account, which will reduce any amount payable to shareholders.

That being said, there have been some holdings that have paid a dividend in the past financial year, primarily as a way of increasing their attractiveness to a wider pool of investors. This, alongside two special dividends received in the year, has generated some underlying income allowing the trust to declare a dividend of 0.6p per share, which was paid to shareholders in early September 2024.

However, this only equates to a yield of c. 0.2% based on the share price as at 02/09/2024, which we believe should indicate to investors that the majority of returns for RKW are likely to be from capital gains.

Management

Richard Staveley is the lead fund manager of RKW, with Nicholas Mills as assistant fund manager. Richard has 25 years of experience in smaller companies investing having previously started at PwC where he became a chartered accountant. He then had a stint at Société Générale managing their UK Small Companies fund, before going on to co-found River and Mercantile where he launched and managed the R&M UK Small Companies fund. This preceded a move to Majedie, before in September 2019 he took on lead manager duties of Gresham House Strategic (GHS), the predecessor to RKW. RKW is now the only vehicle Richard manages.

GHS was originally launched in 1999 but, despite a change of strategy to UK smaller companies in 2015, began a wind-down procedure in December 2021 when Gresham House used its position as largest shareholder to instigate, following Richard's departure as fund manager in May of the same year. The shares were eventually bought by Harwood Capital in April 2022, which then saw Richard reinstated as manager under the Rockwood moniker and him implementing the current strategy. Rockwood is part of the Harwood Capital Management Group, which was founded by Christopher Mills in 2011. It has a range of interests across private equity, real estate, and business services, and specialises in smaller companies. This includes other investment trusts in the UK smaller company sector, like Odyssean (OIT) as well as North Atlantic Smaller Companies (NAS) run by Christopher Mills. Christopher founded Harwood and is also head of the investment advisory group that provides input to Richard for stocks in RKW. We understand there are strict Chinese walls in place between the internal Harwood divisions. There remains a high level of ownership of RKW shares by members of the Harwood group and company of 24.9% as at 07/08/2024, from a maximum allowance of 29.9%, which they believe indicates a fully aligned and focussed fund management team.

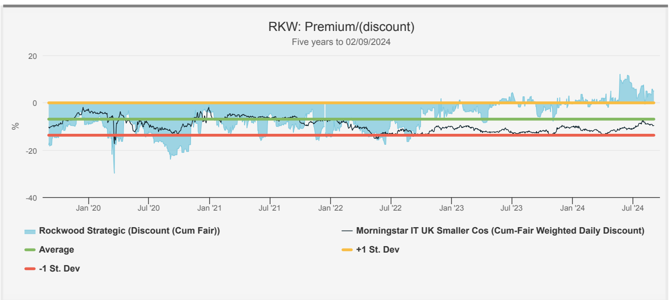
Discount

RKW currently trades at a premium of 2.4%. This stands in contrast to much of the trust's history over the past five years where it traded at a discount, at an average level of 7%. RKW's rating has steadily improved under Richard's tenure, following strong performance. The trust's shares first moved to a sustained premium in mid-2023. The board has been active in keeping the premium to within reasonable figures through share issuance. It has the authority to issue up to 20% of share capital per annum, though this limit was reached in the first half of 2024, following which the premium climbed into the high single figures.

A new prospectus was published in July 2024 allowing the board to issue up to a further 20% of share capital in the year, which was approved at the AGM. As such, the board has begun issuing shares again, which has led to the premium narrowing closer to NAV. This might make for a more appealing entry point for long-term investors.

RKW's premium stands in contrast to the wide discounts seen elsewhere in the AIC smaller companies sector, which currently trades at an average discount of 9.7%. We would therefore attribute the rating of RKW to the sector-leading performance. The renewed share issuance authority has helped narrow RKW's premium, and is also supporting the growth of the trust, which now stands at £89m. This means assets are closing on £100m, which is often the minimum level at which many institutional investors may consider an investment. Should RKW pass through this level, it has the potential to increase demand for RKW's shares.

Fig.5: Discount



Source: Morningstar

Charges

RKW charges a straightforward management fee of 1% of NAV. There is also a performance fee of 10% for NAV returns over 6% per annum, subject to a high-water mark. In our **previous note**, we highlighted the trust had a fixed fee structure until assets passed £60m. Now this has been achieved, the percentage fee has been implemented.

Whilst some investors may find performance fees off-putting, we note that the current charges, including the management fee, are significantly lower than the under previous management. Furthermore, the performance fee is capped at 3% when the trust's NAV is below £100m. If the NAV is above £100m on average the total fees including management fees are capped at 3%. The fees also reflect the considerable work that goes into identifying companies and helping instigate performance within them and therefore, the fee arguably reflects the level of work put in. And, of course, a performance fee is only paid if the trust has performed particularly well.

The OCF for the financial year to 31/03/2024 was 1.58%. This figure includes some one-off fees resulting from the move from AIM to the main market in the financial year. This was also based on an average NAV throughout the year of £48.5m, in contrast to the current NAV of c. £89m. Should assets remain at these levels, or continue to grow, there is the potential for fees to come down as a percentage as some of the fixed costs are spread over a wider asset base.

This OCF compares to a weighted average of the UK Small Companies sector of 0.81% according to figures from JPMorgan Cazenove on 02/09/2024. RKW has a KID RIY of 2.45% compared to the peer group average of 1.23% though we caution the calculation methodologies do vary.

ESG

Richard takes a pragmatic approach to the consideration of ESG factors in his process. With the level of engagement he has with the management teams of his portfolio companies, governance tends to be the standout element. When Richard builds the investment case for a company, his confidence in the ability of a management team to be able to execute the plan will be critical. Therefore, only those with high corporate governance characteristics will be suitable for the portfolio.

For environmental and social issues, Richard takes a common-sense approach. He will consider these issues based on qualitative inputs, rather than using methods such as scorecards, which are likely to be labour-intensive, especially in smaller companies due to the lower level of disclosure. Examples of the social issues that Richard will consider include a company's treatment of its key stakeholders, such as customers, employees, and suppliers, as this will affect the firm's future fortunes and the ability to perform a turnaround. Any risks Richard identifies will be used to engage with the firm to encourage them to work on improving any issues. These are also monitored post-investment.

As a result of the low coverage in the small-cap market, Morningstar does not have a formal ESG score for RKW.

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