Rockwood Strategic

RKW's focus on micro-caps with a value mindset offers a differentiated approach, with differentiated performance...

Update
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Overview

Manager Richard Staveley takes a value-orientated approach when constructing a portfolio for Rockwood Strategic (RKW). He looks to capitalise on the lack of research at the smallest end of the market cap spectrum in order to profit from the extreme price inefficiencies that exist as a result. He regularly targets companies below £150m market cap as these are often overlooked by other investors from which he has delivered strong **Performance**.

Richard primarily focusses on turnaround situations where there is scope for material profit and valuation recovery. He creates an exit strategy within the investment case and identifies the required catalysts for change. The strategy typically buys meaningful shareholder stakes, often well in excess of 5%. These provide the basis for constructive engagement where Richard will offer advice to help create value for shareholders, ensure catalysts are recognised, and eventually have a material influence on the outcome of the business. To do this effectively, he maintains a highly concentrated portfolio of c 20 companies split between 'core' and 'springboard' positions. These are backed with conviction, where the largest positions can be over 10% of the portfolio meaning each can have a significant impact on returns (see **Portfolio**).

The trust has had an eventful history, though this has now settled, with the manager and strategy in place for a number of years albeit with a short hiatus (see **Management**). This approach has been supported by the parent group and manager through a considerable shareholding. RKW has also delivered strong returns for shareholders under Richard's strategy which is primarily due to realised returns from several individual stocks, although raised cash levels in market falls will have had an impact. That being said, RKW is one of the best-performing trusts in the UK smaller companies sector since the manager took over, which may be reflected in the considerable narrowing of the **Discount**.

Analysts:

Ryan Lightfoot-Aminoff
Ryan@keplerpartners.com

Analyst's View

In a populous sector, we believe RKW stands out by offering a genuinely differentiated approach, that means it owns a portfolio of companies that are unlikely to be owned elsewhere (see **Portfolio**). Richard's focus on the smallest companies in the market, selected with a valuation mindset, means that the factors driving performance are likely to be different to what can be found elsewhere in the peer group, or from an investment in a tracker. As such, we believe RKW could be considered as a complementary holding to balance more quality growth-focussed peers, as well as being attractive in its own right.

Not only has this differentiated approach led to a unique portfolio, but it has led to sector-leading **Performance** too. This performance hasn't just been driven by a buy-and-hold approach seen elsewhere, but through constructive engagement by Richard and the experienced team at Rockwood (see **Management**). There have been higher cash levels though that will have contributed to relative performance in falling markets, but on the whole, we believe the trust is less reliant on market forces to drive returns as the manager can help instigate a performance turnaround, including through M&A activity which can be supported by the flexibility of the wider Harwood group, albeit we understand with strict rules in place. As such, we believe the trust can genuinely provide good performance in a variety of market backdrops. This is supported by the highly concentrated nature of the portfolio, meaning success in just one holding could have a material impact on the returns of the trust.

BULL
Strong performance since manager and strategy inception
Highly differentiated approach leading to a unique portfolio
Both manager and the supporting team are specialists in this market segment

BEAR
Concentrated, high-conviction portfolio can add risk
Micro-cap investments can struggle from liquidity issues
The trust charges a performance fee which may not appeal to some investors

Portfolio

Richard Staveley, manager of Rockwood Strategic (RKW), looks to capitalise on the lack of research at the smallest end of the market cap spectrum in order to profit from the extreme price inefficiencies in this segment of the market. He invests in companies below £150m market cap which are often overlooked by other investors for being too small. They may be at these levels a result of having fallen out of favour following a period of weakness, or have a hidden gem of a business that hasn't been recognised, but the lack of research means they are rarely identified. As Richard and the team (see **Management**) are specialists in this space, they believe they can find these companies and benefit from a turnaround in performance.

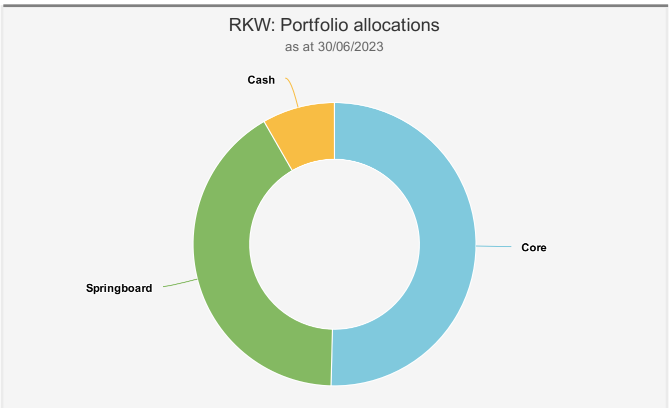
Richard has a value investing strategy. One of the benefits of investing in an under-researched area is that there are usually undervalued businesses. This approach helps set the trust apart from its peer group, the AIC UK Smaller Companies sector, as a number of these trusts invest in the same quality growth stocks which leads to similar portfolios. Richard believes this gives him an edge as the team have less competition for ideas, as well as offering investors a genuinely differentiated portfolio.

The process of identifying these companies starts with an investment universe of around 1,000 companies in the FTSE AIM and FTSE Small Cap indices, before removing those operating in the likes of biotechnology, early-stage resources, and unproven tech business to leave around 500 stocks. From this, Richard will use some quantitative screening and his extensive network in the smaller company space to identify ideas. These are then analysed by looking for companies with good free cash flow, a proven business model, or valuable assets and the ability to recover from a period of weakness. Richard will also want to create an exit strategy before any investment which will not only give a full picture of the investment but also should help with liquidity concerns. We understand that the scale of the wider Harwood group may provide Richard with an opportunity here, as other vehicles within the group may wish to take over RKW's stock position in order to expand their own holding. The group will take a maximum stake of 30% across the Harwood firm though we understand there will be strict rules in place on information sharing.

Richard originally took control of this strategy in September 2019 but left in May 2021 following a disagreement over how to grow the trust. Following a review in December of the same year, then majority shareholder Gresham House began a wind-down process which started a liquidation of the portfolio and increase in cash (see **Gearing**). Harwood Capital subsequently bought out Gresham House's stake and reinstated Richard as manager in April 2022 which we discuss in more detail in **Management**.

Richard's strategy has remained the same throughout. The portfolio is split into 'core' and 'springboard' positions. For the former, they will take a position size of between 5 and 15%, with the aim of owning at least 5% of the company. These will be firms of outstanding value which offer material scope for profit growth. There are currently eight of these core positions, making up c 50.4% of NAV as of 01/09/2023. Springboard positions will be smaller, at around 2% to 4% when the manager wants to start building a position, though these are allowed to run as share price performance comes through. As we discuss in **Gearing**, Richard will also likely have cash on hand to take advantage of short-term price inefficiencies.

Fig.1: Core & Springboard Allocations



Source: Rockwood

Richard is not a passive holder of these companies though. In line with the approach of the wider Harwood group in which Rockwood sits (see **Management**), Richard takes a private equity approach to an investment. As such, he will constructively engage with the management team of his investments and provide advice and guidance to help them unlock shareholder value. He believes this can help add value to a business and generate better returns. We would argue this is another differentiator for the trust in that it is not just a buy-and-hold strategy. In some cases, this will include taking a seat on the board for direct involvement and cooperation with other investments from the Harwood group.

Flowtech Fluidpower is a good example of the sort of stock Richard is interested in. The company delivers essential components and services to the fluid power industry, such as hydraulic pumps, valves, and filters. The share price has struggled as the firm has been hit by supply chain issues, as well as the poor development of a digital strategy. A member of the Rockwood team has joined the board of directors, currently as interim Chairman, and through engagement with the company, they have brought in a new CEO. Richard believes that the changes will lead to improved profitability, which would allow for some strategic acquisitions to grow the business, or make it more attractive for a buyer to come in.

Due to this intensive active management approach, the portfolio is highly concentrated at just 20 stocks. This amount allows for an appropriate amount of time to engage with each company, as each is a big enough weight to have a material impact on performance, whilst providing enough diversification to de-risk the strategy. The manager only expects to add three or four new holdings a year, meaning the portfolio is very focussed, with the majority of the capital in the top-ten holdings.

Top Ten Holdings

COMPANY	SECTOR	%
RM plc	Education services	12.5
Centaur Media	Media	8.0
M&C Saatchi	Media	6.6
Flowtech Fluidpower	Distribution	6.4
Trifast	Industrials	5.8
City Pub Co	Consumer	5.3
Pressure Technologies	Industrials	5.1
Galliford Try	Construction	4.7
Finsbury Food	Consumer	4.4
Van Elle	Services	4.2
TOTAL	-	**63.0**

Source: Rockwood, as at 30/06/2023

Gearing

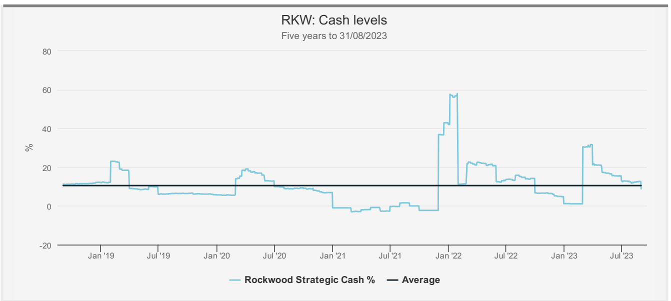
The investment policy allows for gearing of up to 20% of gross assets (25% of net assets), calculated at the time of drawdown. However, we understand there are no plans to utilise this in the foreseeable future.

Richard believes his focus on the smallest companies in the index means there is ample risk being taken in the fund. As such, he does not wish to increase the risk level further by adding gearing. Furthermore, the trust's low current level of assets means that obtaining a gearing facility would come at a high rate, which could act as a headwind to potential performance.

Instead, the trust has been run at a net cash position, which is currently 8.3%. Richard has the flexibility to run cash higher than this, if necessary, best demonstrated earlier in 2023 when cash was over 30% following the takeover of Crestchic, a large portfolio holding. This has been steadily deployed in the six months since to the current level. He also holds cash to take advantage of volatility in his mostly illiquid holdings as well as potential follow-on investments such as rights issues.

In the chart below, we have shown the level of cash in the trust since Richard took over management which includes the proposed wind-down period in December 2021 which led to an increase in cash (see **Portfolio**).

Fig.2: Net Cash

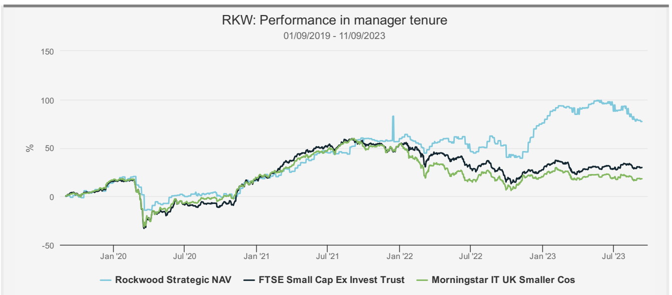


Source: Morningstar

Performance

Performance has been exceptional since Richard took over the trust in September 2019. As we have shown in the chart below, the NAV has returned 77.2% in this period, versus a sector average of 18.2% and the trust's benchmark – the FTSE Small Cap ex Investment Trust Index – returning 29.8%. We believe there will be a number of factors that may influence performance, though stock selection will likely be the most influential. The highly concentrated portfolio, where the top-ten holdings made up 63% as of 30/06/2023, means each company can have a material impact on the performance of the trust. Richard has a goal of generating an internal rate of return (IRR) of 15% per annum over a three-to-five-year period, equivalent to 100% over five years. Whilst this is ambitious, he believes it is achievable due to the level of value in the under-researched area of the market he operates in, and the level of constructive engagement he does with his holdings to generate value. This has resulted in several realisations over the past few years at significant IRRs, such as RPS Plc at c 149%, National World at 201% and Ted Baker at 131% over the course of a three-year period.

Fig.3: Performance Since Manager Inception



Source: Morningstar

Past performance is not a reliable indicator of future results.

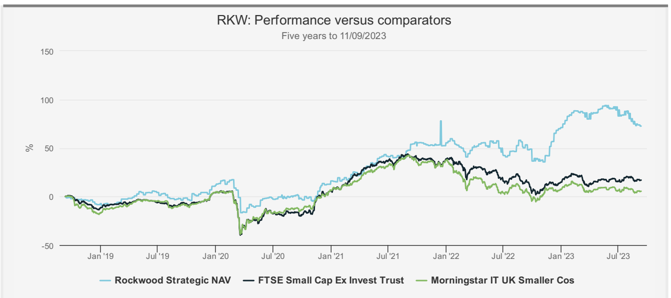
The focus on micro-caps will also be a contributor to relative performance, as the average size of the portfolio company is significantly lower than the benchmark and peer group, and so the appetite of investors for this segment will be important. By operating in this space

Richard is able to best execute his value strategy and find under-researched opportunities, which may not be the case with larger companies. This can have an impact on the risk profile of the trust, as there is considerable illiquidity risk in this area, but as we discuss in **Portfolio**, an exit strategy is put in place at the point of initial investment to mitigate this over the long term. We believe these factors offer uniqueness to the portfolio which has also been exhibited in a differentiated performance profile since Richard first took over the management of the strategy in September 2019.

As we discuss in **Gearing**, Richard has held a significant level of cash over his tenure, at an average level of 10.5% but as high as 31% in the past year following a takeover of Crestchic, a large portfolio holding. The strategy did, however, deploy the cash relatively swiftly after the takeover proceeds were received in March and had run cash down to c. 1% demonstrating cash may not be a permanent feature. Whilst we understand holding cash at any point in time is unlikely to be the result of a tactical decision, as Richard doesn't try and time the market, it is worth being aware that some of the relative performance track record has been impacted by the cash levels. Happily, so far in periods where markets have performed badly, these have coincided with periods of high cash. However, there are no guarantees this will be the case in the future.

In the chart below, we have demonstrated this performance as part of the wider five-year track record, though we would highlight that Richard was not managing the trust under this strategy at the beginning of the period. This term also includes a period where the trust began a wind-up procedure in December 2021, which led to cash climbing to c. 60%, though this was subsequently reversed when the Harwood group became majority shareholders in May 2022 and reinstated Richard as manager (see **Portfolio**).

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

The UK stock market has faced significant headwinds in the past year due to the relatively high level of inflation which has led to higher interest rates and tighter credit conditions. This has primarily had an impact on the growth-orientated stocks, but Richard believes that the value trade has still plenty of scope to run. As such, he believes there is still outstanding value on offer, especially in the micro-cap space. Even so, he highlights that the investment case for each of his holdings is very stock-specific. Therefore, whilst prevailing market conditions are beneficial, the primary driver for performance going forward should be the very low valuations Richard currently sees, which he believes offer scope for significant returns.

We believe the engagement and involvement of Richard and the team with their portfolio holdings can also have an impact on performance. As we discussed in **Portfolio**, Richard prepares an exit strategy alongside an investment case, meaning that the sale of a holding could in theory come at any point. We understand the crossholding with other Harwood trusts may be a factor in this. Whilst there is a strict limit on the ownership of a company across the group at 29.9%, this level of ownership would offer significant influence over a firm, especially with regard to M&A. As such, we understand the performance of RKW may benefit from the flexibility the wider group offers.

Dividend

Richard's focus is on growing the trust and achieving scale which he wants to achieve by investing in companies that can increase in value. This includes using income received to reinvest back into the stock. As such, dividend distributions from the trust are unlikely to be a feature of the investment case. This may change in the future as the trust achieves scale, though this is not certain.

That being said, there is some underlying income generated by some individual companies where Richard has engaged with the management teams, believing a dividend would be a good way of releasing value and increasing the attractiveness of the stock to a wider pool of investors. However, Richard has used this income to reinvest in his portfolio to help with future growth. The trust has also experienced some one-off costs (see **Charges**) which have reduced the amount paid out to shareholders. Partly as a result of this, there have been no dividends paid in the past two financial years to 31/03/2023. We understand that performance fees will be charged to capital going forward and that now the strategy has converted to an Investment Trust, it will be adopting the required payout of 85% of income received net of expenses. Whilst many of the fund holdings are in business recovery mode, usually accompanied by a dividend cut, the strategies value approach does result in companies that have dividend-paying capabilities. Therefore, investors may expect a very modest amount of dividend payments in the future.

Management

Richard Staveley is the lead fund manager of RKW, with Nicholas Mills as assistant fund manager. Richard has over 23 years of experience in smaller companies investing having originally started at PwC where he became a chartered accountant. He then had a stint at Société Générale on their UK Small Companies fund, before going on to co-found River & 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.

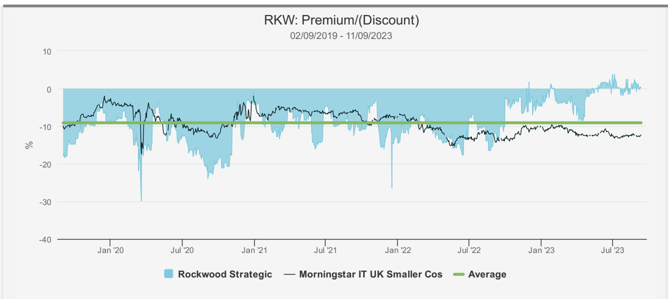
GHS was originally launched in 1999 but despite a change of strategy to UK smaller companies in 2015, began a wind-down procedure in December 2021 when Gresham House used its position as largest shareholder to instigate, following Richard's departure as fund manager in May of the same year. The shares were eventually bought by Harwood Capital in April 2022 which then saw Richard reinstated as manager under the Rockwood moniker and he implemented the current strategy. Rockwood is part of the Harwood Capital Management Group which was founded by Christopher Mills in 2011. They have a range of interests across private equity, real estate, and business services, and specialise 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 provide 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 28.5%, from a maximum allowance of 29.9%, which they believe indicates a fully aligned and focussed fund management team.

Discount

The discount on RKW has narrowed materially in Richard's tenure with the trust now trading close to NAV. The discount stood at 19% when he took over which then narrowed to single digits before widening again as the trust's future became uncertain (see **Portfolio**). Following Richard's reappointment, the discount began to narrow once more, the shares even trading at a premium for several periods in 2023. The current premium is 0.2%. The manager believes this pattern is a demonstration of the positive market reaction to the approach and Harwood's capability. This is further evidenced by a comparison to the peer group which currently has an average discount of 12.3% and has remained around this level for a sustained period.

The board have been issuing shares since May 2023 to help manage the premium which we believe will likely be a factor going forward. This will also help grow the trust which is a key goal for the board. At present, the Harwood group and associated members, such as manager Richard, own 28.5% of the outstanding share capital. We believe this provides a strong alignment of interest between the manager, the parent company, and investors, though will have an impact on the free float of the shares. We note there is a concentrated shareholder base, with over 70% of share capital held by the top-ten groups on the register, albeit some of these may be diversified amongst them with smaller investors. Given the concentrated share register, we believe any decision by shareholders to sell or buy may have a notable impact on the discount.

Fig.5: Premium/Discount



Source: Morningstar

Charges

Following the change in strategy for RKW, there was also a change in the charging structure. The management charge for net assets up to £60m is fixed at £120k per annum to allow the trust to regrow to scale without charges being too much of a headwind. Once assets reach this level, the fees will revert to 1% of NAV. Under the previous investment manager, they were 1.5%.

The manager also charges a performance fee of 10% based on NAV returns over a 6% hurdle rate. Under the previous investment manager, this was 15% with a full catch-up charge once the hurdle was reached. The new approach is subject to a high watermark, and total fees are capped at 3% when the NAV of the trust is below £100m. We understand that some investors may find a performance fee off-putting, though we believe that in the case of RKW, considerable work goes into identifying and helping instigate performance and therefore, the fee arguably reflects the level of work put in.

We calculate the OCF for the financial year to 31/03/2023, including the performance fee, to be 3.62%. However, we note that includes significant one-off costs totalling approximately 1.78% attributable to the changes made by Rockwood over the control of the strategy, such as the migration from AIM to the premium segment of the market. These include conversion costs and professional fees which are likely to be considerably lower going forward. Excluding these, the OCF for the year would imply a level of 1.84% ceteris paribus. This OCF compares to a weighted average of the UK Small Companies sector of 0.78% according to figures from JPMorgan Cazenove on 29/08/2023. RKW has a KID RIY of 1.48% 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 stand-out element. As discussed in **Portfolio**, 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 disclosure in the sector, Morningstar does not have a formal ESG score for RKW. However, we believe that ESG is unlikely to be a primary feature of the trust and therefore this may not be suitable for investors for whom it is an essential factor.

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