Stuart Widdowson (Odyssean Capital) – Concentrating on UK Smaller Companies

Tom Yeowart: Stuart, welcome to the podcast. Thank you very much for coming on.

Stuart Widdowson: Good afternoon. Thanks for having me.

Tom Yeowart: So, starting at the beginning of your career you spent a bit of time as a strategy consultant and then you moved to the private equity side with HgCapital for five years. Can you talk to us about those experiences and what you learned as both a strategy consultant and then more specifically doing buyouts in private equity land?

Stuart Widdowson: Sure. So I initially started as a strategy consultant with a company that between being offered the job and starting had been acquired by another company. And then within the first six months, that company got acquired as well. And it all fell apart actually and 20 of us were left to do our own buyout after six months. So I learned very quickly that people based M& A doesn't really work in consulting businesses. But in terms of the day to day work, most of the work we did was doing a lot of primary research and commercial due diligence for private equity houses.

It's a bit like the survey you do on your house, but effectively we were doing the market and competitor survey to try and validate growth assumptions for PE houses. It was very demanding work. We did a different company in a different sector every three weeks, had half a week off and then back we were again, working quite late. But the benefits of that were, we really got to understand lots of businesses in quite a lot of depth, worked out how to get information about niche companies and niche sectors, quite often globally, and then assimilate a lot of it and come up with conclusions.

So that was great. And I ended up getting to know HgCapital who approached me and asked me to come on board about two and a half years in. And I'd basically started at sort of level one in private equity, quite an interesting time, it was the aftermath of the dot com crash. Seeing that experience of how fundamentals do matter early on in your career was interesting and really understanding how over that period of five years, when you made an investment, how you were going to make money other than just the rating going up. So Hg was really one of the pioneers in Europe of having an operational team to go into a portfolio company and say, okay, we need a proper business plan. We need a clear view of where we want to be in three years. What needs

to happen operationally, what needs to happen strategically and get that plan together and just deliver it. Hg's mantra was always sell a much better business than the one you invested in, and I learned a lot through that period about self-help.

One really good example is you might think company making 12% operating margins is quite good because maybe a similar company in the UK market does that, but I was really taught by Lisa Stone, who was the then COO. Go and have a look internationally, you know, actually most of the peers in America making 20% margins, 12% isn't really good and why is that? Or a very similar business model in different sector makes 22% margins, why is that? What are the gaps? And I found that very interesting. And if you look where that's led to quoted investing and where we are now, we really like the self-help opportunity and it's intrinsically interesting, not just to make money for clients, but leave a business in a much better state than when you invested.

George Viney: How did you find your way into public markets? You joined at a start of a golden age for private equity and the private equity world has done amazingly well for its operators, owners, investors. But you took the decision to go into public markets. A sort of rather contrarian choice. Why was that?

Stuart Widdowson: The nature of the people that work in private equity was changing. And when it originally started, if you look at 3i, most people joined 3i as a graduate, and then the PE houses that we know of today started to spin off. They were originally staffed by accountants and then in the mid-to-late nineties onwards, it was strategy consultants and increasingly, when I was there, it started to be investment bankers and corporate financiers. And the market had started to become much more organized. In the old days, the nineties, most of the buyouts were a company that was a non-core asset of a big company or government owned. You bought them really cheap on cash flow. You didn't pump much leverage in, and there was maybe two or three of you competing to buy that asset and you almost could choose what you wanted to buy.

During my time at Hg, that world had started to change to much more competition, much more people looking at stuff. Every asset was auctioned and you had, we used to call them the strategic financial buyers. The people that basically just had a different cost of capital than you. And it just became who was prepared to pay the biggest price. So the number of deals you'd maybe would complete fell, the deal teams became bigger and quite often you'd work really, really hard and not get anywhere.

And I liked investing. I like spotting companies. I've always had a personal interest in investing. My dad always used to bring back Investors Chronicle home and I used to read it 12, 13, 14. I always had an interest. I was like, actually, I want to go and invest. I want to go and invest in companies. And that's why I made the decision to leave and do quoted investing. In fact, actually going back to about 2001, I talked with Ian Armitage, who was then the chief exec of Hg and is our chairman now at Odyssean, about this whole concept of running public equities, but in a very concentrated portfolio and almost with that mind-set of being a private equity investor. So that's what I went and did.

Tom Yeowart: And the focus on smaller companies specifically, does that relate to your point on competition? There just being less competition in that space, but also it's easier to apply that private equity mind-set because you have more influence on a smaller company than you do a great big oil tanker in the FTSE 100 or wherever.

Stuart Widdowson: We aim to be at least a top 10 shareholder in our portfolio companies and our objective is to try and be the best informed, to have the best quality in-depth conversations with the management teams, and it's much easier to do that with a small company than it would be, I don't know, Diageo or another company like that, where there's quite a fragmented register.

I think the other perspective is also, the market we work in is very imperfect. So when I first went into it in 2006 the question I had was, look, are there always going to be cheap stocks around? And in small cap, there always is. The question is, where do you allocate your capital? And the market imperfections of small cap are really driven by, certainly in my view, the structure of the investors in small cap. Most of the investors have open ended funds and they're the marginal buyer when things are going well, and then the marginal seller, as we're seeing at the moment, the last two years, when they get outflows. And their decision making processes are quite often not rational. And if you've got a stable capital base, which we do through the investment trust, and you focus on long term fundamentals, you can basically pick up value that people want to give you. People are throwing away and that's really exciting.

So a whole bunch of factors. But it's really the imperfection, but also the prospects of making really good long term returns. Our long term returns running this strategy are in the high teens, ungeared, post fees, I think that's pretty attractive.

George Viney: And those historic returns, the imperfections you continue to see in the market and your knowledge of UK corporate finance has meant that

you've stayed in the UK rather than go and look at smaller businesses in Europe or the US?

Stuart Widdowson: So we can do up to 20% outside of the UK. We've had a couple of investments outside the UK actually in, we'd describe them as the beer countries in Europe, rather than the wine countries. They tend to have slightly better corporate governance, but they're assets that aren't family controlled in any way. So we have one at the moment, a company listed in Germany. I've known it for 20 years. One of the benefits of actually doing buyouts, you get to know loads of companies over your career. And this is a global market leader, massive market shares. Prior to this morning, trading on a P/E of 11x, great organic growth prospects, not cyclical.

The other factor we look at is, the market perception of UK small companies is buying a domestic company, a Midlands metal basher or retailer, where we really focus on our global niche market leaders that happen to have their head office here. If you look at the small cap index or the FTSE250, typically 50 to 65% of revenues across companies in that index come from the UK. In our portfolio, it's only 24%. So our portfolio companies generate 76% of their revenue outside the UK. It's actually more international than the FTSE100, but that's specifically where we've chosen to go. And that's also a feature of the sectors we invest in. So one of the things I learned from PE was rather than trying to be jack of all trades, master of none, really pick a few sectors and get to know those companies, and get to know their business models well. So we spend all our time in TMT, services, healthcare, and specialist industrials.

The one thing we don't do is ever behave like the index though. So again, you have to make sure you've got the right capital base, the right client base to see you through.

Tom Yeowart: You managed Strategic Equity Capital very successfully between 2009 and 2016 and then obviously left to set up Odyssean Capital. And I'd love to hear you talk about what your ambitions are for Odyssean, what you're trying to create and the culture you're trying to build that supports strong long term performance.

Stuart Widdowson: One of the really nice things about Odyssean was bringing together people who I'd worked with or really respected in the market to come and create what we're trying to do, which is basically make asymmetric long term returns for our clients and attract long term clients.

And I'm quite old fashioned in that I believe that most financial institutions like stockbrokers or asset managers should be partnerships. So we've set up our LLP, there's not a capital gains play for us. This is basically a business where all the partners will do well, if we will do well. And my rather starry eyed objective is to 15, 20 years' time, I decided I don't want to do this every day, leave behind a business that's going to outlive me. That's really good with a good reputation at making good investments for clients and having great customer service.

So that's really the starry eyed ambition and the culture is really there to support that. So Ian Armitage, our chairman, he has a very good expression that basically you have three objectives in this order: clients, firm, self. In reality, if you look after your clients and do the right things for your firm, you're bottom of the pack, but if you do the top two things well, you do fine. And also his other mantra is have fun, make money, right? So it's got to be fun as well. And I'm really, really delighted that we brought a group of people together that actually enjoy what they do and it has its good times, its bad times, but the people you want to be in the trenches with and small caps can be quite volatile, that makes a massive difference.

I think the other strength that we have is the partnership with Harwood with Christopher Mills. I think he's run his investment trust since 1981. He's run closed ended funds since 1975. I think he is the longest standing fund manager in the UK. He's seen it all and he's very patient, doesn't interfere and has given us a really stable base. They provide our back and mid office. So we spend all of our time on investment and clients. We get all the benefits of a boutique with none of the hassles, which is fantastic.

The five years we've been going have been really hard. Our market's not made a positive return nominally since then. We're really pleased we've made a sort of 45 to 50% in that difficult market, but that's really been because the culture and because the support we've had.

George Viney: Maybe you didn't anticipate what those five years have been like, but the name Odyssean suggests a long journey and many trials. Is that the thinking behind the name of the firm?

Stuart Widdowson: The irony was, I thought that was the end of the trials because Ian and I had talked about setting this business up for about 10 years and we eventually got there.

I think the name of it was really to reflect investing is a long game. We can do analogies of marathons and all that type of thing, but things happen along the

way and you've just got to stay in the game and be consistent and you'll get some years where everything works and you look a hero and some years where you do everything right and it doesn't work, but you've just got to stay in the game and keep being consistent as much as possible. And you'll get to where you want to get to and you've got to be resilient and determined.

Tom Yeowart: Your strategy is clearly very differentiated to many of your peers. A lot of your peers have broadly diversified portfolios with a lot of holdings. You follow a very different approach in concentrating. I guess a lot of people's perception is that small caps equal’s risk. Diversification is good. And clearly your track record suggests that there is a very viable other way of doing this.

Stuart Widdowson: Excellent question. I don't think we'd say it's better or worse. It depends on how you look at it and really what you want. The most extreme way is can you run money as a passive in small cap? Well, not really. The only thing you can buy is the iShares UK small companies, which we'd say, well, actually that's not really small cap. And it's underperformed every year it's gone.

So, you can play small cap passively if you want, but you get what you pay for. The thing about concentration is it doesn't work every year or every period, but over the long term, concentrated funds tend to outperform if they're executed well. We look at periods and I think we outperformed two thirds of the time, but we've generated massive alpha. So I think statistically, that suggests it works, but you have to have patient long term investors. I think in terms of the diversification, we take the view that we're looking for companies and investment situations with particular attributes, and there just aren't that many of them at any one time.

And we think our addressable universe is 350 companies. Our goal is to own the best risk reward 15 to 20 companies out of those 350 at any one time. And we're really, really, really disciplined about what gets in the portfolio. And we have many, many debates around this. We have a very detailed investment note and that's really what drives the portfolio. If we have a portfolio of 50 and have real diversification there, would we consider it? Well, maybe, but then we wouldn't know these companies as well. We wouldn't be able to engage. We wouldn't be able to spend the time.

I think in a world where everyone's so bifurcated between growth and value, what we do is totally different. And that's what we offer our clients the choice of.

George Viney: Do you think it's riskier?

Stuart Widdowson: How do you define risk?

George Viney: I define it as the permanent loss of capital. And if you have 17 holdings and something happens to one that you couldn't possibly have predicted, like a pandemic, maybe, then that leaves you much more exposed in that one single issue than if you had 30 companies, you'd still be diversified.

Stuart Widdowson: We see risk in a very similar way. So if you look at the investments that don't work, everyone talks about the investments that work, right? Our last annual report, we effectively said, we've had 30 exits or so in the first five years we've been going, there are three that hadn't worked, right? So we think the win loss ratio is really good and the performance suggests that when we get it right, we get it really right. And when we make mistakes, as you always do, it's not catastrophic. So I think the way we look at it is, across a normal cycle would say, look, how can we find a stock where we think there's a very, very high chance of 15% annualized return? Upside above that, but where there's a very low chance of losing capital.

Yes, you are exposed to that. But what we tend to find is the way we pick stocks is when things go bad, they don't go down and stay down. Something tends to happen. There's an opportunity, maybe a corporate takeout, which gets your cost back. If a business is fundamentally a decent business and it steps on a banana skin, and maybe you need to go and work with others to change the management team, you can always find a good management team to go and sort out what's potentially a really good business. Where we shy away from is a cheap, bad business because when it goes wrong, no one wants it.

Private equity won't buy it, trade won't buy it, and you won't get a good management team in to go and run it. Was it Buffett that said when a bad business comes in contact with a good management, the business keeps its reputation. And I've found that so many times over my career. And that's one of the three things we focus on. Basically just try and find good businesses. You won't get them all right, but the bad ones, you won't get wiped out in.

Tom Yeowart: It's fascinating when you look at your track record in that, despite the concentration a lot of your outperformance has actually come in more difficult market environments. So I'd like to dive deeper into the quality aspect of what you look at. How you think about and define quality, what you're specifically looking for in companies to give you confidence that they're going to be bigger and better in five, 10 years' time.

Stuart Widdowson: The first thing we look at is the numbers. One of my rule of thumbs is don't invest in a company that can't make 10% operating margin. It's just a litmus test of value add of a business. That automatically excludes swathes of the market. Would we ever invest in a construction company, even if it's really cheap? No, not good. So, we look at that, we look at return on capital employed. So we're not in the camp of Terry Smith, CapEx light businesses. We will look at more capital intensive businesses, but they have to be capable of making attractive return on capital employed, given the dynamics and given the opportunities in the market.

Where possible, we like companies where there's an element of either recurring revenue or repeat custom or particularly where they're a very, very small part of their end customers costs. So they're never going to be the first people in line for pressure on reducing prices or alternatively, they can put pricing up quite aggressively and we've certainly benefited from that over the last couple of years with inflation.

So we look at what the numbers say. The second thing is we look at the strategic and competitive position of a business. Where does it sit in its supply chain? And companies we love are ones where they don't have any supplier dependencies and an ideally massive fragmented supplier base, massively diversified customer base with hardly any competitors. And that means the company is just in a really, really strong part of its supply chain. The German company I mentioned earlier, I suspect everybody is an indirect customer of this company. It has a 70% global market share in gas springs for automotive. So these are the things that keep your boot up or your bonnet up of your car. They have strategic advantage. They have got the lowest cost producer and for somebody to compete against them and take stuff away is really, really hard. No supplier dependencies and they virtually supply everybody. So, real customer dependency as well.

So that's a really good example of something that's in a really good position in its supply chain. Other things we look for in quality. Who are we buying alongside? Who else is on the register with us? And we want people who are going to be benign or supportive of the same objectives that we are. What we don't want is somebody on the register who has very different objectives and a mind-set for what should happen at a company. Or could be conflicted. So, management's a really good example. We look for management to have skin in the game, but not be dominant to the point they see everybody else as a provider of equity capital, not a co-owner.

Our final litmus test is, because we came from private equity, if we could, and we had the capital, would we be a hundred percent owner of this business? I don't know if you remember Victor Kiam, Remington, I like the business so much, I bought it, right? The reason we think about this is because liquidity is patchy in small cap. If you get into a company, you might not be able to sell your shares for quite a long time. And are you happy being in that company? And it's a really, really key thing that we consider. Is it good enough for us to want to own? And if it is. It can get in the portfolio.

George Viney: You tend to find these businesses in certain sectors, which ones are they?

Stuart Widdowson: So TMT, healthcare, specialist industrials and services. Yeah, these sectors, but quite often they are niches within this, so in industrials, we've got a lot in business-to-business electronics at the moment. A lot of people think electronics is scary and think of Apple and consumer electronics. B2B electronics are great because they tend to have very long product life cycles and the barriers to entry are much higher and the margins are much higher. So there are certain niches that we really, really focus on. And the benefit there is because we have a track record of investing in companies in those sectors over many years, we know what good looks like.

We can segue into self-help. Many small companies in the electronics sector don't have very efficient manufacturing, and we've historically invested in periods where these companies have put in something called lean manufacturing. If you're an engineer, that basically means being very efficient about how you make your stuff, your production flow, what you do in house versus outside. Your dwell time between processes. Do you have 80 steps in your process or 50? Where's the inventory in between? And when companies get this really really right and optimize this, we've seen them add 300 basis points to gross margin and take a turn out of working capital. Now, if you invest in a company, you know that's not done that. You know, that there's upside irrespective of what happens to the market. And you know, that company is going to be worth more after they've done it.

And we just time and expertise arbitrage. And our job is to help make sure that happens. And that's one of the benefits of really getting to know a few sectors quite well. Ed calls it pattern recognition. We've done it in tech enabled services. One of our first investments was making 9% operating margins. We looked at the revenue mix and it should have been making 18% margins in our experience in that sector. And there was a clear plan to get there. Gross margin improvement. They had 4,000 people around the world. They managed through

Excel, really inefficient. Utilization was 10 percentage points below where it should be. And then on top of that, they've been built by acquisition and they had unallocated central costs of a hundred million out of a £230 million cost base that no one owned these costs. So the costs weren't being efficiently managed. And we looked at that and said every time we see this in a company, they take at least 10% of that cost base out if someone focuses on it.

And the benefit that we had is when we invested, none of that potential improvement was in the share price.

George Viney: Where do you stand on cyclicality and your appetite to own cyclical businesses? You mentioned you'd like to see some repeat purchase and be a small percentage of customers' costs. These businesses have self-help and that gets them through lean years, in some cases, but they may also have a fantastic plan for self-improvement. It gets derailed because the cycle turns against them and they're fighting fires elsewhere. So presumably there's a spectrum and you sit somewhere on it. Where would you say you sit?

Stuart Widdowson: I would say we're cycle aware as opposed to trying to time cycles. One of the challenges of say more cyclical assets is, we tend to look at price-to-book and EV/sales more than P/E, at the bottom of their cycle they tend to be on their trough ratings and the top of the cycle, they tend to be on their peak ratings. So provided you are very cautious and careful about the multiple you invest in at the time you invest in, over the medium term, the cycle doesn't matter that much in our view. The only risk is if you get caught out by a horrific downturn like the GFC. So we don't shy away from cyclicals.

If you look back at the 1970s through stagflation, the best performing sectors, not surprising was oil, mining did pretty well, third best sector industrials, because they have typically really good pricing power. And certainly we feel at the moment that industrial cyclicals in the UK are a really hated asset class. The average company in our portfolio in that sector is trading on probably 40% of their long term EV/sales. There's an opportunity there and no one else wants to go there at the moment.

So we're not shy of it, but our view is actually if we can find those opportunities where you're not just getting an attractive price today, but actually think that asset can be improved in some way... Look, if things get a bit worse, or it takes a bit longer to recover, there's still something that can be generating fundamental value. And when it does recover, because it always does, you'll get a double whammy.

We've got a real live issue in the portfolio at the moment where we've got a structural growth story that's doing really, really well, but we see 80% upside, but moderate risk. Or we see something cyclical that might not quite have hit the bottom, but on a three year view, it's not got 80% upside, it's probably got 150-200% upside. Rationally, if it was your capital, you'd be reallocating away from non-cyclical stable to cyclical, because that's the right thing to do over the next three years, but it's quite hard to do.

Tom Yeowart: Can you talk more about the role of valuation and the role of valuation in both buying new holdings, but also trimming and selling holdings because a lot of fund managers are often better at buying than they are at selling.

Stuart Widdowson: In terms of how we think about before we get in, there are two things we really consider. One is what we call static value and the second is dynamic value. Static value is basically, are we paying 80p for a pound of value today? And it's not the same as value investing as in buy cheap in a stock that might go bust. We've talked about the quality lens. What we're really looking at is saying on the basis of not just public market multiples, but more importantly, actually what we know to be trade M&A multiples or what we think private equity can pay for these assets, are we paying at a price that gives us a margin of safety today? And again, going back to what I said earlier, quite often that's an EV/sales or a price-to-book number, much more stable over time. So if you can buy a pound of intrinsic value for 80p, the second thing is, well, how's that intrinsic value, how's that going to grow the next five years? And that's what we call our dynamic valuation.

And we think there's five ways you can grow that intrinsic value. Sales growth, margin improvement, free cash flow to pay down debt, multiple expansion. And the final one is adding value through M&A. And we want to find investments that have as many of those as possible. It's a multi-leg investment case. The reason we like that, and this comes back from something we learned at Hg is, if you've got lots of ways to make money out of a situation, probability is you're going to make some money. And even if two or three of these things don't work, you probably get your costs back.

And the best situations are where the multiple drivers are quite well balanced. So there's a bit of sales growth. There's a bit of margin improvement. There's a bit of free cash flow and a bit of a re-rating.

We've invested in lots of software companies over the years, but they're all the brilliantly boring ones. I've owned virtually every provider of public sector

software over the years. I remember buying one in 2008 where our entry valuation was a 16% free cash flow yield. And it was growing at 2% a year with a bit of margin improvement, but we were getting our target return just on free cash flow yield. And ultimately actually that company got bid for at a 50% premium in a market that fell 30%. So again, somebody else saw the value and that was a catalyst.

So that's how we think about stocks and that dynamic value drives what we think the intrinsic value is going to be in three or four years' time. We then compare the share price today with that intrinsic value in three or four years' time. And that gives us an IRR, and we can add a dividend yield to that. And that gives us our projected return out of that investment. That has to be above 15% for every investment. And then we compare it to what we already own. So we have our daily cost of capital. And then we overlay on top of that, actually how risky do we think that is? A low risk 16% is probably better than a high risk 17%. So that's how we think about managing the portfolio.

Why do we sell? Chemring would be a really good example, fantastic company. We bought it soon after we launched. And that was a self-help play, a company putting itself back on their feet having had a bust balance sheet for many years. A lot of operational improvement. We've made very good money out of it. Ukraine war happened, market fell 15% or so, Chemring re-rated 40%. And we said, this is a great company. It's got a fantastic management team. There are really good times ahead for this company, but it doesn't make our return requirements now. And not only that, everything else in our portfolio, the expected returns just gone upwards. So we literally started selling Chemring the day that the Ukraine war was announced and the shares re-rated.

George Viney: You will own quite large stakes in smaller companies and a stake that size would trade not quite on appointment, but much more illiquid. You can't always choose your exit moment, and if everything goes well, I'm sure you can see sustained operational momentum, which would sustain a better exit that might mean that you're selling a much lower prospective IRR than you would if your model said I can generate higher returns owning the next best alternative. So how do you manage your exits given some of those constraints and the visibility you have into the operational momentum that's driven a turnaround situation?

Stuart Widdowson: Excellent question. And a lot depends on liquidity. Our spectrum where we focus is sort of a £100m - £1b n. Average market cap at the moment is £470m in the portfolio. But there's a real range in there. At the bottom end, the small stuff, in reality, many cases you're reliant on, if things go

well, two things really to happen for exit. Either the company grows into 200-300 million market cap, and it finds new buyers and becomes a growth stock, right? And then your exit is into the market to all the diversified managers that wouldn't own it when it was a bit under a cloud or it was a bit small, but actually, it works for them now and it's becoming a bigger part of their index. And if they don't own it, they might underperform and they just have to have some. And I've seen that over time.

That doesn't always happen. So where a company can't grow to the point of attracting more widespread interest, most of the time, your exit is to some sort of corporate transaction. If you look at many of the sectors that we look at and the fact that many of our companies are international, don't really have a following here, it's probable that the best owners of these businesses long term are big corporates from overseas. So, we have a couple of companies in the portfolio that generate only 5% of revenues in the UK. The fact that they're here is really an accident of history. They're not well understood by the stock market. They're never going to be 500 million, but there's two or three obvious people that probably will make a lot more out of them and that bring many more synergies than you'd ever have as a public company.

So in those situations where they're less liquid, we would possibly invest reasonable stakes, make sure the Board's aligned, make sure everyone's incentivized to get those businesses to a point where they become good enough for the obvious people to want to own them. A really good example from my previous career at SEC was a company called e2v Technologies, global market leader in niche electronics. Really struggled to get a following over here. We exited that business selling to Teledyne, quite a well-known, US, high quality corporate buyer. We were an investor for seven years in that company, and it had gone from being a basket case with great IP, but poor financial disciplines, poor operational management. At the exit, Teledyne called them up one day and said, can we come and have a look at your factory now? Did a tour, after 40 minutes went to the chairman and said, yep, it's good enough for us to buy now, what do we have to pay? They were going to value it on a totally different basis to the rest of the stock market.

One of the things I learned from that experience is really good trade buyers like Teledyne or a Danaher, they're not interested in buying a bargain of stuff that needs fixing because it's career risk for the corporate buyer that wants to buy that company. What they want is a company that, all the things have been sorted out. The lean manufacturing has been done. The R&D has been better structured, so we're spending R&D in the right place now. The working capital has been sorted. The supply chain issues have been sorted. So they know when

they can buy it, they can plug it in, take the overhead costs off and no one's going to get fired for the acquisition going wrong. And they'll pay a premium for that.

So that's at the bottom end. That's how we see helping these companies transform to reach their potential where either they could become a growth company or alternatively the obvious buyer with synergies is prepared to buy them and really pay up.

Tom Yeowart: How do you go about identifying these businesses and also identifying them at a time when, as you say, they're on a positive path to making the changes to improve rather than, maybe only just starting to think about it or not even thinking about change at all?

Stuart Widdowson: They're always there. And I think the real trick is working out what you think good looks like with these businesses and making sure you don't pay for a fixed business when you go in before it's actually been delivered. And that's part of the trick, but look at some of it's come through experience. The first investment I made when I stepped off private equity. I'd never really done much in plastic packaging. My manager at the time had said, I think this company is underperforming, and it was literally basically go and work out what it should be doing and how it could be better.

So I spent a lot of time working at this company and it had made lots of acquisitions over time. I think it had gone from five sites to 50. Virtually never closed a site. We used a cash flow based modelling tool called Holt or Quest, they're very similar models, and the company hadn't made cost of capital return for about 15 years, which for those of you on the call that don't know that basically, if you're not making economic cash return above your cost of capital, you're destroying shareholder value.

And this company according to Holt had destroyed shareholder value for 15 years. So something wasn't going right. The shares really hadn't done particularly well and the company spent lots of money on CapEx. And what Holt was telling you was the company was very asset rich, but wasn't efficient. And the question was why? Because if you looked at the balance sheet and the stated return on capital was 7 or 8%. Doesn't seem great, doesn't seem bad. Holt says it's got lower, why? And what we determined was the company owned virtually all its freehold properties across Europe. They couldn't tell you how much they owned. In fact, we asked a friendly sell-side analyst to go and spend some time with the CFO and they came back and said they owned something between 150 and 250 acres of freehold property all around Europe, which had

been there in the company in some case for many years and had housing estates built around it. So potentially very, very valuable real estate.

The second thing was the working capital wasn't particularly optimally managed because the management team's incentives and the way they managed the business weren't focused on return on capital employed. They were just focused on growing earnings per share. So after about several months, we spoke to private competitors, and they said to us 15% return on capital is the right number.

So clearly there was opportunity we felt to improve efficiencies. You get a good management team in there, and over the next four years or so, they released loads of money from working capital, restructured the business. They closed 5 percent of the sites, put all the business into the remaining 45 sites, didn't lose any sales, and took a load of overheads off. Got much better at purchasing and the return on capital did get to 15% and we made tons of money out of it.

And it's those learnings where you think actually, I look at another business at the moment, again the balance sheet is massively understated. It's not making returns. Why? The question is always why? And you have to just keep digging away.

George Viney: How do you determine what's fixable? An historic misallocation of capital and a bloated cost base can be sorted by a few people at the top of the organization, but cultural malaise and a shoddy workforce is really hard to fix. So how do you make sure you're focusing on the former rather than the latter?

Stuart Widdowson: It's an excellent question. Would we ever buy a stockbroker that's underperforming? No, you know, your assets walk out of the door every day. Would we buy a quoted fund management company? No, if the culture goes, there's nothing you can do. So that is another reason that leads us to the sectors we invest in.

How do we spot the performance gaps? A lot of it's down to having looked at or invested in many companies like this. And a lot of it's the backing people to go in and sort it out. Are they any good, well you can diligence them? What have they done before? What do people think of them? What are they starting to do? And then you can basically look at what you think the performance gap is. Niche electronics, our rule of thumb of a decent niche electronics company is 45 to 48% gross margin. So it's all about trying to work that out.

The workforce being on the right page really helps you, but that largely comes from leadership. So in many situations, we back people and we typically see the chairman as the key change agent. In many cases, we see if there is a senior management, cultural issue, there needs to be substantial change. The right route of change is chairman, chief exec, finance director.

And that speaks to have you got the right people on the bus running it? Have you got the wrong people off the bus? And is the prize big enough to go to? So in restructurings at the moment, we think we should be looking at 3-4x return over the next four years. And a less risky situation, you probably take a turn off those returns. And then of course, you don't want a portfolio of the same type of risk profile either. So you've got to have your speed boats, your tugboats and your liners.

Tom Yeowart: You obviously take a very involved approach to investing, much like private equity, but you fundamentally got less control than if you're a private equity buyer of businesses. Can you talk about how you approach engagement to be the most persuasive to companies who you're pointing out the potential for operational improvement?

Stuart Widdowson: Being persuasive, I think if you do your work and really try and understand and get to know a business better, you've always got a much better currency to be credible with people. Also, if you've been around for a while on the register. So would we ever take a stake in a company and immediately call for a shakeup of it after a month? No, because it's just not credible. You need to follow a business and probably have some skin in that business for four or five sets of results, two, two and a half years, really to get to understand what's going on in that business and what could be improved. That can be short circuited a bit, but that's the rough rule of thumb.

It's also the questions you ask. We have many companies turn up, as I'm sure you guys do. We don't flick pages of presentations. We come pre-prepared and quite often what we want to ask them and talk about might not be in the presentation. Lean manufacturing, we had a company in the other day that hadn't implemented lean at all, and we had a 20 minute discussion about the opportunities to improve gross margins in all their US sites, because they've never been leaned. That's what we do. So I think in terms of getting the right people on the bus, the least risky situation is where you've spotted the opportunity and somebody has already got the right person on the bus.

Spire Hospital would be a really good example of that. The opportunity to buy that company came post COVID because the government requisitioned it

effectively. We didn't quite catch the bottom when it was traded on a third of tangible book value, but we got in about half book value, which proved to be a very, very good decision. But Justin the chief exec had come in about 18 months before and started a five year process to improve that business. And it's a much better business now than it was five years ago. Were we influential in that? No. But we did spot the improvement opportunity and we spotted that not just would you get value back as things normalize post COVID, you were going to get a kicker on the other end.

We don't shy away from situations where change is needed though. We're not public about calling EGMs. We would be prepared to if necessary, but one of the benefits of small cap is registers are pretty concentrated. If you are trusted by other shareholders and you're credible, normally change happens quite quickly behind closed doors. Now, I have been involved in board changes at numerous companies where three out of the non-execs change in three months under a new chairman, because you get the right chairman in and they just refresh the board, reset, off you go.

When we get a new chairman in either through our initiatives or others, the question is how you engage with that person. And we have a sort of a cohort or almost a black book of chairman we really like and trust that we've worked with over many years and it's always the same thing. We're going to leave you alone for three months, but can you come back and tell us what the problems are in terms of, is it management, market, or product or service. What's the balance? What do you need to fix it? How much time? Do you need more money? And then you just get out of the way and let good people go and sort it.

But the key for us is it's catalysing that change agenda and saying to people, come on, what can we really do with this business? Incrementalist doesn't work.

Tom Yeowart: There's a wonderful stat, I think it was in your five year review where you highlighted that the comparator index you use produced a compound return of 14.5% in the 63 years until 2017 when you set up Odyssean and, as you highlighted earlier, since then it has produced no nominal return at all. Can you talk about the structural headwinds facing the UK market? I imagine Brexit has been one of them. But what have been those headwinds that have meant that the index as a whole has gone nowhere, even though obviously your strategy has delivered a decent return.

Stuart Widdowson: Active investing in equities generally has been losing share to passives. So I think for general UK active equity funds, that's impacted them and has taken away a marginal buyer or owner, even down at small caps.

The second factor is allocation away from UK equities by pension funds and insurance companies. I think it was around 40% of UK equities used to be owned by UK pension funds and insurance companies 25 years ago. And today it's, I think, four. So there's been structural sellers. Literally, a wall of selling.

We looked the other day at the earnings yield of the FTSE 250 over the last 12 years, and with zero interest rates, you'd have thought the earnings yield would have been pretty low. But interestingly the earnings yield virtually never changed during zero interest rate period. And we think part of that is because of this ongoing structural selling and exit of UK equities and that's even pre-Brexit. What has Brexit done in our view? Well, I think for the marginal buyer, it probably makes UK equities less interesting. But we don't think that's the major reason. I think it's the political uncertainty. And people think they don't need to go there. UK equities are now 4% of global equity allocations. They were 10. So do you need to go there? More companies are being taken private because the market's cheap, there's less choice. Do I need to go there?

So I think that's been a real headwind. I'm optimistic it's going to change. I think another headwind has been de-equitization through private equity takeovers. But the take privates have stopped because now private equity houses are paying 12% on their senior debt and it used to be five. So if anything, I think in the next five years, we'll see what happened in the early-mid-nineties, which is PE houses looking at IPOs and exit. For that to happen though, markets need to re-rate and also there needs to be money coming back into UK equities in particular.

Where are the early buyers going to come from? We think overseas. So in the last two months, we've had numerous unsolicited interest from in particular US investors. They're prepared to look at the UK again. Again, if you look at Quest or Holt the UK market is trading on the biggest discount to intrinsic value I think it's ever traded at. And US equites trading on a much higher premium than they have done historically. Not quite as high as the peak, but still in aggregate, they look pretty overvalued and UK looks super cheap.

And going back to this internationalization, there's lots of companies in the UK market that are trading on massive discounts to their peers in the US. Nick Train talks quite a lot about this. We've got one in our portfolio that's trading on half the EV/Sales ratio of its closest peer in the US market, and that's just nuts. And that can't carry on. And people are starting to see the opportunity. What we're not seeing yet is capital flowing in. Why I think I'm quite excited is when it does, things move quite hard. Q2 '09 market went up 32% in small cap. That's pretty good. Q3 '09, it went up 35%. So those six month period, our market

went up 80 percent because the natural selling had stopped and suddenly the momentum really turned in our market. I don't know when the bottom will be, but I know when it turns the other side, it's going to be quite material.

George Viney: Your focus is clearly on multinational businesses. Not really dependent on UK domestic economy so much. And the businesses you've described have, for a whole host of reasons, idiosyncratic drivers to their returns. But there is something about your asset class being joined at the hip with larger companies, the FTSE 100. If I think about pre-2016, certainly pre-GFC, it was the financials, it was the commodity-based businesses at the top of the market that was driving interest and driving returns for the FTSE 100 that drew capital into smaller companies. Do you think about that relationship and how somehow your pricing environment is very much influenced by the top end of the market?

Stuart Widdowson: Funnily enough we don't see too much of that. I think it's... if you're looking at investing in small cap today, you're probably quite contrarian and you're probably more a value than a growth person. And it's interesting, everyone gets excited about growth small companies. It's really exciting. Everyone want to be the people that say we bought Fevertree at IPO and sold it having made 20x. If you look at the long term in small cap, small cap value massively outperforms small cap growth. And it's the contrarians that come in first. It's the family offices. It's the endowments, the people that will take a 10 year view.

Tom Yeowart: I just wanted to touch on the subject of inflation and the changing cost of capital and I think you've described those two together and, you know, to continue the Odyssean theme, as the sort of Scylla and Charybdis of the current market environment. And I just wanted to get a sense of how your companies are coping with that significant change in the backdrop. And, again, why it's more important to focus on businesses which meet a certain quality threshold so that they can come through this harder operational environment.

Stuart Widdowson: We never believed that inflation was transitory. And about two and a half years ago, one of the benefits having a pretty small portfolio, we went through every portfolio holding and said, if inflation goes to 8%, how are these businesses probably going to behave? Where do they sit in their supply chain, how concentrated are their customers, how quickly can they pass prices on. Similar on the supplier side? And that really started to influence a few things we were doing in the portfolio.

One of the things that's interesting about heavily asset backed companies, if they're well invested, is inflation is a great thing. The capex has been spent. If you run on maintenance capex and you whack your pricing up, your return on capital employed really goes through the roof. Spire is actually quite similar, massive freehold property base, sweat that asset in an inflationary environment, great for shareholders, right? So we thought a bit about that.

I think most companies that we've invested in have passed pricing on pretty well. A few of them there's been a bit of a lag, but then we've seen that as an opportunity because the stock market has gone, oh my gosh, they can't pass the pricing on quickly enough and maybe there's been a small downgrade or sometimes a bigger downgrade opportunity because we know that they'll pass that on.

The pace of the interest rates coming through, I think has surprised many, many people. And you really have to go stock by stock. So again, Spire is a really interesting one. It's relatively heavily geared, which you expect with the asset base, but their interest rates from memory are locked in for a couple of years. So that's really interesting actually in this environment. You've got other situations where perhaps the balance sheets weren't quite as strong as they should have been, and they've been caught out. The opportunity there is to say, well, look, fundamentally, this is a decent business. It's had real bad things happen to it, but if the balance sheet is fixed, this company is going to be a good company again. We've got one in our portfolio that everything has gone wrong for it and the balance sheet's a bit tough, but it's got between 4-8x relative market share to its next biggest competitor in a really fragmented market, massive pricing power. So, you know, in fix that business is going to be worth a lot more in five years' time, and most of its competitors won't survive. Great. Not worked so far, but actually that's the one you want to back.

The quality thing is quite important, so you go back to the construction assets. The reason we won't invest in those is because they're low margin, inflation comes through, if you can't pass on, you lose money really quick and they've got horrible working capital. It's not business you want to be an investor in and they're cyclical, right? So again, that's where the quality comes through, why we don't want to do that.

The final thing on valuations. Many, many growth managers think that the valuation doesn't matter and that probably was right for the zero interest rate period. We probably lost relative performance being price disciplined. My, how that's changed over the last two years. Small cap peaked September '21, massively de-rated and valuation does matter. And that comes back to cost of

capital. There was some software companies on 60x earnings, sub 2% free cash flow yields. Assume they're going to grow forever and surprise, surprise, they haven't. And they're not on 60x earnings now. So, I think that look we always make mistakes. That's life. But we think we've got a framework that hopefully counters those issues of inflation and interest rates and will see us through.

Tom Yeowart: Turning to our closing question, what piece of advice would you give a young Stuart Widdowson at the beginning of his career?

Stuart Widdowson: Find out what you enjoy and you're good at, and get a really good mentor. It has served me really well.

Tom Yeowart: Great answer. Thank you very much for coming on.

Stuart Widdowson: Thank you, gents.