Jim Strang (HgCapital Trust) – Building an Experience Curve in Business Software

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

Jim Strang: Thank you for having me. Delighted to be here.

Tom Yeowart: So, Jim, you've been in the private equity industry pretty much your whole career. I'd love to know how you got into the industry in the first place, but also the general observations and lessons learned from a career in private equity.

Jim Strang: I'm a reformed fund manager. So, I started out as a public market fund manager and then I went into private equity 25 years ago really, after working at Bain & Company. So, my transition was public market fund manager and then I did something I would never recommend, which I did a PhD in finance, and I actually covered private equity in my PhD.

And then when I finished my PhD, I had one study buddy in my study group and she went to Bain, the consulting firm. And she said, if you're interested in this private equity thing, you should give this a go.

Over the period I've been in it, it has grown really significantly. So, it was a hundreds of billions of dollar industry globally when I joined and it's now over 10 trillion. So, it's a big number, but relative to the public market, it's still pretty small but it has grown a lot. And that's been the journey.

Tom Yeowart: We'll go on to talk about Hg Capital as a business, but it'd be great to sort of understand the trust, the function it serves, why it's been, I guess, one of the best performing trusts in the UK market over three decades.

Jim Strang: So, Hg, for the chemists in the room, is mercury. So, it all came from Mercury Asset Management. And the Hg Trust was founded in the 80s under the auspices of Mercury. It's a bit analogue to the old SVG/Permira that groups had investment companies as actually their core source of capital when they were doing very, very small transactions. And that was the history of Hg as it was. Over time, what happened was the Hg management company effectively bought itself out from Mercury, created the independent entity, and the trust was its core client. And over time, what has happened is, like every other private equity firm, they've developed a series of different funds, limited partnerships,

which have grown over time. But the trust has always been the core investor, the core client of Hg, and that continues to be the case today.

So, it's been around for a long time, like many investment companies, and it's broadly been under the management of Hg all the way through its life. It's evolved what it's done over its life, we'll come on to that, but it's effectively been in the same archetype of being a private investment vehicle over all those years. And, as you say, with all humility, it's done really well. It's continued to compound up over a long period of time. It's kind of kudos to them as the manager that's been able to deliver that.

George Viney: Very interested in the history of that evolution and you talked about the great growth of the private equity industry and one of the consequences of that is increased specialisation and Hg is a prime example of an organization that has become increasingly specialised. How did that happen the way that it did at Hg?

Jim Strang: The industry has gone through sort of two or three different cycles of evolution over that long period of time. And alongside that, what tends to happen with time and scaling and competitive dynamics in the market is, what defines success moves from who you know, to what you know. So, who you know works if you're doing relatively small transactions in a relatively uncompetitive market. So, the relationships count. But as the industry gets bigger and more sophisticated and people become involved in a more competitive process, you actually have to codify the what you know, and that ultimately means that you narrow the scope of what you do, and you start to focus more and more on areas where you either have great conviction that there's going to be a very successful outcome, or you have a lot of experience.

And if you look at most major private equity firms of any scale, they all do this to a degree. And what Hg has actually done to quite a great degree. So, if you think about what we do, it's actually narrowly defined really all-around software and technology enabled business services. And in fact, internally when the board is talking about what the manager really does, we don't even talk about sectors. We talk about clusters. There are eight clusters, and everything fits into a cluster, and nothing is outside of the cluster because effectively within the clusters we benefit from an experience curve.

It's like laps of a track. Inside the clusters that we've got, we've done so many laps of the track that the next time something comes up that fits that archetype, then, well frankly, we've already seen it. So, one of the things that is sort of interesting around the business is when they look at a new deal or they make a

new investment, their lead time of actually understanding that investment is measured in years, not weeks. So, I think, from memory, it's about seven. Because of what they're doing and the lines they're looking through, they've had six or seven years to get to know it before the game starts. So that obviously changes the whole risk premise of what you're doing. And if you had a very unconstrained, we'll do anything, anywhere, anytime it comes in the door, then your chances of making a bad decision go up significantly, and indeed your knowledge of how to prosecute the investment, you have to reinvent it every time you do it, which is obviously much more risky than doing sort of the same thing over and over again.

George Viney: How did the major dislocations in financial markets, the financial crisis, the dot-com crash inform those choices as to where you want to play and what sort of businesses you want to focus on at Hg?

Jim Strang: So, I would say the crisis for the industry, the GFC, the performance of funds through that crisis in the private equity industry more broadly was actually reasonably resilient. So private equity talks about what's called vintage year performance. So, the performance of each individual year. And in the last 20 years, that vintage year performance has never gone negative, even through the GFC. GFC was horrid and I think the worst year was 2007 and it was about 7 percent return.

So, what the GFC proved was actually, in aggregate, private equity business is incredibly resilient to the impact of a crisis. The key thing in these private investments that are levered is not to lose control. Because if you put one thing on your bathroom wall for private equity, then the thing you put on your wall is, it's the only asset class in the world where the insiders make the liquidity decisions. They time when they exit as long as they've retained the right to exit, and the only way they lose the right to exit is if they lose control of the company, and that means they've lost control of the capital structure. So as long as they can contain the capital structure, then they can actually ride through quite a lot of choppy return and come out the other side. And then they choose the moment, and you know, that when they choose that moment, that is likely to be a good moment or else they wouldn't choose it because they have that option.

So going through the GFC, you saw a lot of resilience and then coming out of it, Hg went through its next evolution as a management company, they started to narrow the focus down further to areas where they could get more of this flywheel effect, more of the accumulated experience, better decisions, better outcomes, lower volatility, better returns. That's how it kind of came together.

Tom Yeowart: I think a lot of investors looking back over the last 10 years, if you talk about software, probably what comes to mind to them is the sort of big, incredibly fast-growing US based companies that trade on high multiples of sales and you're doing something slightly different. You're focusing on businesses, which as you say, are in very defined clusters. It's business to business. There's consistency and predictability. They're growth businesses, but they're not hyper growth businesses. So, I'd like to understand a bit better what the clusters are, why you focus particularly on those clusters and what a typical Hg investment looks like?

Jim Strang: `In a word, boring. If you look at what the clusters look like, what defines them and Visma is a good example, obviously it's a big investment for Hg. That's accounting. So, they tend to focus on topics and areas where the tools that they provide are enablers of businesses becoming more efficient at what they do, which is a sort of a very obviously laudable and logical goal. They tend to be business critical enablers of improved business efficiency solutions.

And typically you see, and this is something that one of the other managing partners, Matt Brockman, this is his nomenclature, which I'll steal, he calls it the leaky bathtub. So, the leaky bathtub is that because of the nature of these businesses and the way that they are implemented by the customers, they have something like 97 percent recurring revenue. And if you look at many of the sort of clusters that we have, so obviously there's tax and accounting, there's payroll software, there's things like medical imaging software, they kind of have this rhyming characteristic of very, very high recurring revenue. So, the opposite of a consulting business, you start each year at zero. This business, you start each year with 97%. And that's a great place to start from.

And then what you're doing is looking to continually improve what you do. And so, one of the theses that Hg has running at the moment is this thesis called the office of the CFO. And IFS, which is a more recent investment, it's a good example of this. And the office of the CFO thesis is basically, if I'm a CFO, what do I need? Accounting, tax, treasury, compliance, okay, well, let's build a portfolio and let's create all of them.

And then the way you think about that from a customer perspective, you're basically saying, and this is a bit consultant speak, so forgive me, but what's the wallet of the customer? And what's my share of the wallet? And how do I get more wallet? And if I can offer to serve multiple needs from the same customer, from the same platform, then that's easier for the customer and I'm going to get more wallet. And if you look at how the portfolios come together and things are added together, then that all makes sense.

Tom Yeowart: And these companies typically they're growing low double digit organically, top line, and there's an inorganic element on top of that. Is that the case?

Jim Strang: The board would look at it and say it's something north of 20 percent a year, of which is around half is organic and half is coming through M&A. If you think about it again, you're using this sort of a framework, how do you generate more revenue is you either sell more stuff to the same customers or you acquire more customers or you increase the value proposition of what you offer so that you can get better margins. And then obviously, if you can find ways to grow by, for example, in that office of the CFO case of building another vertical to what you already have to become a bigger part of your customers requirement, or you can build scale in an existing business by, for example, going across border and buying a business in a different market, acquiring a new set of customers. That's another set of levers you can pull. That's how it basically works.

George Viney: The model works in a private equity context, but also in terms of the expansion of these businesses, once they're owned by Hg, because that landscape, particularly in Europe, is very fragmented. Why is that the case? Why haven't these providers of B2B, typically white-collar automation software, been consolidated into a much bigger group? Maybe that's what Visma is doing, and eventually we'll get to an end state where there's just a few very big providers of B2B software to SMEs, but there seems to be something about the nature of the software categories that lend themselves to fragmentation and why is that?

Jim Strang: I suppose at one level, what you need to begin building a software company is actually not that much. It's not as if you need to go and build a massive factory and go and start making stuff. If you have IP knowledge and technology, you're in business. So, it lends itself to lots of new business formation. And if you look in the market map of how many private companies in this archetype are there in Europe, it's thousands and thousands and thousands. So, it's a deep pool to swim in.

And actually, ever the more so because innovative new companies are formed every day. And that's one of the things that we as a board are always actually asking is, because we're all a bit paranoid, which is a good thing, we're all a bit paranoid about what we're missing and technology disruption risk. So, if someone develops a better mouse trap, then what do we do? And the good news is Hg are like, you know what, we've thought of this. Something like OpenAI or ChatGPT, we go, oh, ChatGPT, that could really ruin lunch. We've been

working with them for seven years, we're a franchise partner with them. So, we're on the other side of this disruption conundrum that we're actually figuring out how to disrupt everybody else rather than worrying about how we're going to get disrupted. So that's the sort of dynamic.

George Viney: There's also a force of fragmentation that comes from local laws, local languages, local tax systems, that sort of thing as well, which presumably is helpful in a business model that is a natural consolidator in this space.

Jim Strang: Yeah, Hg talk about horizontal versus vertical software. So, we're in the vertical software world, whereas Microsoft Excel is horizontal because every industry would have it. Whereas we're more in tax compliance, accounting, payroll, etcetera. These are for different verticals, and they're more or less challenges to going cross border because of that. Iris, for example, what they do, if you're going cross border, then you're subject to different rules in different places. You need to manage the jurisdictional challenges of operating in different markets.

George Viney: All investors are defined by what they don't do as well as what they do. And there are large categories of software, like cyber or productivity and design that you've deliberately seem to have avoided. Why is that?

Jim Strang: The Hg team are unbelievably rigorous in what they'll allow to pass through the system. So, we've had the clusters for several years. We often ask them a classic question add one, lose one. So, what's the next one you would add? And what would be the one that you would get rid of first if you had to? And what they are very clear on is saying if we're going to add a new cluster that has to meet a whole bunch of criteria. So, they would say, you have to be able to believe you can build an experience curve. So, there's no point in bringing something that's just like one individual opportunity because there's no way you can build an experience curve. You need to think actually there's enough merit in this that we can establish a position and the archetype of what we're buying fits the leaky bathtub and the whole customer journey and value creation that goes with it, and it could become a significant cluster.

If you find that, then we want to have the conversation. If you can't find that, then don't even start because we're just not going to get anywhere. And that's very clear. One of the great things about great firms in private markets is the better they are at framing exactly what it is they do and don't do; it makes it a heck of a lot easier. You know, what is our ambition? What do we do? How do

we do it? And then stick to clearly defined operation of that model, then we have more chance of just being able to keep doing what we're doing.

On the flip side, what would you jettison, you would pick where the opportunity is declining. So, there's less to do, there's less opportunity to continue to build that experience curve. And we haven't done that particularly, but it's always a question. What we do as the board, every November, we have a slightly toes to the fire session where we say, okay, did what got us here get us there in terms of where we want to go? What do we need to do differently? And how do we feel about that? So that's front of mind, thinking through how it evolves.

When I took over chairing the company a few years ago, a friend kindly pointed out, it's a bit like Alex Ferguson leaving Old Trafford. This thing's done nothing but go up in a straight line for 20 years. Good luck. So, one of the things that we tried to think through is, okay, does the model perpetuate? Does it continue to scale? And actually, the interesting thing with Hg is Hg has two lookalike firms in the States, which are considerably larger. So, one of the things we did was looked at them and what they did. And said, well, actually, if you look at how they've evolved and what they're doing, are the returns holding at scale and they were holding at scale. So, there was a sort of a decent sense of actually the model does seem to continue to scale and therefore we should broadly continue doing what we're doing and not try and change anything materially.

Tom Yeowart: Hg is quite different to many private equity firms in the sense that you do own some software businesses for the truly long term and maybe focusing a bit on Visma. Visma was very early to invest in cloud and true SaaS as a business model, far earlier than some of its listed peers. How much of a benefit is long term focused private ownership versus public equity listed businesses but also versus, I guess, a PE approach where you're buying and selling in a five-to-six-year window.

Jim Strang: The nature of what some of these businesses have, is they have very long-term compounding potential. Visma, it compounds up now at a faster rate than it did when it originally was acquired 18 years ago. So, it's a bit of a great example. The way I would describe it, as we understand it as a board, when deals come into the system and they become actionable, then what Hg are looking at is trying to understand what's the full potential of what this business might be over a typical five year cycle, because any further than that is difficult to imagine. And what's our conviction in what that full potential could be? And that's why the accumulated knowledge and experience really matters, because the more you've seen something, the more conviction you have around what

you're ultimately going to be able to deliver. Because you're using the same tools and toolkit and people and personalities to get there.

What can happen, is when the initial part of the journey is embarked on it becomes evident some businesses actually have a much longer-term potential. And you can actually see them compounding up to a much greater extent. And actually, what you can do in that circumstance is you can course correct. So, you can say, actually, this has got a much longer-term opportunity and let's organise a little differently. So, what they do as a manager is they are thinking through, you know, everything rhymes, everything's in the same archetype, but they're not all created the same. Let's be thoughtful about how we think about them, how we resource them, and what role they play in the portfolio.

Tom Yeowart: Hg has got a very strong heritage in Europe. It's built out an ecosystem, there's a network of people, there's a network of companies you've observed for multiple years. And I know Hg have been building out a business in the US. How repeatable are the advantages you have in Europe in the US, which is just a much more competitive market?

Jim Strang: So, the US has been a factor and consideration for quite a while, several years. So, Hg first started out, boots on the ground, in New York. Not doing deals, but having a portfolio support operation, building a network. The other thing around it, though, which is also super key is when private equity firms go cross border, what matters is what they know, not who they know. So, the characteristics of the businesses that you would see in the portfolio in the US are very analogue to what you would see in the rest of the business in Europe.

So I think they were thoughtful in the pace of development and in building the team and the muscles and in starting to do things that rhyme with what the core capability is and therefore try and manage the risk and build out the organization so that it looks of a sufficient scale to be able to operate consistent to the European hub. And then latterly, the business has hired some very important personalities into that business, particularly a chap called Alan Cline who came from Vista. So, he is now there, and he is guardian of that franchise and the development of it.

So, is the US market more competitive? Yeah, probably. It's also enormous. So, in terms of the sort of number of opportunities and the flow, I don't think that's a particular challenge. What again, in a way, I think Hg seems laser focused on and indeed the board are laser focused on it because it's so obviously a potential

challenge is making sure that that build out goes right and making sure that the culture of the firm stays the same.

George Viney: Jim, could you talk a little bit about the human element of the model and the proposition to founders that Hg make compared to other financial buyers or trade buyers of the same assets, and then subsequently, once they're part of Hg, how you maintain that entrepreneurship that made the business that's been acquired successful in the first place.

Jim Strang: The basic gist of it is that I think if you're an entrepreneur and you own an asset in the space, there's a sort of a halo effect, which is created by all the success that's come before. If you look at Visma as an example. That's a real calling card. So the success of the prior investments and all the management teams that have worked with the business and how they've worked with the business becomes, if you like, a fantastic mechanism to find more because if you are an entrepreneurial management team and you want to go on a growth journey, then who better than Hg because of that record of what they've done in the past and how they've done it.

On the transaction side. They're outbound as well. So, they're trying to find businesses that fit the archetypes that operate within the firm. And again, if they're going out to try and find businesses and engage with entrepreneurs, then they've got such a back catalogue of people that can talk about and bring to bear, that's a pretty compelling combination. And what that often means is when they get into dialogues with businesses, they're very privileged dialogues because it's not like there's a whole bunch of people trying to do this because there's not really an opportunity for others to replicate that engagement because they don't have the same history.

If the founder wants to sell to a strategic, then that's kind of game over. So, you know, the business loses independence and that's a very different outcome, very different path. The path that would be followed if it was bought by an investor would be, we think the full potential of this business is five times the scale it is today, and this is how we get there. And then, by the way, this is how it rhymes with other things we've done. We have loads of conviction that this business can deliver that, and we'd like to go on the journey with you.

George Viney: So, it's giving those founders and entrepreneurs the support that they need, but also in a way guaranteeing their independence and control in the next leg of growth.

Jim Strang: Businesses all go through cycles of life. And it can often be that at the end of the first cycle an owner or entrepreneur will be, well, actually I have an ambition here, but I don't feel I can make the leap. I don't necessarily have the experience or the toolkit or the knowledge to be able to take it to the next level without taking on a lot of risk. And this is a way to de risk that evolution with someone that's done it before. So that's often a dialogue. It's I have a vision for my business, which is much greater than its current status, and I need a partner to help me get there.

Tom Yeowart: Hg itself has clearly grown significantly in terms of the number of people it employs and going back to your point on maintaining that culture within Hg, I'd love to hear you talk a bit more about how they've sustained that, but also how they're leveraging their greater scale to drive operational improvement at the businesses in which they invest?

Jim Strang: On the culture topic, how do you figure that out? The way that we get to that really is we have regular engagement with them to understand if there's any changes in the wind direction. Leadership sort of sets the agenda for culture and leadership has been very stable. So, we understand who the key people are. In terms of like very senior joiners to the leadership group, Alan is the last senior joiner to the leadership group. So, we were very keen to understand how he would be integrated into that group. It took them well over a year to hire him. So, they had a very long honeymoon to make sure that he was culturally consistent with the values that they have.

The board, we have all the formal interactions, we have all the informal ones as well. Because private equity to some extent is still a village and actually, we know who lives in the village. So, our radar to pick up if anything is moving out of kilter is pretty good.

On the value creation side, I think that's something that is pretty difficult to understand outside in. At one level, there is a capability toolkit, is the way I would describe it. And the capability toolkit is put into a platform, and I think it has eight or nine different individual elements to it. So, one element would be things like customer success, right? So, what does that mean? So, customer success is a very clearly defined set of tools that allows you to improve the profitability of your relationship with customers, either by acquiring new ones or by getting more wallet from existing ones. It's a playbook. It's well understood.

So, the team that Hg has are basically looking at all the different portfolio companies, understanding what their plans are and then thinking through what

we need to put into this mix to accelerate the path of development along that plan. And it could be talent, there's a part of this capability which is all about talent. One of the things I said to the group a couple of years ago was it's actually like you've created the world's best toy shop for software companies. It's all there. And therefore, what they have to do is decide how to allocate resources. It's not that they don't have everything. It's just that they need to figure out who's getting what, when. Make sure it's utilized to the greatest impact.

The other thing which I think is great is, learn from each other. So, they create a learning network, they call it Hive, as in Hive Mind, where the key individuals from the different portfolio companies benefit from each other. So, if the Access CFO wants to talk about a particular topic, he can just get hold of the Visma CFO, and they swap notes. And multiply by 50 odd businesses. So that's a pretty cool toolkit.

George Viney: Despite there being, in some cases, a very long-term perspective and intent to own, participate in the growth of an asset. In other cases, the time horizon for investment is shorter. In the latter, how do you manage expectations, Hg's and the business's, so that the companies themselves don't become overwhelmed, that they're forced to grow too fast, do too many acquisitions, that the pace of growth is appropriate for their resources and capabilities?

Jim Strang: The trick is to understand the relative situation one by one. So, I think it's always a bit of a dance between, you don't want no pressure, but you don't want too much pressure. And one of the roles of the portfolio team and the investment committee is to make sure that the right amount of encouragement is being put into the mix. And I think as well, the other thing with Hg, which is actually something they do, and I think is really interesting, is when it is sort of a moment to reflect on the role that a business plays in the portfolio, they have a group that does that.

So, one of the challenges of private equity is, if you just let the people that do the deal determine what happens with the deal, then there's an inherent bias. So, if it's not going well, they'll say, okay, fine, well it's going to go better. Trust me, I'm a doctor. But actually, that can be less than ideal. So, what Hg do is they basically say, actually, we're going to have a group that looks holistically across everything and reflects on where they are today and their ability to generate returns tomorrow. And we'll decide top down what we do with them. So, which assets are less potential investment wise, okay, we treat them in one particular way. There are assets which are sort of in the middle, fine, carry on, continue,

and there's ones which have got this sort of long term, gosh, that could be amazing and again, treat them differently. Because that's done top down, not bottom up, that's really helpful.

George Viney: So, there's some inevitability therefore, that there are going to be a few privileged assets within the group that become outside successes compared to other things. They're given the resources, the time, they have the right profile to generate supernormal returns compared to their peers. And so, the portfolio has to be managed in that context.

Jim Strang: If you look at what great private equity investment firms do and how they do it, you'd see that. You would see very low loss rates, so the capital that gets impaired tends to be really low, a sort of a bunch in the middle where they're doing just fine. And then, you get breakout deals, which move the needle. You would see that in the Hg portfolio. And for the Board, what we have to just make sure is like, how much is too much? So, we can end up holding some quite large positions in assets, but we absolutely get that they are large.

And indeed, we conducted a secondary transaction last year now to release some capital and actually to try and take out some of that single asset risk. To bring it down to a level where we felt more comfortable that it worked.

Tom Yeowart: To your point on the loss ratio being very low. It's partly a function of the pond you're fishing in, and the durability of these businesses, but when things do go wrong, why did they go wrong?

Jim Strang: Looking at some things we've seen over the years, I would say you can get the market wrong. So, you might think that there's a pattern of behaviour that the market is going to exhibit and you're going to play into that. And that maybe changes. So, things like through COVID, obviously we had people engaging with offices in different ways and employers in different ways. And that can have a ripple on the market if you like, where people are not in the office. It has weird effects in certain places. So that's changed the thesis.

One thing that is useful in that regard is generally within a year, you know. Is it absolutely what we thought it was, is it actually, gosh, it's way better than we thought, or actually not quite what we thought it was. Generally, a year is the magic number. And so, after a year, you can reflect and see, okay, what did we get wrong? And indeed, what went right, but what did we get wrong? And what do we need to do about it? And if it's market, then markets tend to recover. If it's company related, then what's the miss? It could be people, there's just a

challenge somehow in the organization. But again, what you hope is if you're spending years looking at stuff before you do anything, you should have a pretty clear idea on the organization and the people.

The way these businesses are sort of formed in their markets, they're in leadership market positions. So, they're maybe not the leader, but they're not far off. So generally, if you have a problem, then in any market downturn, the leaders come out in a better, relative competitive position than they went in, because obviously the weaker have a bigger problem in a downturn. So as long as you stick to that, the sort of thesis of what you're buying, where you're buying it and looking for things in a leadership position, then you should be able to see value recover, and therefore the amount of money that you lose should be low. And indeed, that's what the data would tell you.

George Viney: Those resilient businesses can carry quite a lot of debt and some businesses in the portfolio will carry more debt than others. The average, I think it's between 7-8x net debt/EBITDA, which is by any standards quite high, but more normal for private equity. But I think the range goes from nine and above, so there's clearly some businesses are carrying more debt than others. Could you help us understand how Hg decides how much debt to allocate to different businesses and what determines that. And how in wanting these businesses to come out stronger in any difficult period, how you ensure that you don't constrain the growth potential of businesses by giving them too much leverage.

Jim Strang: Sure, I'll give you the board perspective on it. On the capital structures, the things that we are trying to focus on is the resiliency of them. So, the quantum is quite high, seven turns of leverage is obviously chunky. The value of the assets that we have, which we keep validating by every time we sell something, is 20 something times. So, the capital structure is about one third levered, and that's a lot lower than private equity in average. So private equity is more like 50%. So, this is significantly less levered than the industry would be.

But it's still in quantum a lot. So, what we're trying to make sure is the resiliency of the capital structure. So, the burden on the company of having the capital structure that it's got. And that is also a function of the path. So, if the company is going to have a significant amount of M&A, for example, then it's probably going to have to start off with a lower level of leverage because it might pick up as it goes. So, what we try and figure out when we talk to the manager, is just appropriateness given the circumstances.

So, the circumstances mean that the businesses that we own are pretty resilient to standing quite a lot of leverage because they're very high margin and they're

very high value. What drives the outcome is transforming the EBITDA of the business and the leverage is there as an enabler to get on the journey, but it's not creating the value. What drives the outcome, if you look at the businesses, their EBITDA growth is compounding up. If you look at the top 20 businesses, EBITDA growth is compounding up at 25%. If you compound something at 25 percent for five years, it's going to be about a 2.5x size that it was at the start.

But nonetheless, we worry about the worst thing that could happen because the thing that really messes up a deal is if you lose control of it through the capital structure. So the single thing you have to make sure is that you don't and that the things that will trip you up are, if you have restrictions in the leverage structure, covenants, or if you have a refinancing risk, so that the capital structure doesn't port far enough for you to be able to do what you need to without having to refinance it.

And so, things that we will check in the annual strategy refresh is what's the liquidity profile of the different businesses and when do we need to worry about the refinancing and have you thought about this? And unsurprisingly, they get that. So, the manager is very much of, okay, thank you for your input, but we really do think about this sort of stuff, and this is what it looks like. The other thing around the organization, there's a whole dedicated team inside Hg that just does this. The Capital Markets Group that works across all the portfolios and actually works for HGT because we also have a balance sheet. So, you know, Capital Markets Group will come to the board a couple of times a year and say, this is what's happening. Big bad world, this is what's happening. This is what it means for the portfolio. This is what it means for you. And as a company with a revolving credit line, we want to know when that is going to run out and how do we make sure that we don't get caught out with this as well, but it's all aligned with the same objective.

George Viney: That level of growth must give you as a chairman of the board comfort about valuation of the unquoted assets, which, as you can appreciate for buyers of the trust is a thorny issue. One that isn't always transparent, certainly compared to public market investing. How do you get comfort that the asset values are both conservative, but also relevant and accurate along the way.

Jim Strang: It's probably topic number one. The way that we come at this is, there's a very thorough approach around valuation. So, we have the audit valuation and risk committee and I note the risk, so we've introduced that over the last few years because it's so important that we do this all as one package. So, the way the valuation process works. It's all done bottom up. So, every portfolio company has its own valuation pack. When the valuation Bible lands

on the door, when they email it out, the lights go dim, it's a big document, hundreds of pages, but its got lots of granular data. So, every company, bottom up.

Nearly all the companies are valued on a profitability metric. So, they're valued on their EBITDA. And it's nearly always last 12 months metric. So, one of the things around that is, when you sell a business, you don't sell it off that metric. You sell it off the prospective metric. So, if the businesses are growing, and they're growing at 25 percent a year, then there is an automatic uplift through the math. Because you're selling next year's story today. It's a growing story. So, the value of things equal should be higher. If we're selling something, there should be an inbuilt value upside.

When it comes to how you then get to value, so you have a metric, then you need a multiple. And I was reading Morgan Housel's book over the Christmas period and great line in that book. And it's very true. All that value is, is a number times a story. And in terms of the story, the way we craft it, we have a peer set of public comparables and relevant M&A transactions. And you'll probably for each deal have something like 15 different comparables, maybe 20 split between. And each individual comparable is annotated in the pack, identified, and weighted. Because something like Intuit, okay, it's a really relevant comparable, but we don't have a business that looks 100 percent like that. So, it's weighted. So, there's a weighting attached to it. So, the list of names and a weighting for public comparables. And then there's a list of M&A comps and a weighting. And that gives you a sort of geometric average of what the different valuation metrics should be. And that gets checked, clearly by the board, but also by the auditor.

And what we look for is changes. So, if anything drops in and out of a basket, we need to know why, if a weighting changes, we need to know why and that has to be explained. And that's what that valuation pack is actually doing. So, it's a huge, if you like, geometric sum of all the different assets, and that gets you to enterprise value. And then we adjust for the capital structure, which is just understanding the debt value, and then we adjust for the ownership percentage, and that reflects our individual ownership of that individual business' equity, and that's what flows through the pack for every individual asset.

And clearly, apropos my earlier comment, when businesses transact, our history is transacting significantly above where they're marked So, yes, I mean, the valuations are significant. But if you look at all the data, all the facts and indeed the precedence, it's all validated.

George Viney: The use of peer groups and deal comps attaches the process to, I suppose, broader sentiment towards these assets and is there a sense that valuation multiples have generally shifted up? I'm aware too that the growth prospects of the portfolio's assets has as well so there is some logic to that, but nonetheless, by marking them in the way that you do, you borrow returns from the future because the gap between where you're marking and eventual sale is smaller over time?

Jim Strang: The aggregate carrying value of the portfolio has risen because the software industry multiples have risen. And we've risen with it. What you've seen over the last year and a half, those multiples have compressed, and we've compressed.

Another thing actually I should say on the baskets between the public peers and the M&A comps, we change the relative weighting over the life of an asset. So, when an asset is newly acquired, it weights more to the M&A because the M&A is just completed. And I think it's three years. After three years, we switch the weighting. So, we put more onus on the public comparable s to try and make it a bit more market orientated.

Nonetheless, the values have risen and over the last couple of years, those carrying values have also come down a way. And if you look in the back of the report and accounts, you see the bridge. So, you see how value is created. And the predominant impact on the outcomes is still the profitability increase, and if you like, with the multiple contracting, it has been hauling an elephant a bit because these things are netting. So, if you think about what the business has done in terms of a NAV growth over the last couple of years, it slows. Because of the way of the multiple compressing on the aggregate carrying value, so we definitely are not immune to that. And so, you've seen that multiple reduce the bridge.

Jim Strang: And then when we sell assets, again, the business is able to sell assets at or above the multiples that we're carrying on that.

Tom Yeowart: There's been significant change over the last two years and interest rates have gone up at a pretty rapid pace and just want to explore a bit about how that's changed M&A, both the investments Hg are making, but also the bolt on acquisitions Hg's underlying investments are making. And whether these compressed valuations are leading to more activity or whether there's sort of more general uncertainty about potential recession is leading to less activity. I'd just be interested in your thoughts on that.

Jim Strang: So the market more broadly, what you've seen is slowdown in M&A last year particularly and for private equity managers in general the slowdown in M&A has made it difficult for them to sell assets, which has made it difficult for them to raise more assets because of the cycle being disrupted.

And what you saw last year was that the assets that did transact were sort of the bluest of the blue chip because they were able to transact. Hg managed to sign or announce four quite large transactions, which is actually a very significant part of the balance sheet of the company was able to transact, which is great.

What you see now is the M&A activity levels are quite a bit higher. So, what's happened is we've now sort of gone through the cream on the top of the cake and we're now into the ice custard layer. So, in the custard layer, maybe the asset quality is not quite as blue chip as it was last year, but because businesses have grown, they've grown into the valuation gap, and you see the gap between buyers and sellers start to narrow. So, you see a bit of an unlock, which I think should be good for activity.

Because basically the system, the market, it's a self-healing thing. It doesn't like shocks and 500bps in a year and a half is a shock. So that didn't go down very well, but it realigns, and it readjusts. And that's kind of what's happening. The interest rate environment that's out there, we were there five years ago is fine, right? We can make it work at that level. Where it gets tricky is if you're caught between two different places. That you started in one world and you're now in another one, you have to adjust. But if you're starting in the same world that you're operating in, then it works, and I think that's what you'll see the gradual unlock will start to sort of ripple through this year.

Tom Yeowart: I read that despite M&A activity for the PE houses being down for the reasons you articulated, at the actual underlying company level, they were making lots of bolt on acquisitions. Is that the case?

Jim Strang: And that's because in a downturn, the strong gets stronger. The relative competitive position of a business with a strong market position gets better in a downturn because it benefits from the challenges that other businesses face. That's what this portfolio is. It's all got attractively positioned market positions. That's why they're interesting assets to own in the first place.

Tom Yeowart: Turning to our closing question. What piece of advice would you give a young Jim Strang at the beginning of his career?

Jim Strang: My father said to me that if I ever wrote a biography, it should be called the path of most resistance. So, I would say, I think probably just trust your gut. I think it's very easy to second guess yourself. Another good friend had a great way of putting it, which is there are no bad decisions, just bad outcomes. Everything is a good decision, so don't be scared to take them.

Tom Yeowart: Thank you very much for coming on.

Jim Strang: Thank you. Pleasure.