Oakley Capital Investments

OCI's historic NAV potentially belies progress made by its underlying companies…

Update
14 December 2021

Summary

Oakley Capital are one of a select group of private equity managers who have a listed fund as a cornerstone investor to their limited partner (LP) funds. The listed private equity sector remains a relatively narrow peer group, and so whilst OCI has been a strong performer amongst its listed peers (see **Performance**), many investors may not appreciate how strongly Oakley's funds have performed relative to the wider private equity peer group. Recent data from Prequin puts the Oakley Fund III (2016 vintage) in the top 5% of the European Buyout funds of the same vintage on several investment return metrics.

Underpinning NAV growth in recent years has been the strong earnings growth across the portfolio. In the interims, Oakley Capital stated that the average year-on-year EBITDA growth for the portfolio had been 35% to 30 June 2021. This impressive growth trajectory is enabled by the focus on digital businesses, which have been able to transcend many issues that traditional business models have had to contend with (such as rises in inflation or supply chain issues). If the earnings growth continues to come through, the portfolio's average valuation multiple of 12.3x (EV/EBITDA as at 30/06/2021) appears undemanding. Indeed, further strong NAV growth is not reliant on multiples expanding.

OCI will be reporting the 30/12/2021 NAV in late January, which will enable more meaningful comparisons with the peer group, most of which make quarterly NAV announcements (or more frequent). In 2022 and going forward, OCI will make quarterly announcements, which we view as a good step forward in helping investors understand the NAV trajectory, and over time potentially a narrower discount.

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Analyst's View

We think Oakley's focus and expertise in specific sectors, its proven ability to source investments (platform or bolt-on) through its proprietary network of entrepreneurs and its discipline in terms of pricing and valuations means OCI is highly differentiated from peers.

This differentiated approach has paid off for investors, given the strong performance in NAV terms (and share price) over the five years to 30/06/2021 (see **Performance**). The average holding period for Oakley Capital's investments has been around four years (Source: Oakley Capital), which compares to the average maturity of the current portfolio being between 3.5 – 4 years. In this context, we would expect that Oakley should be able to take advantage of the current 'sellers' market' in private equity markets.

We believe that evidence from other LPE trusts suggests that OCI will be reporting further progress in NAV growth at the year-end. At the time of the interims, Oakley attributed several key drivers of NAV growth, amongst them IU Group and TechInsights. Both companies represent 'classic' Oakley companies, in dominating their niches and using technology to grow. Importantly both companies seem to have been making strong progress since OCI's interims.

Oakley is in the process of raising Oakley Fund V, and we expect an announcement on how fundraising has gone in Q1 2022. With institutional investors potentially committing capital at NAV (into Oakley Fund IV), we continue to question why the market ascribes a significant **Discount** to OCI's shares.

BULL
NAV growth largely driven by attractive secular growth trends and portfolio-company performance
Oakley Capital has a clear edge in a competitive market
Board and manager enacting progressive changes towards 'best in class', which should reduce discount over time

BEAR
Concentrated portfolio means that returns can be materially impacted by specific company performance
Private companies offer limited liquidity, and returns can be lumpy
Private-equity funds charge relatively high fees

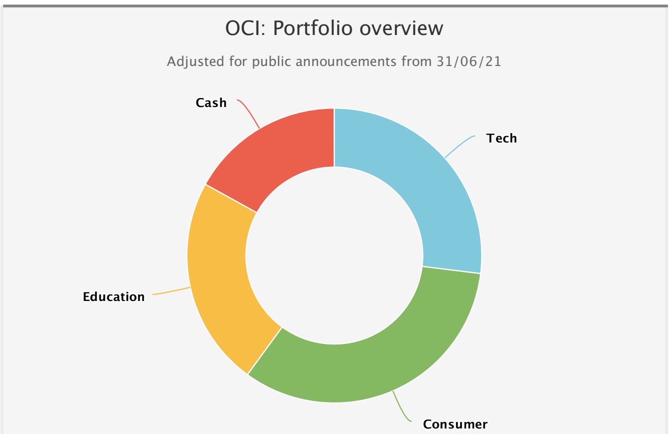
Portfolio

Oakley Capital Investments (OCI) is a directly investing listed private equity trust, which has seen strong growth in NAV total returns over 2021. Whilst it is moving to quarterly NAV announcements next year (2022), it currently reports half-yearly. As such, the most recent NAV date is 30 June 2021, and the next (31 December 2021) will be announced in late January 2022. The first half of the year saw strong NAV growth of 11% on a total return basis for the six months to 30 June 2021. This strong performance came on the back of a good year in 2020, which saw NAV total returns of 18% (exceeding the five-year compound annual growth rate of 16%).

Underpinning these results has been the strong earnings growth across the portfolio. In the interims, Oakley Capital stated that the average year-on-year EBITDA growth for the portfolio had been 35% to 30 June 2021. This impressive growth trajectory is enabled by the focus on digital businesses, which have been able to transcend many issues that traditional business models have had to contend with. As we discuss below, it's not hard to imagine that the secular growth enjoyed by many of OCI's portfolio companies will not be derailed by a rise in inflation or supply chain issues. If the earnings growth continues to come through, the portfolio's average valuation multiple of 12.3x (EV/EBITDA as at 30/06/2021) appears undemanding. Indeed, further strong NAV growth is clearly not reliant on multiples expanding.

Oakley Capital Investments invests across Europe in three core sectors: technology, consumer and education. OCI's portfolio consists of 22 underlying companies (including the most recent investment in Seedtag), largely invested in through Oakley funds. Around 70% of these companies (by value) deliver their products or services digitally, and 75% of the portfolio has subscription-based revenues or those that recur. The chart below shows the breakdown, including the significant cash on the balance sheet (see **Gearing**).

Fig.1: Portfolio Overview (Adjusted For Seedtag Investment & Buybacks)



Source: Oakley Capital, Kepler Partners

Full details of OCI''s portfolio can be found on the company's **website**. At the time of the interims, Oakley attributed several key drivers of NAV growth, amongst them IU Group and TechInsights. Both companies represent 'classic' Oakley companies - in that they dominate their chosen niche and are using technology, bolt-on acquisitions and moves to a subscription model to grow earnings rapidly. Importantly both companies seem to have been making strong progress since OCI's interims.

IU Group is seeing continued growth from its position as the largest education technology business in Europe and the largest university in Germany. According to **S&P Global**, it is now serving roughly 87,000 students and 10,000 corporate clients. This represents strong growth from the 15,000 when Oakley first invested in the company, and also impressive growth from the interims when Oakley quoted a figure of 75,000. According to S&P Global , IU Group is currently in the market raising debt funding in order to refinance existing debt and fund a distribution to shareholders. IU Group was OCI's largest investment as at 30/06/2021 at 12.3% of NAV. If the debt fundraising is successful, this might suggest a further increase in the valuation and/or an element of de-risking as capital is returned to investors.

TechInsights (3.2% of NAV) is a world leader in semiconductor reverse engineering, providing proprietary analysis on components in semiconductors and microelectronics. It dominates its niche on a global scale, and under Oakley's ownership, the business has moved to a subscription model. In time, we understand that it hopes to widen its market to include electric vehicles. A key part of Oakley's strategy for their companies is to add "bolt-on" acquisitions for them to build scale and efficiencies. Oakley has supported over 100 of these types of deals since the firm was launched two decades ago. We note that since the interims, TechInsights has acquired two businesses, VLSI Research based in Canada, and The Linley Group based in Silicon Valley. Both businesses are complementary to TechInsights existing product offering, and demonstrate the company is making strong steps forward to further develop its product on a global basis, as well as further broaden the competitive moat making it an ever more essential service provider to its subscribers.

Aside from investing in market leaders with strong secular growth potential, Oakley Capital believe that a strong contribution to their historic returns has been their ability to source investments at attractive prices. The average entry multiple of the current portfolio is 9.4x EV/EBITDA (Source: Oakley Capital), which is well below valuation multiples across the sector currently. Oakley has a proprietary network of founders/entrepreneurs through which they are often referred to other founders looking for an experienced investor to take their businesses through the next stage of value creation. The team typically aims to be the first institutional investor in the entrepreneurial businesses they back (75% of Oakley's deals are uncontested, and 85% of deals have Oakley as the first PE investor) and are happy to embrace the sort of complexity that might put off other potential investors.

We think that Oakley's focus and expertise in specific sectors, its proven ability to source investments (new or bolt-on) through its proprietary network of entrepreneurs and its discipline in terms of pricing and valuations mean OCI is highly differentiated from its peers. This differentiated approach has paid off for investors, given the strong performance in NAV terms (and share price) over the five years to 30/06/2021 (see **Performance**). The average holding period for Oakley Capital's investments has been around four years (Source: Oakley Capital), which compares to the average maturity of the current portfolio of between 3.5 – 4 years. In this context, we would expect that Oakley should be able to take advantage of the current 'sellers' market' in private equity markets. The next NAV announcement is due to be announced in January 2022. We believe that all the signs show that Oakley is likely to report further progress in NAV growth.

Gearing

OCI stands out from the peer group in terms of its balance sheet and approach to gearing. When the trust was launched in 2007, the financial crisis that soon followed impacted many listed private equity trusts. However, OCI avoided these problems thanks to its very strong balance sheet and lack of gearing. Memories of this period have made OCI's board reluctant to arrange a debt facility. We understand that the board continues to debate its merits, but so far, OCI has not employed gearing during its life, with cash consistently held on the balance sheet.

We estimate that OCI currently has cash of £158m or 17% of NAV. The board aim to forecast investment requirements (cash out) and realisations (cash-in), so as to manage cash resources as effectively as possible. To any extent that the board see an opportunity to return surplus capital, they have done so historically through a buyback programme. The most recent of these was completed just after the interims, with c. £7m of shares bought back, which was highly accretive to NAV having been achieved at a discount of 20%.

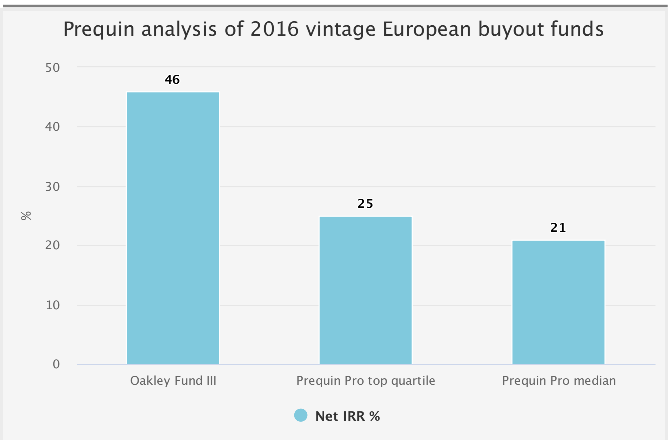
In the listed private equity sector, gearing can also be thought of in terms of the commitments made to the funds for investments that have not yet been made. OCI has outstanding commitments to Oakley funds of c. £430m. A majority of these is to Fund IV, which closed in 2019, but c. £54m is committed to Oakley's Origin Fund, which targets smaller (€10m to €50m equity tickets) transaction sizes than the main fund. Of the total commitments, only around £250m is likely to be drawn, giving an adjusted commitment cover of 63%.

When compared to the LPE peer group, OCI is relatively highly committed as a proportion of NAV. However, we understand that Oakley is currently in the process of raising Fund 5, with OCI expected to make a significant commitment. As such, the extent of that commitment will, in our view, give a good indication of the board's confidence in future cash flows from realisations and investment activity. As we note in **Portfolio**, IU Group may potentially return capital to investors, which would further add to OCI's liquid resources. In this vein, we also note that the average holding period for Oakley Capital has been around four years (Source: Oakley Capital), which compares to the average maturity of the current portfolio of between 3.5 – 4 years. In our view, this suggests that cash holdings are likely to rise over the short term.

Performance

Oakley Capital are one of a select group of private equity managers who have a listed fund as a cornerstone investor to their limited partner (LP) funds (it is OCI's board that sets the trust's commitment to each successive fund). OCI, therefore, provides a liquid access route to otherwise very illiquid and hard to access funds. The listed private equity sector remains a relatively narrow peer group, particularly for directly investing managers. Whilst OCI has been a strong performer amongst its listed peers (see below), many investors may not appreciate how strongly Oakley's funds have performed relative to the wider private equity peer group. Recent data from Prequin puts the Oakley Fund III (2016 vintage) in the top 5% of the European Buyout funds of the same vintage on several investment return metrics. This is impressive, and with Oakley in the process of raising Oakley Fund V, we expect an announcement on how fundraising has gone in Q1 2022. With investors potentially committing significant capital at NAV (into Fund IV), once again, it calls into question the logic behind the market ascribing a discount to OCI's shares.

Fig.2: Sector NAV Total Return Performance

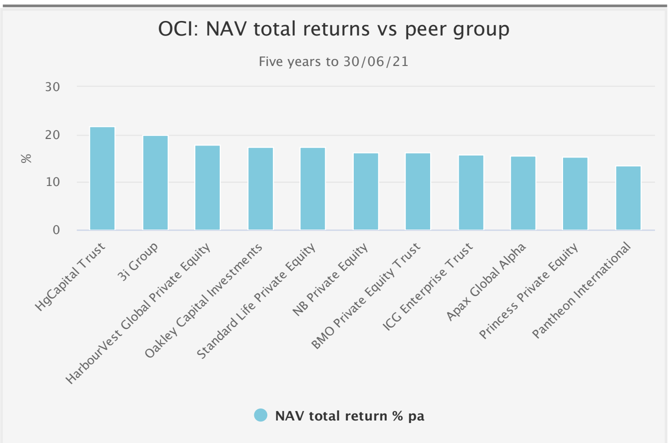


Source: Prequin, to 30/06/2021

Past performance is not a reliable indicator of future results.

OCI has performed very strongly over the five years to end June 2021, delivering NAV growth of 17.5% per annum, to 30 June 2021. NAV growth in the first six months of 11% would have been even stronger had it not been GBP strengthening against the Euro, which detracted 3.5% from NAV over the period. OCI will be reporting the 30/12/2021 NAV in late January, which will enable more meaningful comparisons with the peer group, most of which make quarterly announcements on their NAV (or more frequent). In 2022 and going forward, OCI will be making quarterly announcements, which we view as a good step forward in helping investors understand the NAV trajectory, and over time potentially a narrower discount.

Fig.3: NAV Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

As we note in **Portfolio**, the average age of the investments in OCI's portfolio is between 3.5 – 4 years, getting near the average holding period for Oakley Capital's investments historically of c. four years (Source: Oakley Capital). An exit is where a good proportion of private equity value accretion is recognised, which suggests OCI is positioned well. Indeed, Oakley Capital has a track record of achieving very profitable exits. The combined track record since inception shows a total of 17 realised investments since Oakley Capital was founded, which have delivered a return of 3.9x on invested capital and a 77% gross IRR (i.e. before fees). The average uplift on a sale has historically been 44%.

Dividend

OCI's dividend policy is to pay a dividend of 4.5p per share each year. The dividend is paid in two equal instalments of 2.25p each, in October and April each year. At the current share price, the 4.5p total dividend represents a yield of 1.2%.

Management

Oakley Capital is the investment adviser to the company. It was founded by Peter Dubens in 2002, and he remains the managing partner. With Oakley's success (Oakley's 2016 Fund 3 ranks in the top 5% of peers according to Prequin), the team has been expanding and now constitutes eleven investment partners (including Peter). Aside from the breadth and depth of experience, the team aim to harness a unique network for sourcing investment opportunities.

Peter Dubens' background is as an entrepreneur, having originally founded his thermochromic t-shirt business aged 18, which was subsequently sold. Peter has a long and impressive track record as an active investor, and within the public markets, he had notable success with Pipex and 365 Media. He later decided to formalise his investing activities through Oakley Capital. Oakley Capital Investments (OCI) invests in the Oakley Funds and was launched in 2007. Oakley Capital currently has assets of c. €4bn under its management. Oakley Fund IV closed its fundraising in 2019 at €1.5bn, and OCI represented 27% of the fund. OCI is also committed to the Oakley Origin Fund, which will target lower-mid market deals and, as a result, smaller transaction sizes than Oakley's main fund.

OCI board members (which include Peter Dubens) and Oakley partners own c. 11% of OCI, representing a significant increase since 2018 (c. 1.2%). We understand that Peter has committed more than £100m to the Oakley Capital Funds, and his total holding in OCI is 18.8m shares, representing 10.4% of the company.

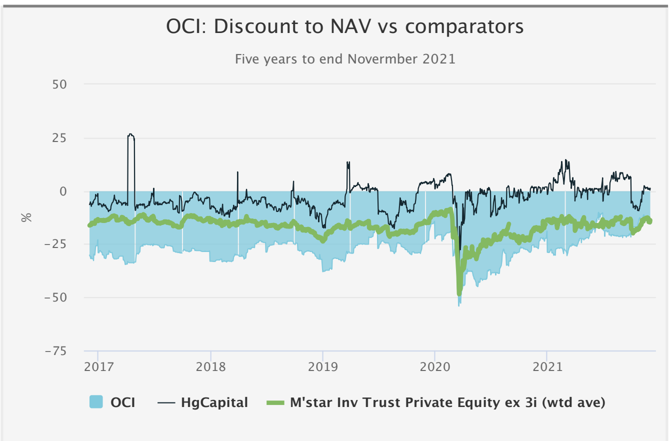
Discount

As will be discerned from the graph below, OCI has traded on a persistent discount to NAV, and historically significantly wider than peers. The board of OCI have taken progressive steps over the years to try to narrow this discount (**covered in this previous note**), which as might be appreciated from the below, is starting to have an effect. That said, OCI only publishes its NAV every six months, and so whilst the discount may appear to be more closely in line with the average for the peer group, in reality, the peer group NAVs are generally based on 31/09/2021 data or more recently.

If, as we expect, OCI reports a higher 31/12/2021 NAV, then the real discount to NAV currently is likely to be wider. Next year, OCI will be publishing its NAV every quarter, meaning that the information lag will be lessened and potentially give investors more confidence in the NAV, and perhaps the discount may narrow further. In the lead-up to the next NAV announcement, observations on the discount are rather meaningless, other than to note that close peer HgCapital

Trust continues to trade on a premium to its 30/09/2021 NAV. A further disparity is that HGT's underlying portfolio is valued at 26.3x on an EV/EBITDA basis (30 Sept 2021) compared to OCI's 12.3x as at 30/06/2021.

Fig.4: Discount To NAV



Source: Morningstar

Whilst the discount has narrowed considerably, we believe this is more than justified by the strong long-term performance track record of Oakley Capital, and the resilience exhibited by the portfolio during 2020. We believe that should OCI's strong performance continue along with the higher standards of governance and investor communication, OCI may be rewarded over time by a rating more in line with HgCapital (premium of 2%) rather than the wider peer group average. Whilst there remains the risk that the discount will widen out once again, the board do have powers to buy shares back to take advantage of mispricing, enhance shareholder returns and help support the shares. As we discuss in **Gearing**, we believe that when the board announces its commitment to Oakley's Fund 5, investors can take this as an indication of the potential for further buybacks.

Charges

Oakley Capital manages the investments made through the Oakley funds, where OCI pays the same management fees that any other investor would. These are 'typical' for the private equity industry and constitute 2% of commitments for a five-year period post-inception, and thereafter 2% on capital invested. Fees are not charged on the value of investments, and after the first five-year period has elapsed, fees are not charged on uninvested cash.

The managers are also entitled to a performance fee ("carry") of 20% on returns over an 8% p.a. hurdle rate. In the case of the Oakley Funds, this is on the entirety of the fund. The latest KID was issued in August 2021, with the Company's ongoing charges (excluding performance fees) were calculated as 2.63% of NAV. The KID RIY cost is 6.5%, of which 0.47% is portfolio transaction costs, and 3.52% is historical carried interest (performance fees). Whilst this is undeniably high in absolute terms, the contribution to KID costs from historic performance fees is reflective of the strong performance of the portfolio.

ESG

Oakley Capital has embraced ESG for some years now, having been a signatory to the UN's PRI (Principles for Responsible Investment) since 2016. Oakley Capital states that incorporating ESG into their investment process as well as their investee businesses culture is a key way to protect and create long-term investment value beyond the standard drivers of compliance and risk management.

At the 2021 capital markets event, we heard from Oakley Capital's Head of Sustainability, who explained that the team were implementing a strong and meaningful ESG agenda. The team are aiming to help influence change for the good, to benefit people, the planet and each investee company. This is being driven by the senior partners at Oakley Capital, who see it as their responsibility to set the moral compass, identifying and applying good practice with regard to ESG matters. Oakley Capital hope to be able to report metrics for each company going forward, and if they are successful, that the portfolio as a whole will show improvements as they have been achieved over time.

Being controlling investors in companies, private equity firms like Oakley Capital have the potential to meaningfully influence the direction of travel, with regards to ESG. It is clear to us that Oakley Capital are committed to integrating ESG fully into their processes and their stewardship of companies over the period of their ownership. We look forward to seeing further reporting developments. In our view, successfully implementing ESG will enhance returns for OCI shareholders on a NAV basis, but also – given the amount of investor interest in ESG – could also help to contribute to a narrower discount over time.

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