



RATHBONE UNIT TRUST MANAGEMENT
FUND MANAGEMENT FOR YOUR INVESTMENT NEEDS

RATHBONE RECOVERY FUND

INVESTMENT PRINCIPLES & PROCESS

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INVESTMENT PRINCIPLES

- Quality companies outperform over the medium and longer term.
- We will not buy into a company just because it is cheap. Cheap companies can remain cheap for a very long time – we need to identify a catalyst for change.
- The success or otherwise of a company is usually determined by the people that run it – strong management is crucial for a recovery situation.
- Meeting every management team regularly, is necessary to get ‘a feel’ for how things are going within the company – qualitative and quantitative assessments are equally important.
- ‘Forensic accounting’ is a key pillar of our process. Cash-flow, and more specifically ‘cash conversion’, is a more reliable indicator of the health of the business than profits. It is the first metric we look at.
- An in-depth analysis of the balance sheet and banking requirements is essential.
- We like to run our winners and sell the losers – we will not shy away from admitting when we are wrong.

THE PARAMETERS OF THE FUND

- Actively managed, long only investment style.
- A balance of investments across the FTSE Small Cap, FTSE AIM, FTSE 250, FTSE 100 indices.
- Country allocation: mainly UK-listed, with the ability to invest up to 20% in Europe.
- Around 60 companies, spread across most sectors of the market.
- Largest holding 4%.
- Bottom-up stock driven process, with macro overlay.
- Investment horizon – flexible, from six months to five years plus.
- Benchmarked against the FTSE All-Share index – while being index aware, we refrain from making decisions simply to align ourselves with the index.

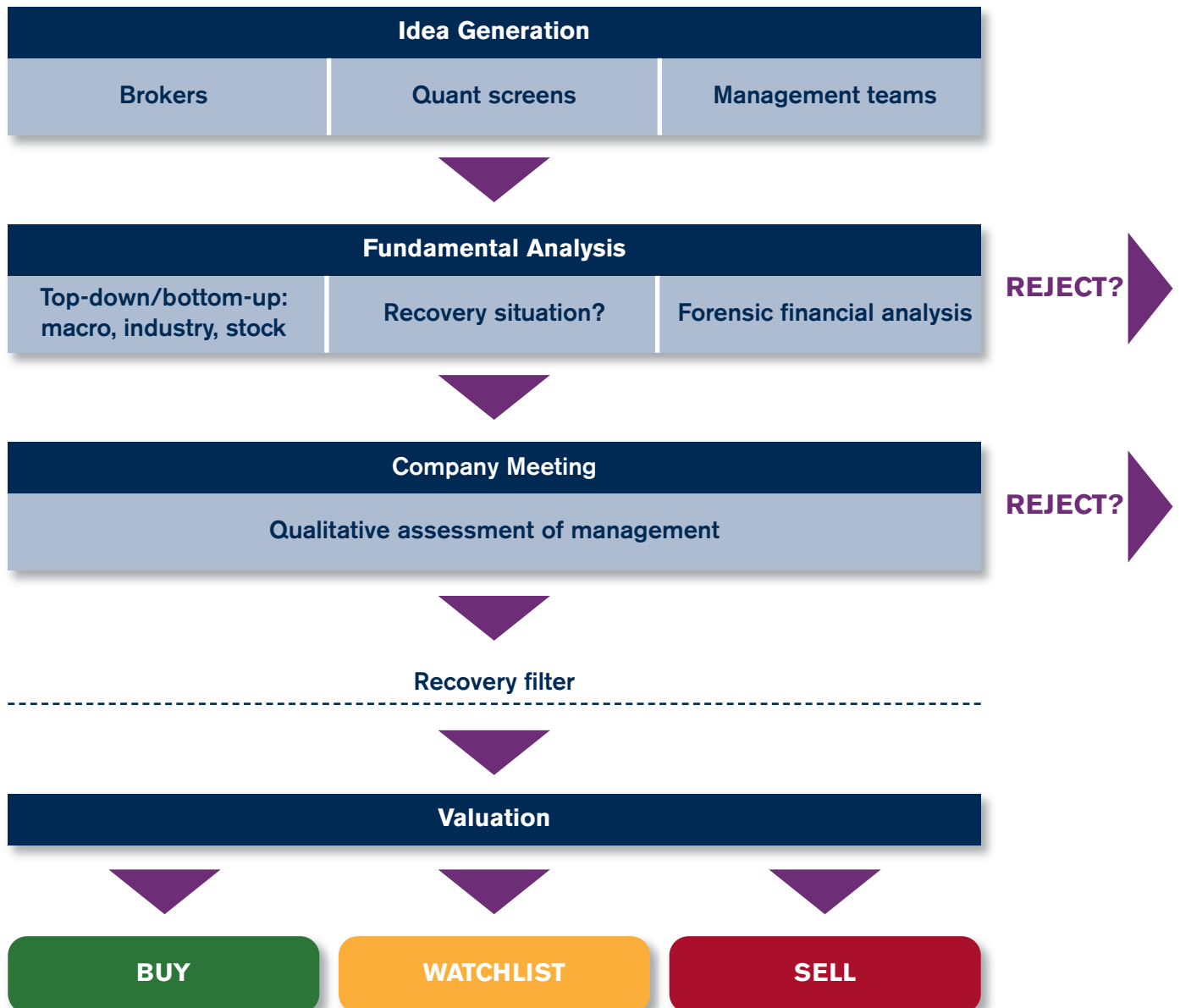
WHAT WE MEAN BY 'RECOVERY'

We interpret a recovery situation as 'a company whose potential recovery value is not appreciated by the market'. This is a broad definition of course which can encompass many different things to different people, so in this document we will attempt to clarify what criteria are necessary for a company to qualify as an investment in this fund.

The selection of a recovery opportunity requires both:

1. Identifying a reason for the current undervaluation relative to its potential; **and**
2. Identifying a potential trigger for recovery.
 - Focusing on point 1, the issue may lie at the **macro, industry, sector, or stock level**, or a mixture of these. For example, the company's earnings and valuation maybe below potential because of the stage we are in the economic cycle. Cyclical companies were hit hard during the recent recession, and some have yet to recover to anywhere near their full potential. We try to identify those cyclical businesses whose management teams rationalised in such a way to produce **structural improvements** down the line, who have **used the downturn to make a better business, rather than just survive**. These businesses have greater long term recovery potential, and the valuations should reflect the fact their earnings profile, and position within the industry, have improved.
 - At the **sector level**, the dynamics may have changed to the benefit of the better managed companies. Competition may have been significantly reduced, thereby improving the position of those left standing. At time of writing the cash & carry sector is one such example, where **Booker** is benefiting from the fact its competitors are mostly laden with debt.
 - **Identifying an issue at the stock level is often where we tend to add the most value**. This is a function of our bottom-up-driven investment process, where we analyse and meet companies often less well known to the wider investment community. We have the flexibility to invest right across the size spectrum, and as a result anomalies are often found in companies that have very few, if any, external analysts following them. The issue may be a change of **management**, where previous management practices have been exposed by the recession; or it maybe the **restructuring** of a particular division; or a restructuring of the finances. With regards to the latter, we are more cautious, unless this is accompanied by a change of management at the same time. If we are providing finance for a company in distress, we need to be pretty confident of stewardship going forward and structural changes are being made to the business, otherwise the same mistakes are simply made again.
 - Importantly, we are careful to **maintain a mix** of all the issues described above within the fund, so that we are not too exposed to macro issues beyond our control. The **identification of a trigger** for recovery is vitally important if we are to invest. As the definition of recovery can be broad, we are determined to ensure we are not left with 'potential' recovery situations that simply sit there for years adding no value. This fund is active, and we can not afford to simply wait for a recovery without identifying a timeline for a catalyst. We do not invest in companies simply because they are regarded to be 'cheap'. Such companies can remain cheap for a very long period of time, while capital can be best deployed elsewhere to the benefit of our unit holders. The trigger can be anything from a macro economic recovery, a collapse of competition within a particular industry, a management change, a refinancing or a combination of these.

INVESTMENT PROCESS



IDEA GENERATION

Our ideas are generated from a variety of inputs – brokers; screens; our relationship with management teams which we have followed for a long time; and also our top down macro work. The majority of our research is conducted internally; however we sometimes ground this with various analysts reports, economic and industry research and data, and discussions with management teams from different companies and industries. Our bottom-up, industry and macro economic research feed into each other – it is a virtual feedback loop, which enables us to look at a potential investment from every angle.

There are certain criteria we use to help us distinguish the **quality recovery stories – the focus of this fund** – from the low value short term situations which we tend to avoid. Not all of these criteria may be in fulfilled at the same time, but we must be able to identify the trigger for their fulfilment, with evidence in the near term of progression.

- **Forensic analyses of balance sheet & cash-flow.** One of the most reliable alarm bells for a future fall of a company is a deterioration in its ‘cash conversion’. By this we mean the conversion of operating cash earnings or ‘EBITDA’ (earnings before interest, tax, depreciation, and amortisation) into net cash inflow. What converts one into the other is **working capital**, and it is here that many fast growing companies, or companies in distress, start to show vulnerability. For example, if trade debtors start ballooning, is this because they are simply growing faster and debtor days are in fact unchanged, or has the time to the receipt of cash lengthened because their customers will not pay them on time? Have trade payables days fallen because their suppliers are demanding earlier payment over fears of the company’s balance sheet? If debtor days are significantly greater than creditor days, or stocks start building up, the model could be unsustainable, leading to a significant divergence in the P&L (profit and loss) and cash-flow statement, and ultimately a conversation with the banks. **We will not invest in a company if working capital is not adequately managed, or if there is no tangible recovery plan in place to improve it.** Many smaller companies in particular have fallen down by inadequate cash control.

Further down the cash-flow statement we note how well interest payments are covered by cash profits. We analyse the net debt profile in the balance sheet and question the terms on that debt, the repayment profile, the potential for any future hikes in margin to the banks, and the headroom within covenants. If a company will not/is unable to explain these details, we will not invest. There are too many other opportunities out there, and a refinancing can be painful to an existing investor.

A forensic examination of the cash-flow statement can identify an accounting anomalies – any divergence from the P&L, or unusual notes to the balance sheet need to be carefully analysed.
- **Growth potential.** We tend to invest in companies that are on the track to recovery. Therefore we prefer companies that are experiencing upgrades to their earnings forecasts rather than downgrades. When analysing these earnings, we ensure that we are looking at ‘normalised’, ongoing earnings, that are fully diluted by potential increases in shares issued, and fully taxed on their eventual tax rate. This can often lead to a different valuation than that produced by external analysts.
- **Pricing power.** We are wary of investing in recovery situations that have little ability to control their own prices, where perhaps the competition is writing unprofitable business and driving down margins within the whole sector. Unless the company is doing something slightly more specialised, or can provide a better service, they will struggle to write business at adequate margins in this environment. Companies that chase turnover and the expense of margin often end up in trouble, but it would be difficult to hold prices and margin unless it has something extra to maintain that pricing power.
- **Macro.** the macro economic environment will also impact a company to some extent – it is very difficult for a smaller company in particular to buck a wider economic or industry trend. Therefore we try to be cautious about analysts forecasts, and conduct sensitivity analyses on these projection in various scenarios, and analyse the subsequent potential impact on the balance sheet and cash-flow.
- **Management.** The success or otherwise of a company is usually determined by the people who run it, in good times and bad. **Meeting the management of every company we hold or are considering an investment in, is a vital part of the investment process.** Our judgement of a management team is often qualitative in nature, but it is their ability to answer our questions both financial and strategic, which together with their track record, often determines 60% of our decision. We tend to follow a successful management team from one company to another – we are then familiar with their style, their turnaround strategy, and can have confidence in their ability. We like to ensure that the top management are backed up by solid middle-tier managers, and that there are management progression plans in place.
- **Valuation.** We use a variety of valuation metrics, such as P/E, EV/EBITDA, EV/sales, NAV etc. No valuation metric is used to the exclusion of others; all contribute to an understanding of intrinsic value. We are sceptical about the use of Discounted Cash Flow (DCF) models, as there are too many assumptions involved which are difficult to validate. Instead we tend to place emphasis on valuations based on cash earnings.

SELL DISCIPLINE

- We will sell a company if it no longer meets the criteria of the fund, or if a key fundamental changes for the worse. For example:
- If management do not do what they said they would do.
- If a key member of the management team leaves – this would obviously require an investigation for the reasons behind the departure.
- If management fail to answer our questions that are necessary for our understanding of the health of the business i.e covenants set by the banks, or a break-down of working capital, provisions etc.
- If the market/industry that the company is operating in deteriorates.
- If margins start to deteriorate.
- If cash-flows deteriorate. We will sell a company – even if earnings appear to be growing strongly – **if cash conversion falls** (adjusting for seasonal factors) i.e. if trade debtor days and stock days start to build, indicating that the terms of trade are shifting in favour of the customer; or that there are possible problems with overstocking; or if there is a reduction in creditor days indicating that suppliers have the upper hand.
- We will also sell if a better opportunity is found elsewhere – we have a high conviction philosophy, and will not continue to hold if a recovery strategy is not working.
- We will take profits from a company if the holding exceeds our limit of 4% for large caps and 3% for small and mid caps, or if the valuation overshoots the underlying worth of the business. Due to liquidity considerations, we will tend to take profits earlier on the smaller companies in the fund.

We are continuously and critically monitoring the fund, and if a company surprises on the downside, we tend to act quickly. One earnings miss, often leads to three, and there are usually better opportunities where we can deploy the capital.

RISK MANAGEMENT

We manage risk at the stock, sector, market capitalisation and macro level. The fund is fairly evenly split across small, mid and large cap companies, and we spread our risk according to liquidity considerations. For example, our maximum weighing in a FTSE 100 index company is 4%, while for a smaller company is nearer 3% with an average of 1%. We will also take profits in a smaller company perhaps a little earlier than in a larger company. Being a long-only fund with a recovery mandate, we are unable to avoid macro risk completely, so although we have a spread of recovery situations, most companies would inevitably be affected by the onset of another recession. We carefully manage our balance sheet and cash risk, however, such that if this scenario played out, our companies should be amongst the survivors.

The information contained in this document is for use by investment advisers only and must not be circulated to private clients or to the general public.

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