Explaining ‘Latent Value’

In late May we held our first live client webinar (you can view the recording here). Feedback has been positive but there was one topic that requires further explanation. When discussing performance and outlook I mentioned that client portfolios had ‘latent value’ and ‘unrealised value’. Unfortunately, time constraints did not allow for a full explanation of what I meant by ‘latent value’. This note seeks to unpack this concept in more detail.

Setting the scene

Within our multi-asset approach to investing, we find inflation linked cash flows an attractive opportunity. These are characterised as non-market tradeable instruments unlike stocks and bonds, which are freely and easily tradeable. There are many variants of these instruments, including investments based upon holdings in infrastructure (roads, rail, and waterways), social housing, renewable energy sources and music rights. As an example, consider a wind farm. No one would expect a wind farm to be bought and sold quickly and easily. There would be months of negotiations with respect to aspects such as valuation assessment, legal advice, surveys etc. The closest example to our everyday lives would be the sale and purchase of residential property. Ask yourself how long you would expect this process to take.

As the assets are not traded easily, they are held within what is called a ‘closed end’ company. Shares of this company trade on a recognised exchange; in our case it is the London Stock Exchange. The fund/company owns the assets, and the share price of the company represents the prevailing sentiment. If there is more demand for the stock, the price rises. Conversely, the price will fall if the prevailing view of investors is negative. Current sentiment post-Ukraine has been poor, which, coupled with significant increases in interest rates over the last 18 months, has for the first time reduced the benefits of holding these assets as part of our diversified approach. We expect the benefits of investing in closed ended companies to reassert themselves.

Where is the value?

At the risk of getting too technical, as mentioned the share price represents the sentiment. However, each trust will also publish a regular Net Asset Value or NAV which reflects the current value of the combined assets divided by the number of shares in issue. A third-party professional valuer values the assets, and this independent, expert valuation is the NAV. When sentiment is positive within the market the share price will be broadly in line with the NAV or, and this has been the case in the past, more than the NAV. When the share price is higher than the NAV, this is termed as the shares trading at a premium. Likewise, when the share price is trading below the NAV, this is referred to as the shares trading at a discount. Independent third-party valuers use the expected cash flows to derive the NAV, and not guess as to what the market is willing to pay for the assets. This, along with our own analysis, gives us the confidence that market prices are wrong. In the long-term the fundamental value of the underlying assets will have a greater impact on price.

From the table below we can see that many trusts are trading at a substantial discount to their NAV, which is the 'latent value.' Regrettably, your valuations only show the performance of the share price. Therefore, the latent value is not identified; NAV performance is not provided as this is the value of the assets underlying the holding, not its traded share price. The table on the next page highlights our trust exposure indicating share price, NAV and historic highs and lows as of 1st June 2023.

Discount management

From the table one can see several trusts, not all, are trading at levels far below their NAV. So, what can we do to reduce discounts? The passive approach is to wait until the general market environment gets better and expect that a rising tide lifts all boats and all works out well in the end. Whilst we would be beneficiaries of this approach, I believe that taking an active approach is warranted in the case of the trusts that are trading significantly below their NAV. Each of the trusts has a board of non-executive directors, the non-executive refers to the fact that they are not responsible for the day-to-day management of the trust. Day-to-day management of the trust is in the hands of investment specialists, while the board has a fiduciary duty to uphold the best interests of shareholders. My team and I are in regular contact with the management of each trust and are candid in passing on our views. It is less usual to have contact with the boards of trusts as, in normal market conditions, there is no real reason to do so. These are not normal conditions. Therefore, I have spent more time with the chairs of the boards in the last six months than I have done in the last 16 years. Dialogue has generally been very good, and I am comfortable that the boards do have the best interests of shareholders at heart and are working to reduce discounts.

Asset Class	Investment Trust	Price (p)	NAV (p)	Premium / Discount	Peak Premium / Discount	Trough Premium / Discount	Yield
Renewables	Triple Point Energy Transition	65	99.02	-32.8%	15%	-39%	8.4%
	Atrato Onsite Energy Plc	84.4	92.33	-7.8%	16%	-17%	5.9%
	John Laing Environmental Assets	117	125.93	-5.0%	29%	-17%	6.4%
	Bluefield Solar Income Fund	130.2	138.68	-5.0%	26%	-25%	6.5%
	The Renewable Infrastructure Group	120.2	135.87	-9.6%	26%	-16%	6.0%
	Octopus Renewables Infrastructure Trust	98.7	107.24	-7.1%	12%	-20%	5.5%
	Aquila European Renewables	96.5	109.63	-11.2%	15%	-25%	5.5%
	NextEnergy Solar Fund	102.2	113.84	-9.1%	25%	-23%	8.2%
	US Solar Fund USD	72.5	97.47	-23.8%	12%	-24%	7.7%
	Victory Hill Global Sustainable Energy	97	113.87	-13.6%	13%	-15%	5.2%
	Greencoat Renewables PLC	106	111	-3.8%	25%	-9%	6.0%
Infrastructure	HICL Infrastructure Company	143	163.33	-12.2%	43%	-23%	5.7%
	International Public Partnerships	139.2	158.58	-10.3%	30%	-22%	5.7%
	Cordiant Digital Infrastructure	83.2	113.87	-22.6%	16%	-29%	3.6%
	Digital 9 Infrastructure	62.1	114.33	-43.4%	15%	-49%	9.7%
Social Housing	Home REIT Plc*		113.61		21%	-70%	10.9%
	Triple Point Social Housing	55	112.36	-50.7%	9%	-67%	9.9%
	Residential Secure Income Plc	70.4	95.1	-25.3%	9%	-45%	7.3%
Royalties	Round Hill Music Royalty Fund	78	128	-37.8%	16%	-66%	5.8%
Forestry	Foresight Sustainable Forestry Plc	100	105	-4.8%	11%	-8%	0.0%

Source: Bloomberg, FE Analytics, Morningstar Direct.

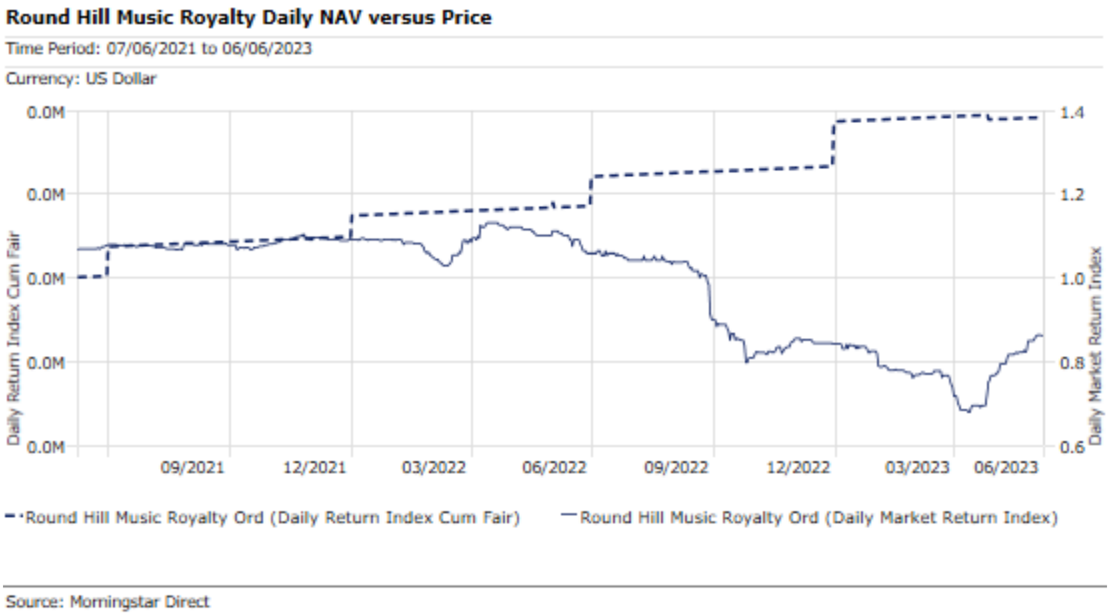
**No current price as the Home REIT Plc share is suspended.*

There are a number of specific strategies that we have asked individual boards to consider, where appropriate. Where the company has cash, we have asked the board to embark on share buyback programs. This is exactly what it seems to be. The company buys back its own shares (it can cancel or keep them for selling back to the market at a higher level in the future) which should naturally lift the share price. In some cases, we have suggested that it would be prudent for the trust to sell part of their assets. This has the benefit of confirming the NAV; the proceeds can be used to strengthen the balance sheet and buy back more stock. In some cases, we have recommended that the board put the entire portfolio up for sale and return cash to shareholders. These strategies can take time to implement but several boards that we have spoken to have already announced to the market that they plan to sell assets. Where we believe that a board is not moving fast enough to address the discount issue, we have voted against the re-election of the board. This highlights our dissatisfaction.

Examples

Not all clients are invested in the following funds, but these examples should give a flavour. In the case of Round Hill Music Royalty Fund, the company's investment objective is to provide investors with an attractive level of regular and growing income and capital returns. The company derives these returns from investment primarily in high quality, music intellectual property. In other words, they own songs, and they get paid a royalty when the songs are played. The company suffered poor sentiment as interest rates began to rise (there is a very technical reason for this that I will not expand upon here). However, the trust continued to post NAV uplifts. At a recent results meeting, the management had the opportunity to put their case across and we have seen a 25% share price increase (to end May 2023) since the last client valuation. The lead manager and his family have been very active in buying shares as they see unrealised value and are now within the top ten of shareholders.

For all the examples below, the dotted line represents the NAV and the straight line, the share price. Therefore, the gap is the discount and therefore the 'latent value'.



Triple Point Social Housing REIT provides accommodation for some of the most vulnerable members of our society. This is one example where my colleagues and I have been in close contact with the manager, the chair of the board and the executive of the management company. All have been very communicative and quick to return calls and arrange meetings. We have had very candid discussions with all parties with respect to the discount. The board put in place a discount management policy (i.e. a policy that seeks to reduce the discount to the NAV) that we do not believe has gone far enough or, more importantly, been implemented quickly enough. There is a plan of action in place that has yet to bear fruit and we watch this space. We voted against the re-election of the board to highlight our dissatisfaction. The trust has seen a 15% uplift in share price since our last client valuation. This uplift was mostly due to its major competitor, which was also suffering from a substantial discount, being taken private at a premium to the current share price. Their board of the competitor agreed to a price that is at a 40% premium to the share price on the day the deal was announced. It is likely that there may be some more horse trading as, whilst a circa 40% uplift is welcome, it is still at a discount to the NAV. The pieces are now moving on the board.

Triplepoint Social Housing Daily NAV versus Price

Time Period: 07/06/2021 to 06/06/2023

Currency: Pound Sterling

Source: Morningstar Direct

John Laing Environmental Assets Group is a multi-asset renewables energy company. Its holdings include wind and solar farms and anaerobic digestive plants, with the common goal of providing renewable energy. Over the past five years the price has largely tracked the NAV, moving to a small premium at the start of the energy crisis. They have been beneficiaries of rising power prices and inflation linked contracts. However, recent government interference has been rife and has taken the shine off sentiment.

John Laing Environmental Assets Daily NAV versus Price

Time Period: 07/06/2021 to 06/06/2023

Currency: Pound Sterling

Source: Morningstar Direct

Whilst these recent uplifts in share prices are of course welcome, they are just the start of the value realisation.

We should also note that all these trusts continue to pay their dividends.

When will we see the value realised?

Unfortunately, this is the trickiest question for me to answer, and I do not have a specific date. What I can state is that, as positive sentiment returns to the market, prices will move as investors will consider that the trusts are trading too cheaply. Buy backs and the selling of assets will have a positive impact. The selling of entire portfolios as boards are forced to realise the value for their shareholders will not only benefit that trust itself but others in the peer group. A peak in interest rates and a fall in inflation will also be beneficial. What I do need to state is that we are loathe to sell these assets at these levels as the fundamentals are positive and the assets are just too cheap. Sadly, it takes time for the market to react, but I am confident that it will do so. As the author and economist, Ben Graham once noted, 'in the short term the market is a voting machine, but in the long run, it is a weighing machine'.

What can go wrong?

Taking the glass half empty view, which is always valid when managing assets, I must ask where the additional risks are. Risky scenarios would include a situation where the economic environment deteriorates further, with persistent inflation and corresponding high interest rates. There is also risk that if companies fail to manage their assets, the NAV falls to meet the share price. It is possible that buybacks have no impact and there is no bid for portfolios at a price shareholders would be willing to accept. I should make it clear that none of these scenarios is our base case and we are not managing expectations in this direction.

An exogenous shock is a threat we must deal with daily. Thankfully they are very rare, but their impact is significant. We cannot manage for this risk. If your fear of such a shock is so great, then our suggestion is that you should not be invested in markets. Some theoretical examples of an exogenous shock would be a Chinese invasion of Taiwan,or a Russian nuclear strike on Ukraine or upon a NATO member nation. These would be big events with horrific loss of life, creating further global uncertainty and would be exceptionally detrimental to markets. The obvious point is that we cannot predict these. We must manage for the base case, which is that inflation will continue to fall, interest rates will start to follow suit. Whether the UK avoids a technical recession (two consecutive quarters of negative GDP growth) is neither here nor there; economic slowdown is upon us. But the start of a new economic cycle is where substantial gains are usually made, and to reap those benefits one must first-and-foremost be invested.

Conclusion

In general, our closed end exposure has provided the returns we would expect, reflected in good NAV returns. The trouble is caused by share prices not representing this in the short-term. We remain convinced that there is substantial, unrealised value within these investments and that the outlook is improving. Falling back on market adages is not core to my style of investing but I believe in this instance one sums it up; it is not about timing markets but time in the market. Long-term investing works because over time volatility smooths itself out. The painful short term is sadly part of the journey, and the price we must pay to participate in the superior longer-term returns that tend to follow periods when latent value is high in portfolios.

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James joined City Asset Management in 2009 and is our Chief Investment Officer, where he is responsible for managing the investment process and chairing the asset allocation, portfolio construction and fund selection committees. He is also a member of our Executive Committee. He has 25 years' experience, including roles at Gartmore, BestInvest and Baring Asset Management, and specialises in multi-asset real return investing. Throughout his career he has been a key mentor for younger analysts and enjoys watching them progress on to their own successful careers.