connection CAPITAL

SUMMER 2019

THE REVIEW

Welcome

It feels like a while since we last published *The Review* and as seems often to be the case, there have been plenty of deals and activity over the period to tell you about.

Despite the continued uncertainty in the UK and the end of Theresa May's premiership, UK SMEs have growth plans and are dealing with the circumstances as the new normal. We are seeing plenty of opportunities in the private equity and debt space and expect to bring several more to you this year, along with a couple of new alternative fund options.

Speaking of which, over the period we welcomed our new Head of Funds, Lorna Robertson. Lorna joins from Invesco where her role covered a range of fund strategies including fixed income, equities, alternative assets, bespoke solutions and fund linked structured products.

In addition we found time to update Connection Capital's website, if you've any feedback we would be delighted to hear it.

Finally, to those of you who made it to our recent summer party, thank you for making the time to pop along and catch up.

As ever, if you have any questions, please do get in touch.

Best regards

The Connection Capital team

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Life Sciences Partners: one of Europe's largest healthcare investors

Deal Completions

Private Equity

Rosa's Thai Café

Co-investment backing the management buyout at fast-growing Asian food restaurant chain alongside sector specialist private equity fund manager, TriSpan. Rosa's has 15 sites in London and recently opened sites at Albert Docks in Liverpool and Trinity Leeds with others in the pipeline. It was recently ranked as the sixth fastest growing UK restaurant chain in the AlixPartners Growth Company Index 2019.

Private Debt

ASK King's Cross

Syndication of a £8m mezzanine loan (with a project profit share), already underwritten and drawn by ASK Partners Limited, funding the acquisition and planning costs for a substantial new mixed-use development in central King's Cross. This was a rare opportunity to invest in one of London's most successful areas of regeneration in recent years, just minutes from the King's Cross transport hub.

Alternative Funds

Life Sciences Partners

Fund manager, Life Sciences Partners, is Europe's largest investor in early stage life sciences companies. Its sixth vehicle (LSP 6) aims to build a diverse portfolio of drug development, medical technology and diagnostics investments. Connection Capital clients invested £5m as part of a €550m raise, alongside the European Investment Fund and global pharmaceutical company Bristol-Myers Squibb. Life science investments are likely to have low correlation with public markets. Target net returns are 2.0-2.5x with upside potential.

BCI Credit Opportunities Fund

Operating a specialist credit strategy which provides capital to alternative lending businesses, this fund targets annual net returns of 12% including a 10% annual income distribution. The loan facilities provided by the fund manager, BCI, are for relatively short periods of time (averaging 18 months) and are fully secured on the receivables due from each lending platform's underlying loan book. Our clients have invested just under £8m so far.

Portfolio Highlights

Private Equity

Mode Print Solutions
(Print services provider)

Our clients backed the management buyout ('MBO') of 'Mode', a provider of managed print services, in 2018.

Performance has been strong since completion. The company enjoyed a record sales quarter in Q1 2019 and also landed its single largest ever client during Q2.

There are an increasing number of acquisitive and organic growth opportunities available to the company. As a result, plans are in place to bring forward the date of some key hires to exploit these. We've noted a number of recent transactions in the sector at upwards of 8x EBITDA which suggests a positive environment for clients' eventual exit from the company, if trading continues on plan.

23.5 Degrees
(Starbucks franchise)

The UK's first Starbucks' franchise has pursued a fast-paced roll-out model since clients first backed it in 2015 when it operated 13 stores. The estate is now 66 units strong. Site openings continue at pace, with nine new openings so far in FY2019 and a further 35 sites in the pipeline, which would take the estate to over 100 stores.

23.5 Degrees remains the fastest expanding Starbucks franchisee and this is recognised by Starbucks, which awarded four further territories to the company in March, taking the total number of counties to 20. We're pleased with progress and remain confident in the management team's ability to drive the company through to exit.

Virgin Wines
(Online wine retailer)

Virgin Wines is a leading UK online direct to consumer wine retailer which benefits from the use of the Virgin brand. Connection Capital clients backed a MBO in 2013.

The company is making good progress in a tricky retail environment. New Chairman John Risman, who brings a wealth of retail experience, has settled in well and has forged a good working relationship with CEO Jay Wright and CFO Graeme Weir. His impact has been most clearly felt in the high quality of strategic debate and the quality of data provided as part of the most recent strategy day Connection Capital attended. Some of the changes in the market, notably the shift in strategy at Majestic Wines/Naked Wines, could also throw up opportunities for the business in the coming 12 months.

The Light Cinemas
(Cinema operator)

The Light now operates 10 sites in the UK (up from three at time of the original investment). Further new site builds are scheduled for 2020. In the interim, management continues to focus on improving EBITDA across the existing estate, with some strategic investments planned. This includes additional screens at Stockport, opened last year, which is currently operating at full capacity on weekends.

The chain was buoyed by the release of the Avengers: Endgame film in April, which broke UK box office records.

23.5 Degrees: the fastest growing Starbucks franchise in the UK, now has a 66 unit estate with 35 more in the pipeline

Private Debt

EPI
(Oil & Gas consultancy)

EPI is a global leader in exploration services to the oil & gas industry. Clients invested £4.75m in 14% secured loan notes and a minority equity stake in 2016.

Trading remains strong, as the higher global oil price has continued to support increased activity across all EPI's key markets. The core marine and land exploration businesses continue to win good contracts, resulting in year-on-year increases in the number of contractors 'in the field'.

Management is reporting continued strong performance in tendering and the confirmed orderbook looks robust for the balance of FY2019 and beyond.

Torquay Leisure Hotels
(Leisure resort)

Our clients provided £3.5m of secured debt into the MBO of this popular multi-site resort group in 2018. Target net returns are 1.9-2.2x total money invested over five years, which includes a 10% annual income payment to investors.

As part of the deal we introduced a Non-Exec Chairman with strong leisure experience. There are strong bookings for the coming summer period and winter bookings are ahead year-on-year.


Torquay Leisure Hotels

Alternative Funds

Permira Sigma IV
(European CLO fund)

This fund invests in the equity/ junior capital of collateralised loan obligations ('CLOs') – vehicles which acquire participations in the senior loans of European corporates. These CLOs are actively managed by specialist credit managers and generate income from the yield on the underlying loans.

Our clients invested in September 2016. The fund is fully deployed and well diversified through 51 underlying investments through 24 European CLO managers. The market continues to grow and enjoyed a record quarter in Q1 2019, as a result there is a healthy pipeline of new issue CLOs to consider.

Distributions to investors began in line with expectation in Q1 2018 and now total 24% of total money paid in. Overall, performance is ahead of plan and target returns of 2.0x money invested are on track.

Beechbrook
(Mezzanine debt provider to private equity-backed businesses)

Clients invested in two separate funds from Beechbrook in 2014 and 2016. The funds provide secured debt to European mid-market private equity fund managers and target net returns to clients of 1.5x total money invested.

The funds offer attractive risk-adjusted returns, given the low level of prior ranking debt in most target companies and the relative lack of competition for Beechbrook.

Both funds are performing well. The earlier invested fund is fully drawn and has distributed 77% of clients' original investment back so far. The latter should be fully allocated well before the end of its four-year investment period.

Commercial Property

119-121 Cannon Street, EC1
(Mixed-use commercial property)

Clients invested £4.6m in the £47m purchase of a mixed-use commercial property on Cannon Street in London's square mile last year. The asset management plan is to actively manage lease events to increase rent roll and to refurbish the building to increase value before an exit in 2021.

Leasing activity continues to be strong in Central London and is above the five year average. Two separate planning consents have recently been granted allowing new lifts and dormer windows to be installed as well as extension works to floors 4 through 6. This includes new roof terraces on the 5th and 6th floor in addition to bike storage space, shower facilities and a refreshed reception.

This should enable the repositioning of the asset as a grade A office in a prime location.

Purpose-built R&D and warehouse facility
(Cambridge site, pre-let)

Clients invested in the development of a freehold site within the Cambridge Compass Enterprise Zone in April 2018. The area is the locus of bioscience companies in the UK and as a result the site has been pre-let to Cambridge Nutritional Sciences on a 25-year lease.

The investment outlook for warehousing and the research and development sector remains positive with strong results for demand and take-up of space in 2018. An estimated 0.6 million sq. ft. of new space will be completed in Cambridge in the first half of 2019, with the vast majority (over 85%) already pre-let or under offer. This lack of availability will help drive prime rents in this region and will support an eventual exit.

Bi-annual distributions to investors commenced in April, in line with the investment plan.

Trends in alternative asset funds: what's the big picture?

Our clients know that the case for investing in alternative assets is compelling. But it's useful to put this into context: what trends have been coming to the fore in recent months? Which strategies have the greatest potential and what is likely to shape the alternative asset funds market - and the types of fund opportunities we offer – looking ahead?

It's clear that at this stage in the economic cycle, investment managers are paying more attention to alternative assets as they focus on yield and seek to smooth out the impact of volatility. So much so that many mainstream players are entering the arena.

Just look at the decision by the Woodford Equity Income Fund, the star manager-run retail fund ostensibly focusing on liquid equity investments, to include an allocation to unlisted company shares in its portfolio.

Woodford recognised that seeking out the hidden value in SMEs can be a smart strategy, and given time, those investments may well have generated positive outcomes.

That the move has been subject to intense media and regulatory scrutiny is due, not to the soundness of those investments, but the mismatch between the open-ended fund structure and the illiquid nature of these underlying assets, creating liquidity problems.

The furore underlined the importance of transparency: those promoting funds must be clear about the strategies they put to clients and demonstrate that they are structured correctly for the types of assets held. It highlights too the risks for the unwary if alternative assets move into the mainstream "retail" market. Fund investors must understand what they're buying.

Seeking out the best market opportunities

But for sophisticated private investors with the right experience, financial capacity and risk appetite, which alternative asset fund strategies are gaining prominence in the market and where might the best opportunities lie?

Though we keep an open mind and consider many different types of funds, there are several particular areas of interest currently:

- **Private Equity funds** – we look for expert managers with a specific specialism e.g. focusing on a market niche or a value-adding strategy such as a "buy and build" approach
- **ESG investing** – Ethical, Social and Governance-focused investments are a hot topic. Long-dated, cash-generative funds investing in green energy infrastructure could be exciting options
- **Real asset funds** – asset-backed investments in shipping or aircraft, infrastructure or property are high on the radar, with a view to delivering risk-adjusted returns while preserving value

- **Non-correlation to traditional asset classes** – we have strong relationships with fund managers in specialist fields like litigation funding and debt funds and are exploring new avenues such as art or music royalty funds
- **Co-investment opportunities alongside funds** – enabling clients to participate direct in specific asset investments within fund portfolios, as well as in the fund itself, is a unique opportunity we are investigating.

For us, it comes down to the quality of the fund manager and the value-add they can deliver. Good opportunities can exist almost anywhere – we're looking for experts with the know-how to identify and capitalise on them. It's a strategy that has served us well, and will continue to underpin our decision-making going forward.

Lorna Robertson, Head of Funds

Private Debt: the flexible formula for SME growth (and other ambitions)

You've probably heard the one about a banker being someone who wants to lend you an umbrella when it's sunny, but takes it back when it rains. But it might surprise you to learn that even after 25 quarters of positive UK GDP growth, the number of 'umbrellas' being handed out by UK banks continues to fall.

Today, bank lending figures to SMEs don't look much healthier than they did five years ago. According to UK Finance, the number of monthly overdraft approvals to UK SMEs regularly exceeded 20,000 back in 2012. In the latest twelve months (to September 2018), the average number of approvals per month was just 11,000.

The traditional banks are becoming ever more rigid in their approach to lending (both in terms of which type of credit risks they are willing to take, and the terms they will lend on). And when they do offer debt funding, it often comes burdened with unrealistic restrictions (covenants) and repayment profiles (amortisation). For SMEs it can often feel more trouble than it's worth.

The benefits of flexibility

As far as we're concerned, there's no reason why private debt shouldn't be available to stable, profitable SMEs. Nor is there any reason why it shouldn't be used to fund a range of requirements including equity release, a change of ownership, or acquisitions, as well as providing growth capital or replacing unsuitable legacy debt.

And we can be commercial in balancing our risk against more realistic covenant and repayment profiles than traditional lenders (often only requiring a 'bullet' repayment at the end of the term). Too often businesses end up chasing their tails to make the next quarterly interest payment, or hit a covenant test, when really they should be focusing on beating the competition.

Clearly there's a trade-off to be considered here with the overall 'cost' of the money – we can afford a more sympathetic approach because we know in the long-run it delivers a better return for all stakeholders. Sympathetic funding might not be the cheapest on the page, but we think SMEs are not just accessing capital, they're ultimately unlocking value.

At the same time, we've seen a growing interest in private debt from private investors keen to increase portfolio diversification and enhance returns at a time of heightened volatility in public equity markets.

Stephen Catling, Head of Private Debt

How we've helped:

The leisure resort

When the family that had owned a unique multi-hotel and leisure complex resort in one of the UK's top tourist destinations since the 1940s decided to exit via an MBO, we supported it with £3.5m of sponsorless mezzanine finance behind a commercial mortgage. Our clients provided the capital that exceeded the mortgage provider's appetite, and delivered an alternative to private equity, which would have demanded too much dilution of the management team's shareholdings.

The property developer

The developer of a new high-spec residential development in central Belfast required funding to "up-spec" units to a higher standard than originally planned, and to release equity so it could pursue additional developments in its pipeline. The senior lender wasn't in a position to provide additional funding, so we worked alongside them to provide £2.6m in short-term secured private debt facilities.

The global oil and gas consultancy

The company's inflexible banking arrangements were not set up in a way which allowed for growth or to deal with the once-in-a-generation oil price slump of 2014-16, so our clients provided a £4.75m mezzanine funding package to enable it to replace its existing senior debt. Structuring it with a final bullet repayment instead of an amortising loan allowed the company to pursue strategic M&A and organic growth opportunities.


The Light Cinemas: benefitted from the release of 'Avengers: Endgame'

Don't miss out

Register at www.connectioncapital.co.uk/client-registration-form to view our investment opportunities

The Connection Capital Portfolio: Net Investor Returns

	Exited					
	Invested £000's	Proceeds (£000's)			Actual	
		Returned	Forecast	Total	IRR	MMx
Private Equity	18,272	26,942	0	26,942	13.3%	1.5x
Commercial Property	21,719	33,824	0	33,824	13.5%	1.6x
Alt Funds	4,700	6,040	0	6,040	9.5%	1.3x
Private Debt	6,373	8,709	0	8,709	15.7%	1.4x
Total	**51,063**	**75,514**	**0**	**75,514**	**13.4%**	**1.5x**

	Total (Exits and live portfolio)				
	Invested £000's	Proceeds (£000's)			Forecast MMx
		Returned	Forecast	Total	
Private Equity	114,277	35,885	154,704	190,589	1.7x
Commercial Property	41,779	34,959	29,032	63,991	1.5x
Alt Funds	69,962	16,547	107,598	124,145	1.8x
Private Debt	19,523	9,292	20,005	29,298	1.5x
Total	**245,541**	**96,684**	**311,339**	**408,023**	**1.7x**

Source: Connection Capital. Data accurate as at 31 March 2019. Returns shown are net of all fees and carry. IRR is internal rate of return. Figures have been rounded.