A special skillset in capital allocation

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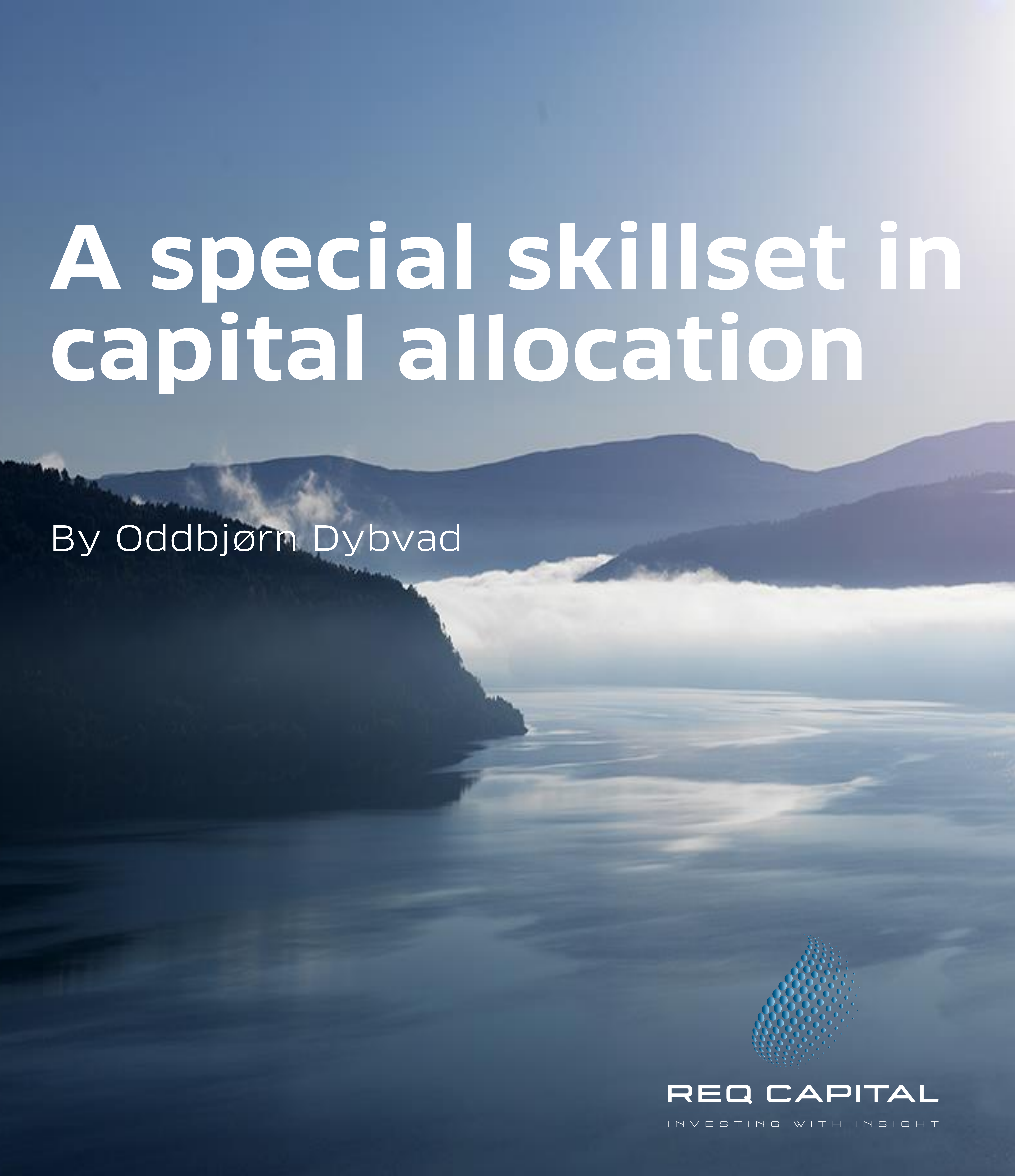

REQ CAPITAL
INVESTING WITH INSIGHT

An important cornerstone of our investment philosophy is exceptional capital allocation. There are many ways a company can allocate its capital. Many of the companies we have invested in use strong free cash flow to buy profitable small private companies. How can this be profitable?

Many of the companies we invest in are excellent at sourcing, negotiating and closing private deals. Over the years, they have developed strong expertise in this type of capital allocation. They are disciplined buyers of well-run small private companies at prices well below market multiples. They repeat the process in a structured manner and consistently close attractive private deals. Capital allocation is at the core of their strategy.

Value creation through small private acquisitions

In private markets, there is great information asymmetry and often less liquidity. Private markets are structurally inefficient, which we believe leads to persistent differences between public and private valuation multiples. Some companies, after decades of practice, are in a good position to exploit these valuation differences.

We invest in many publicly traded companies that acquire private companies at highly accretive multiples for us as shareholders. The multiples are generally in the range of 5-10 times EBITA, well below where the listed companies themselves trade. Over the years we have not seen any increase in the multiples paid by our listed companies for the acquisition of private companies.

The traditional private equity approach is to buy a broken business at low multiples and turn the business around to realize a multiple expansion at exit. The “value creation framework” is easy to understand.

The serial acquirers we own have a very different approach.

They buy private companies with good growth prospects and good returns on capital and source and close these acquisitions at extremely attractive multiples. The "value creation framework" is to let these good companies continue to operate independently, help them achieve their growth ambitions and generate better cash flow. Generally, they work with carrots, not sticks, in terms of incentive structures. They basically create a lot of value through collaboration, permanent capital and offering a permanent home.

> "*As the new owner of a company, Momentum Group does not focus on revolution, but rather on evolution*"
> (Momentum Group, webpage)

Example

Below is an example of one of our portfolio companies, UK-listed Judges Scientific. The company acquires private niche scientific instrumentation companies. Below is an overview of the three recent acquisitions and the corresponding multiples paid.

Private transactions

	Korvus Technology (Oct. 2020)	Heath Scientific (May 2020)	Moorfield Nanotech (Dec 2019)
EV	2,6m £	5,3m £	2,3m £
EBIT	0,7m £	0,9m £	0,6m £
EV/EBIT	3,7 x	5,9 x	3,8

Public company

	Judges Scientific
EV	591m £
EBIT	26m £
EV/EBIT	23 x

Given these multiples on the left, you would assume they are broken companies with no growth opportunities and weak returns on capital. They are not.

These companies are growing with high returns on capital. The transactions on the left are often sourced and negotiated off- market, which explains the multiples paid. When a company like Judges Scientific can deploy capital by acquiring well-managed, high growth companies with an average return on capital of 22%, shareholders like us benefit. The original management continues to run the company as it did before the transaction. Note how small these companies are. EBIT under £1 million explains why many deals stay under the private equity radar. With less competition and information, opportunities arise.

The quality of earnings acquired from these private companies is often at or above the level of the public company. When the company announces its earnings, the acquired earnings trade at the same multiple as the parent company. In the case of Judges: 23 times instead of 3-6 times. For the public company, the key is to find quality private companies that meet or exceed the financial metrics that they can realize themselves as an acquirer. They need to raise the bar and buy at deep discounts. That requires discipline.

Large opportunity set

In Europe alone, there are more than 23 million privately owned small and medium-sized businesses, of which about 15,000 are for sale each year*. Some are bought by private equity firms, others by large strategic buyers. A small number are acquired by our publicly traded serial acquirers, who take a structured approach to buying, holding and supporting their portfolio companies. They rarely sell and rarely acquire companies presented to them by M&A brokers. They tend to source deals on their own. Many of the private entrepreneurs who sell their businesses are concerned with keeping employees employed, continuing the business without restructuring or liquidating assets, and ensuring that the headquarters remains where it has always been. They accomplish this by selling to one of our companies.

We have learned firsthand that capitalism does not always work according to the textbook. Even when there are multiple buyers of assets, the highest price does not always win. Inefficiencies lead to opportunities for our companies.

In summary

The advantage for public investors like us is that we gain access to several well-managed private companies at significant discounts to publicly traded companies. These prices are not normally available to public investors. We have invested in many public vehicles that acquire these private companies and create a lot of value over the years. As long-term investors in publicly traded companies, we enjoy the opportunities that arise in the private markets.