investors CHRONICLE alpha

18 April 2019

LMS Capital: a private equity group in deep value territory

Guided by a top rated fund manager, this private equity firm is selling off its legacy portfolio and recycling cash into new investments with the potential to generate double-digit returns

LMS Capital (LMS)

Ticker	LMS
Current price (p)	48.8p
Target price (p)	63.5p
Market cap (£m)	£37.4m
52-week high (p)	55p
52-week low (p)	44p
Net cash (£m)	£17.7m (31 December 2018)
Shares in issue (m)	80.7m
Financial year-end	31 December
Next event	2019 first-quarter trading update at end April 2019
Company website	lmscapital.com

LMS Capital share price

Source: Bloomberg

Analyst: Simon Thompson
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Alpha Production Editor: Sameera Hai Baig

Simon Thompson's view:

It's sensible to build a margin of safety into the price you are willing to pay for equity in any company. Investment risk can be mitigated further when the company is sitting on a cash pile to minimise the potential downside risk. In the case of LMS Capital, the value of its quoted securities and cash on the balance sheet back up 60 per cent of its market capitalisation, meaning legacy investments being sold down are thrown into the price at 61 per cent below what is a realistic carrying value in the 2018 accounts. As these assets are sold, and cash is recycled into new investments, the company's huge share price discount to net asset value should narrow markedly.

Bull points

- Cash and quoted securities account for 40 per cent of net asset value.
- The shares are trading 35 per cent below net asset value, well below the private equity peer group average.
- New investment manager making headway selling off legacy investment portfolio.
- Talks ongoing to make significant sales of legacy assets.
- Experienced investment management team.
- Investment manager incentivised to generate strong returns.
- LMS plans to return 30 per cent of all realised gains on new investments to shareholders.
- Stringent stock selection process carried out before any investment is sanctioned.

Bear points

- Net asset value per share declined in 2018.
- Currency risk.
- Liquidity – a major shareholder owns a 42 per cent stake.
- No guarantee that assets can be sold at, or close to, book value.

“Between the start of 2012 and the summer of 2016, LMS returned £155m to shareholders by liquidating its investment portfolio”

An interesting investment opportunity has arisen at **LMS Capital (LMS)**, a private equity firm whose investments have been managed by Gresham House Asset Management (GHAM) since August 2016.

Prior to appointing GHAM, the company had been winding down its portfolio in accordance with the orderly realisation of assets approved by shareholders in November 2011. Between the start of 2012 and the summer of 2016, LMS returned £155m to shareholders by liquidating its investment portfolio, a process that had rewarded shareholders given the company had a market capitalisation of £155m and net asset value of £240m when the divestment started.

The investment policy focused on optimising the timing of disposals of individual assets rather than to seek early liquidity at a discounted price. However, as the realisation strategy progressed and the company reduced in size, its expense ratio deteriorated and LMS’s ability to hold investments for longer to achieve better value was being diminished. The future returns to be achieved from continuing with the realisation strategy was therefore likely to be reduced too.

Shareholders approved a new investment policy in August 2016, to optimise value from the company’s remaining assets and allow those with growth potential to be managed for a longer period (thus generating additional returns). This move could enhance prospects for long-term capital growth in the net asset value of the company.

This involved returning a further £17m of cash to shareholders through a tender offer pitched close to net asset value of the company (which was achieved by the summer of 2017) and recycling the proceeds from the ongoing disposals of the legacy assets that GHAM inherited from the previous investment manager into a new investment strategy.

GHAM investment objective and strategy

The investment objective is to achieve absolute total returns over the medium to longer term, principally through capital gains and supplemented with the generation of a longer-term income yield. GHAM is targeting a return on equity, after running costs, of between 12 per cent and 15 per cent a year over the long term. GHAM’s strategy is to invest in assets that typically have a number of the following characteristics:

- Investments that the investment manager believes can generate a 15 per cent net internal rate of return (IRR) over the medium to longer term.
- Investments that are less liquid and which the investment manager believes benefit from an illiquidity discount.

> *"The Quality-score also considers customer concentration, sustainability of margins, capital intensity and the stability and predictability of cash flow"*

- Companies demonstrating strong underlying operational cash flow characteristics and attractive returns on invested capital.
- Alternative, specialist asset classes managed by the investment manager that target long-term, illiquid strategies on preferred terms.
- Funds. GHAM may make indirect investments by means of passive co-investment or fund commitments when it is able to procure preferred terms, and the fund is managed by the investment manager, and net returns are expected to exceed the investment return objectives.
- Private equity. Specifically, where the investment manager believes there is an opportunity for value creation through strategic, operational or management initiatives.

LMS will make direct investments, typically with co-investors, in private equity opportunities including pre-IPO. It may lead or be part of a consortium holding influential or controlling stakes. The focus will typically be on companies with an enterprise value of less than £50m, and in most cases between £10m and £30m, where the investment managers believe that there is an ability to add value to the companies through active engagement. Also, these companies will be off the radar for venture and early-stage funding providers and sub-threshold for mid-market private equity investors, thus creating an opportunity to generate superior long-term returns.

A quality score

GHAM's investment process involves giving each investment opportunity a 'Quality-score' after considering a multitude of factors including: the attractiveness of the market in terms of its characteristics and dynamics; competitive positioning of the company within the market, including product and service offering, barriers to entry, ability to grow, pricing power, and client/customer quality; strength and experience of the board and whether their interests are aligned to other shareholders; and the likely attractiveness of the company to other buyers, be it institutional, trade or private equity. The Quality-score also considers customer concentration, sustainability of margins, capital intensity and the stability and predictability of cash flow.

A good example of how this stock selection works in practice is LMS's investment in Northbridge Industrial Services (NBI), an Aim-traded company that hires and sells specialist industrial equipment to utilities, public sector and oil and gas industries, which issued £4m of loan notes to funds managed by GHAM. LMS participated by making a £600,000 investment, its first new investment since the adoption of its new investment policy in August 2016.

The loan notes were issued at a fixed interest rate of 8 per cent and are due for repayment in July 2021, if not previously converted to equity, and include the option to extend the term of the instruments by two one-year periods on the consent of Northbridge and the bondholders. If extended, the interest rate on the loan notes increases to 10 per cent a year after July 2021. The loan notes are secured, through a second charge over the company, and are convertible into equity at 125p a share. Northbridge's annual results for 2018 showed a significant recovery in its profitability in the second half of 2018, and strong cash generation. The news sent the share price to a 27-month high of 160p, well above the 125p a share conversion level.

Portfolio construction

The portfolio will typically hold no more than 20 investments and capital will be allocated to public or private investments for direct investment or co-investment where GHAM believes such investment is able to generate attractive risk-adjusted returns over the medium to longer term.

GHAM intends to invest in at least 10 new company positions either directly or on a 'look though' by the time LMS is fully invested and the transition to the new investment policy has been completed following the realisation of legacy investments. Investments will be predominantly invested in the UK, Europe and North America.

GHAM manages risk through appropriate portfolio construction, and exposure to any single company – including those single 'look through' company positions within fund holdings – is restricted to 15 per cent of net assets at the time the investment is made. Any investment in securities issued by a single company or investment fund which represents more than 10 per cent of the company's net asset value requires board approval. Also, although LMS is allowed to gear up its portfolio, borrowing is capped at no more than 25 per cent of net assets at the time of any drawdown.

Excellent performing investment manager

GHAM is based in the Square Mile and employs 41 staff. It is led by Graham Bird who heads GHAM's strategic equity strategy alongside Tony Dalwood, the chief executive of specialist asset manager Gresham House (GHE), the parent company of GHAM.

Mr Bird is very experienced in fund management and in corporate advisory work, having been a fund manager and Head of Strategic Investment at SVG Investment Managers (a former subsidiary of SVG Capital), where he helped to establish and then co-manage the Strategic Recovery Fund I (which achieved an IRR of 46 per cent) and investment trust, Strategic Equity Capital. Prior to that he was a corporate financier at investment bank JPMorgan Cazenove, and spent six years as a senior executive at payment systems company PayPoint.

Mr Dalwood is an experienced investor and adviser to public and private equity businesses. He established SVG Investment Managers, acting as chief executive and chairman of this entity, and launched Strategic Equity Capital. His previous appointments include chief executive of SVG Advisers (formerly Schroder Ventures (London) Limited), membership of the UK Investment Committee of UBS Phillips & Drew Fund Management (PDFM), chairman of Downing Active Management Investment Committee and the board of Schroder's Private Equity Funds. Under his leadership, Gresham House has become a leading UK asset manager specialising in alternative assets, with over £2bn under management.

Another key member of the investment committee is Tim Farazmand, who has over 30 years' experience in private equity, including 12 years at Lloyds Development Capital where he completed over 500 investments worth over £2.5bn including what was to become a stock market darling, drinks group FeverTree Drinks (FEVR).

GHAM has already proved its investment management skills at Gresham House Strategic plc (GHS). That company was the top-performing small-cap fund in 2018 versus OEIC and investment trust peers based on data compiled from FE Trustnet and Morningstar. GHS produced a total shareholder return of 20.4 per cent in the financial year to the end of March 2019 too. Since inception in August 2015, Gresham House Strategic has outperformed its benchmark by 13.3 per cent.

This impressive investment performance gives credence to LMS's board's assertion that GHAM has a proven ability to undertake transactions, providing know-how and certainty of execution. Furthermore, the successful investment track record is underpinned by proven operating and technical expertise. The approach to private and public equity is differentiated by an innovative focus on the growth in demand for alternative investments. LMS's board has also been wise to take an equity stake in Gresham House, creating a platform that offers its own shareholders the ability to share in future value creation in Gresham House.

The point is, the market is woefully underestimating the ability of GHAM to replicate the success it has enjoyed at Gresham House Strategic with LMS, now that GHAM has the cash available (see next page) to make new investments for LMS's shareholders.

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“This is an opportune time to invest in LMS is because it made significant progress realising its legacy investments in 2018”

Note:

A call warrant is a financial instrument that gives the holder the right to buy the underlying share at a specific price on or before a specified date.

LMS Capital (LMS)

Ord Price: 48.8p
Market Value: £37.4m
Touch: 46.4-48.8p
12-Month High: 55p **Low:** 44p
Discount To NAV: -35%
Dividend Yield: nil
Net Asset Value: 74.7p
Net Cash: £17.7m

Year to 31 Dec	Net asset value value per share (p)	per Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2014	93.0	10.7	6.3	nil
2015	92.0	0.7	0.3	nil
2016	71.0	-20.8	-20.6	nil
2017	79.9	7.6	8.4	nil
2018	74.7	-4.2	-5.2	nil
% change	-7	–	–	–

Normal market size: 7,500 SETS Source: LMS Capital Annual Report, London Stock Exchange

Incentivising the fund manager

For its part, GHAM earns an annual management fee of 1.5 per cent of net asset value when it is below £100m (LMS has a current net asset value of £60.3m). It is also incentivised under a performance fee arrangement that is based on the new investments made and not on legacy investments. No performance fee is due unless the increase in net asset value of any new investments exceeds 8 per cent compound growth a year. Net asset value of the new investments is calculated after an allocation of operating costs.

To protect the interests of LMS’s shareholders, the performance fee payable to GHAM is capped at 15 per cent of net realised gains made from new investments in any one year. LMS’s board has also committed to return 30 per cent of net realised gains from new investments to shareholders, so that they will benefit from the capital gains made and in the process generate a dividend yield over the longer term.

In recognition of the value of the opportunity to manage the company’s portfolio, the parent of GHAM, alternative fund manager Gresham House (GHE), issued LMS with £1m shares in that company on signing the investment mandate, and committed to issue further Gresham House shares with a value of up to £1.25m on the second anniversary in August 2018. LMS also committed to invest £1.5m to acquire further shares in Gresham House, mainly through 909,000 call warrants issued with an exercise price of 323.7p a share.

An opportune time to invest

This is an opportune time to invest in LMS is because it made significant progress realising its legacy investments in 2018. It ended the financial year with £17.7m of cash, up from £4m a year earlier, a sum equating to 29.3 per cent of its closing 2018 net asset value of £60.3m.

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Moreover, LMS's shareholding in Gresham House has done really well with shares in that company at the highest level since chief executive Tony Dalwood took the reins at the end of 2014. In fact, after accounting for realisations made last year, LMS currently holds 984,000 shares worth £5m in Gresham House, a company included in my 2016 Bargain Shares Portfolio and I maintain a very positive stance on its investment potential too. In fact, if shares in Gresham House achieve my target price of 650p, this would add a further 28 per cent to the value of LMS's stake in the company.

In addition, LMS owns stakes in three smaller quoted legacy investments: New York Stock Exchange-listed oilfield services group Weatherford International (US:WFT); Nasdaq quoted SolarEdge Technologies (SEDG), a company which offers an inverter solution for a solar photovoltaic system; and Aim-traded software company IDE (IDE). In aggregate these three holdings are worth £1.4m at current market prices.

This means that quoted securities on LMS's balance sheet equate to £6.4m, or 10.7 per cent of its closing 2018 net asset value of £60.3m. The total value of LMS's cash and quoted securities is £24.1m, or 40 per cent of the company's net asset value. These liquid assets also represent a chunky sum in relation to LMS's current market capitalisation of £39.4m.

Or put it another way, with LMS's share price trading on a 35 per cent discount to net asset value of 74.7p a share, then once you strip out the aforementioned £24.1m of cash and quoted investments from LMS's market capitalisation of £39.4m, then its other assets – a legacy portfolio of unquoted investments and holdings in funds with a balance sheet value of £18.3m and £20.8m, respectively, at the end of 2018 – are in the price for £15.3m. Effectively, LMS's legacy portfolio of unquoted investments and fund holdings are in the price for 61 per cent below their carrying value in LMS's recently released 2018 annual accounts.

Clearly, the extreme share price discount indicates a significant degree of investor scepticism as to the timing of further disposals from LMS's legacy disposal, and the pricing of them when they occur. LMS booked a thumping £16.2m write-down on its portfolio in 2016 after GHAM ran over the books when it took over the mandate in August 2016, hence the eye-catching pre-tax loss that year in our table. Although LMS booked a £10.4m net gain on the portfolio in 2017, there was a net loss of £2.3m in 2018 which, when added to annual operating costs of £1.5m,3 explains the fall in net asset value in 2018.

However, the scepticism looks to be misplaced given that the £39.1m portfolio of unquoted investments and

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holdings in funds is concentrated in a handful of holdings, prospects of realisations from which are actually rather good. That's important because as cash is realised from these unlisted investments, and GHAM starts to finally recycle the current cash pile into new private equity investments, then LMS's deep share price discount to net asset value should narrow markedly. This has happened with Aim-traded shares in Gresham House Strategic (GHS), an investment company to which GHAM was appointed investment manager in 2015.

LMS Capital portfolio breakdown

Asset type	Holding	Sector	NAV
Quoted	Gresham House	Asset management	£5.0m
	Wetherford	Oil and gas services	£0.4m
	IDE Group	Technology services	£0.2m
	SolarEdge	Photovoltaic systems	£0.8m
UK private –	Elateral	Software	£1.6m
directly held	Entuity	Software	£4.9m
	Northbridge Industrial Services	Industrial services	£0.6m
US private –	Yes To	Consumer goods	£9.3m
San Fransisco	Penguin Computing	Technology	£1.5m
Equity Partners managed	ICU Eyewear	Consumer goods	£1.6m
US private – other	Medhost	Software	£8.3m
UK funds	Eden Venture Partners	European technology	£1.1m
	Brockton Capital	Real estate	£4.9m
	Other	Other	£1.4m
US funds	Opus Capital Venture Partners	Early stage technology companies	£3.1m
	Weber Capital	US small-caps	£0.7m
	Other	Other	£0.1m
Cash			£17.7m
Other net liabilities			-£2.9m
Net asset value			£60.3m

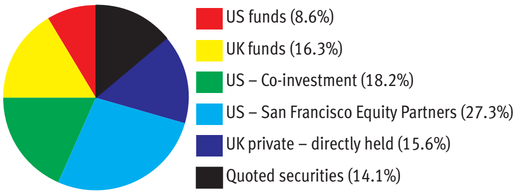
Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments priced at latest market prices. All other assets valued at 31 December 2018. Allowance made in net liabilities for GHAM management fee and LMS Capital operating costs for first half of 2019.

"The £45m portfolio has a bias towards consumer goods, financials, real estate, software and technology"

Realising value from the remaining legacy portfolio

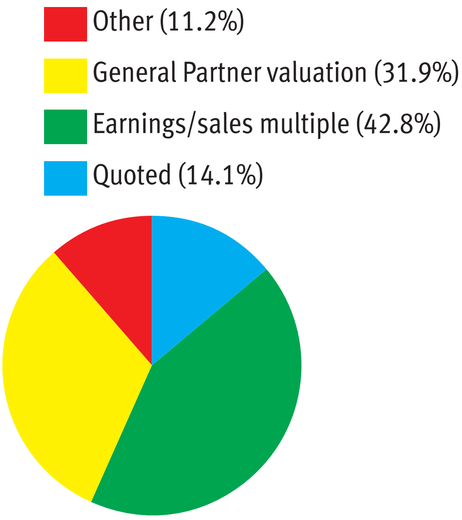
The £45m portfolio has a bias towards consumer goods, financials, real estate, software and technology. This is important to note given the potential to make company specific realisations from these sectors, as highlighted below in the section 'Key realisations to be made from unquoted securities and funds'.

LMS Capital: nature of investment portfolio



Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

LMS Capital: valuation approach



LMS Capital: nature of investment portfolio

Quoted securities	14.1%
UK private – directly held	15.6%
US – San Francisco Equity Partners	27.3%
US – Co-investment	18.2%
UK funds	16.3%
US funds	8.6%

Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

The portfolio also has a weighting towards unquoted securities that are either held in funds, as co-investments or directly held, so it's worth considering how these investments are being valued.

LMS valuation approach

As is common practice in the venture and development capital industry, investments in unquoted companies are structured using a variety of instruments including ordinary shares, preference shares and other shares carrying special rights, options and warrants and debt instruments with and without conversion rights. The investments are held for resale with a view to the realisation of capital gains. Generally, the investments do not pay significant income.

LMS Capital: valuation approach

Quoted	14.1%
Earnings/sales multiple	42.8%
General Partner valuation	31.9%
Other	11.2%

Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

Unquoted securities

Unquoted securities account for £18.3m of LMS's portfolio and are valued using the most appropriate technique such as the price of recent investment, an earnings-based approach, or a discounted cash flow approach. In most cases the valuation method uses inputs based on comparable quoted companies, for which the key unobservable inputs are:

- EBITDA multiples. This metric is the earnings, before interest, depreciation, and amortisation costs and is a proxy for the cash profitability of a company. EBITDA multiples in the range 5 to 9 times are used in valuing LMS's unquoted portfolio and are dependent on the business of each individual company, its performance and the sector in which it operates.
- Revenue multiples. Multiples in the range 0.5-1.5 times annual sales are used and are dependent on each individual investment.

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"Please note that LMS holds investments in funds and unquoted securities through special purpose vehicles"

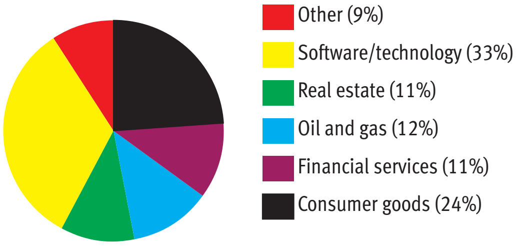
■ Discounts. Discounts of up to 65 per cent are applied to an investee company valuation to reflect the illiquidity of unquoted companies compared to similar quoted companies. The discount used takes into account factors specific to individual investments such as the size and rate of growth compared to other companies in the sector.

Investments in funds

Investments in funds account for £20.8m of LMS's portfolio and are valued using reports from the general partners of the fund interests with adjustments made for capital calls, distributions and foreign currency movements. GHAM also carries out its own review of individual funds and their portfolios to make sure that the basis on which the underlying valuation is made is consistent with GHAM's valuation, knowledge of the investments and the sectors in which they operate.

Please note that LMS holds investments in funds and unquoted securities through special purpose vehicles. In managing the business, it adopts a "look through" valuation across the various internal structures within LMS in order to assess the consolidated external position. The published balance sheet is not a consolidated balance sheet, but is the balance sheet of LMS the company. It includes other intra group assets of £90.2m which nets off other intra group liabilities of £89.8m as well as the external assets/liabilities. This is an accounting issue, and has no bearing on the valuation of the portfolio which, using the latest market prices for quoted holdings, shows that LMS has £45.5m of investments, £17.7m of cash and net liabilities of £2.9m (the latter figure is stated after making an allowance in net liabilities for GHAM management fee and LMS Capital operating costs for first half of 2019) to give a proforma net asset value of £60.3m.

LMS Capital: portfolio sector exposure



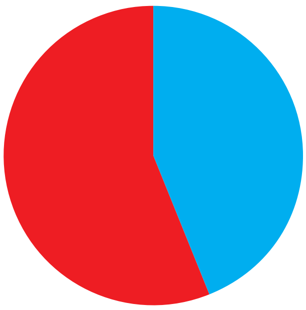
Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

LMS Capital: portfolio sector exposure

Sector	Weighting
Consumer goods	24%
Financial services	11%
Oil and gas	12%
Real estate	11%
Software/technology	33%
Other	9%

Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

LMS Capital: Domicile of investment



Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

LMS Capital: Domicile of investment
The domicile of LMS's portfolio is worth considering because US investments accounted for £25.5m of the portfolio at the end of 2018, and the company does not hedge the currency exposure. That's because the investment manager regards exposure to exchange rate changes on the underlying investment as part of its overall investment return, and does not seek to mitigate that risk through the use of financial derivatives.

Including cash held in US dollar accounts, a 10 per cent strengthening of the US dollar against sterling would have increased equity by £2.8m at 31 December 2018. An identical weakening of the US dollar against the pound sterling would have decreased equity by the same amount. The US investments were valued at the end of 2018 using an exchange rate of £1:US$1.28, the average exchange rate for last year was £1:US$1.33 and the current spot rate is £1:US$1.30.

LMS Capital: Domicile of investment

UK	44%
USA	56%

Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

Key realisations to be made from unquoted securities and funds

The ability of GHAM to recycle cash is dependent on the timing and magnitude of realisations from the balance of LMS's legacy portfolio. Bearing this in mind there is realistic potential for £29.5m of cash realisations in due course from the following six unquoted securities and fund holdings.

Brockton Capital Fund 1 LP

Last year, LMS received total proceeds of £3.1m for its minority shareholding in a private equity real estate investment adviser Brockton Capital LLP, realising a £617,000 gain at the time. The company had originally acquired its minority holding in 2006 when, together with three other cornerstone investors, it backed the establishment of Brockton Capital LLP, and became an investor in Brockton Capital Fund I LP. The investment in Brockton Capital LLP gave the company the right to participate in entities that would receive a share of any carried interest in relation to the performance of Brockton Capital Fund I LP and subsequent Brockton-advised funds. The company still retains its interest in Brockton Capital Fund I LP.

Brockton Capital Fund I LP remaining asset is a super prime residential development site in Mayfair that is under construction with plans to deliver 18 principal and 14 pied-a-terre apartments by mid-2020. In addition, four flats in the adjoining building will be refurbished. LMS is carrying the investment in its accounts at £4.92m, up from £4.6m at the end of 2017, based on the look through interest in the preferred debt position in the development vehicle attributable to the company. It's worth noting that the valuation methodology used is a discounted cash flow model. This means that as the development nears completion the discount embedded in the carrying value of the asset unwinds. This explains why LMS booked £319,000 uplift in 2018 on its interest in Brockton Capital Fund I LP.

Entuity

Operating from London and Boston, US, the UK technology company provides all-in-one network management software to large and medium sized businesses in 45 countries. LMS owns 67 per cent of the equity and invests alongside the founders and management team. GHAM investment team has a seat on the board.

A new chief executive has been driving cost reductions and revenue growth, and the improving operational performance has enabled shareholders' loans to be part repaid in June 2018. The company is evaluating strategic options. The stake was valued at £4.92m in LMS's 2018 accounts using sales/earnings multiple methodology, implying a £1.7m unrealised valuation gain was made in the 12-month period.

ICU Eyewear

Founded in 1997, ICU Eyewear is a global leader in reading eyewear and sunglasses. The company's designs have revolutionized the reading glass industry with fun styles, bright colours and unique patterns at affordable prices. It was the first company to develop and implement a manufacturing process for eco-friendly reading glasses made from reclaimed plastic, recycled metal and sustainable bamboo.

The investment had been completely written off in 2016, but following a restructuring and refinancing, the investment was valued at $1m at the end of 2017 and its carry value has since doubled to $2m (£1.56m) after ICU Eyewear continued to demonstrate its ability to trade profitably.

Medhost

US-based Medhost provides technology services to the medical sector in the US. For instance, it helps companies streamline accounting processes, improve cash flow and patient access, and documentation management.

It is a co-investment with funds of Primus Capital, which LMS has previously had investments in. LMS owns 8 per cent of Medhost's equity and the investment is valued at £8.3m. LMS made an original investment of $5m in 2007 and subsequently received a return of $10.1m in 2013.

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Medhost's 2018 financial performance showed growth in profitability and cash generation. The £103m equity value implied by the carrying value in LMS's accounts indicates potential upside on the basis of comparable transaction multiples in the sector.

Yes To

LMS is the majority investor in a US-based fund, San Francisco Equity Partners (SFEP) which has two remaining investments to sell, one of which is Yes To, a California-based company that develops and sells innovative natural beauty products.

LMS's £8.3m investment in SFEP was revalued upwards in 2017 reflecting the valuation achieved at the time of LMS's partial exit in June 2017 and the ongoing performance of the business which operates in a rapidly growing sector and is run by a well-regarded management team. In addition to the fund investment, LMS has a directly held co-investment in Yes To which is in the books at £927,000. LMS effectively has an aggregate 9 per cent equity interest in Yes To that is valued at £9.3m, implying an equity value of £103m. GHAM's investment team believe that the current valuation of the holding is attractive based on comparable transaction multiples for trade buyers.

Penguin Computing

LMS sold its investment in US technology company, Penguin Computing, in June 2018 and the £1.5m investment in its accounts relates to amounts of sale consideration estimated still to be received from payments due under an earn out arrangement and the release of amounts retained in escrow.

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"It's likely to be more cost effective to split orders into smaller lots to build a position rather than trying to buy in a single order"

Shareholder base

One reason LMS's shares are trading on a large discount to book value is that over three quarters of shares in issue are held by the top 10 shareholders. These include the family of Robert Rayne, who established LMS's investment activities in the early 1980s as investment director, and later managing director and chief executive of London Merchant Securities. He is non-executive chairman of Derwent London plc and a member of LMS's investment committee.

LMS Capital top 10 shareholders

Shareholders	Percentage stake
Rayne family holdings	42.77%
Charles Stanley & Co	10.74%
Armstrong Investment Management	5.88%
Rath Dhu Limited	5.33%
Schroders	3.56%
UBS AG	2.89%
Hargreaves Lansdown Asset Management	2.04%
Smith & Williamson Investment Management	1.98%
Miton Group	1.88%
East Riding of Yorkshire Council	1.53%
Total	78.6%

Source: Source: Gresham House Asset Management, LMS Capital 2018 Annual report. Quoted investments at market prices and other assets valued at 31 December 2018.

That said, LMS shares are readily tradable in bargains in excess of the electronic market size of 7,500 shares and on a bid-offer spread of about 2p a share. Please note though that it's likely to be more cost effective to split orders into smaller lots to build a position rather than trying to buy in a single order.

Target price

LMS's shares trade on a 35 per cent discount to net asset value which compares to an average share price discount of 21 per cent amongst its listed private equity peers. Moreover, LMS has substantial cash backing and liquid quoted shareholdings, so the read through discount being attributed to its £39m private equity portfolio is effectively 61 per cent. That's an extreme discount even for the private equity sector and one that suggests investors are being far too cautious in their view of the company's investment managers being able to make realisations from the legacy investments at or even close to their current carrying value.

There could be news on this front shortly as GHAM revealed at LMS's annual results in late March that it was in sale discussions on assets "that could result in further significant realisation proceeds being received." LMS is due to release a first quarter trading update before the end

"Gresham House has recently bolstered GHAM's investment team with the addition of the Livingbridge VC investment team"

of April. The hint is worth noting as any significant disposal has potential to act as a catalyst to narrow the share price discount to net asset value towards the sector average discount, and even further still given that LMS's cash holdings will then back up a very high percentage of the share price, thus giving GHAM additional cash resources to invest in LMS's new investment mandate.

Bearing this in mind, Gresham House has recently bolstered GHAM's investment team with the addition of the Livingbridge VC investment team. Livingbridge brought its own network and has created additional investment opportunities in the pipeline of unquoted stocks for GHAM to select from. Gresham House announced the acquisition of Livingbridge in the final quarter of 2018, and the timing of that deal explains why LMS didn't deploy any of its cash pile in the second half of 2018, keeping its powder dry in order to take advantage of the investment opportunities in Livingbridge VC's own pipeline. It's only realistic to expect news flow on deployment of LMS's cash pile now that the Livingbridge deal has completed. Although LMS had potential uncalled capital commitments of £3.1m to funds at the end of 2018, Mr Dalwood doesn't expect any to be called.

In light of LMS's attractive valuation, it's worth flagging up that GHAM has impressed Aberdeen Standard Investments to such a degree that Gresham House recently formed a 50:50 joint-venture fund with the global asset manager to adopt the Strategic Public Equity strategy that Gresham House has so successfully deployed for Aim-traded investment company Gresham House Strategic. The point being that LMS investors are getting GHAM's expertise on shares that are trading on a deep discount to net asset value.

So, having considered all the risks outlined below, a rerating of LMS's shares looks in order and I place a realistic 15-month target price of 63.5p on the shares, representing a 15 per cent discount to the last reported net asset value. Offering potentially 30 per cent share price upside, and with solid expectations of further disposals being realised from LMS's legacy investment portfolio, LMS's shares are worth buying.

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Risk assessment

Of course no investment is without risk and there are a number to consider for LMS Capital.

■ Market risk. Economic instability, political uncertainty and low growth in the markets where the company's investments operate create risk as does the potential for lack of liquidity in capital markets.

For instance, deterioration in economic conditions may reduce demand for the products and services supplied by investee companies. Such a negative impact on performance and growth rates may result in lower individual company valuations and lead to a decline of LMS's net asset value and its failure to meet its return targets and investment objective.

■ Volatility in listed equity prices, foreign currency rates and interest rates. LMS doesn't hedge foreign exchange exposure. So, with more than half the investment portfolio held in US assets, this means that it is exposed to movements in the US dollar to sterling exchange rate. Also, the company holds almost 30 per cent of its net assets in cash and cash equivalents that are exposed to interest rate risk.

■ Investment risk. There is no guarantee that investments will perform in line with original expectations or management's plans. Performance may be impacted by competition, regulatory changes or other market developments. And where LMS has only minority stakes in investments it may not be able to influence performance initiatives or exit strategy.

Moreover, poor performance by portfolio companies may result in LMS not meeting its investment return objectives or its realisation and future cash distribution plans. This could impact LMS's net asset value and investors' view of the company's prospects, with a consequent negative impact on its share price.

■ Financial risk. Many of the company's investments produce little or no recurring income and the timing of realisations to provide working capital and liquidity cannot be ascertained with certainty. Also, LMS has made investments in private equity funds which may require further capital contributions, the timing of which cannot be predicted with certainty. LMS regularly monitors this and it had uncalled capital commitments of £3.1m outstanding to funds at the end of 2018, a sum that is comfortably covered by its liquid resources although as noted previously the company doesn't anticipate these commitments being called.

■ Operational risk. Failure of the company's internal

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processes and systems to ensure that it complies with all legal, regulatory and financial reporting obligations would lead to reputational damage and/or financial loss. To mitigate this risk, LMS's Audit Committee, on behalf of the board, regularly reviews the systems in respect of the principal operational risks, as well as reports on the company's related risk management procedures.

- Credit risk. Credit risk is the risk of the financial loss if counterparties fail to meet their contractual obligations and arises principally from the company's receivables and its cash and cash equivalents. LMS limits its credit risk exposure by only depositing funds with highly rated institutions. Cash holdings are held in funds rated 'A' or better by Standard and Poor's.
- Liquidity risk. Liquidity risk is the risk that LMS will not be able to meet its financial obligations as they fall due. Its financing requirements are met through a combination of liquidity from the sale of investments and the use of cash resources. However, with net funds of £17.7m on its balance sheet, and quoted securities worth £6.4m, liquidity risk is not an issue.

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