Dear fellow shareholder,

Electra Private Equity PLC

At nearly 15% of the UK fund, we have a new largest position in Derby Street, so I thought it would be worth setting out the thesis and why we have allowed this concentration.

You will be aware that Realisations (aka Liquidations) are one of the three strategies we invest in, alongside high quality, growing companies and those with hidden assets. We have invested in seventeen Realisations and they have been a source of high returns.

Thesis

Electra will come to an end of its realisation programme this year. It will distribute its final holdings and cash in a form that we can exit within an estimated range of £6.84 to £11.54 per share. Our book cost is £4.13.

History

Electra is a London Stock Exchange quoted investment trust which has existed as a company since 1935 (when it was financing underwater cables – a precursor to the Internet). It came into its present form in 1976 and for twenty five years has been a prominent investor in mid-market buyouts. It suffered a downturn in the Lehman crisis but managed a good record in the following decade. External shareholders pressured it to distribute excess capital from organic realisations and this started in 2016. In 2018 it adopted a policy of complete wind-down and this was when we first invested.

Management

The external pressure was led by an activist company called Sherborne, who have run an effective realisation programme, both minimising Electra's internal costs and working to maximise the proceeds of asset sales. Having an able business partner supports our thesis, as it increases the probability of above-NAV sales prices and of timely capital returns, and decreases the likelihood that a new outside shareholder will halt the realisation.

Realisations to Date

Electra had net assets of £2.07 billion in September 2016 and today this number is just under £200m. It has distributed in excess of £2 billion. Since there have been some buybacks the per share numbers are clearer: an opening NAV per share of £51.49 minus cumulative dividends of £50.25 gives an effective beginning book value of £1.24. This compares to the quarter end market price of £6.32. If you had bought in 2016 and held until now your IRR, including dividends, would be 17% p.a. (Our own experience has been rather better, which I will come to later).

Current Portfolio

Electra effectively has three assets left, TGI Fridays, the American-themed UK restaurant chain, Hotter Shoes, a prominent UK shoe retailer, and a pot pourri of small investments and working capital, which is largely cash. Here is the situation set out in the last report:

31st March 2021

	£m	p per share
TGI Fridays	146	381
Cash etc	32	84
Hotter Shoes	19	49
Net Assets	197	514

Electra has recently announced its endgame. Fridays will be spun off as a separately-traded UK listed company and Electra itself will effectively become the Hotter business, and move to the AIM market. It is unclear where the cash will land. That does not matter to us, as it will stay with one or other company, or be distributed.

To understand the likely range of valuations for these parts let us look at the two operating investments.

TGI Fridays

Fridays was founded in New York in 1965. The UK was the first international offshoot in 1986 and was bought by private equity in 2007. It is is a well-known UK casual restaurant group, selling burgers, cocktails etc with an American theme in 87 locations, widely spread across the country. The complete COVID lockdown was a catastrophe for the sector, especially as many players were more leveraged, had smaller estates and a less established presence on the high street (or shopping centre or retail park) than Fridays. 600 dining sites operated by competitors, or 10% of the pre-COVID total, have closed in the past year. A particularly large number of closures are in the US themed segment (as much as 29%), where institutional capital had funded large-scale, but ultimately unprofitable, growth in the past decade.

Moreover, Fridays' management team have rationalised the cost base to ensure survival and the business is likely to emerge at a higher level of profitability post-COVID (a theme at many of our investees). This, of course, has been an opportune time to renegotiate leases, the fundamental "fixed" cost of a restaurant chain. Post-lockdown demand has been high, already reaching 80% of the former peak by this May. Like-for-like sales in sites open both now and in 2019 have been 12.5% ahead. Management have a pipeline of new sites ready to open, including drive-ins, and have continued to increase the percentage of takeaway and delivery.

Financially, the combination of the above factors mean Fridays is likely to emerge from the pandemic considerably more profitable than before. Based on current trends, turnover is tending towards £250m and EBIT to £31m. Accounting for interest and tax, net profits could soon reach £23m.

Hotter Shoes

Hotter is the largest shoe manufacturer in the UK, possibly an idle boast considering that most domestic capacity has moved to low cost factories in Asia in recent decades. It is however well known as a comfort footwear brand, mainly for females over 55, and has successfully transitioned to an ecommerce first model. It has a customer database of four million (one million active) and 20% of sales are exported, primarily to the US.

Its COVID experience was more violent than Friday's. It was mainly a retail business before lockdown and managed to shrink its shop numbers by 70% through a CVA (an agreed form of creditor concessions, again mainly landlords). Ecommerce is now 68% of revenues and growing fast – 30% growth in the seven months since last October.

By carving out the highly profitable ecommerce division from under the weight of the retail estate, Hotter's management have released a more valuable whole. Regrettably, Electra only reports EBITDA for Hotter, which is as useful as a chocolate teapot. Hotter is owned through a byzantine chain of seven subsidiaries of Electra, but working through the Companies House filings it is possible to find that it had depreciation of fixed assets (mainly shop fixtures and fittings) of £2.7m in 2019. EBITDA was £4.3m then but the above carve out leaves continuing EBITDA of £5.4m and adding some sales growth it grows to no less than £7.3m. Deducting depreciation (which could end up higher or lower than before), interest payable on modest debts and tax, leaves net profits going forward of around £3.2m. Including the much higher sales growth of the most recent period net profits would become around £4.8m.

How could the thesis go wrong?

I discussed this idea a few months ago with my friend Rainer and his first question was, "Do you really want to own a restaurant business and a shoe chain?!" Profound: when we invest in businesses directly, we almost never buy restaurants or retailers. Why? In sum, low barriers to entry, low returns on capital and reliance on debt. It would be a partial defence to claim that we are investing in Electra, a private equity house. We have invested in property companies not actual properties and in a company that funds start up insurance brokerages even though we would never have invested directly in those start-ups. But I must concede that in this situation we are stuck in two industries that are unattractive in principle.

The more nuanced defence to this charge is that this is a realisation. We are partnered with an experienced manager whose job it is to exit positions at or above valuation. They have a very good history of achieving that. Further, our experience of multiple realisations (as well as many investment company situations that were not looking for exits) is that the quality of the owner/investor is as important as the quality of the underlying assets.

Besides, the quality of Fridays and Hotter is rather above average for their industries. It is true that both have net debt, but well within their capacity to service; they both have above average returns on capital; and both are well established businesses that have proved their ability to survive where competitors fell by the wayside.

A bigger problem, at least for Fridays, would be a return to lockdown. While it seems unlikely as I write that restaurants will close again, one cannot rule it out, and this would, at least, reduce the IRR of this investment. Hotter is now more lockdown friendly.

Range of Values and IRRs

This is a very late stage in the life of this realisation. As soon as this quarter, the Fridays holding company will rebrand as Hostmore and be spun out as a fully listed company. Based on our projections for earnings and looking at competitors, it could be worth anywhere from £200m to £350m, once its price settles.

Hotter will remain as the sole operating company within the Electra shell and transfer to the AIM market. It could ultimately be valued at between £30m and £60m (possibly higher if its ecommerce offer continues to fly).

Together with the other assets, principally cash, that gives a final realised value for the whole of Electra of between £262m and £442m, or between £6.84 and £11.54 per share. Our return to date, at an IRR of over 23%, has been good. It has outperformed the average shareholder's experience (who, as we saw, has made 17% p,a.) because we bought and sold to take advantage of the extreme volatility in Electra's share price, particularly in 2020. At one point, our buy price was so low that Fridays was valued at close to zero.

Looking forward, measuring from the share price at the end of the second quarter (i.e. ignoring the gains to date), and assuming a further holding period of between four months and one year, the above range of realised values produces a range of forward IRRs between 8% and over 500%. The latter may seem fanciful but we have often been surprised at the top end by returns from realisations, especially in short periods of time. (And it should be remembered that a very high IRR may simply result from the annualization effect. A 1% return in a week is a 68% IRR but aiming for a 1% return is not terribly sensible in most instances.) In Electra's case, a simpler way to think about this is that our investment (at the current price) could appreciate as much as 80% in the next year and is unlikely to decline. A faster outcome considerably juices the returns. That is a compelling combination.

Conclusion

Why such a big position? As stated in previous letters, we like situations with little downside and manifest upside. Although the two operating companies have some debt, the holding company has plenty of cash and has proven a good steward both during the COVID crisis and over the longer haul. And we have had a number of excellent outcomes from late stage realisations.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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