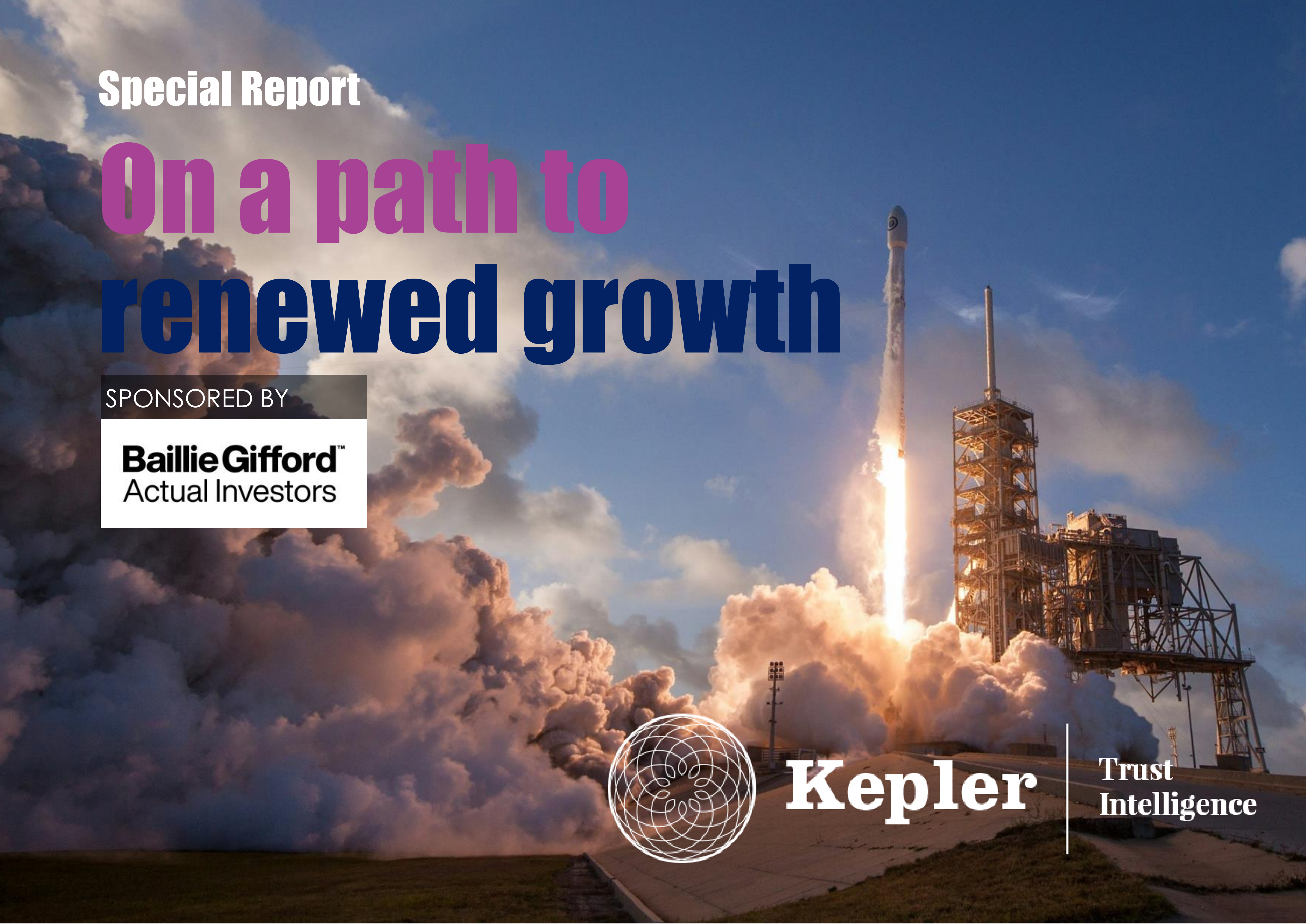
Special Report

On a path to renewed growth

SPONSORED BY

Baillie Gifford™
Actual Investors



Kepler | Trust Intelligence

On a path to renewed growth

EWI portfolio companies are showing clear signs of success..

It was the Microsoft founder Bill Gates who said that most people overestimate what they can do in one year and underestimate what they can do in 10 years. This tends to be true both individually and collectively.

Who would have predicted even five years ago that we would now be in the middle of what many have hailed as the most transformative period for the global economy since the Industrial Revolution? That is, of course, advances in artificial intelligence (AI).

Humanity has been innovating for millennia and continues to reap the rewards. Generative AI is merely the latest piece of evidence of this ingenuity, having come to the public's attention at the start of 2023.

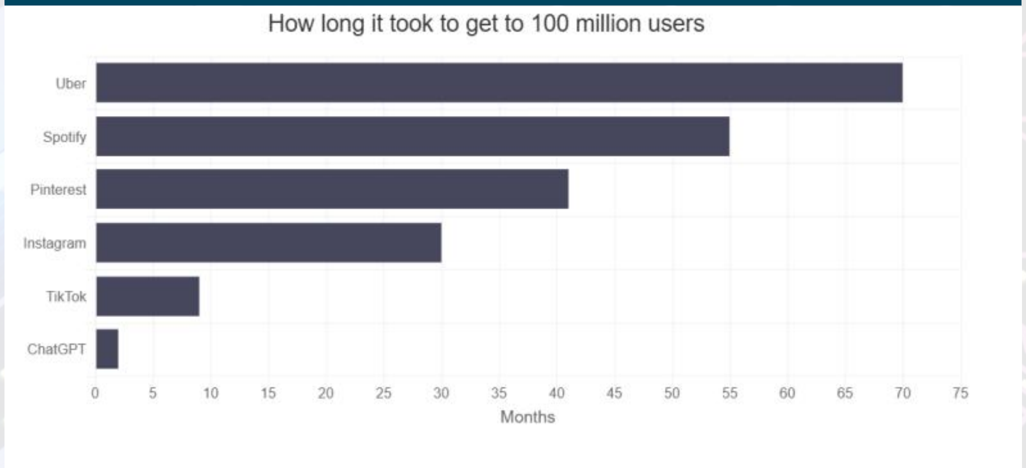
ChatGPT, the leader in the field, became the fastest-growing consumer application in history, gaining 100 million users in just two months. Ever since, investors have been betting big on the so-called 'picks and shovels' AI stocks.

Witness the rise in share prices of semiconductor companies, which make the chips used to power generative AI. Nvidia, for instance, has gone from being a $365 billion company in January 2023 to $3.2 trillion today.

No doubt generative AI has been the biggest invention we've seen since the turn of the millennium, which heralded the internet era, but technology doesn't have a monopoly on innovation. Indeed, healthcare-related industries are just as transformational.

FIG 1: 'Record-breaking ChatGPT'

Source: UBS, Yahoo Finance



>>

Health check

The speed and efficiency with which vaccines for the coronavirus were invented, approved and distributed, as well as popularity of the GLP-1 therapies, or weight loss drugs, are two high-profile examples from the current decade alone.

In fact, medical technology is the technical field to have applied for the most patents in Europe between 2015 and 2022, at 110,886, according to MedTech Europe, ahead of digital communications at 105,884 and computer technology at 100,161. The pharmaceutical and biotechnology fields have been active in patent applications too, sitting in seventh and eighth position respectively.

Moving further down the lifespan of drug development, the number of clinical trials has more than doubled since 2015, with almost half a million carried out in 2024. This would be a record high number of trials in a calendar year.

When it comes to investing in cutting-edge technology, then, technology itself is a key component, but so too are the healthcare and biotechnology sectors.

FIG 2: 'Biotech is an innovative sector'

Source: European Patent Office

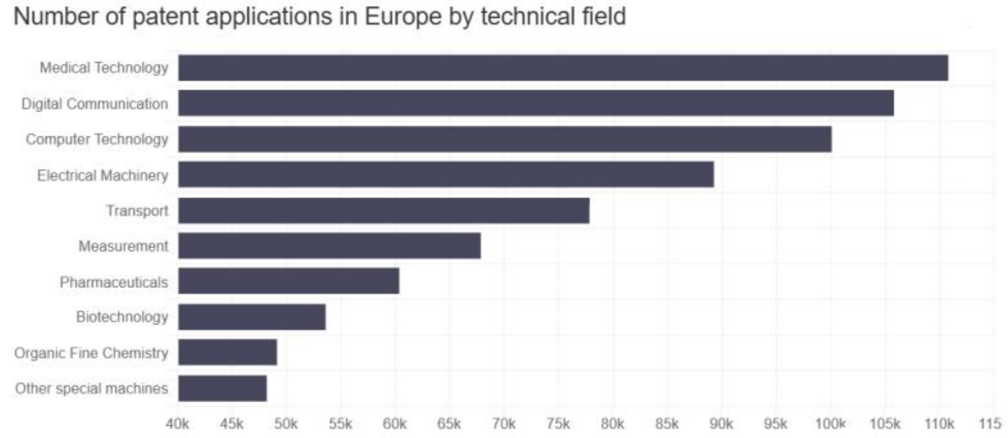


FIG 3: 'Clinical trials have more than doubled'

Source: National Library of Medicine

>>

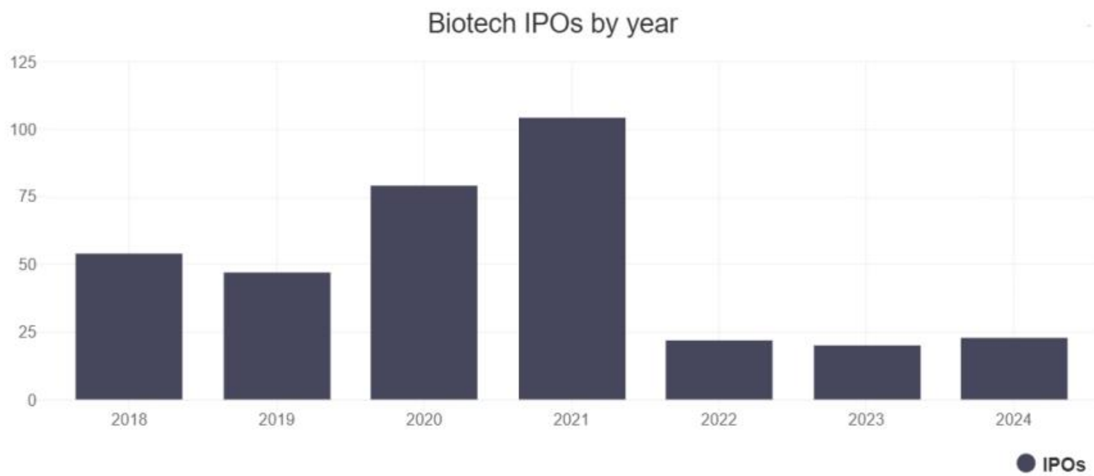
Catalyst for a rebound

For investors, healthcare is an interesting area with a wealth of opportunity. You can find more mature companies that make drugs or sell health insurance, for instance, that offer attractive dividends but arguably more pedestrian growth potential; medium-sized firms in areas such as medical device making and veterinary surgery offer slightly higher potential growth; while smaller-cap names tend to be less profitable (sometimes even unprofitable) but play into more exciting themes and provide the potential for rapid share price gains.

Populations all over the world are getting older, fatter, sicker and richer, making healthcare a potentially enduring investment theme. Yet, as with most areas of the stock market recently, investors have been quite myopic in their focus.

As the so-called Magnificent Seven mega-cap tech stocks have been blowing all other firms out of the water, so have the GLP-1 drugmakers.

FIG 4: 'Depressed Sentiment'



Source: BioPharma Dive

The popularity of weight loss drugs has propelled shares in Novo Nordisk, which makes Wegovy, and Eli Lilly, which makes Mounjaro, to have doubled in the past three years. So, as size becomes safety in the eyes of many investors, small caps have been out of favour, and that's been even more extreme among small-cap healthcare companies.

The benchmark small-cap S&P 600 Index, for instance, provided a 6.3% annualised return in the five years to 29/11/2024, while the S&P SmallCap 600 Health Care Index fell by an annualised 5.7% in the same period of time.

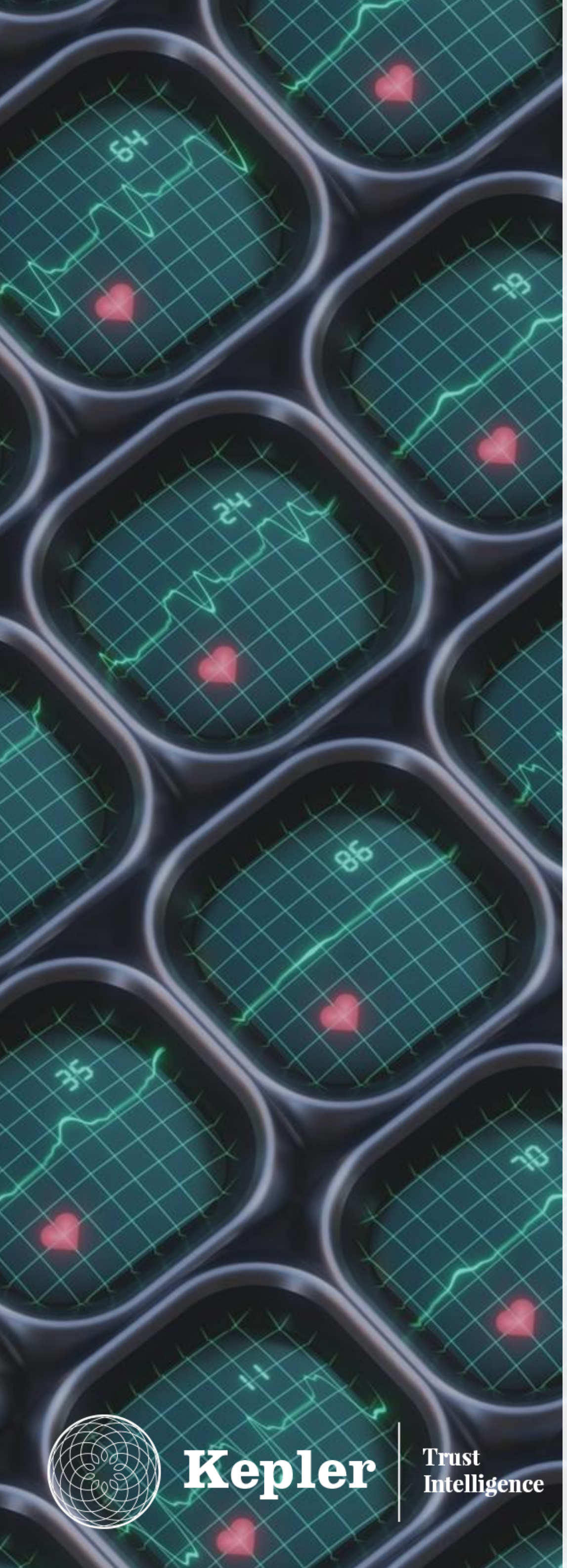
There have been some green shoots popping up for the sector more recently, though. The small-cap healthcare sector is still lagging the broader smaller-company market, but by much less – and absolute returns are finally positive, with a gain of 12.4% made year-to-date.

Initial public offerings (IPOs) are a key part of the biotech industry, as they give young companies the funding that they desperately need to develop their drugs, while simultaneously providing their early-stage venture capital backers with an opportunity to make a return on their investments.

There were 104 biotech IPOs in 2021, according to the news website BioPharma Dive, but the IPO window slammed shut during the following couple of years, with 2022 seeing just 22 IPOs and another 20 in 2023. Last year was low too, with 23 IPOs, but there are plenty in the pipeline, suggesting the window is reopening slowly but surely.

If the US, and by extension the global, economy can skirt a recession, and interest rate cuts continue to come, smaller companies should be set fair for a period of outperformance, with small-cap healthcare and biotechnology potentially leading the way.

>>



In at the ground floor

Fortunately, the investment company wrapper makes it easy for investors to get exposure to healthcare stocks in a number of different ways. The most obvious way is by investing in one of the investment trusts that reside in the AIC: Healthcare and Biotechnology sector.

Companies such as Bellevue Healthcare (BBH) and International Biotechnology Trust (IBT) provide specific exposure to small-cap healthcare and biotechnology stocks while offering the potential for an unexpectedly good stream of income by paying dividends out of capital.

The obvious problem with buying an investment trust solely dedicated to healthcare stocks is that there's no diversification: even if it only accounted for a small part of your overall portfolio, your hopes for that holding are pinned on one inherently volatile sector.

Small-cap healthcare and biotechnology investing isn't for the faint-hearted. Discovering the innovative, life-changing medicines needed requires substantial investment. In 2022 alone, the global pharmaceutical industry spent around $244 billion on research and development (R&D). That's expected to hit $300 billion by 2028.

Listen to our recent podcast with EWI:

Diversification

Perhaps a better way to play the healthcare theme is through a generalist investment company that can combine a focus on healthcare innovation alongside innovation from other sectors, such as technology.

One trust that fits the bill is **Edinburgh Worldwide (EWI)**, a truly diversified global portfolio of immature, entrepreneurial smaller companies. These are firms that are addressing a wide variety of societal and business problems, often using new technology or novel business practices to do this.

The entrepreneurial companies that EWI invests in are highly innovative and there are plenty of exciting themes running through the portfolio. No more so than healthcare, which accounts for a chunky 40% of the total portfolio.

As you have seen through this article, this focus on small-cap healthcare has been a headwind for EWI over the past three years. Many of the stocks that it invests in have been knocked off course by the effects of the pandemic and lowered R&D budgets due to inflationary pressure.

Yet co-managers Douglas Brodie, Svetlana Viteva and Luke Ward retain their conviction in the potential for long-term novel treatments. Indeed, more and more of the innovation within the sector comes from smaller, nimbler competitors than larger incumbents.

There are early signs of a return to healthcare growth, and it now seems as though the negative impact on R&D budgets was a temporary phenomenon, rather than a long-term slowing of growth.

This changing sentiment has already started to shine through, with Shockwave Medical, which makes cardiovascular devices, having received an acquisition offer from Johnson & Johnson. The resulting multiple was nine times EWI's entry price.

>>

For those companies remaining in EWI's portfolio, the most important thing is the clinical and commercial progress that they deliver. Happily, many are showing clear evidence of success.

Alnylam, for instance, reported positive test results for its drug vutrisiran, which treats patients with a rare but deadly heart-stiffening disease called ATTR amyloidosis with cardiomyopathy. If vutrisiran gains regulatory approval, it could generate between $2 billion and $4 billion in annual sales for a company whose total revenues currently are $1.5 billion a year.

No one-hit wonder

EWI is by no means a healthcare play, though. The biggest sub-industry within the portfolio is software, followed by aerospace and defence, with top holdings in the portfolio including the spacecraft designer and maker SpaceX and the military tactical drone maker AeroVironment.

One such exciting and innovative company within EWI's portfolio is PsiQuantum, which aims to launch a quantum computing (QC) system with practical uses before the end of the decade. If it can succeed, it would give PsiQuantum first-mover advantage in a market that the consultancy McKinsey has predicted to be worth up to $131 billion by 2040.

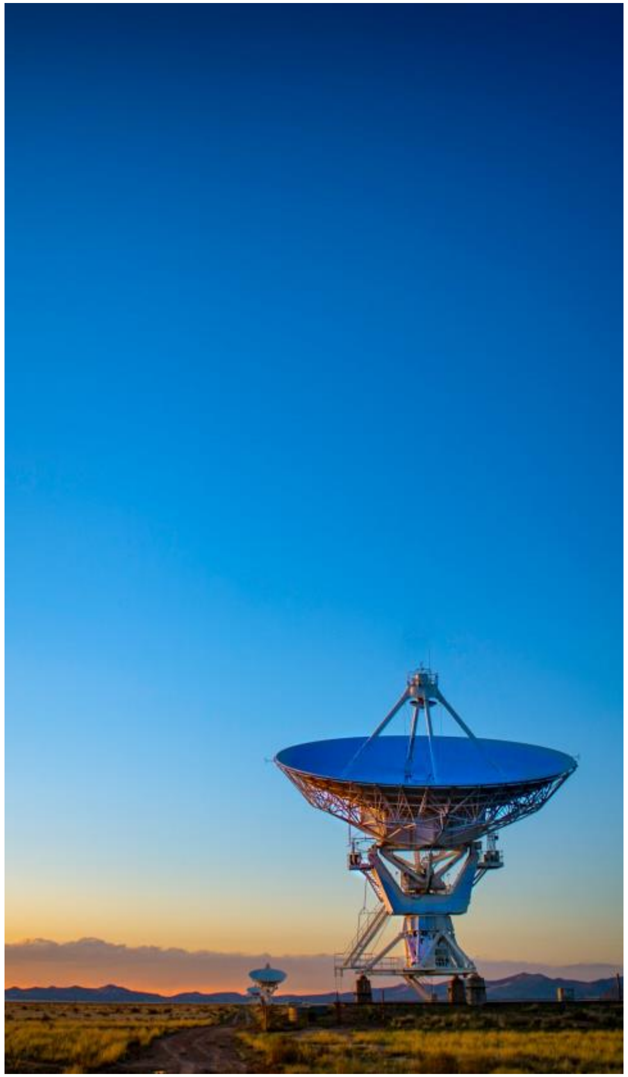
QCs can model the world in much greater detail than classical computers, but researchers have historically struggled to scale the technology for various reasons. They could result in faster development of new medicines and lead to better energy systems and fertilisers, among a host of other advances.

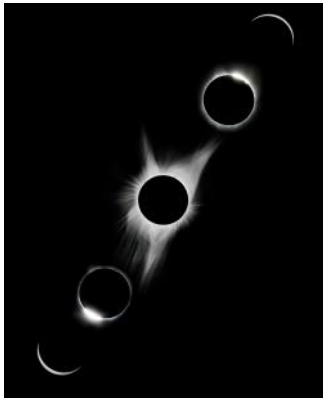
SpaceX also saw a third successful test launch of its next-generation Starship rocket, as well as further growth in the constellation of Starlink satellites.

The case for private companies

EWI's managers look for smaller companies early in their lifecycle. Crucially, EWI's investable universe isn't restricted to only publicly listed companies – the managers can invest in private businesses, too.

Private companies accounted for 26.4% of EWI's portfolio as of 31/08/2024. Both PsiQuantum and SpaceX were first invested during 2019, with the Fortnite maker Epic Games added in 2020, among others. EWI has reduced deployment into new private investments in the past two years as it reached its private company capacity limit. It now prioritises supporting its existing businesses through follow-on funding.





>>

The private company part of EWI's portfolio provides exposure to areas that are hard to access for investors in public companies. As well as quantum computing and space infrastructure, EWI is invested in blockchain, nuclear innovation and the metaverse.

Many of these areas offer opportunities for structural growth. The space launch services market is expected to grow from $15.3 billion in 2023 to $43.9 billion in 2032, while the global nuclear fusion and advanced materials market is forecast to grow from $1.7 billion in 2035 to $6.8 billion by 2040, compound annual growth rates of 12.4% and 31.6% respectively.

It's no surprise that a lower proportion of EWI's private companies are cash-positive than EWI's public companies because they tend to be at an earlier stage in the innovation curve. Despite this, EWI's private companies are of a similar size to the public companies in the portfolio. This is a reflection of the large but nascent opportunities they are aiming to seize.

Private companies are valued much less frequently than public companies, where the stock market puts daily values on each firm. Importantly, though, EWI has a robust valuation process for its private portfolio that aims to reflect the price that would be paid in an open-market transaction for that holding.

TABLE 1: 'EWI's portfolio by size'

Source: Baillie Gifford

	Public (%)	Private (%)
Micro (<$300m)	4	2
Small ($300m-$2bn)	36	25
Mid ($2bn-$10bn)	40	29
Large (>$10bn)	20	44

All holdings are revalued every three months and at certain trigger events by the valuations team, with external challenge and regular independent auditing. In the 12 months to 30/04/2024, EWI's 27 private companies were revalued 159 times.

Correcting course

The early-stage companies that EWI focuses on have a higher proportion of their potential profits further into the future (what some call 'long-duration equities'). As a result, their share prices were hit hard as inflation boomed and central banks hiked interest rates steeply. EWI's shares were down as much as 70% from their 2021 peak to their 2023 trough.

All told, EWI's net asset value total return in the five years to 30/11/2024 has been -3.8%, well below the 53.8% gain from its S&P Global SmallCap Index benchmark, an undoubtedly disappointing outcome for shareholders.

It's worth noting at this point the attempt from the activist investor Saba Capital Management to requisition a shareholder meeting aimed at installing its own directors (Saba partner Paul Kazarian and principal at private investment firm JOAD Investments Jonathan Zucker) onto the EWI board.

We would make two points. Saba highlights the "persistent trading discounts" that EWI and its other six targets are trading at, noting in particular EWI's three-year average discount to NAV of 12.9%. Yet, EWI's shares currently trade at par.

EWI's chairman recently urged shareholders to resist Saba's efforts to overhaul the board, telling The Times: "I see Edinburgh Worldwide as offering huge opportunities to all its shareholders and I am determined to ensure that can continue."

Indeed, the EWI board has already leapt onto the front foot, announcing a raft of changes aimed at getting EWI back onto a path to renewed growth, which have already been approved by shareholders.

Importantly, the investment strategy remains the same, with the board still enthusiastic about and committed to EWI's vision and strategy in identifying these game-changing businesses, including those from the private space, under the management of Baillie Gifford. The one management change made was the promotion of Luke and Svetlana to co-managers alongside Douglas.

Elsewhere, the number of holdings allowed within the portfolio has been reduced to a range between 60 and 100, down from 75 and 125 previously. It is hoped that this will ensure that the portfolio will remain streamlined and make it easier for the managers to scrutinise and manage existing holdings.

In addition, the maximum market capitalisation limit at the point of initial investment of an investee company has been increased to match the largest constituent of the S&P Global SmallCap Index. The rationale for this change was that the previous maximum market cap was set at $5 billion 10 years ago. Today, the largest company in the S&P Global SmallCap Index is MicroStrategy, which has a market cap of c. $67 billion.

>>

Finally, the board has committed to returning up to £130 million in capital to shareholders in 2025, enhancing the share buyback programme the board embarked upon in 2024, which has been value accretive and helped get EWI back to trading at a premium, currently of c. 3%.

Powerful tailwinds

We think that it's worth recalling the stellar performance that EWI's managers achieved in the pre-2021 period. EWI's share price total return outperformed its benchmark index's gain by c. 300 percentage points between 01/02/2014 and 31/01/2021.

Remember, too, that the forces that served to hold EWI back in the intervening time look set to recede. Indeed, some potentially powerful tailwinds seem to be re-emerging, which the managers believe will lead to strong returns for those patient shareholders who have kept the faith.

First, if rising interest rates were a headwind to performance, it stands to reason that falling interest rates should be positive for performance (remember, the US Federal Reserve cut rates by 100 basis points in 2024, with more expected this year).

Second, sales growth slowed during the second half of 2021 and through 2022 as many of the themes within EWI's portfolio faced operational challenges or reduced demand (think: online platforms whose sales compare badly to their lockdown performance or financial services firms adjusting to higher interest rates).

Now, though, growth is reaccelerating and projections for revenue and earnings growth for EWI's holdings are notably ahead of the S&P Global SmallCap Index. In fact, many holdings have emerged from pandemic-related disruption operationally strengthened and are now taking market share.

In addition, portfolio companies have been refocusing on value-enhancing growth while still reinvesting in their businesses. This has shown through in capital expenditure and R&D spending ratios that are more than four times higher than the benchmark. Alongside this, the managers expect 20–25% of the portfolio to display increasingly mature financial returns over the next 18–24 months, potentially lifting performance.

Despite this increasing financial maturity, the managers are at pains to point out that pre-profitable firms, with attractive business models and enough cash-generating potential to support their growth plans, will remain an important part of the portfolio. To hammer this point home, 10 of the top 15 contributors to EWI's performance over the long term have been unprofitable at the point of purchase, including, most notably, Tesla.

Often, the patience of EWI's management and their ability to embrace uncertain outcomes creates the clearest opportunity to outperform.

EWI already benefits from tapping into some powerful and enduring structural trends, whether that's the need for better healthcare, the AI revolution, a breakthrough in quantum computing or further advances in space exploration.

Allied to this, recent market moves have left small caps at their cheapest compared to large caps since 1999, a point after which we saw a decade of small-cap outperformance. Any narrowing of this discount, and/or a re-rating of early-stage companies that deliver on their investment case, would be huge tailwinds for EWI.

Read more about Edinburgh Worldwide Investment Trust

>>

Watch our recent webinar with EWI:

IMPORTANT DISCLAIMER

This report has been issued by Kepler Partners LLP. The author of this report is aware that Kepler Partners LLP has a relationship with the companies covered in this report and/or a conflict of interest which may impair the objectivity of the research.

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided here is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. The information contained here is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

Disclosure – Non-Independent Marketing Communication This is a non-independent marketing communication commissioned by Baillie Gifford. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.