Gabelli Value Plus+ Trust

Update
28 August 2019

Summary

With exposure across the market cap spectrum, and a disciplined proprietary value investment philosophy, the Gabelli Value Plus+ trust offers a differentiated investment solution and portfolio to a typical US equity vehicle. Using the proprietary Private Market Value with a Catalyst™ investment process that focuses on both the intrinsic value and strategic premium that a company offers a potential purchaser, the managers seek to identify companies which are trading on a substantial discount to the price which an informed buyer would pay for an entire business in a negotiated transaction. In addition to this, they seek to identify a catalyst(s) to realising this value, looking at a variety of factors or potential drivers of a rerating. These can be company specific or relate to the industry at large.

Historically, Gabelli's forty plus years running this investment process has provided attractive downside protection characteristics whilst offering a relatively idiosyncratic returns profile. Whilst the trust itself has a relatively short track record, having only been launched in February 2015, Gabelli as a firm has been operating with the same investment philosophy since 1977, with annualised CAGR outperformance of c. 4% relative to the broad equity universe, using the S&P 500 as representative.

Since launch, the trust has generally demonstrated an ability to protect capital against market drawdowns. It has also shown a reasonable degree of correlation to value strategies, in line with the investment proposition.

The focus on bottom-up analysis often leads the team into stocks with low levels of broker coverage in the smaller cap areas of the market. Around 10% of the long-term portfolio has historically been invested in companies that eventually became the subject of takeover bids (consistent with the focus on evaluating the value of a company to its 'Private Market Value').

Whilst the portfolio is differentiated from the wider US market in any event, further differentiation is afforded with the option of investing a portion of the portfolio (currently around 10%) in merger-arbitrage opportunities, where companies are the subject of takeover bids and tend to trade just below the takeover offer value until consummation; returns from these opportunities are uncorrelated to wider market movements.

The trust focuses on total return rather than generating an income, so distributions are not guaranteed; income generation is likely to be a side-effect, rather than an aim of investment.

With investors continuing to favour highly liquid, large-cap secular growth opportunities, the trust has remained at a discount to NAV in its recent history; currently this is around 7%. The board has previously been active in buying back shares to try and manage this, and a tender offer is currently being considered. The tender offer will be for up to approximately 14.99% of shares outstanding, but, as this was only announced on 31.07.2019, full details are yet to be confirmed.

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Pascal Dowling
+44 (0)203 384 8869

Thomas McMahon, CFA
+44 (0)203 795 0070

William Sobczak
+44 (0)203 598 6449

Callum Stokeld
+ 44 (0)203 795 9719

Portfolio

Gabelli Value Plus+ focuses on investment in US companies with a disciplined value approach first developed and implemented via the firm's older investment strategies in 1977. Whilst value remains a key component of the team's investment thesis for any particular stock, the process also emphasises identifying a catalyst to a stock re-rating which will allow the inherent value to be realised over time.

The team frames their value assessment on the value to an informed buyer of a company. If they can identify a company trading below this value, they then seek to identify a catalyst for a re-rating. The 'Private Market Value' is deemed to be the sum of the intrinsic value of company and the strategic premium it would offer to a potential buyer. This process is the proprietary Private Market Value with a Catalyst™ methodology developed and institutionalised by Mario Gabelli, the Chief Investment Officer.

Returns are very much focused on absolute performance, with little reference to the wider benchmark indices. This is reflected in the highly-differentiated portfolio, which shows an active share of over 98% to the Russell 2000 Value Index (as of 30/06/2019). The objective of the trust is to maximise total returns, with a minimum of 10% p.a. returns in real (inflation-adjusted) terms target.

With a weighted average market cap of only $16bn compared to $243bn for the S&P 500, the trust has a significant skew towards smaller-cap opportunities. The managers note that smaller companies typically have greater long-term growth prospects, but also that there is much less broker analyst coverage for smaller-cap companies relative to their larger peers. This situation has been accentuated in recent years by the withdrawal of analyst coverage of smaller companies by many of the major banks in the US. Alongside this, the managers note that smaller companies are more likely to be subject to takeover bids or other aspects of financial engineering that can act as catalysts for realising values.

The focus on returns in an absolute sense (as opposed to relative to the wider index), coupled with the value process, tends to lend the trust relatively defensive characteristics as compared to the wider market. As we illustrate in the performance section, this approach is backed up by the numbers since the trust launched. The managers note that historically most of their outperformance has come in periods of falling markets (whilst the long term Gabelli strategy has also performed broadly in line with the wider market during periods where the market was rising since launch in 1977).

Stocks are assessed as to their worth to a strategic buyer were they to attempt to purchase them in a negotiated transaction. Idea generation is derived from a large analytical base of over 40 analysts undertaking stock research. If a company is trading at a significant discount to what the analyst deems to be its private market value, they deem it to have the requisite margin of safety demanded of a value investment, in line with the traditional Graham & Dodd value investing philosophy. The team generally will not include any stock which does not in of itself offer at least a 30% discount to the deemed private market value at the time of purchase; conversely, selling discipline focuses on exiting stocks when a catalyst materialises and stocks subsequently reach or exceed their identified private market value.

Catalysts for stock re-ratings can be either 'hard' or 'soft'; 'hard' catalysts are likely to relate to a stock specifically, whilst a 'soft' catalyst may relate more to wider sector or macro observations (such as the likelihood of sector consolidation). These catalysts cover a wide range of potential scenarios, from spinning off divisions to regulatory changes or industry consolidation. Overall, the managers are looking for a spread of different catalysts to be realised over a variety of time periods.

Stock analysis focuses heavily on the intrinsic value of a company, undertaking detailed analysis of assets and items both on and off the balance sheet. Other factors, such as cash flows, are considered, but particular emphasis is placed upon identifying 'strategic values' which are not adequately recognised by the wider market. As well as the replacement value of company assets this also accounts for less tangible factors, such as the competitive position of the company. A key aim is to avoid acquiring positions in poor quality companies solely because the stocks are optically cheap.

Although potential M&A targets are only one factor that the analysts seek to identify, companies which are potential takeover targets have comprised around 10% of the portfolio on average; a recent example of which was their holding in Allergan. The managers had identified this as a stock with more than one potential catalyst to a rerating, which was trading on a relative discount to the rest of its sector. Whilst the wider pharmaceutical sector has some soft catalysts in place, with incentives for consolidation and regulatory changes, Allergan could also have conceivably spun-off one or more of its product lines to best realise returns for shareholders.

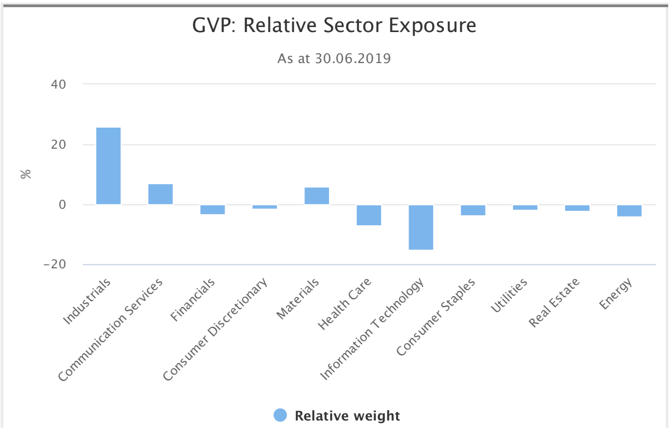
Gabelli as a house also have extensive experience in merger-arbitrage, and this trust is lent further distinctiveness by its incorporation of this strategy as a component of the trust. Where an agreement has been reached for a company to be taken over, the trust may take a short-term position (usually lasting 60-90 days prior to the deal being finalised). During this period, share prices will often trade slightly below the agreed takeover price over due to factors such as potential regulatory risk and the risk that shareholder approval is not forthcoming. By exploiting these small disparities in deals likely to be finalised, the trust managers expect to generate a rate of return of around 200-300bps over 3-month LIBOR.

This has historically comprised around 10-30% of the portfolio, though exposure has been towards the lower end of its historical range as market volatility during Q4 of 2018 offered more attractive long-term positions. The retained shorter-term holding should, however, continue to provide a source of returns with no to low correlation to wider equity markets, improving portfolio diversification and lowering volatility.

Current portfolio & positioning

As has often been the case in recent years, the value focus embedded in the investment process has resulted in the trust having a significantly underweight position in technology companies relative to the broad stock market, and a significant overweight in industrials.

Fig.1: Sector Allocation



Source: GAMCO & S&P

The portfolio has become more concentrated in recent months, with the number of stocks having been reduced to 82. This is not due to a paucity of ideas in the investment universe, where the managers believe the opportunity set remains wide, but a conscious decision to increase conviction in their best ideas. Around 33.5% of the portfolio is held in the top 10 stocks, with a noticeable tilt towards smaller companies relative to the wider US market.

Currently one of the highest conviction positions is in Herc Holdings, a spin-off of the Hertz car rental business. Herc operates in the equipment rental sector, an industry worth over $50billion annually in the US. In the post-2008/09 world its business model has changed, and equipment rental has become more much diversified and deep. Customers now lease a much greater amount of equipment, including smaller tools which previously they would have bought. The sector is growing by c. 5% p.a., and Herc is undertaking improvements to operational efficiency with the aim of increasing EBITDA margins towards a more industry competitive c. 45% from a current level of c. 34%. Research coverage is fairly low, with less than 12 brokers covering this stock.

Whilst market sentiment towards this stock is facing headwinds from a perceived risk of economic slowdown, the company itself is highly focused on the outperforming US economy, whilst a high percentage of its business is focused on maintenance and repair work. The managers see substantial embedded value in this stock, attaching a PMV (private market value) of c. $88 in 2020, with the stock currently trading at $39. With the equipment rental sector highly fragmented, the managers believe Herc could represent an attractive takeover target in the event of consolidation (presently Herc has the third-largest market share). Gabelli has held this stock since it was spun off in June 2016, and added to the position into market weakness.

Gearing

The managers have the ability to gear the trust to 15%, but have not yet availed themselves of this facility. They believe the structural advantages of a trust format are, in large part, the ability to access less liquid small cap opportunities, as opposed to the ability to gear market returns.

Returns

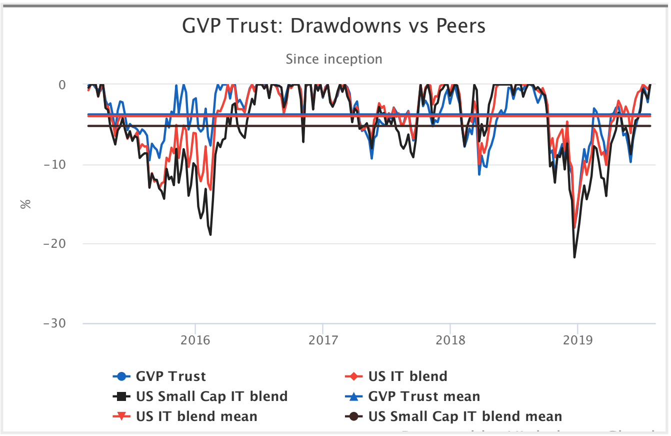
As discussed in the portfolio section, the investment process is a duplication of an older strategy operated by Gabelli since 1977. Over this period, the Gabelli All Cap Value strategy, run according to the same methodology, has provided a compounded annual growth return of 15.6%, well in excess of the S&P 500 CAGR of 11.6% (Source: Gabelli).

The managers have identified that their focus on ensuring there is a margin of safety, their focus on high quality businesses, and on returns in an absolute sense have helped to ensure the strategy tends to outperform on the downside. This has been borne out by returns since inception of this trust. The graph below shows the maximum drawdown on an ongoing weekly basis for:

- The Gabelli Value Plus+ Trust (blue lines)
- An equal weighted (at time of investment) blend of all AIC Investment Trusts investing in the US stock market (red lines)
- An equal weighted (at time of investment) blend of all AIC Investment Trusts investing in smaller companies in the US stock market (black lines)

The further from 0% the line is, the greater the fall from the peak for each portfolio.

Fig.2: Drawdown



Source: Morningstar

Clearly stylistic considerations have affected returns at various points over this period, but it can be observed that the Gabelli trust has successfully mitigated the downside on average more successfully than its peers. This is despite the fact that the broader peer group contained a diversity of strategies operating different investment propositions, which should have offered diversification benefits.

The period since launch has been a challenging one for 'value' investment strategies, with wider market sentiment focusing generally on secular growth opportunities. Over the same period, small-cap strategies have also struggled relative to large-cap strategies, with these factors proving twin headwinds to the Gabelli trust.

In the table below we can see the average rolling R2 of the trust's NAV to large-cap US equities, to small-cap US equities, and to 'Value' style US equities. The higher the number, the greater the correlation of returns on average. What this would suggest is that generally the trust has provided relatively idiosyncratic returns, but also that generally it has shown greater correlation to value factors (on 71% of data points this has been the case). In a challenging period for value investing, this has been a headwind.

R2 To US Indices

	TO US LARGE CAP	TO US GROWTH	TO US SMALL CAP	TO US VALUE
Gabelli Average R2	0.32	0.32	0.37	0.40

Source: Morningstar

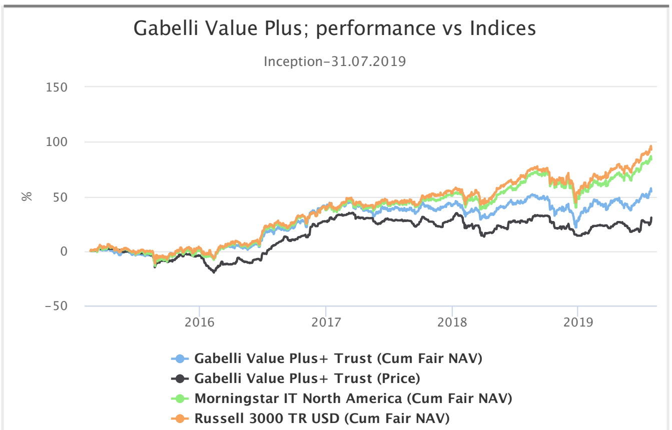
Value has fairly consistently underperformed growth since the trust launched, as can be seen in the graph below. This shows the relative six-month performance of a value-style US equity index against a growth-style index over the past 15 years; when the line is above 0%, it indicates that value styles have outperformed. The period from six months after the launch of the Gabelli trust is in blue; as can be seen from the relatively few and constrained periods of value outperformance, this has not been an environment conducive to outperformance for the trust.

Fig.3: US Value Relative Performance To Us Growth

Source: Morningstar

This has been reflected in the NAV performance of the trust, which has lagged the wider market with NAV returns of c. 54% compared to 92.7%

Fig.4: Since Inception

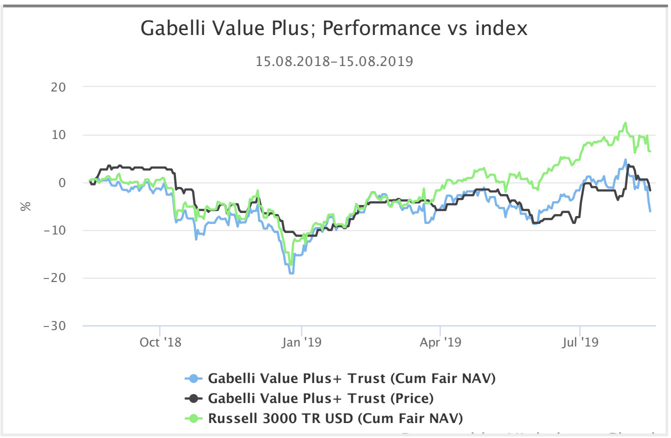


Source: Morningstar

Over the past year, the trust performed broadly in line with the wider market; however, as the market rally seen thus far in 2019 accelerated, investors have once again preferred highly liquid, large-cap growth strategies, and the trust has lagged accordingly.

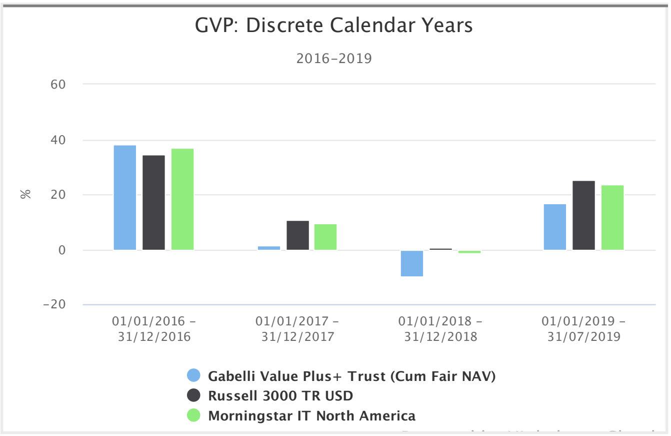
Whilst a value rebound in 2016 was helpful to performance, 2017-2018 proved challenging. Year-to-date the trust initially participated in the market rally, but has since lagged somewhat as investors increasingly took imputed continued bullishness from the US Federal Reserve.

Fig.5: One Year



Source: Morningstar

Fig.6: Discrete Calendar Year Performance

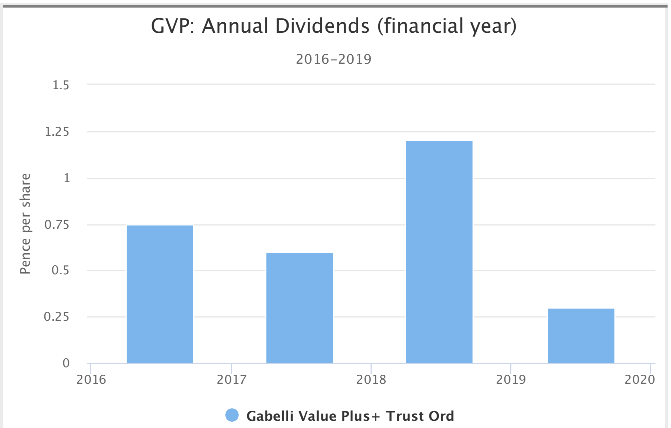


Source: Morningstar

Dividend

Dividends are regarded by the managers as a component of the total return, albeit they are likely to comprise a smaller element of returns to shareholders than returns from capital. Dividend streams are incidental, however, rather than targeted, and are likely to be variable.

Fig.7: Dividends



Source: AIC

Management

The management team is led by Mario and Marc Gabelli, who are supported by a team of six other portfolio managers and over 40 research analysts, between whom there are more than two centuries of professional experience.

GAMCO was founded by Mario Gabelli, who pioneered the "PMV with a Catalyst™" approach, in 1976 as an institutional research firm. It is now a publicly-listed company in the US that employs roughly 200 individuals, oversees assets worth c.$40bn and manages around 2,000 separate accounts for institutions and high-net worth individuals. It runs over 30 open-ended funds and 16 closed-ended funds, making it one of the largest closed-ended players in the US, with c.$7.5bn AUM. Outside of the US, it has offices in London, Tokyo and Shanghai.

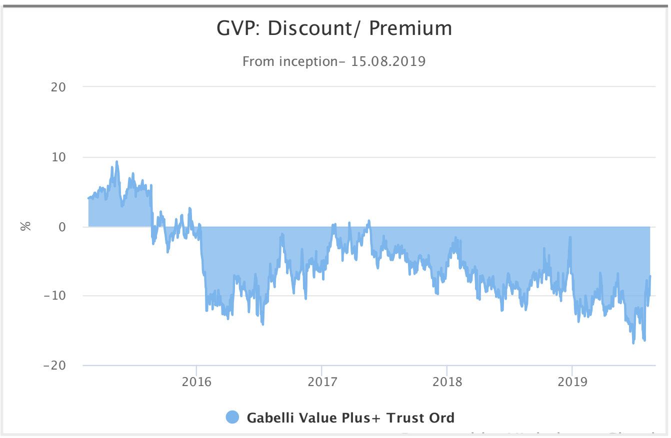
Jonathan Davie has recently notified the board of his intention to step down as a Director and Chairman of the company when a suitable replacement is found. The board is strengthened by the addition of Christopher Mills, founder and CEO of Harwood Capital, as a new independent director since Summer 2018 and confirmed at the 2019 AGM. Given this is GAMCO's first major venture into the UK market, we believe having such an experienced pair of hands chairing the trust can only be a positive.

Though not particularly well-known in the UK, Gabelli is in 'household name' territory across the Atlantic. GAMCO Investors, which is the investment manager for the trust, was launched by veteran value investor Mario Gabelli in the mid-1970s and has grown to be one of the leading fund management groups in the US with assets of $40bn under management and roughly 200 investment professionals on the rota.

Discount

The discount on the trust has remained stubbornly high at around -7.2%, but steps are being undertaken to try and narrow it. Over the previous financial year, ending 31st March, the company bought back 244,308 shares in total at an average price of £1.26, with these shares held in treasury. Since then, they have purchased a further 1,294,500 shares at an average price of £1.26. We observe that recent buybacks have come when the discount widens beyond 13%. The company is able to purchase up to 14.99% of shares in issue (excluding treasury shares). The company recently announced that a tender offer for up to 14.99% of shares in issue is also being mooted at this current time.

Fig.8: Discount



Source: Morningstar

Charges

The OCF on the trust is 1.36% with management fees of 1% based on market price. Management fees are taken 75% from capital and 25% from income. The size of the trust (with net assets of £134.5m) means that the OCF is amongst the higher in the sector, and compares to an AIC North American sector average of 0.98% (though this figure is skewed by a very large low outlier). The KID RIY figure is 1.47%, compared to a sector average of 1.37%, although we caution that methodologies vary.

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