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UNQUOTED TRANSACTION: FOLLOW-UP QUESTIONS

Mitchell Fraser-Jones, 6 March 2019

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.

As announced last week, the LF Woodford Equity Income Fund (the fund) has recently transferred some of the portfolio's individual unquoted stocks to Woodford Patient Capital Trust (the trust) in exchange for shares in the trust.

This is the conclusion of almost eighteen months of work. We first discussed the concept of moving the equity income fund's unquoted exposure to a position in the Woodford Patient Capital Trust, in late 2017. It has been a lengthy process involving numerous parties to ensure that it has been executed in an appropriate way and that it is in the best interests of investors on all sides.

We want the fund to remain exposed to this part of the asset class because it represents a very exciting and compelling investment opportunity. We have helped to build some very impressive businesses within this part of the portfolio. Some remain at a relatively early-stage of their development but are making tangible progress on the road to commercialisation. Others are well-advanced on that journey and are now at a stage where a stock market listing in the near future would appear appropriate. Not everything has gone according to plan but, in aggregate, the unquoted part of the portfolio has added meaningfully to the fund's performance since launch, and we are very confident that it will continue to add significant value.

The transaction signals the start of a strategy to switch the fund's unquoted exposure from individual holdings to shares in the trust. You can read more about the transaction in the original blog post, but we wanted to take the opportunity to answer some of your follow-up questions.

How was the transaction valued?

Woodford is the investment manager for both the fund and the trust. Link Fund Solutions is the ACD/AIFM for both products and is responsible for the valuation of all unquoted holdings in both products. The unquoted valuation process is completely independent of Woodford and is line with International Financial Reporting Standards and International Private Equity and Venture Capital Valuation Guidelines. Unquoted valuations are revisited every six months, or more frequently if milestones are reached, further funding is raised or if other relevant events occur. Link utilises the services of IHS Markit, an external independent valuer, in this process.

The valuation of each co-held asset is therefore the same in both products. It is our agreed policy with Link and Northern Trust (as Depository), that if an asset is to be transferred between mandates, the most recent valuation point must be less than two months old.

In light of the above, all of the five assets had been revalued by Link and IHS Markit within the two months prior to the transaction. As is required under the Companies Act when acquiring new shares for non-cash consideration, the assets transferred have to also be independently reviewed by an appropriately qualified and independent auditor. Duff & Phelps was appointed by the WPCT Board to carry out a review of the valuations of the the assets being transferred. It subsequently confirmed all five valuations were fair and reasonable.

Who represented WPCT shareholders interests during the negotiations?

The trust's Board represented the interests of its shareholders throughout the period in which this transaction was being discussed and agreed. Susan Searle, Chairman, Woodford Patient Capital Trust, said:

"This is a highly positive transaction for shareholders. We've increased positions in portfolio companies, in which the Board and the manager has conviction. The Trust has raised funds at a significant premium to the current share price, resulting in no dilution to shareholders and a scaling of the Trust.

"The Board sought advice from a range of parties and had the companies, which we already own and know well, independently valued. This deal has been something we have been considering for many months and the Board, which is fully independent, has debated the merits of this transaction with its advisors and concluded it is a positive deal for its shareholders."

Will you publish the independent valuation reports?

Transparency is at our core, and we have led the industry on this issue. However, we are not prepared to publish any unquoted valuation reports, as they can contain sensitive information which is not in the public domain. Furthermore, given the independence of the unquoted valuation process, technically, these reports are not ours to publish.

How much of the fund is invested in unquoted companies, post-transaction?

As a UCITS fund, there is a restriction on the amount that can be invested in securities that are not listed on an eligible market, such as the London Stock Exchange. No more than 10% of a fund's assets should be invested in securities that do not meet the eligibility criteria as defined by UCITS requirements.

Although generally the securities that fall into this limit are those that are not listed on a market, there are a few nuances that mean it is not a straightforward calculation. Examples include:

- Securities that are quoted but that are listed on an ineligible market
- Recently issued unquoted securities where there is an undertaking to apply for admission to an eligible market within 12 months of issue

This means that some of the fund's quoted securities are classified as unquoted for the purposes of this calculation. Meanwhile, some unquoted securities are classified as quoted because there is a documented intention to list.

As at the end of February 2019, the fund's exposure to securities classified as unquoted for the purposes of this calculation, was just under 8%. The calculation and classification of securities is also constantly monitored by Link, as ACD for the fund.

Irrespective of these classifications, the important thing to focus on is the quality of companies that we have invested in. This is why we publish the full portfolios each month and provide investment case summaries and regular updates on the largest positions. The opportunity that lies ahead of these businesses is much more important, in our view, than whether they are classified as listed or unlisted.

How will Woodford manage the potential conflict of interests here?

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The potential conflicts of interest have been thoroughly assessed and managed in terms of both sets of shareholders, not just by Woodford, but by all parties involved in the transaction. We have worked closely with Link as ACD/AIFM and Northern Trust as Depository for both products to ensure that all potential conflicts of interest are appropriately managed. Within Woodford, these were (and will continue to be) reviewed through our Governance and Risk Management Frameworks.

From a trust perspective, the transaction was approved by the Board and reviewed by its external third parties, including Stephenson Harwood as its external counsel. The strategy across the two products has been discussed at length between all parties to ensure that the transaction is in the best interests of investors.

Will you be double-charging?

Typically, if a fund buys another fund (or trust) under the same management, it waives its own fee to avoid 'double-charging'. In this instance, however, we do not charge a fee for the management of the Woodford Patient Capital Trust. The ongoing charges (currently 0.18% per annum), purely cover the costs of running the trust. As such there is no management fee to waive.

There is, however, the prospect of a performance fee, which will accrue once the trust's net asset value growth exceeds a hurdle rate of a cumulative 10% annualised return. We are conscious of feedback from some investors, who would like to see us take steps to ensure any future performance fee from the trust does not result in double-charging. We are therefore exploring our options here, but no decision has yet been taken.

Did the trust seek shareholder approval for this transaction?

The Board has undertaken its own independent analysis on the merits of making the transfer. The trust does not need approval from shareholders as the new shares have been issued under its current authority to annually issue up to 10% of the Company's issued ordinary share capital. That authority was approved by shareholders at the AGM in June 2018. It deliberately sought to ensure there was no dilution.

Does buying the trust at net asset value mean an immediate loss for the fund?

Yes, the value of the trust holding in the fund will be valued at the prevailing market price, rather than its net asset value (NAV). The prevailing price is currently below the trust's NAV, so this does mean a small loss for the fund on the transaction in the short-term. However, we have explored how much it would cost the fund to purchase the equivalent position in the secondary market and our analysis suggests it would cost more and take significantly longer, than buying at NAV in this way. The fund is paying what the trust's assets are actually worth and we are doing this with the belief that the assets will significantly appreciate over the medium-to-long term.

Meanwhile, on the other side of the transaction, issuing shares to the fund at NAV (plus costs) ensured that trust shareholders did not suffer any dilution.

market capitalisation
- The LF Woodford Equity Income Fund and the Woodford Patient Capital Trust may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value
- The price of shares in the Woodford Patient Capital Trust is determined by market supply and demand, and this may be different to the net asset value of the trust. This means the price may be volatile in response to changes in demand
- Long-term outcomes are more binary – extremely attractive rewards for success but some businesses will inevitably fail to fulfil their potential and this may expose investors to the risk of capital losses
- Young businesses have a different risk profile to mature blue-chip companies – risks are much more stock-specific, which implies a lower correlation with equity markets and the wider economy – it can take years for young businesses to fulfil their potential, this investment requires patience

Important information

Before investing, you should read the Key Investor Information Document (KIID) for the fund – or Key Information Document (KID) for the trust – and the Prospectus which, along with our terms and conditions, can be obtained from the downloads page or from our registered office. If you have a financial adviser, you should seek their advice before investing. Woodford Investment Management Ltd is not authorised to provide investment advice.

The Woodford Patient Capital Trust currently intends to conduct its affairs so that its securities can be recommended by IFAs to ordinary retail investors in accordance with the FCA's rules in relation to non-mainstream investment products and intends to continue to do so for the foreseeable future. The securities are excluded from the FCA's restrictions which apply to non-mainstream investment products because they are shares in an investment trust.

The Woodford Funds (Ireland) ICAV (the "Fund") has appointed as Swiss Representative Oligo Swiss Fund Services SA, Av. Villamont 17, 1005 Lausanne, Switzerland. The Fund's Swiss paying agent is Neue Helvetische Bank AG. All fund documentation including, Prospectus, Key Investor Information Documents, Instrument of Incorporation and financial reports may be obtained free of charge from the Swiss Representative in Lausanne. The place of performance and jurisdiction for all shares distributed in or from Switzerland is at the registered office of the Swiss Representative. Fund prices can be found at www.fundinfo.com.

Woodford Investment Management Ltd is authorised and regulated by the Financial Conduct Authority (firm reference number 745433). Incorporated in England and Wales, company number 10118169. Registered address 9400 Garsington Road, Oxford OX4 2HN.

Woodford Patient Capital Trust plc is incorporated in England and Wales, company number 09405653. Registered as an investment company under section 833 of the Companies Act 2006. Registered address Beaufort House, 51 New North Road, Exeter, EX4 4EP.