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INVESTOR

Chrysalis Investments

Investment Companies | Update | 7 February 2024

Turned a corner

Chrysalis Investments (CHRY) seems to have turned a corner. The welcome 6.5% jump in the NAV over the final quarter of 2023 (see page 11), encouraging news from many portfolio companies, an NAV enhancing (but unnamed) disposal in the works (see page 6), and the prospects of a more supportive interest rate environment all help underscore the trust's attractions.

We expect that shareholders will be happy to support the continuation vote scheduled for the AGM in March (see page 13).

CHRY's share price may be a long way off its low from last March, but with the discount sitting at 46.2% and the chance of NAV-enhancing exits freeing up cash to fund NAV-enhancing share buybacks, there is scope for it to move significantly higher.

Sector	Growth capital
Ticker	CHRY LN
Base currency	GBP
Price	77.1p
NAV	143.37p[1]
Premium/(discount)	(46.22%)
Yield	Nil

Note 1) Published NAV as at 31 December 2023.

Supporting growing businesses

CHRY aims to provide access to returns available from investing in later-stage private companies with long-term growth potential, an investment class that has traditionally been difficult to access for individual investors. CHRY also benefits from the flexibility to continue to support these businesses after they IPO.

> Prospect of share buy backs following disposals under new capital allocation policy

> Portfolio increasingly mature

> Aiming to distribute up to 25% of net cash profits on realisations longer term

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Domicile	Guernsey
Inception date	6 November 2018
Managers	Richard Watts, Nick Williamson
Market cap	441.38m
Shares outstanding (exc. treasury shares)	572.5m
Daily vol. (1-yr. avg.)	1.74m shares
Net gearing	Nil

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Click for CHRY's peer group analysis

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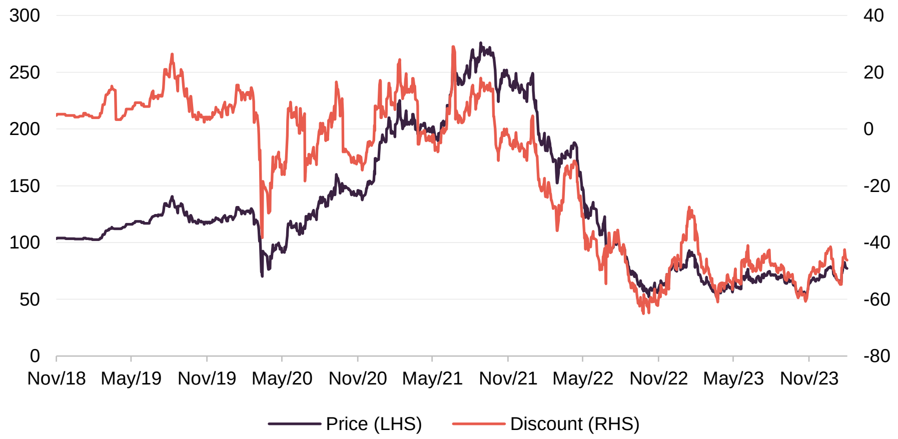
At a glance

Share price and discount

Over the 12 months ended 31 January 2024, CHRY's shares traded between a discount to NAV as wide as 61.0% and as narrow as 33.4%; the average discount over that period was 50.3%. As of publishing, CHRY's discount was 46%. Over 2023, the discount settled into a range of about 60% to 40%. The recent trend has been of discount narrowing and would have looked more impressive but for the impact of CHRY's higher NAV figure as at end December, which was announced on 29 January and so is only now starting to feed through into the share price.

Time period 31 December 2018 to 06 February 2024

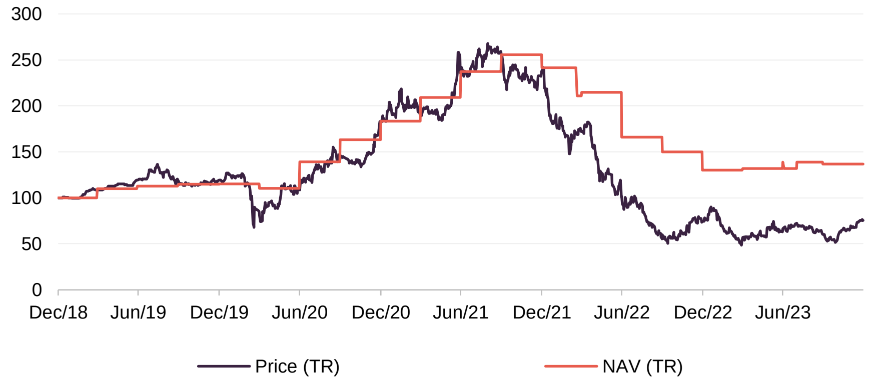


Source: Morningstar, Marten & Co

Performance over five years

CHRY's NAV for end December 2023 came in at 143.37p, up 6.5% on the figure as at 30 September 2023, and 10.3% higher than the end-March 2023 NAV figure that we used in our last note. The trend does seem to be upwards and the encouraging noises about NAV-enhancing disposals, revenue and earnings growth, and potential IPOs all suggest that this will continue.

Time period 31 December 2018 to 31 December 2023



Source: Morningstar, Marten & Co

Year ended	Share price TR (%)	NAV total return (%)	MSCI UK TR (%)	NASDAQ TR (%)	S&P 500 TR (%)
31/12/2019	19.4	15.1	16.4	33.6	26.4
31/12/2020	52.8	59.3	(13.2)	43.9	14.7
31/12/2021	30.3	31.6	19.6	28.4	29.9
31/12/2022	(68.6)	(46.1)	7.1	(24.1)	(7.8)
31/12/2023	1.0	5.0	7.7	46.0	19.2

Source: Morningstar, Marten & Co

Fund profile and management arrangements

Investors may wish to consult the fund's website at chrysalisinvestments.co.uk

CHRY's investment objective is to generate long-term capital growth through investing in a portfolio consisting primarily of equity or equity-related investments in unquoted and listed companies. Having the ability to back growing companies, regardless of whether they are listed or not, is core to CHRY's investment rationale.

At launch, the company's name was Merian Chrysalis (ticker MERI). That changed in December 2020, following Jupiter's acquisition of Merian Global Investors Limited. The management team of Nick Williamson and Richard Watts (the managers) moved across from Merian. They are supported by research analyst Mike Stewart, legal counsel James Simpson, and finance director Bekki Whiting.

Lead managers will be focussed solely on CHRY's success

At the end of November 2023, CHRY's board announced that it had agreed, in principle, to enter into a three-party contract with a new investment management business formed by the managers – Chrysalis Investment Partners LLP – which will take over investment management services from Jupiter, and with G10 Capital Limited, which will take over as AIFM. The change will take effect from 1 April 2024. As a result, Richard and Nick will be solely focused on CHRY's portfolio.

CHRY's investment management fee will be comprised of (i) 0.5% of NAV per annum (unchanged from that paid to Jupiter); and (ii) an additional AIFM fee of 0.05% on the first £1bn of NAV plus 0.03% on any net assets above that level.

Annual performance fee capped at 2.75% of NAV, and subject to same high watermark

Details of the performance fee were discussed in our last note, but to summarise:

- subject to approval by shareholders at the forthcoming EGM, the manager will be able to earn a performance fee calculated as 12.5% of NAV total return outperformance of an 8% hurdle and subject to a high watermark (currently 251.96p per share);
- there is a cap on performance fees paid in any one financial year of 2.75% of NAV (reduced from 3.75% as proposed earlier in 2023);
- the fee will be paid mostly in shares; and
- 75% of the fee will be deferred and released subject to criteria based on the company's long-term performance.

The new investment manager will have a 12-month minimum initial term, following which the new agreement will be terminable on six months' notice.

Capital allocation policy

Prospect of share buy backs following disposals under new capital allocation policy

Having consulted shareholders, CHRY's board has decided that it would like to introduce a new capital allocation policy. The aim is to return the first £100m of cumulative future realisations to shareholders subject to it retaining a liquidity buffer (essentially ensuring the company has enough available cash to cover large cash outflows if necessary).

CHRY would maintain a liquidity buffer of up to £50m to ensure funds are available to support portfolio companies if needed. As Figure 2 on page 7 shows, CHRY had liquid assets (cash plus shares in Wise, which is listed with high liquidity and therefore easily converted to cash) of about £34m at the end of December 2023.

While the discount remains wide, the £100m would be returned by way of share buybacks. It seems likely to us that concrete news of a meaningful potential disposal (such as that discussed on page 6) would lead to a re-rating in any case and the buybacks would accelerate that process.

CHRY has the usual permissions to repurchase up to 14.99% of its shares in issue and would ask shareholders for permission to buy back more if that authority was exceeded.

Aiming to distribute up to 25% of net cash profits on realisations longer term

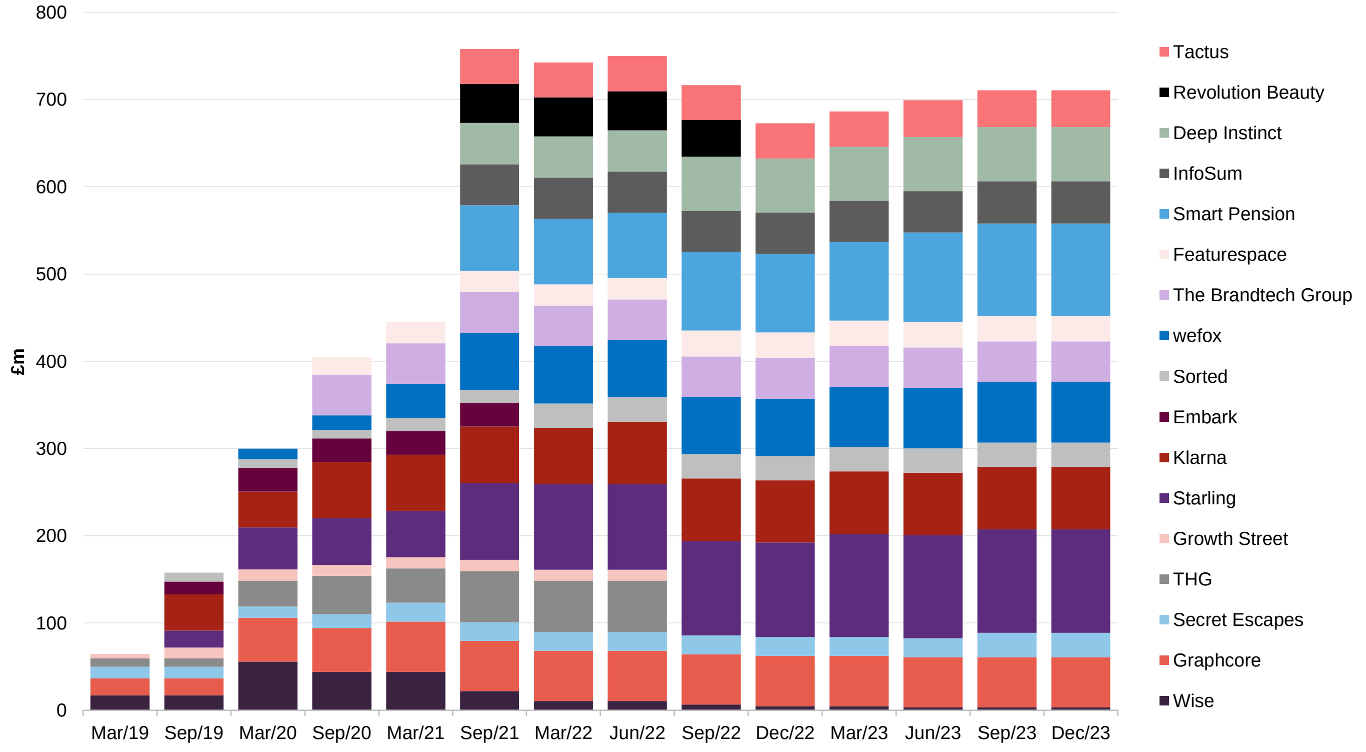
Once £100m has been handed back, the plan would be to balance CHRY's capital allocation between further distributions to shareholders (such as additional buybacks or dividends) and portfolio investments, aiming to distribute up to 25% of net cash profits on realisations.

We think that this is a sensible move by the board and one that should give comfort to shareholders as they consider whether to support the company's continuation (see page 13).

Portfolio activity

As Figure 1 shows, CHRY has continued to invest in its portfolio. Each coloured block represents the amount of money invested in each company at the end of that quarter. There is a drop in March 2022 as Embark is sold, another in September 2022 as THG and Growth Street leave the portfolio, and another in December 2022 as Revolution Beauty leaves the portfolio. You can also see the amount invested in Wise dropping as the managers sell down that stake.

Figure 1: Portfolio progress since launch – amounts invested



Source: Marten & Co

In the quarter ended 30 June 2023, CHRY invested £12.5m into Smart Pension as part of its $95m Series E fundraising and put a further £2m into Tactus.

The position in Wise was trimmed again as its share price continued to climb.

Then, in the next quarter, CHRY invested £6.5m into Secret Escapes to help recapitalise it and fund its growth. The company is generating meaningful levels of EBITDA. The travel sector is continuing its post-COVID recovery. The managers say that this is a business that they might be ready to exit in about 12-18 months' time.

Portfolio increasingly mature

Interestingly, we think, there was no investment activity in the final quarter of 2023 on the grounds that most investments are now well-funded. This may be an indication of the increasing maturity of the portfolio.

Potential disposal

Likely disposal to kickstart buyback programme?

On 5 December 2023, CHRY said that it had visibility over a likely disposal at a valuation that would add about 5.5p per share to its end September NAV. That uplift is equivalent to about £33m, implying (we think) that the value of the whole disposal would be at least twice that; likely more. This looks, therefore, more than sufficient to fund CHRY's first buybacks under the new capital allocation policy.

That disposal is not a potential IPO, but – as we discuss later when looking at Klarna – after a long hiatus, the prospects of an IPO of a portfolio holding are improving.

Case against Revolution Beauty

CHRY's recently-published annual results note that it has potential claims against Revolution Beauty, in relation to the shares that it bought in July 2021 for approximately £45m and finally sold in late 2022 for approximately £5.7m in total.

CHRY says that the original share purchase was made on the basis of information provided to the company by Revolution prior to the company's purchase of the shares in Revolution, and during the period in which the shares were held prior to their sale, that contained misstatements and material omissions.

CHRY wrote a formal letter of claim to Revolution Beauty on 22 November 2023, which requested a response within 28 days. A response has recently been received asking for a further 28 days to provide a response. CHRY is now considering next steps with its retained lawyers, Travers Smith.

Current portfolio

Figure 2 shows the split in the valuation of CHRY's portfolio as it was at the end of December 2023. The final – MOIC – column represents the multiple of the end December valuation relative to the amount invested in that company.

Figure 2: Portfolio as at 31 December 2023

	Business description	% of portfolio 31 Dec 2023	Value 31 Dec 2023 £m	Amount invested £m	MOIC (x)
wefox	Europe's largest digital insurance platform	22.1	188.8	69.2	2.7
Starling	UK challenger bank	20.2	172.7	118.3	1.5
Brandtech	Digital advertising and marketing services	11.0	93.6	46.4	2.0
Klarna	Online payments business with buy now pay later option	10.9	93.2	71.5	1.3
Smart Pension	Workplace/automatic enrolment pension schemes for SMEs	9.0	77.1	105.6	0.7
Featurespace	Financial crime risk management using real-time learning	7.0	59.4	29.5	2.0
Deep Instinct	A US cybersecurity company	4.9	41.5	62.2	0.7
Graphcore	Artificial intelligence processor business	4.1	34.8	57.6	0.6
InfoSum	Data collaboration platform	3.0	25.6	48.5	0.5
Secret Escapes	Travel company that helps minimise unsold inventory	2.9	25.1	28.0	0.9
Wise	Online foreign exchange	1.5	13.1	3.3	4.0
Tactus	Supplier of custom gaming PCs, components and accessories	0.9	8.0	42.1	0.2
Sorted	SaaS company with a delivery management platform	0.0	0.3	28.3	0.0
Gross cash		2.4	20.7		
Total			853.9	710.5	1.2

Source: CHRY

Looking at some of these in more detail:

Wefox

Organic growth of about 35% is achievable and continued M&A will accelerate this

The managers say that Wefox (wefox.com) is still one of the fastest-growing companies in the portfolio although, given that it is now a much larger company than it was when CHRY first invested in it, the percentage rate of growth is slowing. They feel that the company is capable of generating very attractive levels of organic growth and continued M&A will accelerate this (Wefox has been buying businesses as one way of expanding its business into new territories). New hires have strengthened the management team.

New platform launching in April 2024 – will use AI, data and automation to streamline insurance processes

The focus has shifted away from using data collected by the business to write its own direct to consumer (D2C) insurance. Instead, it is launching a platform in April 2024. Wefox says that the platform uses artificial intelligence (AI), data analytics, and automation to streamline insurance processes, improve risk assessment, and enhance customer experiences, whether the client is an insurance company, a broker, a partner or customer.

Wefox has secured some interesting new affinity insurance partners. One example is a project with WINDTRE, one of Italy's largest telecoms businesses, which is selling a range of insurance policies, not just covering phones.

Wefox has been raising debt finance recently, with $110m of funding from four banks secured in 2023, on top of the $55m extension of the Series D round that we discussed in our last note. The equity of the business is valued at $4.5bn. CHRY's managers say that Wefox was profitable over the month of December 2023.

Starling

Starling has attracted sizeable inflows and profitability has increased as interest rates have risen

Starling's (starlingbank.com) profitability has increased significantly as interest rates have risen and its interest rate margin has widened. The managers note that Starling's initiative to pay 3.25% interest on the first £5,000 of customers' current account balances and 5.53% on one-year fixed saver accounts has attracted sizeable inflows. Starling now has over 4.1m customer accounts.

Part of Starling's business model is to monetise the investment that it has made in its software. Engine, its SaaS (software as a service) division, secured its first two customers in November – Salt Bank in Romania and AMP in Australia.

CHRY's managers sees substantial upside to Starling's current £1.16bn valuation

We discussed Starling's 2023 financial year (FY23) results in our last note, however, there is reason to believe that the company's carrying valuation for Starling is conservative. The managers recently noted that the company is currently generating a pre-tax ROE of 40%. We believe that this implies c£300m of profit before tax. A £3bn valuation seems reasonable, which would add over £270m to the value of CHRY's stake, or about 48p per share. Alternatively, the managers note that Monzo, which is a similar size to Starling, is rumoured to be worth about £4bn, which would suggest an even bigger uplift is achievable.

Brandtech

Substantial cost savings coming through

With the Jellyfish acquisition (discussed in earlier notes) done, Brandtech (thebrandtechgroup.com) has been extracting substantial cost savings as the integration progresses; 370 jobs have gone and CHRY's managers say that the combined business has great potential.

More recently, Brandtech has been building its capabilities in AI (its Acorn-i proprietary SaaS technology was already one of the fastest growing parts of its business) with the acquisition of Pencil AI, a tool for creating ads faster and cheaper using generative AI. CHRY's managers say that it also allows firms to better-target customers. Take-up of the service is said to have been 'incredible'. Brandtech CEO David Jones says that he has never seen such interest in a product and Pencil AI is ahead of the competition.

CHRY's managers acknowledge that there has been some weakness in luxury goods advertising, and leadership changes at some big brands have delayed spending decisions. Nevertheless, they are still looking for Brandtech to deliver 20% organic growth over the long term. They suggest that Brandtech is currently generating in excess of $1bn of revenue and that the business should be capable of generating a c20% EBITDA margin in the medium-term.

Klarna

Klarna is now profitable

Klarna (klarna.com/uk) has been releasing positive updates and may release another later this month. The Q3 2023 results published in November 2023 showed that the group is now profitable, with an operating profit of SEK130m in the quarter (about SEK500m excluding restructuring costs, share-based payments, related payroll taxes, depreciation and amortisation). The company noted that its US business has now recorded gross profits for four consecutive quarters.

Klarna is accessing new markets and new categories

The rate of growth has been accelerating, with 30% revenue growth, and profitability has been helped by a fall in credit losses (essentially, these are losses from loans not paid back) as a percentage of gross merchandise value (0.33% in Q3 2023 versus 0.74% a year earlier). Klarna is accessing new markets and new categories. One that CHRY's managers are excited by, for example, is its tie-up with Air BnB (customers in seven countries can now use Klarna's services to spread the cost of their trips). With a much higher ticket size and access to a differentiated customer base, this relationship has good potential.

The managers envisage that Klarna could be worth about $18bn based on Klarna trading on the same gross profit multiple as closest-listed peer, Affirm. CHRY has a 1% stake. On those figures, a Klarna sale could add about 30p to the NAV.

Klarna CEO says US IPO quite likely soon – aspires for a triple-digit-billion-dollar valuation

Klarna's CEO Sebastian Siemiatkowski was interviewed recently by Bloomberg and talked about his thoughts on an IPO of the company. He said that an IPO, probably in the US, was likely 'quite soon'; he also added that the aspiration was for a triple-digit-billion-dollar valuation. That may be wishful thinking, but it makes CHRY's managers' valuation target look reasonable.

Smart Pension

As we discuss on page 11, there was a down round (which is when new investors put money into an unlisted company at a lower valuation than a previous investment round) for Smart Pension (smartpension.co.uk) three or four months ago. However, CHRY's managers think that the UK business alone justifies the carrying value and the rest is in for free. A peer – Cushon, with £2bn of AUM (assets under management)– was recently acquired by NatWest for an EV of £169m, which the managers think represents a multiple of about 12.5x current year revenue.

Smart Pension is cost cutting as it integrates recent acquisitions

At Smart Pension, a programme of cost cutting is underway some of which reflects efforts to integrate recent acquisitions, which include Evolve Pensions – a workplace pension provider – and ProManage LLC offering managed accounts and other personalised retirement solutions to plan sponsors and plan participants in the US. Smart Pension has also launched a pension solution product in connection with Mercer, which the managers could generate significant AUM inflows in the coming years.

As of November 2023, the Smart Pension Master Trust had AUM of £4bn and was seeing monthly contributions to its schemes of £100m. CHRY's managers say that the wider Smart Pension group has total AUM of about £12.5bn.

Featurespace

Featurespace's (featurespace.com) accounts for calendar year 2022, published in November 2023, show an acceleration in the company's ARR growth, up 40% on 2021 and accounting for 70% of all revenue in 2022 and 80% over the first nine months of 2023.

Featurespace board sys it will not be needing to raise additional equity or debt capital

The loss for 2022 was £20.9m. However, operational cash generation in 2023 is said to be very strong and, at the end of September 2023, Featurespace had cash of £25.2m, not much changed from the position at the start of the year. The company's board has said that given the trajectory of growth and cash generation, it will maintain a strong financial position, without the need for additional equity or debt capital.

Featurespace is shifting to profitability while still winning additional business

CHRY's managers note that the company's focus on a SaaS sales model helps margins. They feel that the business is at an inflexion point – shifting to profitability while still winning additional business. Research published by Featurespace shows that financial fraud rates continue to rise and the proportion of false positives – transactions that get blocked but should not have been – is also climbing. Featurespace's solutions can combat this.

Deep Instinct

Demand for Deep Instinct's services is being accelerated by rapid growth in AI-powered cyberattacks

CHRY's managers say that Deep Instinct (deepinstinct.com) is still growing strongly and organically and remain convinced that the business has great potential, saying it could generate one of the strongest returns across the portfolio if management successfully execute their strategy.

Demand for its services is being accelerated by rapid growth in AI-powered cyberattacks. However, they note that the business is still lossmaking. CEO Lane Bess has been in the job almost a year. He is focused on building the team. The company's sales strategy has pivoted more towards storage providers rather than endpoint users. In October 2023, it launched its Deep Instinct Prevention for Storage (DPS) business to be used wherever data is stored.

Deep Instinct's is in discussions with AWS

The managers say that traditionally, cloud storage providers have treated threat prevention as a problem for end customers, but there has been a shift in attitudes to accountability and the agile defence provided by Deep Instinct's product is appealing.

Deep Instinct's is a potential acquisition target

The company has secured other contract wins and may be an attractive acquisition target, given that it offers a unique play on the use of deep learning for cybersecurity. The managers feel that there is considerable value in its intellectual property. However, a sale is not on the agenda in the short term – the company is only just getting going.

Sorted

Sold for a nominal sum following write downs

Sorted (sorted.com), which operates a SaaS business that supports retailers' deliveries and collections, is being acquired by Location Services Limited for a nominal sum. CHRY had already written down the value of its position in the company over 2022 and 2023 so that at CHRY's year end in September 2023, the position was valued at around £0.3m.

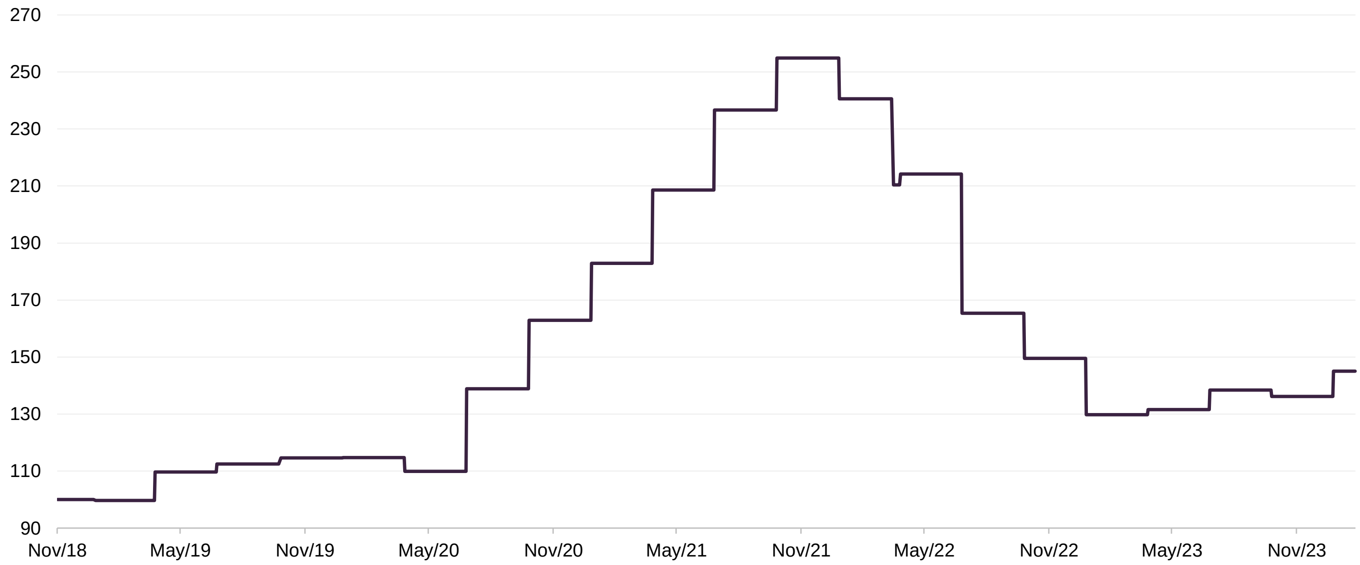
Performance

Up-to-date information on CHRY and its peers is available on our website

CHRY's NAV for end December 2023 came in at 143.37p, up 6.5% on the figure as at 30 September 2023, and 10.3% higher than the end-March 2023 NAV figure that we used in our last note.

The trend does seem to be upwards and the encouraging noises about NAV-enhancing disposals, revenue and earnings growth, and potential IPOs all suggest that this will continue. Further support comes from the likelihood of interest rate cuts to come, which eases the pressure on growth company valuations.

Figure 3: CHRY published NAV total return performance since launch



Source: Morningstar, Marten & Co

Figure 4: Cumulative total returns for periods ending 31 December 2023

	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	launch (%)
NAV[1]	6.5	4.8	(3.0)	(20.7)	45.5	45.0
Share price	24.9	4.0	1.0	(58.7)	(24.6)	(24.9)
MSCI UK	2.3	2.7	6.8	37.9	39.3	33.8
NASDAQ	9.6	8.1	46.1	42.3	173.7	155.0
S&P500	6.9	5.6	19.1	42.7	107.0	94.2

Source: Morningstar, Marten & Co. Note 1) NAV based on last published as at 31 December 2023.

Figure 5 below shows the changes in valuation for each of CHRY's assets since our last note, which used valuations as at 31 March 2023.

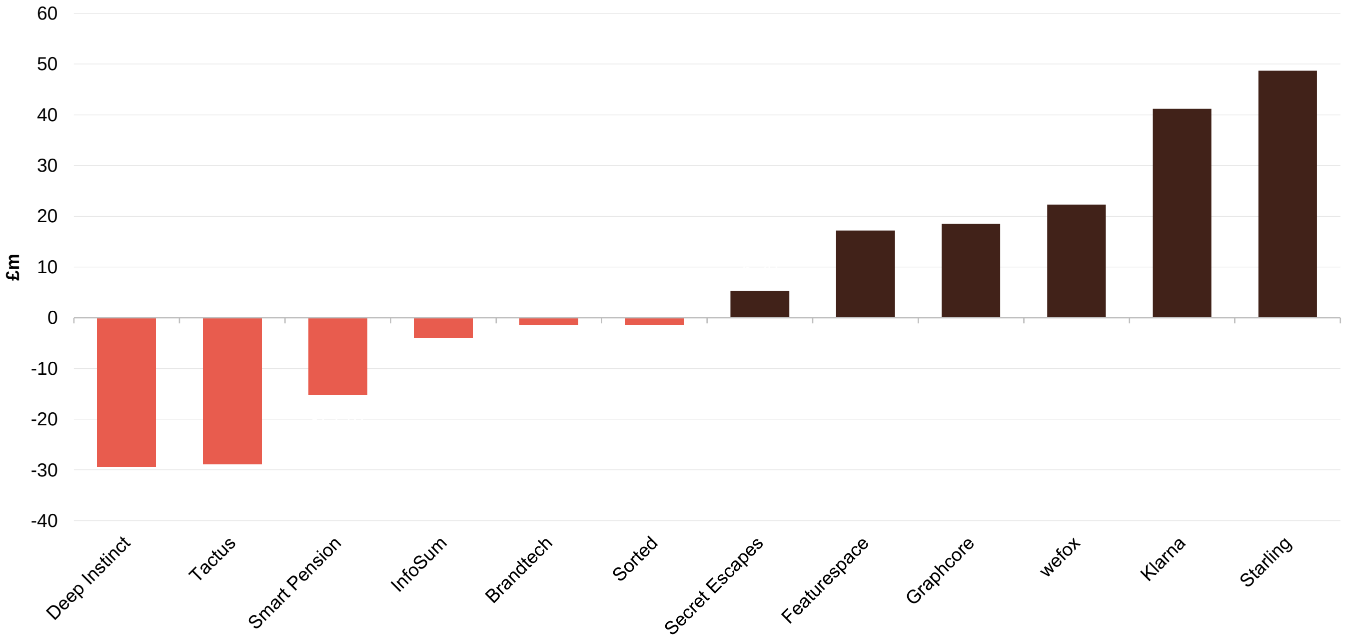
The overall valuation of the fund rose from about £776m to £854m over the period from 31 March 2023 to 31 December 2023. Despite its promise, Deep Instinct was the largest detractor, but this could change dramatically if the company succeeds in winning business from one of the large cloud service providers.

Tactus Holdings has been affected a tougher trading environment.

Smart Pension's Series E funding round was conducted at a discount to previous valuations, likely reflecting the more difficult funding environment.

However, these negative moves are more than offset by good news elsewhere in the portfolio. The jump in Starling's profitability that accompanied the rise in interest rates, and the shift to towards profitability at Klarna and Wefox that we discussed earlier, were the main drivers of this.

Figure 5: Contribution to changes in valuation of CHRY's unlisted stocks since our last note



Source: Marten & Co

The excitement around the potential IPO of Klarna underscores the potential for this portfolio as sentiment improves and the IPO market warms up. In addition, there is the potential disposal of one of the assets in the portfolio to consider. This could not be through an IPO given the degree of certainty that was implied in the announcement. More likely, this reflects a bid for one of CHRY's holdings.

Premium/(discount)

Over the 12 months ended 31 January 2024, CHRY's shares traded between a discount as wide as 61.0% and as narrow as 33.4%; the average discount over that period was 50.3%. As of publishing, CHRY's discount was 46%.

We have discussed the reasons for CHRY's shares shifting from trading at a premium to a wide discount in previous notes. The main driver has been the market's response to rising interest rates and the associated possibility of a recession.

Over 2023, the discount settled into a range of about 60% to 40%. The recent trend has been of discount narrowing, but it is worth noting that this would have looked more impressive but for the impact of CHRY's higher NAV figure as at end December, which was announced on 29 January and so is only now starting to feed through into the share price.

Another factor at work was the surprise uptick in UK inflation for December, which raised fears of a delay to interest rate cuts. Since then, grocery price inflation has come in below expectations, that figure may have just been a blip.

We think that the upward momentum in the NAV should gradually drive down the discount. However, a sizable disposal and the subsequent implementation of the capital allocation policy discussed on page 6 could have a more dramatic impact.

Figure 6: CHRY premium/(discount) since launch

Source: Morningstar, Marten & Co

Forthcoming AGM and EGM

First continuation vote at March AGM as promised

With five years under its belt since the IPO in 2018, CHRY is, as promised, holding a continuation vote at the AGM scheduled for 15 March 2024. Thereafter, shareholders will get to vote on the continuation of the company every three years.

As we have discussed elsewhere in this note, after a period of setbacks linked largely to macroeconomic events outside the managers' control, CHRY's performance is picking up. The managers have demonstrated their ability to identify and back promising businesses and we see no reason why shareholders should want to call time on the company.

In our last note, we set out the proposed adjustments to CHRY's performance fee – notably the reduction from 20% to 12.5% outperformance and the retention of the high watermark. At an EGM scheduled to follow the AGM, shareholders will be asked to approve this arrangement.

Previous publications

Readers interested in further information about CHRY may wish to read our initiation note, Shepherding its portfolio through the storm, published in September 2022, or our update note, Putting growing pains behind it, published in July 2023.

IMPORTANT INFORMATION

QuotedData is a trading name of Marten & Co, which is authorised and regulated by the Financial Conduct Authority.

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