LMS Capital Eye

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An interview with Robbie Rayne, CEO, LMS Capital

Investing through the cycle

With a successful track record of investing in businesses over the last 30 years, Robbie Rayne considers how LMS Capital's investment strategy positions the group in the current market environment.

How would you describe LMS Capital's investment strategy?

We invest our own capital in a range of companies and funds which we believe have the potential for superior growth over the medium to long term. We favour sectors where we can use our knowledge and skills to actively manage our investments for long term benefit.

What makes you different to other investment houses?

Since we do not directly use third party capital, we have a more flexible investment holding period and a longer-term time horizon than most.

Unlike many funds, our portfolio is risk managed and risk diversified; we are multinational, although primarily US and UK, and invest in businesses at all stages of development.

We have grown steadily by investing our own money. We started 30 years ago with about £11m and we are now managing just over £300m, having generated some £1bn of cash over the period.

We also pay great attention to whom, not just what, we invest in and – in fact, you could say that we invest in people more than companies.

Has the strategy changed over time?

As we have grown, the balance of investments has moved towards later stage financing. Early stage companies require a lot of management time and, whilst they can deliver higher returns, we consider the number of people in our team and where their efforts are best spent. In the last couple of years we have built an investment team whose members have blue chip backgrounds and track records in investing in both established and growth businesses, as well as substantial operating experience.

What are the key benefits of a longer-term time horizon?

It allows us to mitigate risk and achieve higher rates of return by investing in businesses that mature at different times and in different places. We are never forced sellers and are in a position to ride out periods of slow growth as and when they occur.

It also generates new opportunities. We have frequently backed management teams we know in new ventures that have gone on to become high profile businesses in their own right.

What are your objectives for growth?

We look for a net 12-15% compound growth with some of our best returns having been generated over a period of eight years or more. Weatherford International, with whom we have had a relationship for 20 years, is returning more than 20%.

Have you chosen sectors based on your investment style?

We concentrate on sectors that we believe are truly long term growth sectors, but we will also take opportunities in other sectors.

It's interesting to look back at where we saw growth in the past. We were founder shareholders of BSB, later BSkyB, which, at the time was high tech and similarly high risk. Before that we were looking at North Sea Oil and, during the tech boom in the late 1990s we backed some remarkable companies like Intertrust, which was very early into the market for security over the internet and Commerce One, an e commerce business. We feel the same way about energy today. Despite recent falls in valuation, prospects for the sector remain good and much of what we are doing now is in this area: oilfield services, replacement technologies and reinvigoration of oil fields.

How is the current climate affecting your activities?

Our house is in order so we think we are in a good position. We have spent the last 18 months paying rigorous attention to what we are doing and building a very strong team. We have no gearing and we have cash in the bank, so we can and we will carry on investing. It's possibly different for others. The private equity model of making returns today through high levels of cheap debt are over probably for a long time. Financial engineering on its own is no longer enough.

It's also important to protect the capital that is already invested. For example, we are encouraging some of our companies to extend contracts, perhaps from their current short term agreements to more secure five or ten year arrangements.

Are you still seeing the same number of investment opportunities?

It varies by industry. In technology, there are still many opportunities and the all-equity financing market remains strong. We're also seeing some very interesting post IPO public to private opportunities in our favoured sectors. The public markets have decimated the small caps so there are plenty of excellent small to medium sized companies, with good cash flow and no debt, trading on tiny multiples.

Is there more competition for deals?

Even though the traditional private equity model is having difficulty, there is still plenty of equity investment available and there remain good opportunities to make good investments. In the current climate we are finding that people like our long term approach, however, we never underestimate the level and quality of the competition.

Has your investment strategy changed substantially to reflect the new environment?

In a lower margin, slow growth environment, we will be looking at basic industries where consolidation gains can be achieved and where capex can improve profitability. However, our basic investment model will not be substantially changed.

"In the current climate we are finding that people like our long term approach"

News Update

Martin Pexton, MD, LMS Capital

International approvals for ProStrakan

ProStrakan Group received US FDA approval for Sancuso, a patch used to treat nausea in chemotherapy patients in September and launched the product with a 67 person sales team on the 3rd of November. Sancuso is the group's first product launch in the US.

Marketing approval from the UK Medicines and Healthcare products Regulatory Agency has also been received earlier than expected for ProStrakan's cancer pain treatment Abstral. ProStrakan has licensed the exclusive rights to Abstral in Europe and North America from Swedish pharmaceutical group Orexo, with whom the group recently launched Abstral in Sweden. Abstral is now expected to be launched in the UK before the end of 2008, with further EU launches in 2009.

LMS Capital holds 9% of ProStrakan.

LMS Capital invests in Pims Group

In June 2008, LMS Capital invested £2.5m in Pims Group, a private UK-based supplier of waste water pumping systems and services, alongside Inflexion.

Pims Group was founded in 1972 and installs and maintains pumps within systems for sewage and storm water. Based in the South East but with national coverage, Pims operates in both the domestic and commercial markets and last year installed over 700 pumping stations as well as operating over 4,000 maintenance contracts, including some large contracts with major retailers

Martin Pexton writes; *"Pims is a good example of the type of investment LMS Capital looks for; an infrastructure business with a strong customer base and good margins, in a sector with solid prospects and the opportunity to grow through acquisition. LMS Capital was asked to join the buyout by Inflexion, with whom it has invested in the past and with whom it will work to provide follow on funding when required."*

Other news in brief

August 2008

Yes To, the natural personal care business, launched its range of products in Ireland. The Yes To brand is now available in 13 countries and has been extended to include Yes To Carrots, Yes To Tomatoes and Yes To Cucumbers. Yes To is an investment made by San Francisco Equity Partners, a fund set up in partnership with LMS Capital.

August 2008

Eye-Fi, the developer and manufacturer of the world's first wireless memory card for digital cameras, secured $11m in series B funding in August 2008 from a number of investors, including LMS Capital. Eye-Fi has developed a number of industry partnerships, including one with Lexar Media, which recently announced the launch of its own wireless memory card using Eye-Fi technology.

Hands on investment

Most investment houses claim to pay great attention to the relationships they have with portfolio companies but it is not always clear what this actually means in everyday practice.Whilst the majority of investors are likely to market themselves as 'hands on' and supportive, it is well known that some prefer to invest and then step away.

At LMS Capital, managing portfolio companies is not an arms' length activity. We put a high value on relationships and, in a competitive, and generally very small world, we believe this approach gives us both significant competitive advantage and a higher rate of investment return. Since we invest for the long term, our relationships have to have staying power and work for all parties for the several years we may be invested.

Of course, the nature of a relationship changes over time, usually dictated by the size, stage and requirements of the investee business, but we believe there are some characteristics of successful relationships between investors and their portfolio companies which remain constant whatever the status of the deal.

- **A strong rapport:** Initial chemistry with a management team is a huge competitive advantage in a pitch situation but needs to be maintained in a long term relationship. We work hard to build relationships that are close enough for the CEO to be comfortable phoning us for a quick steer and where the management team feels that a problem or an issue is a shared one.
- **Mutual respect and openness:** Relationships need to be challenging but not adversarial. We aim to communicate frequently and to be as open with management teams as we possibly can be and expect them, in turn, to be open with us. The last thing an investor needs is to suddenly

“Our relationships have to have staying power”

hit a crisis that management knew was coming but didn’t feel they could talk about and, in a similar way, the last thing a management team needs is for an investor to announce a change of direction or exit without a sensible dialogue beforehand.

- **Mutuality of interest:** Relationships are made more simple when the financial incentives for management are correctly structured and aligned with the financial interests of the investor. We work very closely with portfolio companies to incentivise management teams to take the business in a direction that benefits both our interests.

- **Day to day practical support:** Many companies, particularly the smaller ones, do need help from investors with some of the day to day practical aspects of running a business. And, sometimes, just being able to offer an outside perspective to a team that might be bogged down in the detail is useful. We find that the practical experience our team has gained from outside the financing sector – we know what it’s like running businesses – enables us to give management teams the support they need when they need it. We aim to make decisions quickly and we frequently use our wide base of contacts to solve problems we may not be able to solve immediately ourselves.

- **Trust in management’s judgement:** Whilst it is important to have a ‘hands on’ relationship with a portfolio company, this doesn’t mean that an investor has to be involved in everything the business is doing and every decision that is made. Trusting management and knowing when to let go is vital in building a successful long term relationship. We aim to support a management team when it is needed but, when the time is right, we are more than happy to step back and let them get on with the job.

- **Paying particular attention to the needs of the CEO:** The relationship between an investor and the CEO is crucial and can take many forms depending on his/her level of experience. The CEO’s job is often a lonely one and, for us, it’s as much about being supportive of the CEO’s position in the business as it is about supporting the business itself. Occasionally it’s a mentoring relationship, albeit light touch, but, more typically, we act as a sounding board, asking the right questions and offering an additional perspective on ideas. It’s important to note, though, that this relationship cannot be to the exclusion of others. There are examples of businesses where the CEO *is* the issue and its resolution requires the trust and confidence of the wider management team.

- **Developing relationships with other investors:** In many cases, in particular in early stage companies, more than one investor will be involved – hopefully with a similar aim. We find that building relationships with these other investors saves time, effort and reduces the likelihood of conflict – it’s a real problem for a company if its investors don’t talk to each other or, worse, work against each other. Working with other houses substantially widens the pool of experience on offer and is of huge value to investee businesses.

- **Finally, maintaining a sense of perspective:** Whilst close personal relationships are important, it’s critical that they are not so close that they get in the way of making the right decisions. Investors have been known to carry on putting money into a failing business or to leave a management team in place when they really shouldn’t have. To guard against this, we seek to be realistic at all times – never unduly optimistic or pessimistic – and always open with management about what we expect and clear about the circumstances under which we would change our view. It may sound simple – and it should be – but getting it right is probably the key factor that will determine the success or otherwise of a long term relationship.

The financial benefits of a good relationship: Energy Cranes International

John Jordan was recruited to Energy Cranes in January 2005 to oversee the US business and later that year was appointed CEO of the whole group. The business was sold in March 2008 for £142 million, returning £83 million in cash to LMS – a multiple in excess of 4.5 times and an IRR of 40%.

Martin Pexton: *“John showed tremendous energy and vision both in developing the existing business and in making and integrating key strategic acquisitions. His appointment was a major influence on the success of the company and on growing shareholder value.”*

John Jordan: *“Having a close working relationship with Martin as investor made my job a whole lot easier, not least in terms of decision-making, and I always knew that I could count on LMS’s support. Together we achieved a great result for all shareholders.”*

Who we are

LMS Capital is an international investment company with 30 years' experience of investing its own capital in companies in the UK and US. During the past 24 months we have assembled an experienced investment team and are now actively looking for new funding opportunities. Our objective is to deliver sustained medium to long term growth for shareholders.

- We typically invest between £5m and £15m initially, but our capital structure means we can increase that investment over time depending on the funding requirements of the business.
- We have a development capital/growth buyout emphasis and are experienced in buy and build situations.
- We are specialists in applied technology, energy, healthcare and medical, media and leisure and real estate. However, we retain the freedom to invest outside our core sectors, enabling us to take advantage of opportunities when they arise.
- We are a long term investor with a flexible holding period and are not constrained by the fixed investment periods of many private equity houses. Our average holding period is eight years, but we have been involved in some businesses for significantly longer.
- We are flexible about the percentage stake we take in businesses, as long as we have a position of meaningful influence and a strong working relationship with the management team.
- Our investment team is small but highly skilled and well connected, with experience in a range of sectors across every stage of company. Most importantly, each has substantial operating experience, meaning we know how to best support management teams – we have seen many issues before and understand the importance of making decisions quickly.
- Our direct investment team is complemented by the relationships we have built up with other venture capital and private equity groups. We have access to more expertise as well as the fund and co-investment opportunities that these relationships generate.

At the half year (30th June 2008), LMS Capital had approximately £300m of net assets, including significant cash. We expect great management teams will continue to thrive in today's challenging times and look forward to hearing from management teams or advisers with a credible business plan or funding opportunity.

Our team

United Kingdom

Robbie Rayne
Established LMS Capital's investment activities in the early 1980s as Investment Director, and later Chief Executive, of London Merchant Securities. Works across all sectors but recently focused on technology and energy. Chairman of Derwent London plc and non-executive Director of Weatherford International Ltd.

Martin Pexton
Director of London Merchant Securities until 2007 and previously a Director of Allen & Overy and Deloitte, Haskins & Sells. Broad sector experience in oil and gas, real estate, professional services and technology. Director of Cityspace, Wesupply, Elateral and Vio Worldwide and led the recent sale of Energy Cranes.

Tony Sweet
Previously CFO of Systems Union group and a partner at PWC. Takes an active role in the group's investment activities, working closely with portfolio companies on strategic planning and funding requirements. Director of Wesupply.

Pieter Hooft
Previously with Apax Partners and JP Morgan. Sixteen years' experience in the UK and Europe advising on and leading deals in a broad range of sectors from consumer and retail to IT services. Leads the group's UK investment activities.

Ed Snow
Formerly of Amadeus Capital Partners and Deutsche Bank, with sector experience including infrastructure software, search engines, electronics and online gaming. Co-founded and floated vehicle security technology startup at 27. Leads the group's technology investment activities.

Jamie Szpiro
Previously with Kaupthing, Singer & Friedlander and Wintrust plc. Broad range of financial experience, including mid market buyouts as well as direct operational and M & A experience from the sale of Wintrust plc. Works across the group's UK investment portfolio.

Jamie Rhodes
Previously seed funded, operated and sold three successive ventures in the food arena, with sector experience in consumer products, retail, leisure and logistics and distribution. Works across the group's UK direct investment portfolio as well as being responsible for UK fund investments and quoted stocks.

United States

Scott Potter
Established San Francisco Equity Partners in 2005 in partnership with LMS Capital. Broad operational experience in the technology sector and now focused on investing in expansion stage companies in the IT, media, consumer and service sectors. Responsible for the group's US investment portfolio.

Brian Bank
Previously with Ernst & Young consulting in the high tech and healthcare supply chain management sector. Responsible for the group's investments in US venture capital and private equity partnerships as well as overseeing the group's US-based co investment portfolio.

Gene Weber
Founder of Weber Capital Management, operator of US investment funds in which LMS Capital invests. Previously with Weiss, Peck and Greer and McKinsey and Company.

For full biographies please visit the LMS Capital website.

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