SCOTTISH MORTGAGE INVESTMENT TRUST

Investing in private companies: manager insights

Lawrence Burns
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Reflecting on a decade of private company investing

Hello, I'm Lawrence Burns, deputy manager of Scottish Mortgage. Last year marked a decade of the Trust investing in private companies. Over the last decade, private company investing has become a core part of Scottish Mortgage, comprising up to 30 per cent of our assets and giving our shareholders access to a range of differentiated growth businesses.

From SpaceX radically lowering the cost to access space, to Northvolt providing the battery manufacturing capacity to power Europe's energy transition, to Tempus Labs developing personalised cancer diagnoses driven by artificial intelligence.

Today, our private company exposure is concentrated in a small number of these large private companies. Indeed, our five largest private holdings account for nearly half of our private company exposure.

Why we invest in private companies

There are four main reasons we invest in private companies. The first is that companies are staying private for longer. When we began investing in private companies, we had no desire to become early-stage venture capitalists. We were merely adapting to the type of companies we invest in, staying private for longer.

Consider that when Amazon went public in 1997, it was just three years old and valued at $700m. When Alibaba, our first private investment, listed in 2012, it was 15 years old and worth nearly $200bn. Today, SpaceX is 20 years old, and yet it remains private and worth over $100bn.

MANAGED BY BAILLIE GIFFORD

The reason we began investing in private companies was so that our shareholders would not be deprived of the returns generated by some of the most exciting growth companies in the world that were simply opting to stay private for longer.

The companies that make up the bulk of our private company exposure are, therefore, neither small nor early-stage. They can have thousands of employees and billions in annual revenue. Indeed, the majority of our assets invested in private companies are in businesses that would be large enough to join the FTSE 100.

The second reason we invest in private companies is because we believe we have an edge in access. Our closed-end structure, our scale and most importantly our reputation as long-term patient shareholders have enabled unusually good access to the world's most sought-after private companies.

This matters because private companies don't choose who they talk to, but they choose their shareholders as well. The best meetings with private companies are, therefore, those that resemble a two-way interview process.

The third reason is that understanding how the world is changing solely through public companies is akin to trying to construct a puzzle with half the pieces missing.

Investing in Ant Group, for example, allowed us to better understand the potential of MercadoLibre's financial arm. Indeed, private company investing has provided us with a lens into the future, allowing us to understand new areas such as synthetic biology, artificial intelligence and climate solutions earlier.

It also allows us to get to know exceptional growth companies sooner and has become a funnel for new ideas into the portfolio. We have now had 35 private companies transition to public holdings. And over 40 per cent of the total portfolio is invested in companies that were first owned when they were private.

The fourth reason is that investing in world-leading private companies has traditionally been neither accessible nor cheap. Scottish Mortgage is able to democratise access to the world's leading private and public companies for an annual fee of 0.34 per cent.

Valuing private companies

Our aim is to hold our private companies at the value we believe we would get were we to try to sell our shares. The valuation is arrived at by a separate team with oversight from both the Scottish Mortgage Board and our auditors PwC. Tom

Slater and I are not involved in this process and are usually informed via email after any valuation changes have been applied.

The valuations are kept as up-to-date as possible. To achieve this, 532 revaluations were made last year alone, with 84 per cent of our private instruments being re-valued five times or more. The result was that in aggregate, private company valuations were written down by 28 per cent, which compares to a fall in the NASDAQ of 14 per cent over the same period.

Looking forward

The recent past has been a painful experience for our shareholders, but as we look forward, we are optimistic given the continued operational progress of our companies and because the deep underlying drivers of change in the economy have continued through this period unabated.

What has changed, though, is that we have transitioned from an environment of capital abundance to capital scarcity. Despite this, we have seen a number of our private companies successfully raise further capital, while several of our larger private holdings are already generating positive free cash flow.

Moreover, we are seeing companies bring down their cash burn materially. This has partly been made possible because the cost of capital has risen, and that's reduced the supply of capital. This has created a more rational and more benign competitive environment for many of our companies.

Nevertheless, it is likely that a few of our smaller private company holdings may still find themselves causalities of this new environment. Should that happen, we expect the impact to represent only a very small percentage of the portfolio. As ever, our performance will be primarily driven by those companies that succeed rather than those that fail.

And as we look to the future, for all the gloomy economic headlines, it is striking that entrepreneurship appears to be increasing. US Census data shows that the rate of new business formation has increased by over 40 per cent since 2019.

Combine that with the breakthroughs in artificial intelligence and the need to rearchitect our entire economy towards a sustainable energy future, and it seems unlikely that we will find ourselves bereft of transformative growth companies to invest in any time soon.

The role of Scottish Mortgage, therefore, will continue to be to support the growth in entrepreneurship in good times and bad, whether public or private, for our shareholders. We are both excited by what is to come and intensely grateful for the continued trust our shareholders place in us and for their patience, particularly over the last year. Thank you for listening.

Annual past performance to 31 March each year (net %)

	2019	2020	2021	2022	2023
Scottish Mortgage Investment Trust plc	16.5	12.7	99.0	-9.5	-33.6

Source: Morningstar, share price, total return, sterling.
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