

Manager insights: Tom Slater

July 2024

Your capital is at risk. Past performance is not a guide to future returns. A Key Information Document can be found at scottishmortgage.com

00:00:08

Tom Slater: If you go back three years, the world had come to a lot of our companies. They were experiencing very strong demand, they had access to capital with virtually no cost, and as a result of that, they were growing very rapidly. They were investing heavily and that's what the market was rewarding them for. I think the period over the past 18 months, two years has been one of adjustments to a world that is just a lot less certain. Whether that's from the standpoint of two hot wars going on globally, the emergent Cold War between China and the US, changes in society post-Covid. And, weaving its way through all of that radical, technological change.

And I think in that environment, resilience has become a lot more important than optimisation. And I also think that just the simple interest rate cycle has forced companies to think much more carefully about prioritising where they want to invest. And at the same time, when you think about funding projects, it's more likely that you will have to fund them from your existing operations. And therefore, running your business efficiently has become a much higher priority.

00:01:18

And so what we've seen in our companies is moving to a phase of driving efficiency, improving operations, prioritising growth projects. Making that a bit more tangible, take something like Amazon as one of our largest holdings. It saw a surge in demand through the Covid period and invested very heavily into that. It's hard actually to comprehend the scale of that investment. It had taken them 25 years to get to the footprint they had going into Covid and they doubled that footprint in the space of two years. Millions and millions of square feet of capacity.

And at the same time, they went from using third party logistics providers to doing their own logistics. So they built a logistics business the size of UPS in the space of a couple of years. And all that investment underpinned very strong revenue growth. But if you make that kind of investment at that kind of speed, you're obviously not going to be getting as much as you can out of those assets. And so, in the past 18 months, what we've seen is a renewed focus on running that new capacity much more efficiently. And you've seen this huge surge in cash flow as a result.

00:02:30

And that's replicated across the portfolio. So on a like-for-like basis, the free cash flow generated by our portfolio companies has more than doubled in the past 12 months. So yes, that's Amazon. But it's something like Spotify where there is prioritisation of the investments in the expansion

projects, whether that's podcasting or into books. But it's also an understanding that they need to be more efficient within their existing organisation because they need to be able to fund that growth, and they need to give the market confidence that it's profitable growth. And actually the number of examples I could use here is pretty numerous.

But overall growth is not as fast as it was three years ago but most companies are still growing pretty rapidly. And there are big long-term trends playing out that we're just in the early stages of, whether that's the transition to a clean energy model, the electrification of transport, whether it's the commercial exploitation of space, or using RNA technology to produce different outcomes in healthcare. Or maybe just simply the digitisation of a number of established industries, which still have a long way to go. So, we think there are lots of reasons for optimism.

00:03:43

Moderna: a year of transition

Having mentioned RNA I might just dwell on that for a second. Moderna was our biggest headwind to performance over the past year. Now its technology gives us the ability to programme the body's cells to make proteins. And that technology platform, enabled it to produce the Covid vaccine at a breathtaking pace. And, there were a couple of really positive consequences for the company that came from that. The first was a huge influx of cash, which allows it to fund its other projects. And the second was a proof that this technology is safe, that this molecule is safe. It has been given to a billion people worldwide and there have been no widespread adverse health effects.

The challenge that the company has faced over the past year is around the transition from epidemic to endemic Covid. The disease remains as deadly for vulnerable populations today as it ever was. But then, if you look at vaccination rates, they are less than a third of vaccination rates for the flu, despite Covid being more dangerous. And there's no good medical reason for that. I think the reasons are more social, political, and simply vaccine fatigue after what we've been through. But that's been a challenge.

00:05:03

It doesn't though change the investment case for us for Moderna. We foresee the application of this technology to many respiratory diseases, which will be a huge win for the healthcare system. It will meaningfully reduce the number of occupied beds over the winter flu season. And there are many viruses that have been discovered over the past 50 years that we don't have vaccines for, some of which have damaging long-term health effects. And finally, this technology can be deployed in cancer. And the results there are extremely encouraging.

As an aside, we talk about this as healthcare but what we're really talking about is AI, because what the company is doing is taking huge datasets generated by gene sequencing and then using AI to learn from those datasets and to deploy a personalised vaccine to an individual based on that analysis. So Moderna has been a headwind for us, but our enthusiasm has not been dampened by what we've seen over the past year.

00:06:00

Private companies

One of the projects we have been working on is really trying to improve the transparency around the private holdings, their performance, the way that they're valued. And it felt to us a year ago that a big driver of the discount on our shares was uncertainty about the private portfolio. What we are trying to do is balance respecting the rights of these companies to privacy, and of course the non-disclosure agreements that we've signed, whilst trying to pull together the useful data points that we can share to give you a sense of how those companies are performing.

Private companies are part of what make Scottish Mortgage unique. Being able to provide access to some of the world's exceptional private growth companies. And do that without increasing costs for shareholders, which we think it really is a special proposition. When we look at the portfolio today, and the progress that we're seeing within our private companies, I think it's safe to see that not only the operational performance, but the financial performance, is phenomenal.

00:07:05

What really matters is those top 10 private companies that makes up around two-thirds of our exposure. And when you look at the revenue growth of those top 10, that's sitting at about 80 per cent. So I think as a starting point, we should say that these companies are still growing really phenomenally rapidly. At the same time, these companies have been able to adapt to this new capital environment. We've seen them control their costs and focus on cash generation. And you can really see that come through in the account. So within that top 10, just over half by weight is cashflow positive. That's not to say they've turned off the tap in terms of innovating, investing in the business, they're still spending heavily on research and development. But it just shows where they are in terms of maturity. They're self-sustaining, controlling their own destiny.

For the ones that aren't cashflow positive, we've also seen them take control of their own destiny with successful fundraisings. So Redwood Materials raised more than a billion dollars. Zipline, the drone company, raised fresh capital, as did Databricks. They have many years of cash runway and ample liquidity to fund their growth plans over the coming years. And that's a really important attribute in the current environment.

00:08:18

So, you've got robust revenue growth, you've got improving cash flow and profitability. And these are super-charged by the structural trends that these companies are exposed to. So if you take the topic of the day, artificial intelligence. In that top 10, you have companies like Tempus in the healthcare space. And what they're doing is using AI to analyse oncology cancer records to help physicians better think about treatment paths for their patients. Or you've got Databricks, which is a company very much in the right place at the right time, deploying data and AI technologies to large enterprises. If you look at the energy transition, our second biggest private holding is

Northvolt. They've got a \$55bn order backlog to make lithium-ion batteries for electric vehicles. Redwood Materials are building the infrastructure to recycle these batteries.

Our largest private position is SpaceX. It launched 96 rockets last year accounting for about two-thirds of all commercial launches. It really has no peers when it comes to scale and cost efficiency. The company's latest rocket, Starship, has unprecedented capabilities and will be able to transport 150 metric tonnes of payload into orbit. And when fully operational it will cost significantly less to do that than the company's current generation of rockets, despite carrying 7 times the amount of cargo. It is close to commercial launch.

00:09:52

Starlink, the satellite communications subsidiary, has over 3 million subscribers and is growing rapidly, bringing connectivity to underserved parts of the world. Its unique access to launch capacity puts it way ahead of the potential competition. It already has sufficient scale to generate cash.

So we think our private portfolio has got a really good combination of drivers behind it: very strong operational performance, robust financial performance. And then those structural tailwinds.

Now, I think what's in a lot of shareholders minds is IPOs. When are some of these companies going to list on the stock market. That IPO environment has been pretty barren for the last couple of years. From a Scottish Mortgage perspective, we had one company IPO last year. There was nothing the year before that. You compare that to 2021, where we had something like 14 companies make that transition. So there's a real backlog of companies that we have in the portfolio, which are IPO ready, ready for public markets, but they've almost been waiting for the right condition. And I believe we'll start to see activity pick up over the coming months and years.

00:11:03

So we're excited to see that happen. And we're excited about the underlying progress, whether that's in AI, digitalisation, scientific and engineering progress, the opportunities presented by transitioning our energy model. We think these are fertile investment ideas for years to come.

Conclusion

Jeff Bezos, the founder of Amazon, stressed the importance of focusing on the things that don't change as you're trying to build a business. For Scottish Mortgage, that means seeking the most exceptional growth ideas and opportunities, and being patient and constructive owners of the companies we find there. Harnessing the outsized impact of a small number of extraordinary companies to drive our returns. And at the moment there are lots of opportunity to do exactly that.

00:12:00

Annual Past Performance To 31 March each year (net%)

	2020	2021	2022	2023	2024
Scottish Mortgage Investment Trust	12.7	99.0	-9.5	-33.6	32.5

Source: Morningstar, share price, total return, sterling.
Past performance is not a guide to future returns.

Risk factors

Unlisted investments such as private companies, in which the Trust has a significant investment, can increase risk. These assets may be more difficult to sell, so changes in their prices may be greater.

The trust charges 100 per cent of the investment management fee and 100 per cent of borrowing costs to capital which reduces the capital value.

Important information

This communication was produced and approved at the time stated and may not have been updated subsequently. It represents views held at the time of production and may not reflect current thinking.

This content does not constitute, and is not subject to the protections afforded to, independent research. Baillie Gifford and its staff may have dealt in the investments concerned. The views expressed are not statements of fact and should not be considered as advice or a recommendation to buy, sell or hold a particular investment.

Baillie Gifford & Co and Baillie Gifford & Co Limited are authorised and regulated by the Financial Conduct Authority (FCA). The investment trusts managed by Baillie Gifford & Co Limited are listed on the London Stock Exchange and are not authorised or regulated by the FCA.

A Key Information Document is available by visiting our Documents page at scottishmortgage.com