ACCESS ALL AREAS

Peter Singlehurst, Investment Manager. April 2018

BAILLIE GIFFORD

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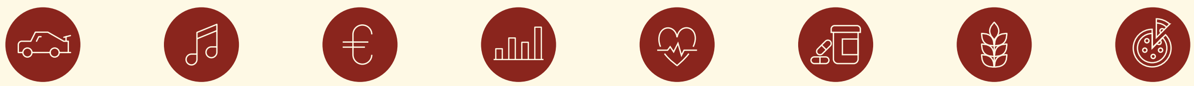
ACCESS ALL AREAS

Our enthusiasm for finding great growth businesses will, we hope, not be news to you. The asymmetry of returns inherent in equity markets tasks us with seeking out the small fraction of companies that will be genuinely transformational, and hence grow to be worth many times their current value.

Imagine the businesses you might encounter in a single day:



You're going to see your doctor and, from an app on your phone, you summon a car to collect you and take you to the station. The driver isn't chatty, allowing you to listen to a new album, or indeed any of over 30 million songs. Once on the train you can catch up on a podcast; it's a little worrying, with this week's episode discussing the impact of lower rainfall on farmers' crop yields, incomes and potentially our food security. Encouragingly, you note a mention of a technology which treats seeds to make them more robust in dry environments. Relieved, you tap over to Facebook to get the latest update from your daughter on her travels; all is well but with a quick trip to another app you send her some euros just in case. Now in the waiting room, you check your current glucose levels; your continuous glucose monitor has been a vast improvement in managing your diabetes. You still inject daily but the doctor mentions trials of an implant which could slowly dispense your treatment over a period of months. While you're here, given your age, you are tested for heart disease. This is much better than last year; a non-invasive scan allows the creation of a 3D model of your cardiovascular system to show signs of potential issues. All clear, and time for home. The journey is smooth though, unseen, the planned train for this route is in the shed for repairs. Yesterday a system of sensors collecting data from all over the rail network suggested the train was likely to break down imminently. Rather than risk blocking the network, delaying passengers and incurring costs, the train company decided to bring the engine in for maintenance. You arrive on time but it's getting late so you open another app – your favourite pizza place will deliver to your house. A successful and hassle-free day!

Forgive the hypothetical, but the above represents eight companies in which Baillie Gifford has invested over the past year or so. They are demonstrably varied in their activities yet these disparate businesses do have one thing in common – none are listed on public equity markets.

As a firm we have been investing in unlisted companies for a number of years and more recently offered this capability to our Long Term Global Growth (LTGG) clients. At the start of last year we made our first unlisted investment on behalf of a small cohort of LTGG clients; since then we have invested in seven more.

It is worth briefly reflecting on why we began investing in private companies. There have always been three facets to this. First, we have seen a build-up of high-quality, high-growth companies in the later stages of the private markets. We believe that this change is structural and driven by regulation, cultural attitudes amongst management teams, and an availability of capital to private companies. Second, as a result of deferring a listing, many of these later stage businesses exhibit the same characteristics as the high growth public companies we have been analysing for decades. Finally, we have always believed that investing in these companies will be of benefit to all our clients. Not only as many of these businesses compete with listed holdings, but it also helps us build a deeper understanding of the next generation of public companies and enables us to make better decisions as and when they become investable for our 'public-only' clients.

1

Many companies are choosing to stay private longer. In the US, the median time from first venture funding to IPO continues to edge upwards from five years a decade ago to over eight years in 2016 (we are eagerly awaiting data for 2017). Similar trends can be seen around the world. At the same time, technology-led business models are enabling some companies to reach unprecedented levels of scale quicker than ever. These forces are reducing the amount of growth and value creation available to public market investors. Our goal is to counteract this by investing in businesses earlier than would otherwise be possible for public market only strategies.

– ...we have seen a build-up of high quality, high growth companies in the later stages of the private markets.

2

To be successful at investing in private companies two conditions must hold. First, we must have access to these investment opportunities; after all, private companies can choose their shareholders. Second, we must have the ability to analyse these businesses and value the upside appropriately to make sure attractive opportunities are grasped and low-quality businesses are avoided. The number of opportunities we look at each year continues to grow. In 2017 we looked at 161 unlisted opportunities, up nearly 30% from 2016. Naturally, there was a huge range in the quality and source of these opportunities, from a quick introduction followed by a polite decline, to full blown investment research. Some of these companies went on to become investments, while others fell at the final hurdle. This spread is as it should be.

– ...we simply have a bigger opportunity set for those clients who have given us permission to invest in private businesses.

What is pleasing is that our reputation as investors in public markets remains incredibly important and a source of some great opportunities as private company investors.

Our ability to analyse unlisted companies will take longer to bear out. We have always asked to be judged in line with our investment time horizon of 5–10 years, and we are not yet within this window for the majority of our private investments. Nevertheless, there are some early indications that we might have found some companies capable of generating outsized returns for our clients. Some companies have gone on to raise capital at higher valuations, for example Lyft and Spotify, the latter of which is now making tentative steps towards the public markets. Inevitably, some companies have had rocky patches. Intarcia Therapeutics' initial application for approval of its therapy for Type 2 diabetes was not granted as hoped. It is refiling and this will hopefully turn out to be just a delay rather than anything more serious, but it nevertheless serves as a reminder that no journey is smooth. We do not expect all our private investments to work. As in public market investing, we strive to offset the loss made by the handful that don't work out by finding those few special companies that can increase the value of our clients' initial investment many times over. In this respect we are doing nothing different from how we approach investing in public companies; we simply have a bigger opportunity set for those clients who have given us permission to invest in private businesses.

3

We have always strongly believed investing in private businesses is of benefit to all our clients. This allows us to get to know the next generation of public businesses in much greater detail prior to them entering the public markets. Spotify is the most topical example of this. Our first interaction came in 2013, we invested in 2015, and are now considering whether to participate for our wider client base in the planned listing. We cannot pre-judge here whether we will or will not participate, nor state with total confidence whether Spotify will flourish or flounder from here. But it is possible to state with a reasonable degree of certainty that any decision we make will be better informed and based on a deeper understanding of the business than if we had not been an investor for the past three years.

We are more excited than ever about the opportunities we are seeing to invest in private companies. Meanwhile, conversations with our clients suggest this is no longer a controversial or fringe area in which to deploy capital. Our belief that there are some very attractive businesses to be found in the later stages of the private markets has strengthened and morphed into something far more fundamental. It is increasingly clear to us that the model of dividing investment strategies between public and private equity is broken. An arbitrary line is drawn at IPO with different investors seeking exposure to growth either side of the line. Public investors must forgo the value created before companies go public, while private investors with limited life funds are not able to hold investments for the long term after a public offering, even when significant upside remains. We believe the problem for public investors has become acute as more high growth businesses stay private longer. A strategy dedicated solely to one of private or public investment can therefore access some of a company's growth and associated value creation, but not all. In thinking about how we can invest our clients' capital in the best growth opportunities in the world, we need to think about how we can dissolve the artificial boundaries between private and public investing. This places a responsibility on us to find a structure that will allow our clients access to the array of investment opportunities we see in high-growth private businesses.

In line with our existing investment philosophy, there are two non-negotiable criteria that any vehicle able to invest in private companies must meet. First, it must create an alignment between our investment horizon and the longevity of capital. Most private investment funds have limited life structures, artificially capping investment time horizons and often forcing an 'exit' even when significant upside remains. Second, as with our public equity vehicles, it must be low cost, allowing our clients to keep more of the returns generated by the investment of their capital.

Finally, it would be remiss of us not to thank those LTGG clients who have put their trust in us to invest in private companies on their behalf. It has been a fascinating year introducing unlisted investments into their portfolios. We have no doubt that the coming years will be just as interesting and already have some exciting leads that we are working on. We hope that we can continue to find transformational businesses and justify the trust these clients have placed in us. At the same time, we hope we can demonstrate to our wider client base the attractions of the businesses to be found in the later stages of the private markets and earn their trust too.

STOCK EXAMPLES

Lyft

APRIL 2017

What does it do?

A ride-sharing company.

How did we find it?

We were first approached in late 2015, when Uber was the clear market leader. Over the next year Lyft continued to take share and we invested in early 2017.

Why do we like it?

Lyft's founders come from hospitality and transportation backgrounds. Their vision was to combine these tenets in the ride-sharing company, providing a better service for drivers and riders. This focus, combined with market-leader Uber's very public woes, has led to them steadily taking market share in an already rapidly growing market.

Recent operational progress

In 2017 Lyft more than doubled the number of rides it facilitated to over 375 million. Market share in early adopting US cities is close to half, and coverage rose from 55% of the US population to 95% in the year. Lyft has also cautiously begun to operate outside of the US, trialling the service in Canada. A subsequent funding round, led by Alphabet, valued the company at $10 billion – Baillie Gifford invested at a valuation of just under $7 billion.

TransferWise

SEPTEMBER 2017

What does it do?

An international money transfer business.

How did we find it?

We first met co-founder Taavet Hinrikus at a conference a number of years ago and followed up with a meeting in Edinburgh. We invested when the company came to raise capital.

Why do we like it?

TransferWise provides a cheap and convenient way to move money across borders. Netting flows in each country at the mid-market rate means that the cost of transfer can be up to 10 times cheaper than traditional brokers. The company's technological advantage is not merely in processing transactions but also in its consumer-friendly website and app.

Recent operational progress

TransferWise serves over 2 million business and personal customers, moving over £1 billion every month. It has also attained a 15% market share in its most mature market, the UK, which remains dominated by large banks – for now! TransferWise has recently announced the roll-out of a borderless bank account, including a debit card, which allows users to hold and convert up to 28 currencies.

HeartFlow

FEBRUARY 2018

What does it do?

Develops medical software for the non-invasive diagnosis of heart disease.

How did we find it?

We were introduced to HeartFlow via the chairman of Intuitive Surgical, a LTGG portfolio holding since 2010.

Why do we like it?

Diagnosis of coronary artery disease (CAD) is complex. HeartFlow's non-invasive tests are more accurate and reduce unnecessary testing and therefore costs. Unfortunately, CAD is the leading cause of death worldwide and diagnostics are poor – in over half of cases, death is the first presenting symptom, making the opportunity vast. Unlike many medical companies, the software-based nature of the business creates attractive margins and scalability.

Recent operational progress

HeartFlow has just launched its first product, which uses CT scans to analyse blood flow in the arteries, in the US, Europe and Japan. Importantly HeartFlow has been awarded a payment code by the US Centres for Medicare and Medicaid Services, meaning that the use of HeartFlow's diagnostics will be nationally reimbursable. This allows years of generated clinical data to be made available to aid diagnoses in a much wider patient group – around 185 million individuals.

CURIOUS ABOUT THE WORLD

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