EDISON

Georgia Capital

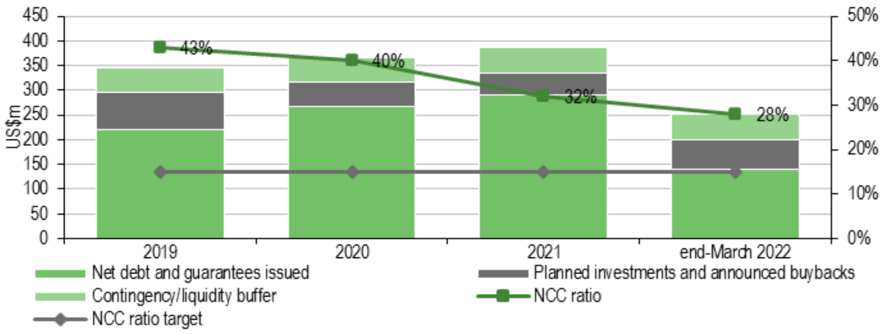
A portfolio of market leaders in Georgia

Investment companies
Private equity

31 May 2022

Georgia Capital (GCAP) has announced an updated strategy centred around: capital-light opportunities with the potential to reach an exit valuation of more than GEL300m; deleveraging at both the holding and portfolio levels; and putting ESG at the core of its investment approach. It will aim for regional expansion of its large, capital-light businesses (at present mainly the retail (pharmacy) business) and continue its capital allocation to investment stage businesses (renewable energy, education and clinics & diagnostics), as well as further share buybacks. GCAP's one-year NAV total return (TR) to end-March 2022 in GEL terms was 12.4% (31.7% in sterling terms), mostly driven by the successful sale of its 80% stake in the water utility business. In Q122 alone, NAV declined by 16.5%, primarily due to the impact of higher discount rates, lower peer multiples and the decline in Bank of Georgia's share price.

GCAP continues its deleveraging efforts



Source: Georgia Capital; Note: NCC, net capital commitments (see later in the note)

Why invest in Georgia Capital now?

The Georgian economy recovered quickly from the COVID-induced downturn, with real GDP up 10.4% in FY21 (after a 6.8% decline in FY20). The IMF expects 3.2% growth in FY22 (while TBC Capital forecasts 5.5%+) and the country has strong growth prospects for 2023–27 of 5%+ pa, according to the IMF. GCAP provides geared exposure to the Georgian economy at a wide 49% discount to NAV, mostly through resilient, market-leading businesses in sectors like healthcare, pharmacy, financials, renewable energy and education.

The analyst's view

GCAP's prospects are underpinned by a robust outlook for the Georgian economy (despite global macroeconomic and geopolitical headwinds) and the solid performance of its major holdings. GCAP seems less willing to sell any of these at present (focusing on divesting the 'subscale' businesses), as the wide discount to NAV limits new investments which are more value-accretive than share buybacks. While this suggests a lack of sizeable valuation uplifts on exits in the near term, we believe that GCAP's successful realisation of the water utility business in February 2022, coupled with the fact that 85% of its portfolio was valued externally at end-2021 (c 95% starting from end-June 2022), supports its reported valuations.

NOT INTENDED FOR PERSONS IN THE EEA

Price		**659p**
Market cap		**£301m**
NAV		**£582m**
NAV per share*		1,292p
Discount to NAV		49.0%

*At end-March 2022.based on a £/GEL rate of 4.07

Yield		0.0%
Ordinary shares outstanding*		45.1m
Code/ISIN		CGEO/GB00BF4HYV08
Primary exchange		LSE Premium
AIC sector		N/A
52-week high/low	725p	459p
NAV high/low	1,507p	990p
Gross gearing*		43.0%
Net gearing*		9.2%

*As at end-March 2022

Fund objective

Georgia Capital focuses on scalable private equity opportunities in Georgia. These opportunities have the potential to reach at least GEL300m equity value over the next three to five years and the company can monetise investments through exits as investments mature.

Bull points

- Majority of portfolio exposed to resilient and well-established businesses.
- Successful disposal of the water utility business reinforces confidence in GCAP's exit capabilities and portfolio valuations.
- Regular dividend income from several portfolio companies.

Bear points

- High discount to NAV limits GCAP's activity in terms of new investments.
- A concentrated portfolio exposed to a frontier economy is inherently higher risk.
- GCAP has just started building its track record of investment realisations.

Analysts

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Edison profile page

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Market outlook: Brisk recovery from COVID-19

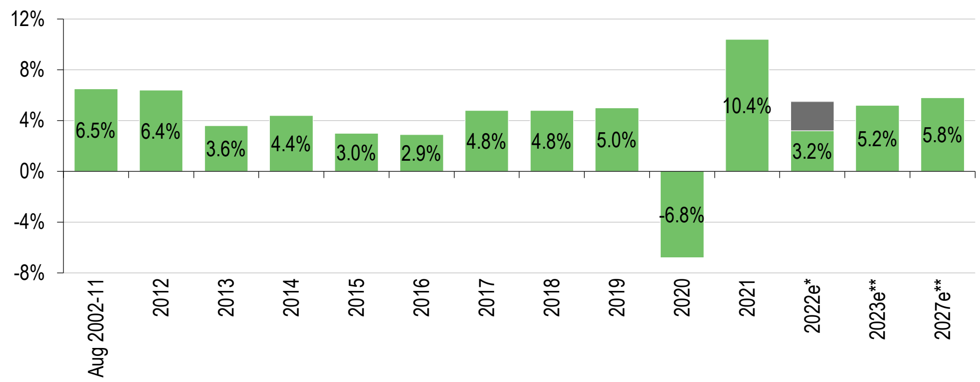
The Georgian economy has remained in a consistent long-term growth trend over the 15+ years to 2019, driven by broad-based reforms in economic management and governance following the ‘Rose Revolution’ in 2003, with real GDP growing at an impressive 5.6% CAGR between 2002 and 2019 (fuelled by private investments supported by foreign direct investment (FDI) and consumption).

While GDP declined by 6.8% in 2020, the economy recovered swiftly from the COVID-19 downturn, with growth of 10.4% in 2021 (bringing it above the 2019 level) and 14.4% y-o-y in Q122. This was driven by fiscal support and commercial lending boosting domestic demand, but also by strong export recovery and high remittances. Meanwhile, the National Bank of Georgia (NBG) increased its refinancing rate to 11% currently from 8% at end-2020 to curb inflation, which was 12.8% in April 2022 (albeit mostly due to high food and energy prices, with core inflation at 5.3%). Current account deficit is an inherent characteristic of the Georgian economy, with 9.8% in 2021 (versus 12.4% in 2020) and 5.5–12.5% since 2010. Historically, this was mostly covered by FDI, but last year it was largely debt financed. Total public debt to GDP improved to 49.4% in 2021 from 59.9% in 2020 (with external public debt at 39.8% versus 47.5% in 2020), according to GCAP citing Georgia’s Ministry of Finance and NBG.

In its April 2022 economic outlook report, IMF forecast Georgia’s real GDP growth at 3.2% in 2022. While this forecast may not fully capture recent concerns about an increasing risk of a recession in Europe, we note that there are a number of factors supporting the Georgian economy this year, such as strong remittances (up 58.8% y-o-y in April 2022, partially driven by immigration from Russia) and growth in exports (up 34.5% y-o-y from January to April 2022, 10.1% in April 2022 alone from a high base), including a positive impact of cargo re-direction from the northern route. We also note the appreciation of Georgian Lari (c 7% against the euro year-to-date). Consequently, local brokers expect a higher real GDP growth rate, eg TBC Capital at 5.5%+ (which is also aligned with GCAP’s expectations of at least 4–5%).

For 2023, the IMF forecasts 5.8% growth, while by 2027 it expects 5.2% per year, which is above expected growth in emerging and developing Europe (1.3% and 2.4%, respectively), as well as the broad group of emerging markets and developing economies (4.4% and 4.3%, respectively). Georgia’s current credit ratings are Moody’s Ba2 (negative outlook), S&P Global BB (stable), Fitch Ratings BB (stable).

Exhibit 1: Georgia’s historical and forecast real GDP growth



Source: IMF Economic Outlook April 2022, TBC Capital. Note: *IMF forecast 3.2%, TBC Capital forecast 5.5%+. **IMF forecast.

Tourism revenues expected to reach 75% of 2019 level this year

Georgia experienced a further recovery in tourism revenues, which in April 2022 were 71% of the 2019 level (19% in April 2021), according to Galt & Taggart Research which expects tourism revenues to recover to 75% of the 2019 level in its baseline scenario. Interestingly, this was coupled with tourist arrivals recovering to just c 52% of the 2019 level. The disparity can be explained by a higher share of visits from outside the region (with higher ticket sizes) and migrant arrivals from Russia, Belarus and Ukraine (which are captured in tourism revenues, but not tourist arrivals) following Russia's invasion of Ukraine (which Galt & Taggart Research estimates at 80,000-120,000 so far). These migrants are often highly skilled workers from industries like IT, representing an opportunity for the Georgian economy. Russia accounted for 19% of tourism revenues in April 2022, followed by Belarus (15%), Israel (11%), EU (11%) and Ukraine (10%).

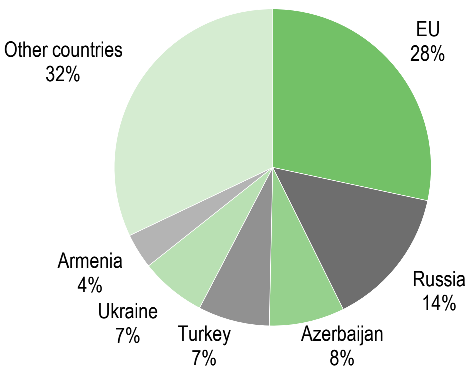
High level of business friendliness and overall solid governance versus SEE/EE countries

Georgia offers an attractive business environment and solid governance structures compared to local peers. FDI in Georgia is assisted by free trade agreements with major trade partners, including the EU (Deep and Comprehensive Free Trade Area) and China (Free Trade Agreement). The World Bank's World Governance Indicators for Georgia are ahead of Southeastern European (SEE) and Eastern European (EE) countries (often even ahead of Bulgaria and Romania, which are EU members), most notably metrics related to the control of corruption, regulatory quality, government effectiveness and rule of law. However, Georgia is somewhat lagging in the 'political stability and absence of violence' category. We also note that Georgia was ranked 26th out of 177 in the 2022 Index of Economic Freedom by the Heritage Foundation and was a top performer among SEE/EE countries.

Diversified sources of FX inflows

In the context of current geopolitical uncertainty, supply chain disruptions and high inflation, we believe it is instructive to examine Georgia's relationships with its major economic partners. Georgia is not excessively reliant on a single country in terms of FX inflows (including merchandise exports, tourism revenues, remittances and FDI), with the EU (including the UK) currently the most important source with a 28% share in 2021, while Russia's share has declined to 14% from c 20–25% in 2013, see Exhibit 2. Moreover, we note the recent pick-up in FX inflows from China (10% share in March 2022), according to GCAP based on data from Bloomberg and NBG (see GCAP's CMD presentation for details).

Exhibit 2: Georgia's combined exports, tourism, remittances and FDI by country in 2021



Source: Galt & Taggart based on National Statistics Office of Georgia (Geostat), NBG and the Georgian National Tourism Administration.

Georgia is currently quite diversified in terms of export destinations, with the EU combined being the key export market with a share of 17% in 2021, followed by China at 15% (with which Georgia signed a free trade agreement in 2018). While Russia remains one of Georgia's important trading partners with a 14% share in 2021 (which is mostly importing commodities, wines, spirits and agricultural products), its significance is lower compared to c 15–20% in 2000–05 or 31% in 1995. Georgia's exports to Ukraine were 7% in 2021.

FDI in Georgia comes primarily from the EU (75.2% in 2021), with Russia having a marginal share (7.3% in 2021), according to Galt & Taggart. Moreover, 41.6% of remittances in 2021 came from the EU, with Russia's share declining considerably from +50% in 2011–13 to c 17.5% in 2021. A recent decline in remittances from Russia and Ukraine following the outbreak of war was compensated by stronger inflows from the EU and US, according to Bank of Georgia's (BoG's) Q122 earnings presentation.

With respect to energy security, we note that Georgia relies primarily on domestic electricity production with an 87% share in 2020, of which 65% came from hydro and 22% from thermal sources, based on Geostat data. While the country does not have its own meaningful oil production (2% in 2020), its import mix is quite diversified, with Russia at 26% followed by Azerbaijan (22%), Romania (15%), Turkmenistan (11%) and Bulgaria (8%). The country covered 92% of its natural gas demand in 2020 through imports from Azerbaijan, with the remaining 8% coming from Russia. In terms of food security, the company's major sensitivity is its low self-sufficiency ratio in the case of wheat at 15% (according to GCAP) and high reliance on imports from Russia. We understand that the Georgian government is in active negotiations to secure alternative import directions.

Geopolitical considerations

While some observers may have concerns about a potential Russian intervention in Georgia as part of its current ambitions to at least partially restore control over selected former Soviet republics, we consider this scenario unlikely in the foreseeable future for a number of reasons. Firstly, Russia invaded Georgia in 2008 and, while it was unable to introduce a pro-Russian government in Tbilisi, it achieved a number of objectives, including 1) the seizure of two breakaway republics (South Ossetia and Abkhazia) by pro-Russian separatists and the Russian military, 2) deployment of anti-missile systems on the southern side of the Greater Caucasus Mountains and 3) preventing Georgia from joining NATO.

Secondly, Russia most likely lacks the military capacity to engage in another full-blown invasion at present given the limited success and heavy losses incurred in Ukraine, the protracted nature of the Ukrainian war (which may also be affected by Western sanctions aimed at impairing its ability to restore lost combat power in terms of advanced equipment). We believe Russia is more likely to try seizing the remaining parts of the Ukrainian coast (including Odessa) to establish a bridge to Transnistria in Moldova rather than embarking on a military campaign in Georgia.

The fund manager: Self-managed

The manager's view

GCAP's strategic priorities include deleveraging the holding company by bringing down its net capital commitment (NCC) ratio below 15%, as well as reducing and maintaining a lower level of leverage in the respective portfolio companies. In terms of ESG priorities, GCAP plans to execute smooth separation of the chairman and CEO roles and set measurable ESG targets at both the holding and portfolio company levels. It targets continued progress on the divestment of 'other' (ie 'subscale') portfolio companies. Achievement of the above will allow GCAP to evolve gradually into a sustainable permanent capital vehicle (PCV), which will have the capacity to redeploy existing capital without needing to issue new equity, while its net asset value (NAV) per share should grow on the back of resilient, often capital-light investments. This will also facilitate the opportunity to return a significant portion of its cash inflows to shareholders.

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Asset allocation

During the recent capital markets day (CMD), GCAP announced its updated investment strategy based on three pillars.

Firstly, GCAP maintains its focus on capital-light, scalable opportunities (especially in service-oriented sectors), which should assist its deleveraging efforts (see below). However, it lowered the minimum requirement in terms of targeted exit valuation of businesses to GEL300m (c US$100m, within three to five years) from GEL500m previously (see our review note published in September 2021 for details). GCAP's management was encouraged to do this following the considerable interest from international investors in its holdings, even for somewhat smaller businesses than originally anticipated.

GCAP plans to enable its large, capital-light portfolio companies to explore regional growth opportunities. In the near term, management sees immediate regional expansion potential in its retail (pharmacy) business, with a five-year target of 400 pharmacies in Georgia (vs 353 currently) and at least 30 stores in Armenia, as well as entry into the Azerbaijan market. GCAP's CEO believes that this business can expand in a capital-efficient manner, that is it can double its market size by investing US$5–10m in total (including working capital), given the cost of opening a pharmacy in Armenia is c US$50,000. In the longer term, GCAP considers its education business, as well as clinics and diagnostics business promising in terms of regional expansion. It is still in the process of assessing the prospects of the auto services business (where it has invested c US$4.6m in total so far). Beyond the above (and some incremental investments in the renewable energy and education businesses), GCAP is unlikely to make any large new investments in the next three to five years. With respect to more capital-heavy industries (such as hospitals or insurance), GCAP will consider managing third-party capital and/or establishing partnerships. We note that the company is unlikely to purchase an additional stake in BoG (in which it already holds 19.9%) given opposition from the local regulator (as highlighted by GCAP's CEO during the recent CMD).

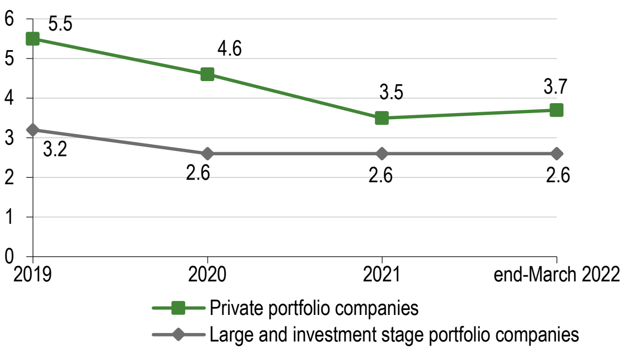
Secondly, GCAP has updated its capital management policy to include the NCC ratio as a core element alongside its existing 360-degree framework used to evaluate the optimal price of any potential acquisition. The direction of GCAP's capital allocations is determined by an assessment of the following: 1) the discount at which GCAP can buy an asset/company in relation to listed peers, 2) the discount to NAV at which GCAP is trading and 3) the discount to fair value at which GCAP's listed portfolio companies are trading (see our initiation note for a detailed discussion of GCAP's approach to analysing potential investments).

The NCC ratio allows GCAP to decide how much capital it should invest, ie it acts as a kind of 'volume button'. The ratio is defined as net debt and guarantees issued at the holding level plus total planned investments, announced buybacks and a US$50m contingency/liquidity buffer divided by portfolio value. GCAP aims to conduct meaningful buybacks and investments at an NCC below 15%, tactical buybacks and investment at an NCC between 15% and 40% and pursue a cash preservation strategy when NCC exceeds 40%. The company is currently focused on deleveraging the holding company by bringing down its NCC ratio below/close to 15% by December 2025 (vs 28% at end March 2022). We understand that the above results from GCAP management's belief that GCAP's leverage is one of the factors contributing to its wide discount to NAV (see the discount section for more detail). We agree with this given both the incremental funding risk and the increased NAV volatility arising from meaningful leverage at the holding company level.

Moreover, GCAP plans to reduce and maintain leverage ratios of portfolio companies at their respective target levels. The aggregate net debt to last 12 months (LTM) EBITDA across GCAP's private large and investment-stage portfolio holdings (including the minority buyout agreement in retail pharmacy) was 2.6x at end-March 2022 (3.7x for all GCAP's private portfolio companies versus 4.6x and 5.5x at end 2020 and end 2019, respectively, see Exhibit 3). We present the leverage figures of individual holdings together with respective over-the-cycle targets in Exhibit 4. It is worth noting that GCAP's management does not expect to provide further loans to portfolio companies going forward.

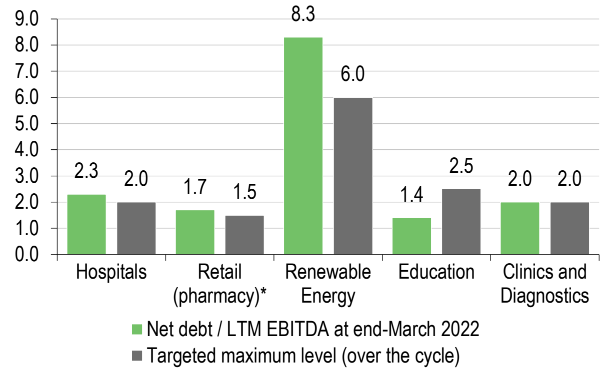
Finally, GCAP will put ESG at the core of its strategy and we discuss its approach to ESG in detail in the investment process section below.

Exhibit 3: Net debt to LTM EBITDA of GCAP's private portfolio



Source: Georgia Capital data

Exhibit 4: Current and targeted leverage of GCAP's portfolio companies



Source: Georgia Capital data. Note: *Adjusted for the capital commitment related to minority stake buyout, excluding which the end-March 2022 ratio would be 0.2x.

Current portfolio positioning

GCAP's private portfolio at end-March 2022 comprised three large businesses (retail (pharmacy), hospitals and insurance), three investment-stage portfolio companies (clinics and diagnostics, renewable energy and education) and several 'subscale' businesses (auto service, beverages, IT outsourcing (previously digital services), housing development and hospitality, see Exhibit 5).

GCAP's most valuable portfolio holding at present is the largest retail pharmacy chain and wholesale business in Georgia with 353 stores (and six stores in Armenia) with a market share of 35% in 2020, which increased from 30% four years earlier (according to Georgia Healthcare Group's internal reporting). It also operates seven stores under a franchise agreement with The Body Shop and has one optician outlet under a franchise agreement with Alain Afflelou. The company aspires to be the largest diversified retail operator for human health and wellbeing in the region.

GCAP also owns the largest hospital chain in the country with 2,877 beds representing a 20% market share. The company operates 16 referral hospitals in locations covering 75% of Georgia's population. Its five-year targets (to 2026) include a 10%+ EBITDA CAGR, EBITDA to operating cash flow ratio of c 85%+ (versus 70.2% in Q122) and a return on invested capital (ROIC) of 13%+ (versus 9.2% in 2021).

The Property and casualty (P&C) insurance business is the top player with more than 65k customers and a 29% market share by gross premiums written in FY21 (according to GCAP). The business has been growing its gross premiums written and net profit by 14% pa and generated an average return on equity of 32% in 2014–21. Its solvency ratio was 174% in Q122 (which it intends to further improve to above 200%) and it had a combined ratio of 81% in FY21 (78% excluding the COVID-19 impact, according to the company). The business plans to enter the regional reinsurance market.

The renewable energy business is a platform for developing hydro and wind power plants across Georgia. It consists of three wholly owned commissioned renewable assets, including the 30MW Mestiachala hydro power plant (HPP), 20MW Hydrolea (acquired in October 2019) and the 21MW

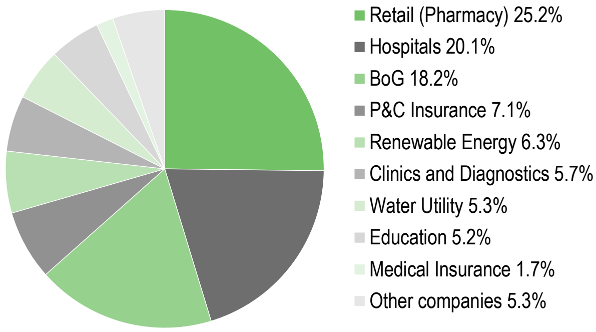
Qartli wind farm (acquired in November 2019 through a public auction). The business also has a pipeline of up to 172MW in renewable energy projects at an advanced stage of development.

Moreover, GCAP continues to hold a 19.9% stake in the listed BoG and a 20% stake in the water utility business after the recent sale of its 80% stake.

GCAP's portfolio at end-March 2022 also included 34 clinics, of which 19 are community clinics and 15 are polyclinics (with two more polyclinics launched in April 2022) serving 595k patients at end-March 2022, which represents a 21% market share. The diagnostics business served 1.2 million patients and performed c 2.6m tests in FY21.

GCAP's education business is the largest player in the Georgian private K-12 market with a 5% share across five campuses and five brands, with a learner capacity of 5,060, including affordable (3,500), mid-scale (760), premium (400) and international (400) segments. It aims to increase its utilization rate at its current campuses to 94% in 2025/26 from 64% in 2021/22 and drive an EBITDA increase to GEL21m from GEL12m over that period. It has also secured six pipeline projects that represent an additional learner capacity of 3,000 and GEL9.0m in incremental EBITDA by 2025. The business also considers growth through M&A.

Exhibit 5: GCAP's portfolio at end-March 2022



Source: Georgia Capital data

Solid dividend income outlook

GCAP collected GEL74.4m in dividend income from portfolio companies in FY21, which is 2.1% higher than the FY19 level (and compares with GEL29.9m collected in FY20). Private companies contributed to a greater extent with GEL59.9m (vs GEL44.0m in FY19). For FY22, GCAP guides to dividend income of GEL90–100m, which implies a year-on-year increase of c 21–34%. We note that BoG has recently declared a final dividend of GEL2.33 per share in respect of its FY21 earnings, which will translate into dividend income for GCAP of c GEL22.8m, according to our calculations.

Performance: One-year NAV TR of 12.4% in local currency

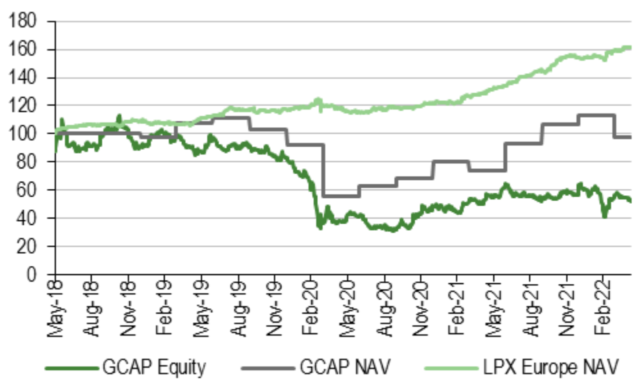
NAV per share was down by c 16.5% to GEL52.62 at end-March 2022 versus end-2021 (down c 14.4% in sterling terms to £12.92), of which 8.4pp came from the negative revaluation of the private portfolio, including 7.0pp from peer multiples/FX and 1.4pp from operating performance/greenfields, with the latter mostly related to GCAP's 'subscale' businesses (beverages and housing development in particular). A further 7.2pp negative impact was attributable to the c 30% decline in the share price of BoG in Q122. At end-March 2022, the bank traded at 0.70x last reported book value despite its above-average return on equity, which is a considerable discount to most listed regional peers.

GCAP's one-year NAV TR to end-March 2022 in sterling terms stands at 31.7%, assisted by the rebound in the Georgian lari (GEL), as its return in GEL terms was 12.4%. This compares to the FTSE-All Share Index at 13.0% and LPX Europe NAV Index in sterling terms at 25.9%. GCAP's one-year NAV TR was driven primarily by the successful disposal of the water utility business at a c 53% uplift to end-March 2021 carrying value, as well as revaluations of the retail (pharmacy), healthcare services and education businesses. Over the last three years, GCAP's NAV TR in sterling is negative 9.5% due to: 1) a c 24% decline in the share price of BoG in total return terms over the period, 2) a c 13% depreciation of Georgian lari against sterling (despite the year-to-date appreciation) and 3) the downward revaluation of some private holdings particularly hit by the pandemic, most notably the hospitality, commercial real estate and housing development businesses.

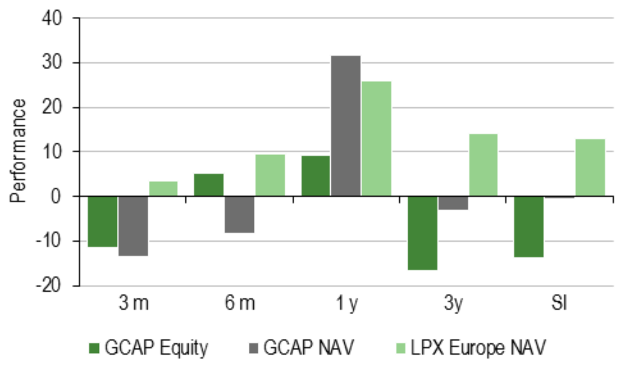
We note that GCAP's current 'live' NAV, updated for the present share price of BoG (rebounding from £11.88 to £16.40), as well as GEL/£ movements (with all other inputs remaining unchanged) stands at £14.82 (ie up c 15% from end-March 2022).

Exhibit 6: Georgia Capital performance to 31 March 2022 in sterling terms

Price, NAV and index total return performance, since IPO rebased



Price, NAV and index total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Performance since IPO and over three years annualised.

Exhibit 7: Three-year discrete performance data

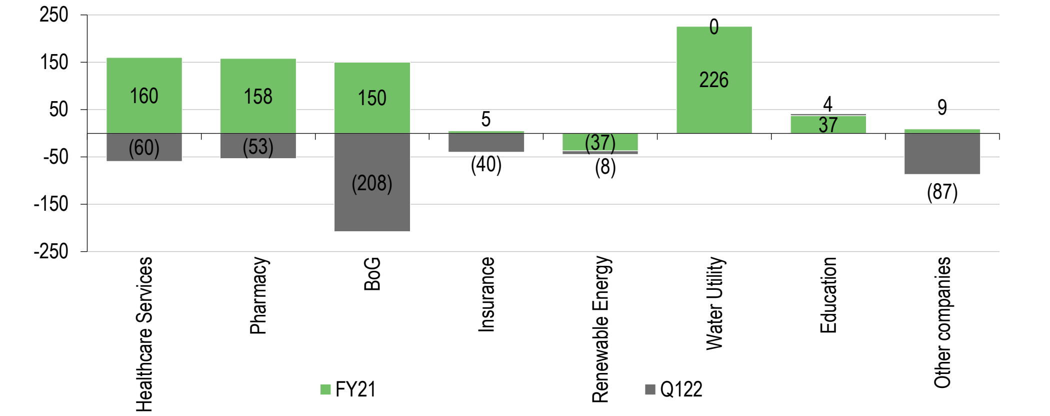
12 months ending	Share price (%)	NAV (GEL) (%)	NAV (£) (%)	MSCI World (%)	LPX Europe NAV (%)	FTSE All-Share (%)
31/03/20	(61.0)	(40.2)	(48.4)	(5.3)	12.1	(18.5)
31/03/21	36.0	55.1	33.7	39.1	5.5	26.7
31/03/22	9.2	12.4	31.7	15.9	25.9	13.0

Source: Refinitiv. Note: All % on a total return basis in pounds sterling, except for NAV expressed both in GEL and £.

Q122 revaluation loss mostly due to higher discount rates and lower peer multiples; underlying performance remains intact

As a result of the increase in the cost of equity in the region, the discount rates used to value GCAP's holdings went up by 1.5–2.0pp in Q122, leading to negative net portfolio valuation effects during the quarter (see Exhibit 8). GCAP's CFO highlighted during the CMD that the contribution of the respective methods to the valuation of GCAP's holdings varies from one company to another, but generally discounted cash flow (DCF) makes up c 70%, while the remaining 30% is split between public multiples (usually c 15–20%) and multiples of comparable private market transactions (normally c 10–15%).

Exhibit 8: FY21 and Q122 value changes of GCAP's holdings (GELm)



Source: Georgia Capital data

At the same time, however, we believe that most businesses demonstrated resilient underlying financial performances (and had very limited direct exposure to Russia and Ukraine, according to GCAP). This translated into LTM revenue and EBITDA improvements of 22.4% and 9.9%, respectively, versus Q121 (excluding the water utility business), with large and investment-stage portfolio companies posting revenue growth of 22.0% and 36.0%, respectively, and EBITDA growth of 18.5% and 27.1% y-o-y, respectively. Exceptions to the above solid performances are GCAP's two 'subscale' businesses: beverages and housing development. The former has been affected directly by Russia's invasion of Ukraine (as c 60% of sales in the wine business had previously been to Russia and Ukraine), while the latter has been hit by raw materials inflation, which has not fed through to apartment prices yet. In Q122 alone, revenue across GCAP's private portfolio companies grew by 15% y-o-y, while EBITDA was slightly down by 0.7% y-o-y (but EBITDA was up 7.5% and 19.7% y-o-y for GCAP's large and investment-stage portfolio companies, respectively). The LTM aggregate net operating cash flow of GCAP's portfolio companies was up 5.6% y-o-y to GEL261m in Q122. We summarise the key revenue/earnings drivers across GCAP's portfolio in Exhibit 9.

Exhibit 9: Key results drivers across GCAP's portfolio companies

	Q122 y-o-y growth		Q122 LTM y-o-y growth		Major drivers
	Revenue	EBITDA	Revenue	EBITDA	
Retail (pharmacy)	14.4%	57.5%	19.1%	29.0%	Same store revenue growth at 12.5% y-o-y in Q122 from a combination of volume and average bill size; chain expansion by 37 pharmacies over the last 12 months to 359 stores at end-March 2022.
Hospitals	9.0%	-19.9%	34.8%	24.0%	33.9% y-o-y increase in the number of admissions (resulting in higher bed occupancy rate at 61.9% vs 57.7% in Q122), as well as a 10.2% y-o-y increase in revenue per bed; earnings affected by cost base restructuring of COVID-19 hospitals, phasing out of COVID-19 government contracts around mid-March 2021 and the absence of COVID-19 state subsidies.
Bank of Georgia	30.3%*	73.2%**	N/A	N/A	Net interest income increased by c 28% y-o-y to GEL271m (with net interest margin up to 5.3% from 4.5% in Q122), while net non-interest income was up 36% y-o-y to GEL124m; cost income ratio improved slightly to 35.0% in Q122 from 35.4% in Q121; cost of risk was stable year-on-year at 80bp; as a result, annualised ROAE was 30.7% in Q122.
Insurance	8.8%*	-19.2%**	14.1%*	-15.6%**	P&C insurance posted a 16.0% y-o-y increase in net premiums earned on the back of credit life and liability insurance; Medical insurance was up 1.1% y-o-y (price-driven as the number of individuals insured was down 7.6% y-o-y in Q122); GEL0.6m unrealised loss on the investment portfolio of the P&C business in Q122; higher medical net claims expenses (amid rebounding elective healthcare services), bringing the Medical insurance segment's combined ratio to 100.8% in Q122 from 95.9% in Q121.
Renewable energy	-1.9%	0.6%	3.1%	6.6%	Electricity generation was up 7.3% in Q122, assisted by favourable hydrological conditions; the average sales price was down 0.9% y-o-y to US$61.0 in Q122; FX headwinds from the GEL appreciation versus the US dollar (revenue and EBITDA in US$ terms were up 6.3% and 9.4% in Q122, respectively).
Clinics and diagnostics	31.6%	12.0%	58.1%	66.6%	Good performance for both clinics (with the number of registered patients up 10.6% y-o-y in Q122) and diagnostics services (number of patients served up 53.1% y-o-y in Q122 with the number of non-COVID-19 tests up 24.8% y-o-y); expiry of pandemic-related state subsidies and phasing out of COVID-19 government contracts.
Education	45.3%	57.1%	35.4%	44.2%	20.3% y-o-y increase in average tuition revenue per learner for the existing capacity and a 25.9% y-o-y growth in the number of learners; capacity utilisation (excluding expansion) up 5.1pp to 95.9%; 23.1% utilisation of the capacity added in Q321 (up 0.4pp q-o-q).

Source: Georgia Capital data. Note: *Operating income for BoG and net premiums earned for the insurance business. **Net income for BoG and the insurance business.

Peer group comparison

In Exhibit 10, we present a group of private equity (PE) funds specialising in direct investments (including co-investments), which we consider peers for GCAP. Having said that, these funds differ from GCAP (which invests exclusively in Georgia) in terms of regional exposure and sector (eg HgCapital Trust is tech focused). As such, none of the selected companies serves as a perfect comparator. In sterling terms, GCAP outperforms the peer average over one year (although it ranks fourth) but is the only company in the peer group that shows a meaningful negative NAV TR over the last three years (see the Performance section above for a discussion of key drivers).

Exhibit 10: Listed private equity investment companies peer group at 30 May 2022* (in sterling terms)

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Georgia Capital	**301.1**	**30.5**	**(10.1)**	**N/A**	**(52.8)**	**1.4**	**No**	**110**	**0.0**
Wendel SE	3,663.6	(0.2)	2.7	2.7	(41.3)	1.0	No	126	3.0
HgCapital Trust	1,786.7	30.9	118.2	194.3	(10.0)	1.4	Yes	100	1.8
NB Private Equity Partners	662.9	29.0	78.5	110.4	(33.9)	2.0	Yes	111	4.6
Oakley Capital Investments	694.3	34.7	98.2	147.4	(31.7)	2.2	Yes	100	1.7
Princess Private Equity	675.2	9.2	47.7	76.1	(24.6)	1.7	Yes	100	5.8
Symphony International Holding	189.6	34.5	(0.1)	(2.9)	(48.4)	3.4	No	100	5.1
Peers average	**1,278.7**	**23.0**	**57.5**	**88.0**	**(31.7)**	**1.9**	**-**	**106**	**3.7**
Rank	**6**	**4**	**7**	**N/A**	**7**	**5**	**-**	**3**	**7**

Source: Refinitiv, Edison Investment Research. Note: TR=total return. Net gearing is total assets as a percentage of net assets. 100=ungeared. *12-month performance based on latest available ex-par NAV as at end-March (Symphony International Holding is as at end-December 2021).

Discount: Remaining wide versus past levels and peers

GCAP's shares had traded in a 10–30% discount to NAV range from IPO in May 2018 until the COVID-19 outbreak, when the share price decline drove the discount to an all-time high of 70% (similar to other listed PE companies). Despite the partial rebound from March 2020 lows, GCAP's shares continue to trade at a relatively wide discount of c 49% to end-March NAV per share at present (or 56% taking into account the BoG share price and FX changes since end-March 2022). This compares with the current average discount of GCAP's peers of c 32% (see Exhibit 10). This is despite the successful exit from the water utility business, which we believe marks an important milestone on the path to validating GCAP's PE investment strategy.

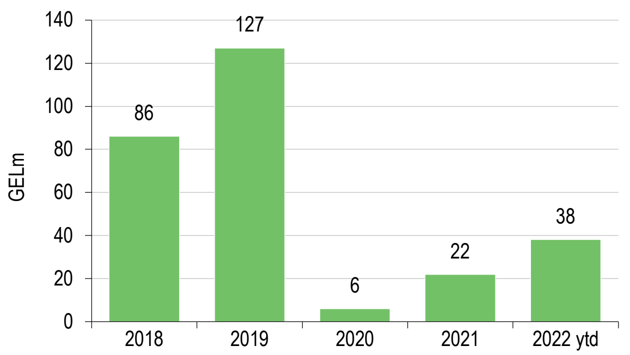
We also note that 85% of GCAP's portfolio at end-December 2021 was valued externally, including (1) the stake in listed BoG (18% of portfolio at end-March 2022), (2) the remaining 20% stake in the water utility business (5% of the portfolio, where visibility is underpinned by GCAP's put option), (3) its large portfolio companies (54% of portfolio) and the clinics and diagnostics business (6% of portfolio). GCAP announced during the CMD that the scope of external portfolio valuation (carried out by Kroll, formerly Duff & Phelps) will be expanded from end-June 2022 to include the renewable energy and education businesses. As a result, 95% of GCAP's portfolio (based on end-March 2022 carrying values) will be either validated by the public market (BoG) or by an independent external valuer.

One factor that could at least partially explain the discount is investors' risk perception of Georgia as a frontier market. Here, we note that the country has weathered the COVID-19 crisis well so far and has a favourable GDP growth outlook (as discussed above). Another reason could be GCAP's net leverage at the holding level, which however has been reduced recently on the back of exit proceeds (and the management will focus on further deleveraging going forward). Finally, some investors may be concerned about geopolitical risks amid Russia's invasion of Ukraine (which we comment on in the Market outlook section above).

Exhibit 11: Share price discount to NAV since IPO (%)

Source: Refinitiv, Georgia Capital, Edison Investment Research

Exhibit 12: Buybacks and issuance



Source: Morningstar, Edison Investment Research

GCAP continues to conduct value-accretive buybacks

Since being carved out in 2018, GCAP has spent US$53m on buybacks, acquiring and cancelling 4.7m shares (as of 6 May, ie until GCAP's CMD). This includes the buyback programme in 2018–19 covering US$35.7m spent on repurchasing 2.7m shares and the current buyback programme (launched in August 2021), which so far has covered US$17.3m spent on 2.1m shares to 6 May 2022 (representing c 4.5% of GCAP's issued shares before the start of the programme), with a further US$1.1m spent on 0.16m shares to 31 May. Meanwhile, it has issued c 11.1m shares (in two tranches) for the take-private transaction of Georgia Healthcare Group (for a background of this transaction, see our initiation note). The net impact has been an increase in GCAP's share count from 39.4m at the time of inception (the de-merger) to 45.8m.

GCAP perceives its continued buybacks as an opportunity to bring the share count back down to 39.4m and in that way set the 'final price' for Georgia Healthcare Group's (GHG's) acquisition (with the current unrealised multiple of invested capital (MOIC) on this investment at 1.6x in US dollar terms). Consequently, it increased its initial US$10m buyback programme by another US$10m in Q122, and then by a further US$10m (as announced at the CMD), of which US$5m is for the buyback and cancellation programme and US$5m for the management trust. Hence, the total buyback and cancellation programme from August 2021 is now US$25m (of which US$6.6m is yet to be spent as at 31 May 2022). Given GCAP's high discount to NAV, its buybacks are highly value accretive (eg they added 1.3pp to GCAP's NAV per share in GEL terms in Q122). GCAP does not plan to pay any dividends as long as its shares trade significantly below NAV.

Fund profile: A private equity play on Georgia

GCAP is an investment company primarily focused on equity investments in Georgia in sectors that are expected to benefit from the growth and diversification of the local economy. The company was established on 29 May 2018, when UK-based holding company BGEO was split into BoG (a leading Georgian universal bank) and GCAP. Since then, GCAP has been listed on the London Stock Exchange and has a wide shareholder structure, including 9% employee ownership. As a result of the de-merger, GCAP owns a 19.9% equity stake in BoG. It agreed that as long as its stake is greater than 9.9%, it will exercise its voting rights in accordance with the votes cast by all other shareholders (on a pro rata basis) during all shareholder votes at any general meeting.

GCAP is self-managed (ie it has no external investment manager) and has an experienced management team of eight members, with all senior team members coming from the former BGEO Group. The team is led by Irakli Gilauri as chairman and CEO, who was with BoG from 2004 and subsequently CEO of BGEO Group from 2011. He has around 20 years of experience in banking, investments and finance. According to the company, his strategic involvement and extensive relationship network has been instrumental over the last 10 years in creating major players in a number of Georgian industries, such as banking, healthcare, utilities and energy, real estate, insurance and wine businesses.

Importantly, GCAP management members have seats on the boards of all its private portfolio companies. The team has a track record of executing more than 40 acquisitions under the BGEO Group in banking, insurance, healthcare, utilities, retail, FMCG and other sectors. After the de-merger, GCAP's management continued to expand the portfolio with several acquisitions (see our initiation note for a detailed list).

Investment process

GCAP sources acquisition targets in industries approved by its Investment Committee based on a comprehensive sector analysis. The deal origination process involves both inbound inquiries from potential sellers (facilitated by GCAP's unique positioning as a local institutional investor), as well as GCAP's active search for attractive businesses and market sounding to evaluate the appetite for selling by owners. The above translates into c 100 investment leads per year. The company also considers participation in public auctions, as illustrated by the acquisition of the Qartli wind farm in 2019. GCAP aims to ensure a smooth transition process within its portfolio holdings through board participation, aligning the company's accounting, tax and legal teams with GCAP standards, as well as capital expenditure monitoring. High-quality management is an important factor considered when evaluating potential acquisitions (given the relative scarcity of experienced company management in Georgia) and GCAP partners in selected cases with existing entrepreneurs who retain a minority stake in the acquired business. A good example here are GCAP's transactions in the education sector.

With respect to portfolio exits, GCAP's investment horizon is five to 10 years from the initial investment and it aims to perform an investment realisation in two stages. In the first stage, it seeks to collect cash from portfolio companies through dividends. The process is usually facilitated by leveraging its investments to free up equity (the team has extensive experience in accessing the debt capital markets, gained under BoG/BGEO). The final exit is executed through standard PE routes, but with a particular focus on trade sales to strategic investors. For some of its larger businesses, it may also consider an IPO, although we believe this exit route is less likely to be utilised (given GCAP's experience with GHG as a listed company; see our initiation note for details). It may also conduct a partial exit by selling a minority stake to a 'silent partner' and continuing to manage the business.

We note that in comparison to PE funds active in developed markets, GCAP may enjoy a more limited number of exit options and these opportunities may occur less frequently. This is due to the limited number of other institutional PE investors in the local market, as well as the relatively small size of the frontier Georgian economy. Having said that, the recent successful disposal of the water utility business (see our previous note for details) is proof that GCAP can acquire (at local valuation multiples), develop through value-accretive initiatives and profitably sell portfolio companies (at international multiples) to a high-quality international strategic investor. GCAP also has a certain track record in terms of local private deals involving selected assets of its holdings to realise a solid return or sell low-return assets to improve the ROIC of the portfolio company. These include:

- the sale of US$45m worth of commercial real estate properties (mostly retail and office) carried out between July and September 2021 at an 11.3% premium to end-March 2021 book value (37% uplift to net carrying value) and a 2.1x MOIC (in US dollar terms),
- the disposal of a 50% stake in the HTMC Hospital for US$12m in August 2020 (improving the ROIC of GCAP's hospitals business by 90bp on pro-forma basis),
- the sale of a 100% stake in the Traumatology Hospital for US$2.9m in April 2022, and
- the divestment of Bahkvi 2 hydro power plant (a development project) for US$2.05m in September 2021 at a 31.5% IRR.

We also note that GCAP's exit strategy involves identifying and familiarising the potential investor base with companies within GCAP's portfolio (as well as with Georgia's macroeconomic story) to facilitate the subsequent realisation process. Moreover, GCAP develops an exit plan from the beginning of the holding period, which entails setting exit targets for the business (eg in terms of EBITDA growth and market share). Finally, unlike most listed PE companies, GCAP does not have any commitments to exit its investments within a specified timeframe, which gives it additional flexibility in terms of liquidity and investment horizon. Going forward, GCAP continues to work on divesting its subscale holdings (ie with limited potential to reach at least GEL300m in exit valuation), targeting meaningful progress over the next 12–24 months, as well as building relationships with potential foreign buyers across sectors it invests in. However, given GCAP's current wide discount to NAV (limiting the range of new large investment opportunities meeting the criteria of its 360-degree framework), we believe the company will be in no rush to exit any of the remaining large portfolio companies (despite the high investor interest it experiences).

Georgia Capital's approach to ESG

Below we outline the key recent activities on GCAP's ESG agenda:

- GCAP aligned its ESG disclosures with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) in its annual and sustainability reports.
- In February 2022, the company became a signatory of the UN Global Compact and officially expressed its commitment to the principles of the UN.

- Also in February 2022, GCAP's board adopted a Responsible Investment Policy, which is integrated into the company's investment and portfolio management processes and procedures.
- GCAP implemented tools for monitoring and reporting ESG aspects within the scope of its Responsible Investment Policy.
- The company published its first sustainability report in 2022

We also note that GCAP's portfolio includes companies that seem to have an overall positive impact on society or the environment, including for instance the healthcare businesses (GHG's facilities conducted 15.8% of the country's total COVID-19 vaccinations), education and renewable energy. GGU (the water utility and renewables company, which was previously fully owned by GCAP) issued a US$250m green bond in 2020 to finance renewable energy projects and develop sustainable water and waste water management practices in Georgia, while building resilience to climate change (it obtained a Second-Party Opinion from Sustainalytics on the Green Bond Framework). Greenhouse gas emissions at group level increased by 6.6% y-o-y to 40,652 tonnes of CO_2 in FY21 (with the per full-time equivalent figure up slightly from 1.88 to 1.89).

Additionally, the company positively contributes to society through a number of activities, such as carrying out sponsorship (GEL1.3m spent in FY21) and charitable activities (GEL0.8m), promoting and enhancing access to education, preserving nature, supporting people with disabilities, raising health awareness and promoting healthcare practices through TV programmes (on which GHG spent GEL97k in FY21), as well as free screening programmes. In terms of employee engagement, we note that according to GCAP's annual staff survey, more than 95% of participants enjoy working at Georgia Capital. As regards gender diversity, 60% of employees at the holding level and 68% at group level are women (two out of five of GCAP's board members and two out of six management team members are women).

We note that in order to improve GCAP's governance structure, Irakli Gilauri recently made a proposal to GCAP's board (which the board unanimously accepted) that on completion of his current employment contract as GCAP's chairman and CEO in May 2023, both roles should be separated. Consequently, he would step down as the CEO and continue as the chairman of the board. On expiry of Mr Gilauri's contract, the board plans to appoint Nick Gamkrelidze as CEO; at present he serves as deputy CEO of GCAP and CEO of GHG, and had already been designated as the prospective CEO as part of GCAP's succession planning before the above announcement.

Gearing: Targeting an NCC ratio of c 15%

GCAP has structural gearing through its 6.125% Eurobonds with US$365m outstanding at end-March 2022 maturing in March 2024 (upsized last year from US$300m through a tap issue). Post balance sheet date, GCAP bought back an undisclosed amount of the corporate bond when it was trading at a yield in excess of 8% and plans to use its available liquidity (and potentially also prospective exit proceeds) to continue repurchasing the bond as part of its deleveraging strategy.

As a consequence of the disposal of the water utility business (with proceeds received on 2 February 2022), GCAP's reported net debt was reduced significantly to GEL239.4m at end-March 2022 from GEL711.1m at end-2021 as cash and marketable securities (mostly Georgian sovereign and corporate bonds) increased to US$232m (GEL719m) at end-March 2022 from US$88m at end-2021. GCAP's policy involves keeping a buffer of at least US$50m in highly liquid assets (included in its NCC ratio calculation, see above). We note that GCAP intends to reclassify US$43.9m of loans issued by GCAP to its beverages and real estate businesses to quasi-equity facilities due to the adverse financial impact from the Russia-Ukraine war. This, all else being equal, will result in an increase in GCAP's net debt to GEL382.1m. As discussed above, GCAP's capital allocation strategy will rely on the NCC ratio (with a target of c 15% by 2025); the NCC ratio's historical levels are presented in the chart on the front page.

Fees and charges: Attractive fee structure

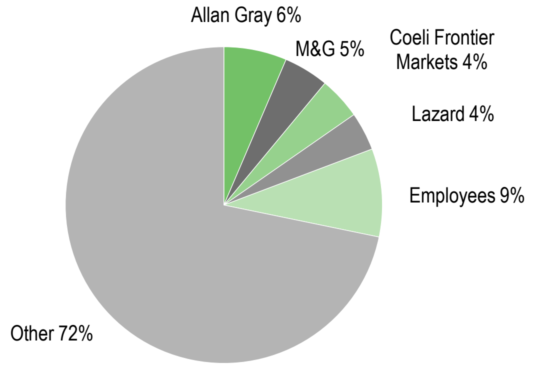
As GCAP is self-managed, there is no management or performance fee charged by an external investment manager. Nevertheless, the company incurs management expenses in the form of salaries and bonuses to its senior staff and management. At present, it has an internally targeted cap at 2% of GCAP's market capitalisation, which it was able to meet in the past with 1.7–1.8% in 2019–21. From 2024, GCAP will modify the target to a maximum of 0.75% of NAV, which is below the c 1.0–1.5% rate normally charged by most listed PE funds. GCAP's LTM management fee to end-March 2022 was c 1.0% of NAV and, after accounting for administrative expenses, its ongoing charges to NAV stood at 1.5%. This is somewhat below the average for its listed direct PE peers (see Exhibit 10 above).

Importantly, around 62% of its LTM management expenses (or c 0.6% of NAV) were share-based (ie non-cash) in the form of zero-cost options. Based on our discussion with the company, we understand that the maximum number of guaranteed and discretionary shares that can be awarded to the executive director and key senior managers in a given year are set out in five-year agreements (which were signed in 2018). In the past, GCAP secured the share awards entirely through buybacks and recently announced a US$5.0m share repurchase program for this purpose (of which US$1.5m has been spent to acquire 203k shares until 31 May 2022). Based on our conversation with management, we understand that together with the shares that are already in GCAP's management trust (a subset of treasury shares), this should cover awards over two years. Each award will vest over six (guaranteed) or four (discretionary) years. The share-based remuneration for other staff members is discretionary and has no particular limit, but we understand that it is a minor part of their remuneration. Consequently, we believe the above represents quite a cost-efficient, performance-based remuneration structure compared to standard PE industry terms (20% performance fee subject to an 8% hurdle rate).

Capital structure

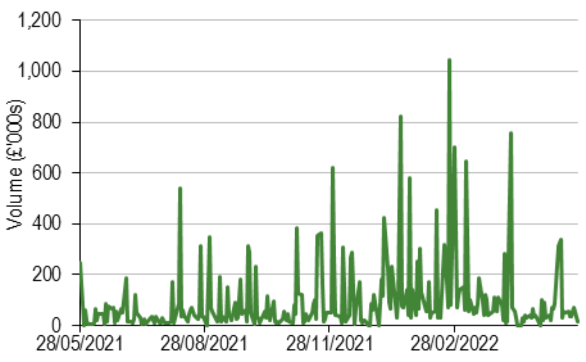
After the cancellation of shares repurchased to 31 May 2022, GCAP's share capital will consist of 45.6m shares. The shares are listed on the LSE premium listing segment. This includes some shares bought back to fulfil its equity-based compensation liabilities. GCAP's number of shares outstanding (excluding shares held in the management trust) stood at 45.1m at end-March 2022 (which does not account for the post balance sheet share repurchases).

Exhibit 13: Major shareholders



Source: Company data at end-March 2022;

Exhibit 14: Average daily volume



Source: Refinitiv. Note 12 months to 30 May 2022.

The board

GCAP's management board consists of six directors, five of whom are independent. William Huyett resigned in June 2019 and was replaced by Maria Chatti-Gautier (March 2020). Caroline Brown did not stand for re-election at the 2022 AGM and ceased to be a board member on 20 May 2022. The five other directors were all appointed in February 2018.

Irakli Gilauri (chairman and CEO), formerly CEO of BGEO Group from 2011, has c 20 years of experience in corporate banking, investment and finance. Additionally, he brings a strong understanding of the Georgian economic, political (his brother Nika Gilauri was prime minister of Georgia in 2009–12) and cultural context.

David Morrison (chairman of the audit and valuation committee) is a lawyer focused on advising public companies in a transactional context (capital raisings, IPOs, M&A) with vast experience in corporate governance and compliance. He was a non-executive director of GHG and previously served as the senior independent non-executive director of BGEO Group (2011–18).

Kim Bradley (chairman of the investment committee), formerly an independent non-executive director of BGEO Group (2013–18), has experience in strategic consultancy as well as property and real estate investments (15 years at Goldman Sachs as a professional in the real estate division).

Massimo Gesua' sive Salvadori has an investment background and experience with international markets and strategy as a bank analyst covering financial stocks globally (at Odey Asset Management, a London-based hedge fund, from 2011). He worked as a management consultant at the London office of McKinsey and Co (2002–11), specialising in financial services.

Jyrki Talvitie (chairman of the nomination and the remuneration committees) has significant board experience, having served on more than 10 boards of both public and private companies in Georgia, Finland, Russia, Kazakhstan and Ukraine. He also has a deep understanding of regional context as well as the financial industry (with 30 years' experience in banks).

Maria Chatti-Gautier has a background in PE (over 25 years) and understanding of investment strategies, alongside her board experience (she has sat on the board of directors of more than 30 companies). She currently serves as partner of Trail Management, an independent Euro-Chinese PE investment firm.

Exhibit 15: GCAP's board of directors

Board member	Date of appointment	Remuneration in FY21 (US$)	Shareholdings at end-FY21*
Irakli Gilauri	February 2018	N/A	1,112,395
David Morrison	February 2018	201,626	66,368
Massimo Gesua' sive Salvadori	February 2018	156,950	13,739
Kim Bradley	February 2018	194,466	35,383
Jyrki Talvitie	February 2018	160,454	12,585
Maria Chatti-Gautier	March 2020	149,796	6,860

Source: Georgia Capital. Note: *Excluding unvested and unexercised GCAP shares held under option through deferred share salary and discretionary deferred share compensation.

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