Investment Perspectives - H2 2016

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"Smaller UK public companies are private companies with a quote" - Is the stock market functioning properly when it comes to smaller companies?

Summary: - Smaller UK public companies, typically those below £100m in size, face many barriers to accessing growth capital from the stock market. Poor liquidity results in these companies being perceived as private companies with a quote. These barriers include:

1) The increasing regulatory burden which makes it harder for pension funds, institutions and wealth managers to invest in smaller companies;
2) 'Impatient' capital and shorter holding periods place a premium on ability to sell at short notice;
3) Reduced sell-side capacity and research coverage which restricts capital flow (primary and secondary) resulting in greater pricing dislocations and inefficiencies.

There is a significant opportunity for investors to generate superior returns through focusing on this inefficient area of equity markets. However, success requires the appropriate fund structure (long-term capital), a longer-term investment horizon and a private equity skill set including significantly higher levels of engagement with management teams and boards in support of longer term equity value creation plans.

Evidence of where the stock market is working for smaller companies

i. Increased IPO activity from 2014 – muted in 2016

2014 and 2015 saw an increase in equity issuance and initial public offerings (IPO's) amongst UK smaller companies (Fig.1). 2015 also saw increased M&A activity which helped reduce the pricing anomalies where small companies were undervalued by the market. However, both IPOs and M&A activity have dropped off in 2016 due partially to concerns over unclear market direction and uncertainty, both pre- and post-Brexit.

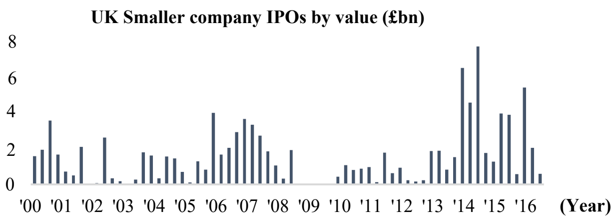

Fig 1: Liberum and Bloomberg data (1 June 2016)

ii. Launch of smaller company investment vehicles

Over the last 18 months we have also seen the re-emergence of a number of dedicated small-cap and micro-cap investment funds (Miton Group, River & Mercantile, Liontrust to name a few). Importantly these "permanent capital" funds are better suited to investing in illiquid stocks over the longer-term and are less vulnerable to short-term volatility of capital flows that tend to have a more adverse effect on small company holdings.

Evidence of where the market is failing smaller companies, creating market dislocations

i. Increased regulation creates barriers for smaller companies to access the capital they need to grow

Following the financial crisis in 2009, regulation designed to make investing safer and increase fee transparency has made it difficult for many institutions and wealth managers to invest in smaller companies. Minimum thresholds for market capitalisation have been rising, higher than the AIM average of £73m and often above £100m.

ii. Shorter horizons and reduced holding periods

Holding periods have significantly reduced over the last three decades, from c.8 years in the 1960s to c.3 months in 2012[1] as investors become increasingly impatient for returns. Fund managers rated on quarterly performance relative to a benchmark place a greater premium on portfolio liquidity, restricting capital flows into smaller companies. Fear of short-term market events and volatility is outweighing the prospects of long term value creation from economic and earnings growth.

iii. Institutional and Wealth Management liquidity constraints

Institutional investor thresholds and liquidity constraints often preclude allocating a significant weighting to companies below £250m.[2] Many also have constraints on the extent to which they can invest in companies quoted on AIM. IHT driven AIM portfolio managers also tend to focus on the larger companies within the universe.[2]

[1] *LPL Financial 2012, Morning Star, Dan Kemp, Oct 2014, Andrew Haldane: Patience and Finance (Bank of England) Sept 2010 . pg10*

[2] *Gresham House Asset Management Ltd, opinion sought from sell side brokers*

iv. Limited broker research coverage of smaller companies

The traditional broker model is under significant pressure due to falling trading commissions. There is increasing focus on corporate transactions, equity issuance and IPO's, to the detriment of smaller company research coverage. This will likely be compounded by MIFID II, which will limit investor's ability to pay for broker research. Companies below £100m in size are typically only covered by their house broker[3] (*Fig.2*) and research tends to constitute shorter 'flash notes' around results rather than more detailed analysis, resulting in many being overlooked and under-researched.

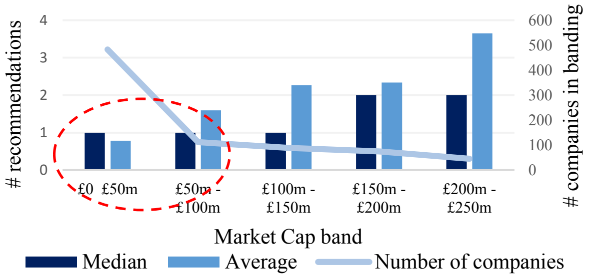

Fig 2: Bloomberg, FTSE All Share / AIM All Share index constituents below £250m (1 June 2016)

The Result

1) Poor liquidity in UK quoted smaller companies

Liquidity fell in smaller company indices following the financial crisis, and again in 2014. Levels have remained stable but low since *(Fig.3)*.

% of free float traded / month – FTSE Small-Cap Index (Ex IT)

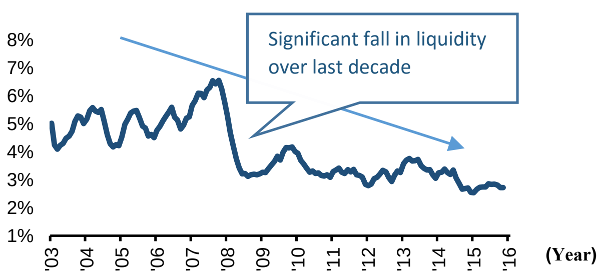

Fig 3. Liberum Capital research (1 June 2016)

2) Widening valuation dislocation as smaller companies continue to be overlooked

Despite stable, albeit lower levels of liquidity, the valuation gap between the larger and smaller companies on the LSE has widened. This has been most acute for companies below £250m (*fig.4*).

Valuation (multiple of earnings) – the size effect

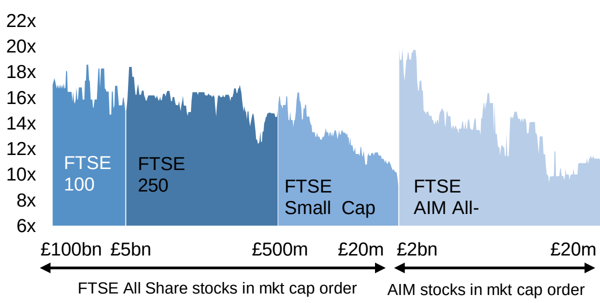

Fig 4. Liberum Capital research (1 June 2016)

The Opportunity

It is well documented that smaller companies are shown to outperform over the longer term, particularly those relatively lowly valued, often at a discount to net assets[4].

Despite this trend of long-term outperformance, small-cap value stocks continue to be overlooked by investors. Capital is allocated instead to larger growth and momentum stocks and the perceived safety of 'higher quality' companies. We believed the market average to be relatively expensive ahead of 'Brexit'[6] (FTSE small-cap trading on c.16x PER and yielding 3%). Since then we have seen an element of correction. We continue to see significant opportunity to generate long-term superior returns by focusing on those areas of inefficiency where there is a significant valuation dislocation, which we believe will become more acute following the vote to leave the EU.

To address this opportunity to generate superior investment performance, investors should be prepared to invest in a smaller company in support of an identified longer-term value creation plan with an identified catalyst or exit in mind. This requires significantly higher levels of engagement with investee management teams and Boards and more thorough due diligence, applying private equity techniques including: clear value creation plans, Board and incentives review plus identified catalysts for exit which may involve a trade sale or taking a public company private. Over the last two years we have seen private equity increasingly engaging with public companies with firms such as the Business Growth Fund (Victoria plc and Styles & Wood plc) or LDC (Boomerang plc and Workplace Systems plc).

Smaller company management teams are increasingly open to constructive engagement with investors prepared to commit new capital in support of long-term strategic plans; by comparison, the stock market may be absent.

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[3] *Gresham House Asset Management Ltd calculations using Bloomberg data*

[4] *Dimson and Marsh*

[5] *Bloomberg data, excluding Investment Trusts, 10 June 2016*

[6] *Gresham House Asset Management H1 2016 Investment Strategy*