Gresham House
Specialist investment

WS Gresham House UK Multi Cap Income Fund

Quarterly commentary – Q1 2024

Past performance is not necessarily a guide to future performance. Portfolio investments in smaller companies typically involve a higher degree of risk. Capital at risk. Extracted portfolio performance is not necessarily indicative of the performance of the fund. Not to be construed as investment advice or recommendation. Views expressed by the investment team are correct at the time of writing but are subject to change.

Overview – Q1 2024

UK equity market performance was mixed in Q1 2024. While recent inflation data beat economic expectations, investor optimism was better reflected in large-cap stocks which outperformed their smaller counterparts over the period; the FTSE 100 grew 3.0% while the FTSE AIM All Share declined 2.4%. Weaker small-cap performance was largely attributable to further outflows from UK equity funds. According to recent Calastone data, March 2024 marked the 34th consecutive month of net UK outflows and the worst month since February 2023.[1] Many small-cap fund managers remain 'forced sellers' of stock, driving further short-term price weakness despite strong fundamental performance in many instances. While creating short-term pressures, we believe these market dynamics present a compelling opportunity to invest in quality UK companies at attractive entry valuations.

During the quarter, the valuation gap between UK smaller companies and their larger domestic peers as well as smaller international peers widened; UK equities now trade at a record 45% discount to global counterparts.[2] Moreover, UK outflows into North American equity funds were greater in Q1 2024 than over the previous nine years combined.[3] Investors continue to exhibit a 'risk-off' attitude toward UK stocks, partly due to the attractiveness of cash investments in the current interest rate environment, which combined with high inflation and rising mortgage rates, has drawn capital away from UK equity funds over the last year. However, we saw catalysts emerge for more positive UK fund flows over the short-to-medium term. Our stock-specific research showed that the amount of cash held on UK investment platforms started to reduce during Q1 2024, while government initiatives such as the British ISA could help draw capital back into UK smaller companies and induce a broader re-rating of the space.

We recognise that macroeconomic and geopolitical uncertainty persists, but we are confident that our portfolio companies are strongly positioned to navigate external headwinds. Our consistent focus on capable management teams, clear value creation strategies with growth levers within management control, structural market tailwinds, defensible competitive positions, and attractive financial characteristics, gives us confidence that our holdings can continue to grow earnings, generate cash, and pay sustainable and growing dividends throughout the cycle.

Newsflow across the portfolio was largely positive in Q1 2024, as several companies delivered positive

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1. Calastone, "Record Inflows to Equity Funds in Q1 as 2024 starts with a bang…", April 2024.
2. Median 1-year forward P/E multiples across various international indexes, excluding investment trusts, sourced from Bloomberg data.
3. Calastone, "Record Inflows to Equity Funds in Q1 as 2024 starts with a bang…", April 2024.

trading updates. As an indicator of portfolio quality and resilience, c.88% of company updates in the fund have been in-line or positive relative to market expectations during 2024.

Performance - Q1 2024[4]

Performance in the WS Gresham House UK Multi Cap Income Fund decreased by 1.4% during the quarter, underperforming the IA UK Equity Income sector which increased by 2.5% and the FTSE All-Share Index which increased by 2.5%.[5]

Key positive contributions to aggregate fund performance came from **Intermediate Capital Group** (23.3%), following better than expected Q4 AUM growth leading to small upgrades to analyst forecasts, along with the announcement of a new organic value creation and product launch strategy which was well-received by the market; **GlaxoSmithKline** (17.0%) following full-year results which disclosed revenue growth ahead of market expectations and an upgraded growth outlook for next year; and **Mattioli Woods** (29.1%) following a recommended cash offer from private equity firm Pollen Street Capital, at a 32% premium to the prior day closing price.

The largest detractors to performance were **Gresham House Energy Storage Fund** (-43.5%) following a trading update which highlighted operational issues with the National Grid and a cut to the fourth quarter dividend, both of which we believe are transitory issues and have left the shares trading at a substantial discount to net asset value; **MoneySuperMarket** (-19.7%) following in-line annual results which were coupled with broker downgrades to long-term growth in the insurance segment, although we are confident that the business is well-positioned to deliver strong performance across its diversified end-market channels; and **RWS Holdings** (-24.1%) despite an AGM statement which confirmed full-year profit expectations in line with market expectations.

Portfolio activity

We made two new investments during the period; into **Pets at Home**, a specialist retailer of domestic pet food, accessories, and services, alongside an effectively franchised and higher margin veterinary offering. We believe that this business trades at an attractive valuation, benefits from structural demand drivers including growing pet ownership and elongated lifespans, and leverages a digital membership platform to drive repeat business and cross-sell. We also invested into **Hollywood Bowl**, the UK's leading tenpin bowling operator and second largest player globally, which we believe is led by a high-quality and incentivised management team with a clear strategy to drive like-for-like growth, supported by a structural trend in consumer spend towards low-ticket experiential leisure.

We made one full exit during the period, from **Ten Entertainment**, another leading UK ten-pin bowling operator, following the completion of its takeover by Trive Capital, a US private equity investor.

We made several selective follow-on investments during the period, including into **Mears Group**, a maintenance service provider to the affordable housing sector in the UK. We believe that risk to market earnings expectations is weighted favourably to the upside given positive bidding momentum for new contracts and strong demand for accommodation services; **Domino's Pizza**, the capital-light master

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4. Please refer to the factsheet for full UCITS-compliant performance figures.
5. The IA UK Equity Income sector and FTSE All-Share Index comparator are used for illustrative purposes only.

franchisee for Domino's Pizza Group in the UK and Ireland, which continues to demonstrate like-for-like sales growth and strong current trading despite macroeconomic headwinds, reflecting its strong consumer value proposition; and **Ricardo**, a global strategic, environmental, and engineering consultancy, which is undergoing a strategic transition to refocus on the higher growth, higher margin, and lower capital intensity parts of the business, where growth is underpinned by environmental structural tailwinds.

Outlook – Q2 2024

We assume that elevated macroeconomic and geopolitical uncertainty will continue to drive market volatility over the coming months. Global investors remain particularly sensitive to new inflation data and interest rates, while conflicts in Europe and the Middle East threaten regional stability.

We believe that volatile conditions benefit stock-pickers focused on business fundamentals, particularly given the further profit warnings across the UK market during the quarter, which demonstrates how optically 'cheap' stocks are not so attractively priced if market earnings expectations lack a solid foundation. We are placing additional emphasis on our differentiated, network-based due diligence approach, gleaning insight and expertise from high-quality professionals and industry specialists. This allows us to build conviction in key components of investment theses and avoid 'value traps' which appear in a subdued market. However, notwithstanding an unexpected deterioration in the external environment, we are seeing greenshoots of improving market sentiment and potential catalysts for a re-rating of the UK small cap space.

Importantly, a growing number of M&A deals across the UK small-cap market is providing further evidence of a disconnect between market valuations and company fundamentals. US and European private equity firms have turned their focus towards the heavily discounted smaller end of the UK market, seeking to purchase companies with high-quality fundamentals at relatively low valuations to offset higher deal funding costs. Indeed, the average one-day premium across UK public-to-private transactions grew to 52% in 2023 from a five-year average of c.40% despite the higher interest rate environment.[6] We expect that M&A activity will remain an important driver of short-term returns, while over the medium term, we see the arbitrage between public-to-private transaction multiples and company trading multiples as a catalyst for a broader re-rating of the UK small-cap market.

Positively, we are also observing a meaningful increase in UK public market corporate activity so far in 2024, signalling that investors are more willing to support high quality businesses with their funding needs. The increase in activity has primarily focused on secondary sell downs and primary capital raises of meaningful size, with an average deal value of £418mn, rather than IPOs.[7] Helpfully, the majority of companies have seen a strengthening share price post-deal, which helps further build investor confidence. Collectively, these factors leave us cautiously optimistic on UK equity market performance during the remainder of 2024.

Important information

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6. Gresham House internal analysis of UK P2P data, sourced from Bloomberg.
7. Dealogic, 06 Apr 24.

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