WS Gresham House UK Smaller Companies 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 and generate cash throughout the cycle.

Newsflow across the portfolio was largely positive in Q1 2024, as several companies delivered positive trading updates. As an indicator of portfolio quality and resilience, c.95% of company updates in the fund

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.

have been in-line or positive relative to market expectations during 2024.

Performance - Q1 2024[4]

Performance in the WS Gresham House UK Smaller Companies Fund increased by 0.2% during the quarter, underperforming the IA UK Smaller Companies sector which increased by 1.4%.[5]

Key positive contributions during the quarter came from **Trustpilot** (+31.0%) following a full-year trading update which demonstrated an EBITDA performance ahead of market expectations; **Mattioli Woods**, (+29.2%) following a recommended cash offer from private equity firm Pollen Street Capital, at a 32% premium to the prior day closing price; and **Craneware** (+22.3%) following a positive interim trading update which indicated accelerated revenue growth and debt reduction alongside an extension of the share buyback scheme.

The largest detractors to performance were **Capita** (-38.6%), following disappointing full year results, particularly in terms of cash performance; **Keywords Studios** (-16.9%) on news that Klarna launched an OpenAI-powered customer service assistant, deemed a competitive threat to Keywords' player support division. However, we view the read across as limited, with the broader investment thesis intact, underpinned by the longer-term structural shift towards outsourcing in the video game industry; and **CVS Group** (-32.0%) following confirmation that the UK's competition watchdog will launch a full investigation into the UK veterinary sector.

Portfolio activity

We made two new investments during the period, into **Hollywood Bowl**, the UK's leading ten-pin 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; and into CVS, an integrated veterinary services business which we believe benefits from structural growth tailwinds, alongside internal levers to drive margin expansion, which is trading at an attractive valuation due to the Competition and Markets Authority (CMA) initiating a review of the sector, the outcome of which we do not expect to materially impact the business value over the long term.

We made three full exits during the period; from **Watkin Jones**, following a period of underperformance due to uncertainty and delays to projects in its end market; from **Ten Entertainment**, another leading UK ten-pin bowling operator, following the completion of its takeover by Trive Capital, a US private equity investor; and from **LSL Property Services**, due to a fundamental change in our investment thesis.

We made several selective follow-on investments during the period, including into **Ascential**, a leading international media company which recently disposed of two non-core business segments, leaving a pure-play events business with market leading brands, that trades at an attractive valuation relative to recent precedent transactions; **Team17 Group**, an independent video game developer which had de-rated following

4. Please refer to the factsheet for full UCITS-compliant performance figures.
5. The IA UK Smaller Companies sector comparator is used for illustrative purposes only.

a detailed review in wake of an unexpected profit warning in November. We continue to believe the company has attractive business fundamentals and trades at a trough valuation, offering an attractive opportunity to add to our position; and **Moonpig Group**, an online leader within the card and gifting market, which continues to drive organic growth from its current customer base, and despite exhibiting resilience through the cycle continues to trade at a discounted valuation.

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.

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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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