Gresham House

SMALL BUT MIGHTY

Brendan Gulston, co-manager of LF Gresham House UK Micro Cap, explains how the fund builds on the company's private equity heritage and network to find small companies with the potential to be long-term winners

Cherry Reynard

What is the guiding philosophy on the micro-cap fund?
We have long thought that the sweet spot for investment is somewhere between £50m and £250m. Our investment philosophy is born from our private equity heritage: the way we have invested in the fund over the 10 years since its inception is part and parcel of being a private equity firm and having a private equity mindset. It underpins how we source and appraise potential investments.

The portfolio is managed at a relatively concentrated level of 40-60 investments and currently we have 45 holdings. They are not equally weighted and we have our largest positions in our highest conviction ideas. A significant part of our process is risk mitigation and we perform rigorous due diligence on the assets we hold. This is part of our unique approach.

We have built a wide network of relationships with entrepreneurs, business leaders and influential thinkers and the information we glean from those people is a vitally important part of what we do. To our mind, it has a materially positive impact on risk-adjusted performance.

Why do you believe micro-cap is a fertile area to invest?
There are 1,250 companies in the Numis smaller companies index (which acts as a proxy for the UK small-cap universe). Of those, around 1,000 are under £250m market cap, so there are a large number of small businesses. These businesses tend to be under-researched with not many backers and not much interest from analysts and as such, hold real opportunities.

However, to navigate it effectively, we need resources and time, and a proven method to perform due diligence on assets when there's not much information available. With that, there's a real chance to glean value from this part of the market.

Today, the micro cap universe trades at a c25% discount to the wider UK small cap universe indicating potential opportunities for valuation arbitrage. As they get larger, and get above the psychologically important £100m market cap, the discount narrows. If we can find high-quality growth businesses that we can back, we can benefit from both earnings growth and a rerating.

Do the companies in the portfolio benefit from M&A?
A lot of the companies in our portfolio make an ideal bolt-on acquisition for a larger company. We have already seen elevated levels of M&A activity in 2019 and have seen five companies either bought out or under offer across our portfolios.

Does your process naturally lead you to certain sectors?
We place a significant weighting on the quality of the management teams and their strategy, so we want to ensure that they are driving the business and its success. That means ruling out companies where their success or failure is largely determined by external factors outside of management control, such as regulatory approval or commodity pricing. Therefore we screen out oil & gas and other mining companies, plus early stage technology.

Having screened out certain sectors, we also look at financial metrics to identify companies that are profitable and cash generative. We also consider aspects such as scalability of business model, competitive advantage and market opportunity.

Typically we find asset-light businesses across sectors such as TMT, healthcare and business services most attractive. That includes financial services businesses as well. We like tech-enabled businesses that have a key niche or sustainable competitive advantage. They need to have a point of differentiation.

Do you invest in a company through its cycle – private equity through IPO and beyond?
Yes, there are a number of examples of companies

where we've done that. We've met them through private equity colleagues when they're thinking about doing an IPO and kept in touch with the management team.

For example, Argentex, a corporate FX solutions business that provides hedging advice to corporate entities. It's a naturally defensive company because it makes money when investors want to hedge exposure to FX markets. We met Argentex at the beginning of its IPO process and, as such, when it came to market, we'd already done a lot of work on the sector, including speaking to a wide variety of people to validate the proposition. Consequently, we were in a strong position to support it at IPO.

What do you like to see in a management team?

We want to see the quality of the broader team. Who is really making it work? Is it the CEO or a combination of the executive chairman and other people? Who is the key individual? A number of us will meet with them; we speak to people they've worked with; we may even look to external reference agencies.

If the CEO is holding the reins, then we want to understand what makes them tick. Do they have situational expertise? They could be really experienced, but it's more important to know where their skills lay. Are they aligned to whatever creates success in the business? Our focus is on understanding the investment teams' strategy, the clarity of that strategy and their long-term vision for the company.

How do valuations of micro-caps look relative to history?

There is always a bit of a difference, but it typically varies between 10-25%. Today, that valuation gap is significant. The rest of the market rebounded from the weakness in the final quarter of 2018, but micro-cap has been more volatile as investors have anticipated a tougher environment.

There are reasons for caution. For example, there is an increasing prevalence of profit warnings and we need to monitor them closely. A recent survey by EY showed that there were around 140 profit warnings in 2017, but we've had 99 in 2019 already. There has never been a high tolerance for companies missing earnings, but at the moment, companies that don't make their targets are being hit particularly hard.

How do you manage liquidity in the portfolio?

There is always a question around the liquidity of micro-cap stocks and it is particularly topical at the moment. We have a multi-pronged strategy. We are really clear on the capacity of the fund and have set it at £350m. It's currently at £170m, so we have a way to go.

We have no more than 5% in any one company and we're always holding at least 5% in cash. A borrowing facility with our ACD means that we can access a further 10% in cash, therefore having the ability to meet redemptions without coming under selling pressure. Equally, with any holding we make, we are always looking at the size of the business, the shareholder register and the flows into the stock.

'OUR AIM IS TO FIND THOSE OPPORTUNITIES THAT ARE UNDER THE RADAR AND HAVE A STRONG COMPETITIVE ADVANTAGE'

Brendan Gulston, co-manager, LF Gresham House UK Micro Cap Fund

With small- and micro-cap stocks, we believe investors need a specialist. We don't have external traders – we do all our own trading – that means we keep a sense of the flows in the stock. As a team we are continuously reviewing market intelligence and keeping abreast of different scenarios.

What makes you nervous today? Do you worry about an economic downturn?

The businesses in which we invest aren't cyclical businesses and their success is driven by the management team, not external factors. The portfolio is constructed to be relatively more insulated from economic cycles. Businesses will be operating in niche markets and tap into long-term structural growth trends. As such, the risks to the portfolio are much more company-specific.

A weakening economic climate may affect sentiment towards the sector and have a knock-on impact to share prices. However, this shouldn't directly affect the success of the underlying businesses. Therefore the risk to our portfolios – given that we specifically search for businesses that are unique both in terms of the wider market and each other – should remain relatively uncorrelated to the broader economic environment. ●

For more information please visit www.ghef.greshamhouse.com

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