

WS Gresham House UK Multi Cap Income Fund

Quarterly commentary – Q2 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 – Q2 2024

UK equity markets delivered a positive performance in Q2 2024, with smaller company stocks rising in-line with their larger peers: the Numis Smaller Companies plus AIM index rose **5.0%**; the FTSE AIM All Share rose **2.8%** while the FTSE 100 grew **2.7%**. Although UK investors added materially to equity fund holdings, inflows were biased towards North American, European, and global equity funds. UK-focused equity funds shed a net £532 million over the period, although outflows were markedly lower in June than in previous months during the year-to-date. More broadly, equities benefitted from some institutional reallocation as investors switched out of bonds following recent price appreciation driven by renewed hopes of UK and US interest rate cuts mirroring Europe.

Through our trading activity, we continue to see ‘forced selling’ of UK equities, reflecting the continued (albeit abating) outflows from this asset class. We believe this trend partly explains the current dislocation between trading multiples of UK smaller companies and private precedent transactions across a variety of sectors. Our recent management meetings with private equity firms held in the Fund suggest two drivers of M&A activity continue to co-exist: buyout firms have much excess capital to deploy, and private-to-private deal-making is subdued by high valuation expectations. Resultantly, private equity pipelines have turned to the UK public market with a bias towards smaller companies where prices are ‘cheaper’ still. On a next-twelve-months price-to-earnings basis, UK equities trade at a c.35% discount to global equities, while UK small-cap stocks below £500m market cap trade at a further 25-40% discount to their larger domestic peers.² Moreover, bid premia for UK stocks remained above historic averages despite elevated interest costs; for example, EQT Group bid for Keywords Studios in May at a 67% premium to prior day close. All of this reflects the compelling valuation opportunity across UK smaller companies.

Macroeconomic and geopolitical uncertainty persisted during the period, but we saw reasons for cautious optimism. Importantly, UK inflation slowed to 2% in May: the lowest level for almost three years.¹ Accelerated real wage growth was reflected in the highest level of UK consumer confidence since mid-2021, with noticeably improved outlooks on personal finances and the wider economy. However, consumer propensity to make ‘major purchases’ remains materially below the 25-year average score and UK household saving rates are markedly higher than across other G7 economies, likely due to higher mortgage costs and memory of recent economic trauma.² While Q2 saw greenshoots of improving sentiment, we are

¹ Office for National Statistics, “Consumer price inflation, UK: May 2024”, June 2024

² Simon French, Panmure Liberum, “What does the UK economic inheritance look like?”, July 2024

only selectively exposed to consumer trends with a focus on structural growth themes such as low-ticket experiential leisure, resilient customer offerings characterised by niche or hobbyist demand profiles, and strong competitive positions.

More broadly, our portfolio construction seeks to mitigate external risks through a focus on high-quality, well-managed businesses with clear value creation strategies, long-term structural demand drivers, and durable competitive advantages, prioritising opportunities where key investment drivers are within the control of management teams and avoiding business models which are exposed to wider market factors.

A consistent investment philosophy, strong relationships with company management teams, and an extensive specialist network underpin our confidence that our portfolio companies will continue to grow earnings, generate cash, and pay sustainable and growing dividends throughout the cycle. As an indicator of portfolio quality and resilience, c.91% of company updates in the fund have been in-line or positive relative to market expectations during the year-to-date.

Performance – Q2 2024³

Performance in the WS Gresham House UK Multi Cap Income Fund increased by **6.4%** during the quarter, outperforming the IA UK Equity Income sector which increased by **4.6%** and the FTSE All-Share Index which increased by **2.6%**.⁴

Key positive contributions to aggregate fund performance came from **Alpha FMC (52%)**, following a recommended cash offer from private equity firm, Bridgepoint, with concurrent publicly disclosed interest from Cinven. The offer represents a 51% premium to the closing share price prior to the first announcement and a 12.4x EV/EBITDA multiple based on March 2025 consensus forecasts, a material uplift from the previous 8x trading multiple; **XPS Pensions Group (29%)** as full-year results showed strong client demand and inflation indexation driving double-digit growth across all divisions and margin expansion, alongside another 5% upgrade to the March 2025 consensus earnings per share forecast; and **The Property Franchise Group (37%)** following reassuring full-year results in challenging market conditions, an earnings enhancing acquisition of The Guild and Fine & Country, and an AGM trading update disclosing 20% year-on-year growth in the sales-agreed pipeline with continued strong growth in lettings (which constitutes a strong majority of the Group's non-FS revenues).

The largest detractors to performance were **B&M (-18%)** despite preliminary full-year results in-line with expectations and strong progress on new store rollout supported by the integration of 51 ex-Wilko stores. However, investors fear a 'like-for-like' growth slowdown due to poor weather, tough comparators, and falling inflation, clouding what the Manager continues to believe is a compelling value creation story driven by 'at least 45 (new store) openings a year' leading to earnings growth, cash generation, and growing ordinary and special dividends; **Sabre Insurance (-14%)** despite an AGM trading update which showed strong growth in gross written premiums driven by a combination of volume growth and disciplined pricing ahead of its expected level of claims inflation; and **GSK (-10%)** due to an adverse ruling in the Delaware State Court which allowed submission of Zantac-related claims, although the company will seek appeal.

3. Please refer to the factsheet for full UCITS-compliant performance figures.

4. The IA UK Equity Income sector and FTSE All-Share Index comparator are used for illustrative purposes only.

Portfolio activity

We made one new investment during the period into **Quilter**, a vertically integrated financial services business providing wealth management, financial planning, and investment platform services to mass affluent and high net worth clients. The Manager believes the business is well-positioned to create shareholder value through its clear organic growth strategy and internal cost-out programmes, has competitive advantages due to its brand strength and diversified distribution model, and trades on an attractive entry valuation which is heavily discounted to precedent transaction multiples due to an FCA market probe where downside risks appear limited.

We made one full exit during the period, from **Smart Metering Systems** following the completed takeover by US private equity group, KKR.

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; **Alpha FMC** a specialist independent consultancy focused on digital transformation across the asset and wealth management sector, subsequently subject to a takeover offer (see above); 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 – Q3 2024

We saw green shoots of economic improvement in Q2 and are cautiously optimistic that positive trends can continue into Q3. UK CPI is now tracking the target inflation level, UK investors have priced in their expectations of two interest rate cuts by the Bank of England in H2, and we have already seen cuts by the European Central Bank.⁵ Similarly, UK consumer confidence is at its highest level in almost three years, albeit consumption remains subdued as shown by recent household saving data. However, with real wages growing, the short-term prospect of unwinding mortgage costs, and the relatively ‘de-leveraged’ UK household compared to 2008/09,⁶ the economic environment looks more supportive of rising consumption than at any point over the last couple of years.

Turning to UK equity markets and interest rates, the prospect of falling bond yields and price appreciation in Q3 may create a favourable ‘denominator effect’ for UK equity fund flows whereby asset allocators re-weight portfolios towards equities to meet their target asset class exposures. The ensuing liquidity injection into UK funds, and UK smaller companies, could alleviate the downward share price pressure of the last two years caused by ‘forced selling’. UK smaller company valuations may then bridge the wide gap relative to their larger UK and international peers, as well as precedent M&A transactions. We see these conditions as supportive of the case for a re-rating of UK smaller companies.

On a similarly positive note, we have seen a growing number of ‘early look’ and formal pre-IPO meetings during Q2 and into Q3. While equity capital market activity during 2024 has primarily focused on existing listed businesses,⁹ notable larger UK IPOs of Raspberry Pi and Aoti took place during Q2, along with a

⁵ Bloomberg, WIRP function.

⁶ Simon French, Panmure Liberum, “What does the UK economic inheritance look like?”, July 2024

smaller IPO of AI-focused IntelliAM in early July. Together with the prospect of improving economic conditions and the possibility of rising UK stock-market valuations, investor and corporate confidence will have grown by observing strengthening post-deal share prices in each instance. We therefore expect further IPO activity to present new opportunities into H2 2024.

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