WS Gresham House UK Smaller Companies 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.[1]

Through our investment 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 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 a Fund holding, 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.3 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.[4] While Q2 saw green shoots of improving sentiment, we are

---

[1] Calastone, "June tops off a record six months for equity fund inflows…", July 2024.
[2] Berenberg and Bloomberg data.

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 and generate cash throughout the cycle. As an indicator of portfolio quality and resilience, c.96% of company updates in the fund have been in-line or positive relative to market expectations during the year-to-date.

Performance – Q2 2024[3]

Performance in the WS Gresham House UK Smaller Companies Fund increased by 8.2% during the quarter, outperforming the IA UK Smaller Companies sector which increased by 7.4%.[4]

Key positive contributions during the quarter came from **Keywords Studios (+81%)** following a recommended cash offer from private equity firm, EQT Group, at a 67% premium to the prior day close; **Alpha FMC (+51%)** 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; and **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.

The largest detractors to performance were **Franchise Brands (-20%)** despite full-year results which showed EBITDA performance at the top-end of market forecasts with all B2B operating segments delivering record profits, albeit management indicated forward-looking caution across some end-markets; and **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.

Portfolio activity

We made 4 new investments during the period. Firstly, into **Hostelworld Group**, the market-leader in the hostelling travel segment, which has a highly capable management team that has defined a clear organic growth strategy focused on its unique social platform, which underpins improved customer economics and will help to drive operational leverage. Secondly, into **Young & Co's Brewery,** which the Manager views as

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

a quality growth compounder with a premium and well-invested primarily freehold pub estate whose entrepreneurial managers are financially incentivised to drive increased site profitability and optimise utilisation, driving compelling LFL growth. Thirdly, into **Fintel**, a provider of tech-enabled services to the UK IFA sector. The Manager is confident that an increasing regulatory burden on UK IFAs and a shift to outsourcing can continue to drive growth, alongside adjacent services to financial product manufacturers. Fourthly, into **Raspberry PI**, a provider of cost-effective single board computers and compute modules into industrial and engineering sectors. Raspberry PI completed its LSE IPO in June 2024, and its strong post-IPO performance bodes well for investor sentiment to deploy capital into UK IPOs.

We made two full exits during the period; from **Smart Metering systems** following its completed takeover by US private equity Group, KKR; and **Mattioli Woods**, which we exited into share price strength following the recommended offer from Pollen Street Capital.

We made several selective follow-on investments during the period, including into **Team17**, an independent video game developer and publisher, which the Manager views as fundamentally undervalued. The business has a clear organic growth strategy focused on expanding and continuing to monetise its large, diversified portfolio of indie games, with the majority of revenue derived from a strong back-catalogue of durable franchises; **Brooks Macdonald**, an investment management services provider, which the Manager views as a leading player in the highly fragmented wealth management sector and as materially undervalued relative to precedent M&A transactions in the space; and **Capita**, a provider of business process outsourcing services, which has disposed of non-core assets in recent years, leaving a more simplified business, with a new CEO who has a clear strategy to reinvigorate organic growth.

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 arbitrage versus their larger UK and international peers, as well as precedent M&A transactions. We see these conditions as supportive of 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

---

[5] Bloomberg.
[6] Simon French, Panmure Liberum, "What does the UK economic inheritance look like?", July 2024

during Q2 and into Q3. While equity capital market activity during 2024 has primarily focused on existing listed businesses[7], notable larger UK IPOs of Raspberry Pi and Aoti took place during Q2, along with a 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.

Important information

Please contact a member of the Gresham House team if you wish to discuss your investment or provide feedback on this presentation. Gresham House is committed to meeting the needs and expectations of all stakeholders and welcomes any suggestions to improve its service delivery. www.greshamhouse.com

[7] Dealogic, 06 Apr 24