

WS Gresham House UK Micro Cap Fund

Quarterly commentary – Q3 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 – Q3 2024

UK equity market performance was broadly positive in Q3 2024 as smaller company stocks outperformed their larger peers, particularly those listed on the main market: the Numis Smaller Companies plus AIM ex Investment Trusts Index rose **2.5%** while the FTSE 100 increased by **1.8%**. However, the FTSE AIM All Share Index fell by **2.7%**.

Over the period, the prospect of medium-term political stability returned as the new Labour government secured a 157-seat majority at the July general election. Although some investors harbour concerns around potential changes to personal and corporate tax in the upcoming budget, we view the government transition as a long-term positive for UK equity markets. A stable political platform with a strong majority and clear mandate contrasts with the volatility and policy uncertainty experienced under previous administrations. While the impact of individual policies will vary by sector or company, we believe greater political certainty is conducive to longer-term corporate planning and investment which can lead to more sustainable economic growth and structurally higher stock market valuations. We also view this stable political environment as a relative strength of the UK compared to other developed markets in Europe and North America with polarised elections, rising far-right influences and increasing social discontent.

The UK economic environment also appears to be improving, with real GDP and inflation outperforming the European Union and US so far during 2024. Similarly, consumer and corporate balance sheets are de-leveraging in line with trends since 2008/09, business investment is on an upward trajectory, and mortgage rates are falling as markets expect lower interest rates, freeing up disposable income for consumption. These conditions support accelerating economic growth which feeds into positive momentum for UK corporate earnings and the opportunity for a broader re-rating of the UK equity market.

Despite these positive indicators, investors withdrew c.£1.2bn from UK-focused equity funds in Q3. Asset allocators continue to favour other global equity markets, especially the US, or fixed income investments as interest rates remain high. Moreover, recent geopolitical uncertainty in the Middle East and selling pressure on AIM stocks has had an unfavourable short-term impact on UK equity fund allocations, negating positive political and economic developments. As a result, we continue to see a structural disconnect between UK stock market valuations and the long-term returns opportunity presented by the numerous high-quality companies in our portfolio. At quarter-end, UK equities traded on an average 11% and 42% discount to European and US peers respectively - the steepest discount to global equities in over 30 years - as well as a discount to precedent M&A transactions across sectors. This is despite relative political stability, lower inflation and higher real GDP, as well as strong business fundamentals whereby capable and incentivised

management teams are executing on clear value creation strategies to consistently grow earnings, generate cash, and pay sustainable and increasing dividends over time.¹ This discount was steeper still in the UK smaller companies space, which traded at a c.30% discount to UK large-caps at period-end.² We consequently see a highly attractive long-term returns opportunity to gain exposure to high-quality UK smaller companies on subdued valuations, at a time when re-rating catalysts are increasingly visible.

One such catalyst is M&A activity which continued apace during Q3 as private equity or strategic trade buyers look to capitalise on suppressed UK-listed company valuations, which may serve to expose the undervaluation theme. There were eleven bids for UK public companies over the period, taking the year-to-date total to forty at an average premium of 40% and some materially higher. We highlight an emerging nuance to this theme in the Smaller Companies space, with carve-outs – where a parent company sells a subsidiary company or business unit – of which there have been 20 ‘meaningful’ instances over the year-to-date. Carve-outs are an underrated yet powerful way for UK companies to unlock real value, with several recent examples where businesses have sold off divisions at valuations higher than the prevailing group valuation - sometimes selling for more than the entire market cap. This shines a light on just how severely undervalued the remaining parts can be.³

For example, in early 2023 Ascential launched a strategic review of its three distinct business units: Digital Commerce, Product Design (WGSN) and a market-leading events business. While we considered each business to be high-quality, they were not complementary within a single group, a cohesive strategy became difficult to form and Ascential was left trading at a sharp discount to its implied sum-of-the-parts value. Management acknowledged these challenges, launched a ‘break-up’ value creation plan, and ultimately sold all three business units for a total value of c.£1.9 billion versus a market capitalisation of £915 million prior to the announcement of the strategic review. Evidently, carve-outs can be a compelling tool for management teams to overcome market discounts and create shareholder value.

Performance – Q3 2024⁴

Performance in the WS Gresham House UK Micro Cap Fund decreased by **2.1%** during the quarter, underperforming the IA UK Smaller Companies sector which decreased by **0.2%**.⁵

Key positive contributions came from **Windward (+1.3% CTR)** as interim results showed year-on-year average contract value growth alongside annual recurring revenue growth, underpinning a narrowing EBITDA loss in-line with recently upgraded guidance; **Gym Group (+0.9% CTR)** as interim results demonstrated robust member growth and incremental wallet share from existing customers, driving strong earnings growth as management now guides to the top-end of the recently upgraded full-year expectations; and **Costain Group (+0.7% CTR)** as interim results demonstrated strategic progress on margin enhancement programmes for FY24 and FY25 and announced a £10 million share buyback scheme.

The largest detractors to performance were **Trufin (-1.1% CTR)** following the termination of a key contract within its Satago division, however interim results came in ahead of consensus expectations at the end of the period due to the exceptional outperformance of two titles within the Playstack video games publishing

¹ Berenberg quarterly data.

² Bloomberg data: all UK companies ex investment trusts less than £250m market cap.

³ See more from Cassie Herlihy, Associate Director Public Equity: [Unlocking value through carve-outs - Gresham House](#)

⁶ Please refer to the factsheet for full NURS-compliant performance figures.

⁵ The IA UK Smaller Companies sector comparator is used for illustrative purposes only.

business; **Inspired (-1.0% CTR)** as interim results were broadly in-line with expectations, but higher than expected net debt and interest costs drove marginal earnings per share downgrades in the current and next financial years; and **Pulsar Group (-0.8% CTR)** on no specific newsflow.

Portfolio activity

We made no new investments during the period.

We made one full exit during the period - from **Alpha Financial Markets Consulting**, following its completed takeover by UK private equity firm, Bridgepoint.

We made selective follow-on investments during the period including into **MPAC Group**, a global designer and manufacturer of industrial process and packaging automation machinery, which we believe has a strong market position within a structurally growing market, with a clearly defined organic and inorganic growth strategy. We participated in an equity placing to fund an acquisition of an attractive palletising business, in-line with the growth strategy to in-fill specific automation capabilities. We also made a follow-on investment into **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 – Q4 2024

Entering Q4 2024, UK equity markets face short-term domestic and international political uncertainty, causing lower UK consumer confidence and rising bond yields. However, disinflation has continued and run-rate economic growth is currently the strongest in the G7. Notwithstanding unforeseen economic shocks, we consequently believe there are visible drivers of improved UK equity market performance.

Our meetings with major UK wealth and asset managers held across the Gresham House strategies have demonstrated that there are substantial excess deposits in the consumer banking system above long-term averages. Even if a proportion of this excess is rediverted into the consumer economy or into 'risk' investments such as UK small-cap equities, then we expect this to strengthen the corporate earnings environment and stock market valuations over the medium term. Potential catalysts for this shift out of excess deposits may include lower inflation and easing cost of living pressures, improving GDP growth, domestic political stability, and higher levels of consumer confidence.

While there are encouraging signals of more favourable UK equity market conditions, we emphasise two investment performance drivers uncorrelated to broader market or economic developments. Firstly, we continue to hold and invest in high-quality UK companies whose long-term earnings growth and cash generation prospects are largely independent from external forces. We actively position the portfolio to benefit from structural growth themes across a variety of sectors whereby key value creation drivers are detached from broader UK or global economic developments. Although there remains substantial performance upside here, we believe our portfolio is not reliant on re-ratings to drive alpha, i.e. share prices can be driven by consistent earnings growth and cash generation from underlying operational performance, disconnected from wider macroeconomic or geopolitical factors.

Secondly, private equity and strategic M&A activity remains elevated across the UK equity market as valuations are discounted versus international markets and private M&A transactions. We understand from

conversations within our private equity network that private equity investors continue to assess the UK equity market as a source of deal-flow, given the attractive valuations (even with bid premia applied) on offer and the relative shortage of investment opportunities in the private M&A market, where transaction activity remains subdued. We also anticipate that private equity will continue to deploy on new deal opportunities in the UK equity market given elevated levels of 'dry powder' (c.\$4 trillion).⁶ We therefore expect that takeover activity, alongside carveouts, will continue to provide an attractive source of Fund returns and liquidity into Q4 and beyond.

Overall, we remain confident that our portfolio companies will continue to grow earnings and generate cash, throughout the cycle. As an indicator of portfolio quality and resilience, 92% of company updates in the fund have been in-line or positive relative to market expectations during the year-to-date.

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⁶ Charles Hall, "Strategy", Peel Hunt Research, 2 Oct 24.



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