Gresham House
Specialist investment

WS Gresham House UK Multi Cap Income 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.

One such example is Brooks Macdonald, which recently disposed of its international business to focus on its core UK operations where growth prospects are strong across discretionary fund management, model portfolio service (MPS), and financial planning. This disposal also provided capital to fund the high-quality acquisition of LIFT in October where revenue and cost synergies are believed to be material. We also highlight TP ICAP, which announced the company is considering a carve-out of Parameta via a separate US-listing, which we see as a significant value creation catalyst given the high-quality nature of this business dovetailed with the significant stock market rating premium of US equities versus UK peers.

Performance – Q3 2024[4]

Performance in the WS Gresham House UK Multi Cap Income Fund increased by **1.2%** during the quarter, underperforming the IA UK Equity Income sector which increased by **2.8%**. We take this opportunity to note year-to-date underperformance of peer and index benchmarks, however, we believe the drivers are isolated and detached from long-term performance prospects. Specifically, the Fund had no exposure to the banking sector which strongly outperformed, while our small-cap bias meant we did not own a select few 'mega-cap' companies including Unilever, Rolls-Royce, and Astra-Zeneca which collectively contributed over 3% of

[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]
4. Please refer to the factsheet for full UCITS-compliant performance figures.

aggregate benchmark index performance (of 9.8% over the YTD).

Key positive contributions over the period came from **TP ICAP (+0.5% CTR)** as the company announced record first-half profits and a third share buyback programme of £30 million alongside unchanged full-year earnings guidance. We also note that the company is considering a carve-out of the Parameta business via a separate listing in the US, which we see as a potentially significant value creation catalyst. Other positive contributors included **Balfour Beatty (+0.4% CTR)** following interim results which demonstrated solid revenue and orderbook growth with positive commentary on long-term structural growth drivers for UK infrastructure investment, as well as a £363 million contract award from National Grid; and **FRP Advisory Group (+0.4% CTR)** following full-year results marginally ahead of market expectations and two accretive bolt-on acquisitions, Lexington Corporate Finance and WilliamsAli Corporate Finance.

The largest detractor to performance was **Gresham House Energy Storage Fund (-0.5% CTR)** despite a positive September trading update which noted growing revenue momentum. Recent operational headwinds were caused by under-utilisation of Battery Energy Storage Systems (BESS) by the National Grid's rebalancing mechanism, however, this issue is actively being addressed by the Open Balancing Platform (OBP), while other positive long-term performance drivers include a substantial portion of GRID's revenues being contracted through the Octopus tolling arrangement over the next two years, and prospects of improved utilisation of BESS in the UK reserve market. We therefore continue to have confidence in the long-term growth opportunity offered by GRID.

The second-largest detractor to performance was **Watkin Jones (-0.4% CTR)** following a profit warning driven by slower than anticipated closures of new forward funding agreements during the summer months due to more challenging financing conditions in the build-to-rent (BTR) and purpose-built student accommodation (PBSA) sectors. However, the business remains a market-leading player and partner to institutional capital in these attractive residential sectors where long-term demand continues to build, as evidenced by the recent entry of L&G into the PBSA markets as well as KKR completing new fundraising in UK real estate funds. We therefore believe the business can return to operational momentum as financing conditions improve and re-rate from subdued levels, while in the meantime, a strong net cash balance sheet provides downside risk mitigation.

The third-largest performance detractor was **RWS Holdings (-0.4% CTR**) which has suffered from negative market sentiment surrounding AI and its perceived threat to natural language service providers. We continue to believe this business retains a clear long-term service proposition underpinned by significant IP, and now trades on a highly attractive valuation multiple (c.4x 2024 EV/EBITDA) which is vastly disconnected from its fundamental business qualities such as blue-chip client relationships, high-levels of repeat software and services revenue, and healthy operating margins.

Portfolio activity

We made two new investments during the period: into **Sainsbury's**, a leading UK grocer and general merchandise retailer which has reset its competitive position due to recent investment and structural market change, is pursuing a clear growth strategy focused on self-help levers within management control, is leveraging unique customer data to build and monetise a retail media network, and is trading on undemanding valuation metrics; and **Impax Asset Management**, a specialist sustainable investment manager led by a high-quality team, supported by long-term secular demand drivers, which has attractive financial characteristics, and trades at an attractive entry valuation due to transitory flow pressures which appear to be abating.

We made three full exits during the period, from **Hipgnosis Songs**, **Alpha Financial Markets Consulting** and **Mattioli Woods**, following respective takeovers by private equity firms, Blackstone, Bridgepoint, and Pollen Street Capital.

We made several selective follow-on investments during the period, including into **Domino's Pizza**, the capital-light master franchisee in the UK and Ireland for the international US-listed group, which continues to leverage its strong digital marketing capabilities and leading UK market position to drive multi-year growth despite macroeconomic headwinds, reflecting its strong consumer value proposition; **Brooks Macdonald**, an investment management services provider, which we view 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 **Sabre Insurance**, a specialist motor insurance provider, executing on a clear margin rebuild programme via consistent policy rate increases ahead of claims inflation, which increases cash generation and underpins a highly attractive dividend.

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).[5] 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, generate cash, and pay sustainable and growing dividends throughout the cycle. As an indicator of portfolio quality and resilience, 89% 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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[5] Charles Hall, “Strategy”, Peel Hunt Research, 2 Oct 24.

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