WS Gresham House UK Multi Cap Income Fund

Quarterly commentary – Q4 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 – Q4 2024

UK equity market performance was negative in Q4 2024, with smaller company stocks underperforming their larger peers. The Deutsche Numis Smaller Companies plus AIM ex Investment Trusts Index, FTSE 100, and FTSE AIM All Share fell by **1.6%**, **0.2%**, and **2.3%** respectively.

The period was characterised by a combination of domestic and global political uncertainty which adversely affected UK equity markets and more so UK smaller companies. Many policies brought forward by the new Labour government in the Autumn budget were received negatively by investors, not least the reduced inheritance tax relief on AIM and the higher corporate costs precipitated by changes to national minimum wage and national insurance legislation. Following conversations with portfolio company management teams since the budget, we believe the recent corporate tax changes will have a broad-based inflationary impact on the UK economy as companies pass on higher costs to prices. We have seen this view mirrored by the upward trajectory of UK government bond yields in Q4, as markets expect higher interest rates for longer than previously assumed.

The negative budget impact on UK equity markets was compounded by the US election results and the subsequent US equity market rally. Having inflected to a small net inflow in November (£317 million) – the first in 42 months – UK-focused equity funds shed a further £221 million in December 2024, taking the annual total outflow to £9.6 billion.[1] Much of the UK outflows over the year, which caused more forced selling of domestic shares and falling valuations, were recycled into global and US equity funds or passive trackers, driving positive valuation momentum in non-domestic equity markets and leaving UK equities trading at a stark discount to international peers heading into 2025; a discount even more pronounced among UK smaller companies, which are now 28%, 57% and 69% cheaper than UK large caps, US large caps and US smaller companies respectively.[2]

The sentiment-based valuation de-rating across the UK smaller companies space in Q4 2024 was a drag on short-term performance. Nevertheless, we believe the valuations of our investee companies are acutely dislocated from their operating fundamentals. On average our portfolio companies grew revenues and EBITDA by 6.4% and 7.1% respectively in FY24, reflecting portfolio construction focused on defensive characteristics

[1] Calastone UK equity fund flow data, 7 Jan 25.
[2] Bloomberg 12M forward price-to-earnings data as at 12 Jan 25 (Deutsche Numis Smaller Companies ex Investment Trusts plus AIM index versus FTSE 100, S&P 500, and Russell 2000 indices).

including structural growth trends, non-cyclical markets, and high-quality financials (including over 20% average EBITDA margins, strong cash generation, and very low financial leverage), affording greater resilience than the wider UK economy to external shocks. As fundamentals focused, high conviction long-term investors, we are confident in the underlying operating drivers of the Fund's investee companies, which combined with the backdrop of heightened corporate activity and our rigorous investment process underpins the potential to deliver highly attractive multi-year total returns going forward.

Performance – Q4 2024[3]

Performance in the WS Gresham House UK Multi Cap Income Fund decreased by **3.8%** during the quarter, underperforming the IA UK Equity Income sector which decreased by **1.3%**.

The principal drivers of relative underperformance in Q4 2024 were:

- Size bias – large cap stock outperformance, where the Fund was relatively underweight vs the FTSE All Share, averaging 18% NAV in FTSE 100 companies.
- AIM exposure – the Fund averaged 23% of NAV in AIM stocks during the period, which experienced a market sell-off precipitated by the Autumn budget which catalysed negative market sentiment around rising corporate costs and potential tax implications (e.g. IHT relief).
- Portfolio company valuation de-rating – material dislocation between the operating fundamentals of our investee companies and their share prices saw valuation multiples decline during Q4. As an indicator of quality and resilience, 93% of portfolio company updates during the period were positive or in-line compared to market expectations.

We also note that negative sentiment as a result of corporate tax changes proposed in the Autumn budget was amplified towards the consumer discretionary sector where the Fund was 9% overweight versus the FTSE All Share on average during Q4. However, our targeted engagements with management teams of affected portfolio companies have built conviction in company-specific measures to offset the budget cost impact across the vast majority of holdings, underpinning our confidence in the prospects of our investee companies to grow earnings, generate cash, and pay sustainable and growing dividends.

Key positive contributions over the period came from: **XPS Pensions Group (+0.6% CTR)** as H1'25 results demonstrated further trading momentum characterised by double-digit growth across all divisions and operating margin expansion; **Quilter (+0.4% CTR)** following a Q3'24 trading update which demonstrated increasing net flow momentum driven by accelerating flows in the IFA channel due to market share gains; and **TP ICAP (+0.4% CTR)** following a Q3'24 trading update which showed revenue growth across all divisions, accelerating growth in equities and multi-asset broking, and a positive update on progression of strategic options for its market leading, high-recurring revenue data business, Parameta Solutions, with a focus on unlocking shareholder value, potentially via a separate US listing.

The largest detractors to performance were: **Impax Asset Management (-0.9% CTR)** which lost c.£6bn of AUM in December as ongoing St James's Place restructuring prompted mandate withdrawals, driving a 7% downgrade to the FY25 profit before tax forecast and de-rating to 5.5x EV/EBITDA (c.23% intra-day share price decline) which we view as materially overdone relative to the fundamental impact; **Pets at Home (-0.9% CTR)** following a weaker-than-expected retail trading outlook and a 5% downgrade to full-year profit before tax guidance, which in our view also resulted in an excessive share price decline given attractive long-

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

term fundamentals; and **GSK (-0.3% CTR**) as two consecutive quarters of declining vaccine sales drove a material de-rating which in our view overlooks the attractive diversification and potential earnings growth across the business.

Portfolio activity

We made three new investments during the period: into **Nichols**, the global brand owner of Vimto soft drinks, which the Manager believes is well-positioned to take share in a structurally growing UK squash market, can drive margin expansion via levers within management control, and will keep benefitting from a diversified and primarily outsourced business model, generating a high return on invested capital and strong free cash flow to support progressive income growth, with yield upside from special dividends; **Greggs** the leading national brand in the UK food-to-go market which the Manager believes is a quality growth business, creating value through levers within management control including new site rollout, extended evening opening hours, delivery partnerships, and ongoing loyalty app penetration to increase customer lifetime value; and **Elixirr** a challenger consultancy firm which is well known to the Manager, with a high-quality customer base diversified by both geography and sector, which is expected to benefit from continued growth in demand for digital consultancy particularly around AI threats and opportunities.

We made two full exits during the period from: **3i Group** on valuation grounds following an upgrade cycle in the key portfolio asset, Action (c.66% NAV) which drove a broad re-rating of the wider Group and exceptional share price performance; and **Phoenix Group** after a fundamental shift in the Manager's investment thesis.

We made several selective follow-on investments during the period, including into: **B&M**, a leading value discounter specialised in fast-moving consumer goods (FMCG) and general merchandise, which leverages supply-chain economies of scale to generate market-leading pricing versus peers and consistent volume market share gains. Following a stark de-rating during the year, B&M trades at attractive valuation multiples of sub-6x EV/EBITDA (pre-IFRS 16) and a 12% free cash flow yield (FY26) which in our view are detached from attractive operating fundamentals; **Pets at Home**, a specialist retailer of pet products alongside an effectively franchised and higher margin vet business. Pets at Home benefits from structural demand drivers, a data-enabled growth strategy, and trades at a steep discount to sector precedent transactions; and **GSK**, a global pharmaceutical company which we believe offers multi-year growth prospects and good earnings quality, underpinned by a diversified portfolio of approved and marketed drugs, a strong vaccines business with protective IP and barriers to entry, trading at a material discount to the net asset value of the on-market drug portfolio.

Outlook – Q1 2025

Looking ahead to this year, we see a number of short-to-medium term catalysts for a compelling Fund performance recovery and believe our companies remain well positioned to offset external headwinds such as high interest rates, low economic growth, and UK government-driven cost inflation. We take confidence from the resilient fundamentals of a healthily growing portfolio which in aggregate was subjected to harsh, sentiment-based de-rating, contrary to the underlying performances and future expectations for the majority of our portfolio companies. We believe that continued mitigation of current headwinds combined with another year of resilient portfolio earnings growth, cash generation and progressive dividends can lead to a correction of prior-year de-ratings, driving Fund outperformance in 2025. While this Fund targets a high single-digit annualised total return, with an attractive income yield of c.4%, the current valuation dynamics and re-rating prospects of our portfolio companies presents meaningful capital upside beyond these targets. The expected dividend yield for 2025 has also grown to 4.6% as the Fund annualises seven new investments made during 2024 and we forecast 15% dividend per unit growth year-on-year.

Two key strands of our investment approach support our ability to actively manage the Fund towards outperformance in 2025. Firstly, our portfolio construction is focused on defensive characteristics including structural growth trends, non-cyclical markets, and high-quality financials (including over 20% average EBITDA margins, strong cash generation, and very low financial leverage), affording greater resilience than the wider UK economy to external shocks. Secondly, our consistent and repeatable private equity approach to UK public market investing, leveraging a high-quality expert network to independently validate key investment judgements, provides a sustainable 'edge' over the wider market in terms of investment appraisal and portfolio monitoring.

We also see upside potential to Fund performance from elevated takeover activity across UK equity markets heading into 2025. While the uncertainty around the Autumn budget led to an M&A slowdown in Q3'24, we observed an uptick in activity during Q4 and anticipate deal momentum continuing into this year. During 2024, buyers paid on average a 44% premium for UK companies, greater than the five-year average despite elevated deal funding costs amidst higher interest rates.[4] From conversations with our private equity network, we understand that private buyers continue to assess the UK market for deal-flow opportunities given the attractive valuations on offer and the relative shortage of investment opportunities in a subdued private M&A market. With c.$4 trillion of 'dry powder' yet to be deployed,[5] we expect that takeover activity will offer attractive returns for the Fund in 2025.

We highlight an emerging nuance to this theme across UK listed businesses, with carve-outs – where a parent company sells a subsidiary company or business unit – of which there have been 20 'meaningful' instances through 2024. 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. We believe carve-outs can be a compelling tool for management teams to overcome market discounts and create shareholder value.

More broadly, we welcome calls for government reforms in 2025 to encourage UK pension fund participation in domestic equity markets, where they are materially under-penetrated today at defined contribution, defined benefits, and local government levels compared to other developed western nations.[6] Any incremental liquidity as a result of supportive policies would aid marginal buying of UK shares and in turn offer the potential to bridge the stark valuation arbitrage to other developed equity markets and precedent M&A transactions.

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[4] Bloomberg data.
[5] Charles Hall, 'Strategy', Peel Hunt Research, 2 Oct 2024.
[6] Department for Work & Pensions, 'Pension fund investment and the UK economy.'

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